2025 BOK Knowledge Partnership Program with Nepal

Liberalization of Foreign Exchange Policy and Capital Flow Management

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Liberalization of Foreign Exchange Policy and Capital Flow Management

한국은행 dongguk UNIVERSITY 산학협력단 Nepal Rastra Bank

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Executive Summary

Nepal has gradually pursued foreign exchange liberalization for the past four decades since the mid-1980s. In 1993, it achieved full convertibility of the Nepalese Rupee (NPR) for current account transactions, and it has been promoting capital account liberalization to attract foreign direct investment (FDI) and maintain macroeconomic stability in recent years. In fact, in January 2025, Nepal introduced a landmark provision through an ordinance allowing outward investment and established the High-Level Economic Reform Advisory Commission to initiate discussions on economic reforms including the gradual opening of the capital account. However, the current exchange rate system of Nepal is a fixed exchange rate pegged to the Indian Rupee (INR), which is far from the flexible exchange rate system that is consistent with capital account liberalization. Therefore, there remain numerous institutional and legal improvements to be made. Accordingly, this study aims to explore the necessary preconditions for achieving capital account convertibility, as well as the appropriate exchange rate and monetary policies, legal reforms, institutional preparedness, the sequential opening strategy of the capital account, and effective measures for risk monitoring and mitigation.

The research findings indicate that under a fixed exchange rate regime, the success of capital account liberalization largely depends on the sequence, speed, and institutional readiness of the liberalization process. Depending on these factors, capital account liberalization can serve either as a catalyst for economic growth or as a trigger for financial crisis. For the success of capital account liberalization, the country must implement liberalization policies consistent with its unique economic and institutional context and focus on improving the quality and transparency of capital inflows. A sound macroeconomic foundation—such as fiscal discipline and low inflation—is

essential. Equally important is the sequencing of reform implementation. The establishment of a comprehensive and multi-layered financial safety net is a prerequisite.

Capital account opening should be carried out in five sequential stages: (1) opening to low-volatility foreign direct investment (FDI) and strategic long-term equity investment; (2) allowing non-resident investment in listed equities; (3) permitting portfolio investment in local-currency-denominated government securities; (4) liberalizing short-term external borrowing and cross-border bank funding; and finally, (5) achieving full liberalization. As a medium- to long-term strategy, it is deemed necessary to maintain a gradual and conditional approach to opening, reform the market-oriented legal framework, shift to an interest-rate-based monetary policy and a flexible exchange rate system, ensure harmony between capital market opening and domestic financial reforms, and strengthening emergency response capacity. In relation to capital account liberalization, the NRB may consider several policy measures such as diversifying instruments for sterilization policy issuing MSB(monetary stabilization bonds), recalibrating the peg against the Indian rupee through an NPR depreciation based on PPP and REER analyses, followed by a transition to a managed floating exchange rate regime anchored to a basket of the Indian rupee, Chinese yuan, and U.S. dollar, introducing a foreign investor registration system, adopting a primary relationship banking system and a financial real-name system, and strengthening regulatory responses to the potential expansion of remittance and settlement through cryptocurrencies including stable coins.

With respect to capital flow management under capital account liberalization, NRB needs to strengthen its foreign exchange reserves to prepare for potential capital outflows. To this end, it would be worth expanding currency swap arrangements with neighboring countries such as India, building on existing frameworks including the Reserve Bank of India (RBI) and the South Asian Association for Regional Cooperation (SAARC) currency swap framework. In addition, NRB should establish a foreign exchange information system to closely monitor capital inflow and outflow

trends. To address potential side effects arising during the liberalization process, it is also necessary to operate an integrated policy mix that combines foreign exchange intervention (FXI), capital flow management measures (CFM), macro-prudential policies (MPM), and monetary policy in a coordinated manner. At the same time, it is necessary to manage short-term external borrowing of financial institutions to prevent excessive increases within a short period, and to continuously expand foreign exchange-related products and interbank FX market participants. Finally, it is desirable to establish a self-regulatory body for the foreign exchange market (tentatively named the "Kathmandu Foreign Exchange Market Operations Council"), in which policymakers and market participants jointly discuss strategies for developing and enhancing Nepal's FX market.

This report proposes a range of policy measures aimed at ensuring the successful implementation of capital account liberalization. Regardless of how well-designed policy recommendations may be, they are of little value unless they are put into practice. In this regard, the commitment of the NRB is of paramount importance. It is hoped that NRB will actively pursue forward-looking and practical implementation strategies for each policy agenda presented in this report. Through such efforts, we expect that this report will provide meaningful support to NRB in formulating foreign exchange policies related to capital account liberalization

The structure of this study is as follows: Chapter 1 describes program overview and progressive report. Chapter 2 analyzes the current status of Nepal's economy and financial markets and Chapter 3 describes Nepal's foreign exchange policy and the current status of capital account liberalization. Chapter 4 reviews general theories related to foreign exchange liberalization systems, while Chapter 5 discusses the economic implications and cases of capital account liberalization. Chapter 6 outlines the sequencing of capital account liberalization, and Chapter 7 addresses capital flow management under capital account liberalization. Chapter 8 presents policy implications and further considerations for the NRB regarding capital account liberalization.

I. Introduction

1. Program Overview

The **Knowledge Partnership Program (KPP)** of the Bank of Korea is a policy advisory and technical assistance program designed for central banks in developing countries. Following the global financial crisis, many underdeveloped economies both within and outside the region, characterized by fragile financial sectors, requested support for financial development based on the Bank of Korea's accumulated knowledge and experience. In response, the Bank of Korea launched the KPP initiative in 2015. The KPP consists of a wide range of activities aimed at sharing central banking–specific expertise, policy implementation experience, and knowledge related to the development of financial systems and financial infrastructure.

In 2025, KPP projects were conducted for a total of eight countries. For the topic *"Liberalization of Foreign Exchange Policy and Capital Flow Management"* requested by the Nepal Rastra Bank (NRB), the Industry–Academic Cooperation Foundation of Dongguk University was selected as the implementing institution. Dongguk University's Industry–Academic Cooperation Foundation carried out the KPP project in close cooperation with the Foreign Exchange Management Department of the Nepal Rastra Bank, with additional collaboration from the Banking Department, the Monetary Management Department, and the Economic Research Department. The overall project was led by Professor Junesuh Yi of Dongguk University, who served as the Project Manager (PM). As shown in Table 1-1, the research team for each subtopic consisted of one academic professor and three practitioners with professional backgrounds at the Bank of Korea.

<Table 1-1>

2025 Nepal KPP Project DGU Research Team Personnel

Name	Role	Affiliation	Position
Junesuh YI	PM	Dongguk University	Professor
Dong Hyun Choi	Researcher	Inha University	Vising Professor
Seung Je Hong	Researcher	Korea Institute for Defense Industry	Research Fellow
Raehyung Park	Researcher	AIMS-CO	CEO
Hyeong Joon Kim	Researcher	Dongguk University	Assistant Professor

2. Program Progressive Report

A. Preliminary Meeting

As the first stage of the project, a preparatory meeting was held virtually (via video conference) on June 16, 2025, from 17:00 to 19:10**.** The purpose of the preparatory meeting was to enhance mutual understanding of the KPP between the implementing institution and the counterpart country, to clarify the counterpart's specific needs, and to discuss the direction of participation by local experts. The meeting was attended by six officials from the Nepal Rastra Bank (NRB)**,** including Mr. Nabin Timilsina, Deputy Director of the Banking Department; all six members of the Dongguk University KPP research team**;** and seven staff members from the Knowledge Cooperation Team of the International Cooperation Department of the Bank of Korea**.**

During the meeting, an overview of the 2025 Nepal KPP project was presented to improve local stakeholders' understanding of the project objectives and timeline. Using a pre-distributed questionnaire, the NRB's specific demands and the overall direction of the project were discussed and refined. Mr. Seung Je Hong, Research Fellow, presented *"The Evolution of the Foreign Exchange System and Its Policy: Historical Experiences and Challenges Ahead, and Measures to Enhance the Capability of Foreign Exchange Reserve Management."* Mr. Raehyung Park, CEO, presented *"Foreign Exchange Liberalization and Policy Responses in the FX Market."* In addition, the Nepal research

team presented *"The Status of NRB Foreign Exchange Policy."* This was followed by a Q&A session based on the previously distributed questionnaire.

More specifically, the participants reviewed Nepal's progress in foreign exchange liberalization and capital account liberalization over the past four decades and discussed the key objectives to be achieved through this project. Discussions also covered existing regulations related to foreign exchange and capital flows in Nepal, as well as potential future policy directions, in order to assess the feasibility of proposed topics and recommendations to be included in the project. To facilitate a more accurate understanding of Nepal's current foreign exchange policy framework, NRB agreed to organize its own research team to prepare a joint research on documenting NRB's current foreign exchange policy status. The Nepalese research team also agreed to provide relevant materials to support the Korean research team in refining its research plan and implementation strategy. Some differences of opinion regarding detailed research subtopics remained and were to be clarified through follow-up email communication. Meanwhile, the NRB expressed strong interest in Korea's practical experience with foreign exchange liberalization and capital account liberalization, and both sides agreed to incorporate these case studies into the research. Finally, the two parties discussed the project schedule and agreed to hold the Kick-off Meeting and Working-Level Meeting on August 3.

B. Kick-off Meeting

The KPP research team visited Nepal from August 1 to August 5, 2025, to conduct an on-site field study. The field study consisted of the signing of the BOK-KPP agreement, the kick-off seminar, and the BOK-KPP working-level meeting.

Prior to the kick-off seminar, the KPP and NRB research teams refined the scope of the study through email and chat communication. Initially, the scope covered overall foreign exchange policy including changes to the exchange rate regime pegged to the Indian rupee; however, the scope was narrowed to focus more intensively on foreign exchange policy

related to capital account liberalization.

The BOK-KPP agreement signing and kick-off seminar were held on August 3 from 10:30 to 16:00 at the Mirasol Hall of the Hilton Hotel in Kathmandu. Participants included 29 officials from NRB, including Mr. Revati Prasad Nepal, Executive Director of the Foreign Exchange Management Department; Mr. Madav Dangal, Director of the Economic Research Department; and Mr. Sanjeev Kumar Jha, Acting Director of the Foreign Exchange Management Department and NRB-side project PM. Also in attendance were six members of the Dongguk University KPP research team and three officials from the International Cooperation Department of the Bank of Korea.

During the morning session of the kick-off seminar, Professor Hyeong Joon Kim presented "Overview of Foreign Exchange Liberalization and Capital Account Convertibility," followed by Professor Dong Hyung Choi's presentation titled "Capital Liberalization under Fixed Exchange Rate Regimes: Economic Implications, Case Studies, and Lessons Learned." In the afternoon, Mr. Mukesh Prasad Sah, Assistant Director of the NRB Economic Research Department, presented on "Current Status of NRB Foreign Exchange Policy and Capital Account Liberalization." This was followed by Research Fellow Seung Je Hong's presentation on "Sequencing of Capital Account Liberalization," and Mr. Raehyung Park's presentation on "Capital Flow Management in Liberalized Capital Account Regime."

In the morning session, basic concepts and economic effects related to foreign exchange and capital account liberalization were introduced, along with case studies of foreign exchange market liberalization in Southeast Asian countries and Korea. NRB explained Nepal's progress in foreign exchange liberalization and its experience with gradual liberalization stages. In the presentation on sequencing capital account liberalization, the necessary and sufficient conditions, economic implications, and essential stages of capital account liberalization in Korea and Japan were discussed. With respect to capital flow management, the presenters explained relevant legal regulations in sequence and provided a detailed comparative analysis of the foreign exchange market structures of Korea and Nepal. During the Q&A session, discussions covered the soundness of Nepal's

banking sector relative to its capital market, potential partner countries for cooperation related to the IT industry, and the determination mechanisms of customer buying and selling exchange rates at Korean commercial banks. The seminar concluded with a shared recognition that significant challenges remain in Nepal's capital account liberalization.

Following the seminar, the research team moved to NRB to continue in-depth discussions with staff from the Foreign Exchange Management Department. Three NRB officials, including Executive Director Mr. Revati Prasad Nepal, attended the meeting, provided an overview of Nepal's foreign exchange management system, and briefly explained the role of the department. NRB also pledged active cooperation, including data sharing, to ensure the success of the 2025 BOK-KPP Nepal project, and explored the willingness and feasibility of investing in Korean assets related to foreign currency asset management. Questions and answers were also exchanged regarding the possibility of a currency swap with Nepal. The BOK-KPP working-level meeting was held at 17:00 in the NRB conference room. The Terms of Reference(TOR) were signed, progress made through the preparatory meeting and kick-off seminar was reviewed, and future research plans were discussed. Both sides deliberated on cooperation measures necessary for the success of the project, specific implementation strategies, and the schedule for the interim seminar, tentatively planned for September 15–19.

Meanwhile, on August 4 at 15:00, the KPP research team paid a courtesy visit to the Embassy of the Republic of Korea in Nepal and held discussions with Ambassador Park Tae-young and embassy staff. The team explained the objectives of the BOK-KPP project and the current status of Nepal's foreign exchange liberalization. The embassy shared information on Nepal's economic conditions, financial system, and the status of Korean residents and companies in Nepal. In addition, the research team requested cooperation regarding visa issuance for NRB officials' visits to Korea and the final seminar scheduled to be held in January 2026.

C. Interim Seminar and Capacity-building Training

The mid-term seminar and capacity-building training were held in Seoul from

September 15 to 20, 2025. The mid-term seminar was conducted to collect feedback from the Nepal Rastra Bank (NRB) on the interim research results and to reflect these comments in the final report. In addition, to strengthen the foreign exchange management capacity of officials from the partner country, training sessions, practical exercises, and meetings with relevant stakeholders were conducted through visits to the Bank of Korea, Hana Bank, and Seoul Money Brokerage.

The mid-term seminar took place on September 16 from 10:00 to 16:00 at the Le Méridien Myeongdong Hotel in Seoul. Six officials from NRB, including the project manager Mr. Sanjeev Kumar Jha, attended the seminar. The Dongguk University project team was represented by seven members, including the senior advisor, and six officials from the International Cooperation Department of the Bank of Korea also participated. Presentations and discussions focused on key policy recommendations included in the interim report, such as the sequencing of capital account liberalization and capital flow management under a liberalized capital account regime.

With regard to the sequencing of capital account liberalization, Mr. Seung Je Hong proposed that in the first stage, low-volatility foreign direct investment (FDI) and strategic long-term equity investment should be liberalized; in the second stage, non-residents' investment in listed equities should be allowed; in the third stage, portfolio investment in local-currency-denominated government bonds should be permitted; in the fourth stage, short-term external debt and cross-border borrowing by banks should be liberalized; and finally, full liberalization should be implemented in the fifth stage. As a medium- to long-term liberalization strategy, he emphasized the importance of maintaining a gradual and conditional approach to liberalization, improving market-oriented legal frameworks, transitioning toward interest-rate-based monetary policy and a more flexible exchange rate regime, ensuring consistency between capital market opening and domestic financial reforms, and strengthening crisis-response capacity. In relation to capital account liberalization, NRB raised the need to consider policy responses such as diversifying sterilization policy instruments, implementing a multiple currency exchange rate system, introducing a foreign investor registration system, and

adopting a main banking system and a real-name financial transaction system.

Mr. Raehyung Park emphasized that, in managing capital flows under capital account liberalization, NRB should build an adequate level of foreign exchange reserves to prepare for potential capital outflows, and suggested currency swap arrangements with neighboring countries such as India as one possible measure. He also stressed the need to implement an appropriate mix of policies by referring to indicators provided by the IMF regarding the optimal timing of capital account liberalization and to the Integrated Policy Framework (IPF). In addition, he argued that short-term external debt of financial institutions should be managed to prevent rapid surges and that participation in foreign exchange-related products and the interbank foreign exchange market should be gradually expanded. Finally, he proposed establishing a self-regulatory foreign exchange market organization (tentatively named the "Kathmandu Foreign Exchange Market Operations Council"), jointly participated in by policymakers and market participants, to collectively discuss measures for foreign exchange market development.

Prior to these discussions, Professor Hyeong Joon Kim presented a summary of academic studies examining the micro-level empirical effects of capital account and capital market liberalization, while Professor Dong Hyun Choi analyzed cases of countries that experienced crises after capital account liberalization and those that did not, emphasizing the importance of financial safety nets. On the NRB side, officials introduced the consensus among Nepalese financial authorities regarding foreign exchange liberalization and the recent direction of foreign exchange policy changes.

Following the presentations, a question-and-answer session was held focusing on the presented topics and Nepal's gradual foreign exchange liberalization policy. Questions were raised regarding the maintenance of Nepal's fixed exchange rate regime, and NRB requested solutions for capital account liberalization that would be feasible under a fixed exchange rate system rather than a floating exchange rate regime. Subsequently, both sides discussed cooperation measures necessary for the successful implementation of the KPP project, and tentatively agreed to hold the final seminar in Nepal on January 8, 2026.

The capacity-building training was conducted to enhance NRB staff's understanding of

foreign exchange transaction mechanisms through brokers under a freely floating exchange rate regime, as well as central bank monitoring and intervention in the foreign exchange market, in preparation for the possibility that Nepal's exchange rate regime may incorporate elements of a floating system in the future. To this end, the training consisted of a first program provided by the Bank of Korea and a second program hosted by Hana Bank and Seoul Money Brokerage.

The first training session was held at the Bank of Korea on September 17 from 10:00 to 16:00. In the morning, the Custody Team led the session, followed by the Foreign Exchange Market Team in the afternoon. During the morning session, an interview with Deputy General Manager Kyung-ho Park of the Custody Team provided an overview of custody-related operations. In the afternoon, Deputy General Manager Hwi-chae Jung conducted training on practical aspects of foreign exchange market management. Meanwhile, NRB held working-level consultations with the Bank of Korea's Custody Team regarding the possibility of opening a Korean won (KRW) account in the name of NRB at the Bank of Korea, in order to facilitate settlement related to principal and interest payments on KRW-denominated loans provided by the Korea International Cooperation Agency (KOICA) to the Nepalese government. The Custody Team explained that KRW settlement accounts at the Bank of Korea are provided only to foreign central banks investing in Korean bonds, and advised that NRB consult with Registered Foreign Institutions (RFIs) that have been allowed to participate directly in the Seoul interbank foreign exchange market since July 2024 if enhanced settlement convenience is required for transactions other than investments in Korean bonds. The Foreign Exchange Market Team also provided explanations regarding foreign exchange market monitoring and intervention procedures under a freely floating exchange rate regime, followed by questions and answers on the decision-making process for market intervention and coordination procedures with the government. All six NRB participants attended the first training session, along with three members of the Dongguk University KPP team, including Professor Dong Hyun Choi, and five officials from the Bank of Korea's International Cooperation Department.

The second training session was conducted on September 18 from 14:00 to 16:00 at Hana Bank and Seoul Money Brokerage. In response to NRB's expressed interest in foreign exchange transaction procedures through brokers under a freely floating exchange rate regime, related training was provided. Participants first visited the foreign exchange dealing room at Hana Bank, where they received explanations on Hana Bank's foreign exchange operations, the dealing room's IT systems, and transaction procedures. Training on practical foreign exchange trading under a freely floating exchange rate regime was also provided by experts from Hana Bank. The participants then visited Seoul Money Brokerage, where experts delivered practical training on the role of foreign exchange brokers and intermediation procedures under a floating exchange rate system. Explanations were provided on the range of foreign exchange products brokered by Seoul Money Brokerage, as well as the foreign exchange transaction intermediation mechanism. During the session, NRB staff, who were relatively unfamiliar with the broker-based foreign exchange system, raised various questions regarding settlement procedures and settlement risk management in broker-mediated foreign exchange transactions. These questions were addressed by staff from Seoul Money Brokerage and accompanying members of the research team. All six NRB participants and three members of the Dongguk University KPP team, including Professor Dong Hyun Choi, attended the second training session.

D. Final Seminar

The final seminar was held in Pokhara, Nepal, on January 8, 2026, for the purpose of discussing and sharing the research findings with the partner country and disseminating them to relevant local institutions. Immediately following the final seminar, a working-level meeting among the research teams was conducted. This was followed by an official meeting with the Acting Governor of the Nepal Rastra Bank (NRB), during which the research findings were explained and a request was made to prepare concrete implementation plans for the proposed policy recommendations.

A total of 35 participants attended the final seminar, including all six members of the DGU research team, three officials from the Bank of Korea, and 26 participants from NRB, including members of its research team. The seminar began with welcoming remarks by Mr. Dayaram Sharma, Executive Director of the Office of the Governor of NRB, followed by opening remarks from Senior Advisor Min-ho Kim. A special address was then delivered by Dr. Neelam Dhungana Timsina, Acting Governor of NRB. This was followed by a group photo session and an exchange of gifts among participants.

As in the mid-term seminar, the final seminar proceeded with presentations organized by chapter of the report. First, Professor Hyeong Joon Kim presented "Overview of Foreign Exchange Liberalization," followed by Professor Dong Hyun Choi's presentation on ″Economic Implications and Case Studies of Capital Account Liberalization." Subsequently, Mr. Mukesh Prasad Sah of NRB presented "Status of Nepal Foreign Exchange Policy and Capital Account Liberalization." These presentations focused primarily on sections that had been revised or newly added following the mid-term report. After lunch, Research Fellow Seung Je Hong presented "Sequencing of Capital Account Liberalization," and Mr. Raehyung Park delivered a presentation on "Capital Flow Management in a Liberalized Capital Account Regime." These presentations corresponded to Chapters 6 and 7, which constitute the core of the report, and were further refined based on feedback received from NRB after the interim report. The research team proposed that, for Nepal's foreign exchange market liberalization policy and capital flow management, efforts should focus on (i) a phased approach to gradual capital account liberalization and strengthening of the financial safety net, (ii) enhancing exchange rate flexibility and strengthening financial supervisory capacity, and (iii) establishing data-driven monitoring systems and a cooperative framework among regulatory and supervisory authorities.

Following the presentations, a Q&A session was held. NRB participants raised questions regarding monetary policy tools related to capital account liberalization, as well as the composition of currencies and weighting within a currency basket in relation to the sequencing of capital account liberalization. They also sought advice on the appropriate

stages—short-term or medium- to long-term—for applying various policy instruments, including foreign direct investment (FDI) during the liberalization process, and requested more detailed explanations regarding the impact of digital assets on capital account liberalization.

In the subsequent working-level meeting, discussions were held on revisions and additions to the final report and the content presented during the seminar. NRB requested additional analysis on stable coins, in addition to cryptocurrencies, in relation to the sequencing of capital account liberalization. NRB also raised the need to reconsider the current fixed exchange rate regime pegged to the Indian rupee. Specifically, prior to adopting a currency basket system proposed as a measure for foreign exchange market development, NRB requested a review of the necessity of revising the fixed exchange rate of 1 Indian rupee to 1.6 Nepalese rupees, which was established in 1993. In addition, editorial discussions were held regarding points that should be emphasized in the final report.

After the conclusion of the final seminar, the venue was moved to Fish Tail Lodge Pokhara for an official meeting with the Acting Governor. All nine members of the BOK-KPP delegation attended this meeting, while NRB was represented by the Acting Governor, other senior officials, and six members of its working-level staff. The meeting began with welcoming remarks by Acting Governor Dr. Neelam Dhungana, followed by a ceremony for the presentation of commemorative gifts. This was followed by an overview of the 2025 BOK-KPP Nepal project, as well as a detailed explanation of the final seminar and the contents of the final report. Most importantly, the Project Manager emphasized that the most critical factor in implementing policy initiatives is the commitment of top decision-makers, and requested that NRB actively adopt the policy recommendations derived from this project by formulating concrete implementation plans. In response, NRB stated that Nepal would pursue gradual capital account liberalization and pledged its active cooperation to ensure the successful completion of the 2025 BOK-KPP Nepal project.

II. Current State of Nepal Economy and Financial Markets

1. Current Macroeconomic State

Nepal, officially the Federal Democratic Republic of Nepal, is a landlocked country in South Asia with a population of approximately 30 million people. Positioned between the powerful economies of India and China, Nepal holds a strategically significant location that, regrettably, has not yet resulted in strong economic growth. The nation struggles with a vulnerable economic structure and persistently low income levels.

A notable aspect of the Nepalese economy is the imbalance within its industrial framework. While an impressive 65 percent of the workforce is engaged in agriculture, this sector contributes only around 24 percent to the gross domestic product (GDP). This discrepancy highlights the challenges posed by low agricultural productivity and emphasizes the urgent need for greater industrial diversification. In contrast, the services sector has emerged as the cornerstone of Nepal's economy, accounting for a remarkable 63 percent of GDP in 2023. This sector, which encompasses tourism, transportation, accommodation and food services, as well as wholesale and retail trade, serves as the primary engine of economic growth. Tourism, in particular, has become a vital contributor, leveraging the country’s stunning natural landscapes and Himalayan resources to generate essential foreign exchange.

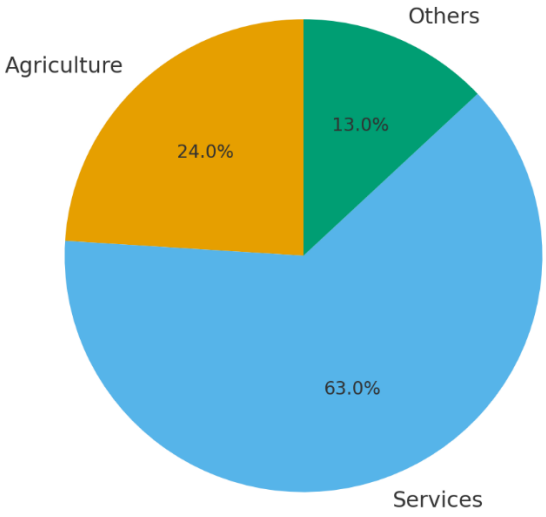
In April 2015, Nepal experienced a significant setback when a devastating earthquake caused extensive social and economic damage. The disaster resulted in a tragic loss of life, destruction of crucial infrastructure, and pushed around 3 percent of the population into poverty. This event starkly highlighted the underlying vulnerabilities within the Nepalese economy.

Nevertheless, there are signs of recovery beginning to emerge. The economy is gradually rebounding, driven by an increase in tourist arrivals, a revival in domestic consumption, and growth in the hydropower sector. Currently, Nepal’s nominal GDP is estimated at around USD 40 billion, while the per capita GDP stands at approximately USD 1,300—

substantially lower than the global average of about USD 10,589. This positions Nepal firmly within the category of lower-middle-income countries (LMICs), yet it also calls for a concerted effort: with focused investments and strategic planning, Nepal has the potential to transform its economic landscape and enhance the livelihoods of its citizens. The journey toward a brighter and more prosperous future is not only achievable but imperative for this remarkable nation.

<Figure 2-1>

Nepal's GDP Contribution by Industry (2023)



Source: World Bank, Asian Development Bank(ADB), IMF statistics

Over the past decade, concluding in 2023, Nepal has exhibited a relatively stable trajectory of economic growth, achieving an average real GDP growth rate of 4.3 percent. However, the economy experienced a significant contraction of 2.4 percent in 2020, largely attributed to the adverse effects of the COVID-19 pandemic, which severely disrupted international tourism and curtailed domestic economic activities. Subsequently, the economy exhibited a rebound, with recorded growth rates of 4.2 percent in 2021 and 5.6 percent in 2022. The government forecasts a GDP growth rate of 4.9 percent for the

fiscal year 2025, a projection that is consistent with estimates from prominent international institutions: the World Bank anticipates 4.9 percent, the Asian Development Bank (ADB) forecasts 5.1 percent, and the International Monetary Fund (IMF) estimates 4.2 percent.

<Table 2-1>

Nepal's Key Economic Indicators (2022-2025)

	2022	2023	2024(E)	2025(E)
Real GDP Growth Rate	5.6%	2.0%	3.7%	4.9%
Nominal GDP (USD million)	41,183	40,908	42,910	44,800
GDP per Capita (USD)	1,348	1,324	1,447	1,497
Inflation Rate (CPI)	7.7%	7.1%	5.4%	2.8%
Unemployment Rate	10.9%	10.6%	10.7%	10.0%
Base Interest Rate	8.5%	6.5%	6.5%	6.0%
Current Account Balance (%GDP)	-12.6%	1.5%	5.2%	6.7%

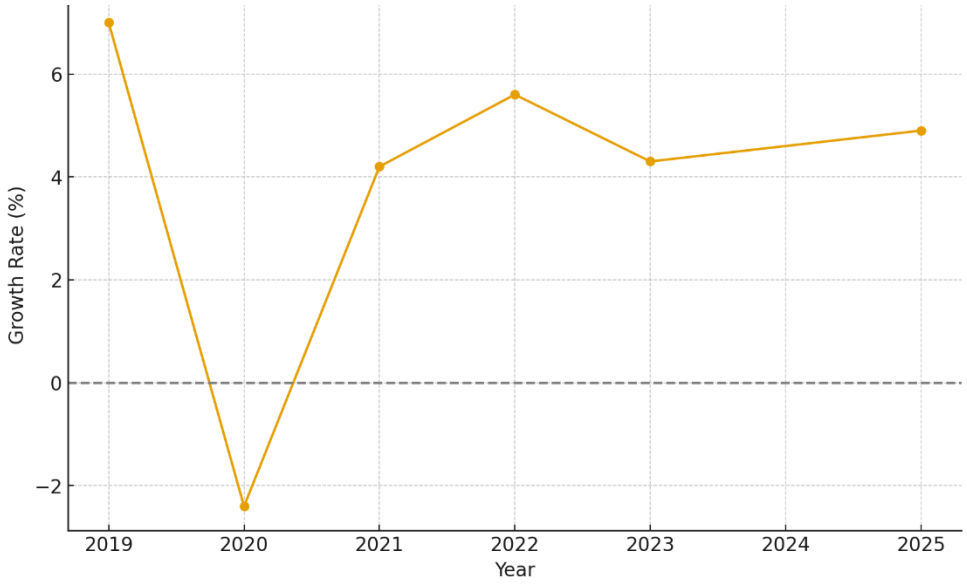
Note: Nepal's inflation rate (CPI) is estimated at approximately 2.77% as of May 2025. Nepal's base interest rate is approximately 6.00% as of September 2025. Nepal's current account balance returned to surplus in 2023, and current account balance in 2025 uses the World Bank estimate.
Source: NRB, World Bank, ADB, IMF, Nepal statistics

On the external front, Nepal has historically faced persistent current account deficits. Notably, after registering a record deficit in 2022, the current account transitioned to a surplus in 2023. This shift has been facilitated by stronger remittance inflows and an improved trade balance. According to estimates from the IMF, Nepal recorded a current account surplus equivalent to 3.8 percent of GDP in FY2023/24, amounting to approximately USD 1 billion. This surplus represents a net positive inflow of foreign exchange, contributing to the augmentation of Nepal's international reserves.

In conclusion, while Nepal continues to confront challenges associated with low income levels and structural vulnerabilities, the economy has demonstrated gradual improvements, predominantly driven by sustained growth in the services sector. Looking ahead, it is expected that remittance inflows, tourism, and hydropower development will remain fundamental pillars underpinning Nepal's economic resilience and long-term development prospects.

<Figure 2-2>

Nepal's Real GDP Growth Rate (2019-2025)



Source: Nepal Rastra Bank, World Bank, IMF World Economic Outlook, ADB Outlook

2. Current Financial Market State

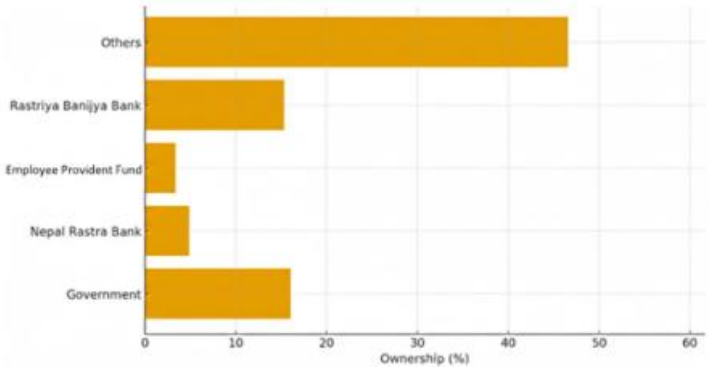
The Nepal Rastra Bank (NRB) stands as a pillar of strength for the national economy, embodying the commitment to safeguard its stability and ensure the soundness of the financial system. As the central bank of Nepal, the NRB carefully crafts and enacts monetary and foreign exchange policies designed to achieve price stability and promote sustainable economic growth, all while adeptly managing balance of payments stability. Moreover, the NRB serves as the government’s trusted banker, overseeing public debt,

providing invaluable financial advice, and acting as a key fiscal agent. This pivotal role places the NRB at the heart of national economic management in Nepal.

With exclusive authority to issue currency, the NRB plays a vital role in shaping exchange rate policy and managing foreign exchange reserves. The entire banking sector—the backbone of Nepalese financial landscape—operates under the NRB's robust regulatory and supervisory framework. As of 2024, this sector encompasses 20 commercial banks and 16 development banks that not only deliver essential financial services but also actively foster industrial, agricultural, and infrastructure development across the nation.

<Figure 2-3>

Nepal Stock Exchange (NEPSE) Ownership Structure (2024)



Source: Nepal Rastra Bank, NEPSE

Beyond banking, Nepal's financial market boasts a diverse array of non-bank financial institutions, including insurance companies, pension funds, and social security funds. These entities are essential in enhancing the system's diversity and resilience. Recent government initiatives aimed at expanding financial access and promoting inclusion have led to a notable increase in service usage among underserved populations and rural communities. This not only fortifies financial stability but also builds a broader foundation for economic growth that benefits all Nepalis.

Significantly, Nepal's financial system has entered an era of digital transformation. The

rise of mobile banking, internet banking, and electronic payment systems has drastically improved transaction efficiency. The widespread adoption of digital payment infrastructure has opened new avenues for financial access, elevating the quality of services and bolstering public confidence in Nepalese financial institutions. Microfinance institutions, dedicated to serving low-income households and micro and small enterprises, have diversified funding sources, empowering vulnerable groups and expanding economic opportunity. The gradual growth of insurance services, including micro insurance, further enhances the resilience of Nepalese financial ecosystem.

The cornerstone of Nepal's capital market is the Nepal Stock Exchange (NEPSE), established in 1994. With a market capitalization of approximately USD 36 billion as of 2024, NEPSE showcases significant public sector participation—58.66 percent held by the Government of Nepal, 9.50 percent by the NRB, 10.00 percent by the Employee Provident Fund, 11.23 percent by Rastriya Banijya Bank, and 11.61 percent by other institutions. This structure ensures that Nepal's capital market remains robustly overseen by the public sector, prioritizing the interests of the nation over private sector pressures.

On the policy front, the government and NRB have championed a series of reforms aimed at stimulating growth and enhancing connections to the international financial system. Key initiatives include the gradual easing of restrictions in the foreign exchange market, as outlined in the 2024/25 monetary and exchange rate policy framework. Import-related regulations have also been relaxed, raising the foreign exchange transaction limit for importing through draft/telegraphic transfer (T.T.) from USD 35,000 to USD 50,000—broadening access to foreign currency. As an exciting development, IT firms and other service exporters are now permitted to exchange foreign currency earnings through commercial banks, promoting the growth of services exports.

To further attract foreign direct investment (FDI), the government made a bold move in 2022 by lowering the minimum investment threshold from NPR 50 million to NPR 20 million, opening doors for small and medium-scale investors. Meanwhile, Nepal maintains a stable fixed exchange rate (peg) regime with the Indian rupee (INR), reflecting its deep-rooted trade and financial ties with its neighbor.

In conclusion, Nepal's financial system is not only grounded in a robust regulatory and supervisory framework led by the central bank, but it is also on a transformative journey toward gradual liberalization and increased financial access. The rise of digital finance, the expansion of microfinance, and the strengthening of capital market institutions exemplify Nepal's dedication to overcoming the challenges associated with a low-income economy and building a stable, inclusive financial future for all. By working together, Nepal can foster an empowered economic environment that supports every citizen.

3. Foreign Reserves and Exchange Rates

Nepal's foreign exchange reserves have experienced significant changes in recent years, playing a crucial role in maintaining macroeconomic stability. As of January 2025, these reserves reached approximately USD 15 billion, marking the highest level in the country's history. The accumulation of reserves has helped mitigate external imbalances and has strengthened Nepal's ability to meet import payments and fulfill external obligations.

<Table 2-2>

Nepal's Foreign Exchange Reserves and Exchange Rate Trends (2022-2025)

	2022	2023	2024	2025(E)
Foreign exchange reserves (USD millions)	9,707	12,278	14,899	15,066
Exchange rate (1 USD = ? NPR)	119	133	138	-

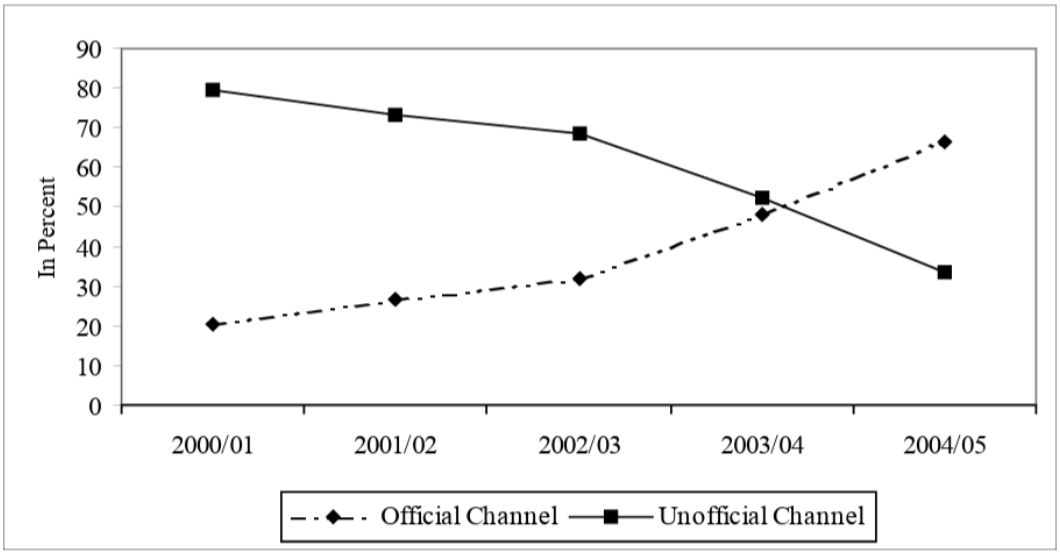
Source: World Bank, ADB, IMF, NRB

In 2022, reserves temporarily declined due to several factors, including the lingering effects of the COVID-19 pandemic, rising global commodity prices, and a deteriorating trade balance. However, conditions improved markedly from 2023 onward. The government implemented various incentives to encourage remittance inflows through

official financial channels, resulting in a significant increase in foreign exchange receipts. Given Nepal's heavy reliance on remittances, which represent a substantial portion of the country's GDP, these measures played a vital role in reserve accumulation. According to World Bank data, remittances from overseas workers will reach approximately $11 billion by 2023, accounting for approximately 27% of GDP. The increase in remittances also had positive spillover effects on domestic consumption and the stability of the financial sector. Meanwhile, while the measurement of remittances through informal channels is limited, an NRB report estimates that they account for approximately one-third of all remittances, or roughly half of those sent through formal channels (Pant, 2006). However, as shown in Figure 2-4, remittances through informal channels have been declining sharply since 2003.

<Figure 2-4>

Nepal's remittances inflow: official vs. unofficial channels (2000-2004)



Source: Pant, B. (2006). Remittance inflows to Nepal: Economic impact and policy options. NRB Economic Review, 20-36.

Exchange rate policy is closely tied to Nepal's overall economic stability. Since 1993, Nepal has maintained a fixed exchange rate regime by pegging the Nepalese rupee (NPR) to the Indian rupee (INR), reflecting the country's deep economic integration with India.

This peg, set at 1 INR = 1.60 NPR, has remained largely unchanged for more than three decades.

<Figure 2-5>

Exchange Rate Trends in India and Nepal against the US Dollar (2021-2025)

Note: USD-INR(Left-side) and USD-NPR(Right-side)
Source: NRB, Google Finance

This exchange rate regime also influences the movement of the Nepalese rupee against the U.S. dollar (USD). The NPR does not determine its value against the dollar independently but instead closely tracks the INR. Consequently, when the Indian rupee appreciates or depreciates against the dollar, the Nepalese rupee follows suit. As a result, Nepal's monetary policy autonomy is limited, with the country's exchange rate and economic conditions effectively tied to India's policy stance.

Overall, the growth of Nepal's foreign exchange reserves has positively contributed to balance of payments stability and enhanced the country's external creditworthiness. Simultaneously, the peg to the Indian rupee has provided exchange rate stability and predictability for trade and investment transactions. However, this arrangement comes at the expense of reduced monetary policy independence and exposes Nepal to external shocks transmitted through the Indian economy. Moving forward, Nepal will need to manage its reserves prudently while also considering gradual refinements to its exchange rate regime and fostering greater financial market autonomy.

<Table 2-3>

Nepal's Exchange Rate System and Exchange Rate Adjustments Against the Indian Rupee (Since 1960)

Date	Quoted Exchange Rate (1 Indian Rupee per Nepalese Rupee)	Regime	Note
1960.4.13	1.60	Indian rupee peg	After the establishment of the Nepal National Bank (NRB) in 1956, free and unrestricted convertibility with the Indian rupee was introduced, and a new exchange rate was announced.
1966.6.6	1.01	Indian rupee peg	The Nepali rupee appreciated 37% after the Nepali government decided not to follow the Indian rupee's devaluation path.
1967.12.8	1.35	*1968-1983 Currency Basket System (INR, USD, gold, etc.)	Nepal's rupee depreciated by 25% due to a sharp increase in the trade deficit with India and a decline in foreign exchange reserves caused by the rupee's overvaluation.
1971.12.22	1.39		After devaluation against the Indian rupee on December 17, 1971, adjustments were also made against the pound sterling, Deutsche Mark, and Japanese Yen from December 22, 1971.
1978.3.22	1.45	*1983-1992 Trade-Weighted Currency Basket System (to address rapid fluctuations in international exchange rates)	* March 30, 1978 - September 19, 1981 (Dual exchange rate system implemented to promote exports) The Indian rupee was included in the currency basket system from June 1, 1983. Previously, the buying and selling rates for the Indian rupee were determined by the reference rate announced by the government. However, as with other currencies, the NRB announced the buying and selling rates daily.
1985.11.30	1.70		14.7% devaluation of the Nepalese rupee against foreign currencies

1986. 5.31	1.68		Expanding the currency basket
1991. 7. 1	1.65		Reflecting the devaluation of the Indian rupee
1993. 2.12	1.60	Indian rupee peg	Reflecting the devaluation of the Indian rupee in the early 1990s

Note: Summary of excerpts from the 50-year history of the Nepal Rastra Bank (NRB) and Sushil P. (2025) History of NPR and INR

Source: NEPAL RASTRA BANK IN FIFTY YEARS, Part III Macroeconomy, FOREIGN EXCHANGE (2005), p.309

III. Status of Nepal Foreign Exchange Policy and Capital Account Liberalization

Nepal Rastra Bank (NRB), the country's central bank, is legally mandated to ensure price stability and maintain external balance. Given India's role as Nepal's largest trade partner, along with close socio-economic and financial linkages and an open and porous border, Nepal has made two hard choices to maintain macroeconomic stability. First, Nepal operates under a fixed exchange rate system, where the Nepalese Rupee (NPR) is officially pegged to the Indian Rupee (INR), while floating against other convertible currencies in alignment with the INR. Second, free movement of capital is restricted in order to have an independent monetary policy.

1. History of Foreign Exchange Liberalization in Nepal

History of FX liberalization in Nepal can be broadly classified in four phases:

- Pre-1990s: Closed Foreign Exchange Regime
- 1990s: Current Account Liberalization
- 2000s and 2010s: Selective Capital Account Easing
- 2020s: Recent Developments

A. Pre-1990s: Closed foreign exchange regime.

Prior to establishment of NRB in 1956, Indian Rupees circulated widely in Nepal, and the Reserve Bank of India managed Nepal's foreign currency holdings. Imports were controlled through a complex and often opaque licensing system, designed to protect nascent domestic industries under an import-substitution strategy. The single most significant step towards monetary sovereignty was the enactment of the Nepal Rastra Bank Act, 1955, which established the nation's central bank on April 26, 1956. After the 1960 Trade and Transit Treaty with India, NRB assumed responsibility for foreign

exchange management and worked to eliminate the dual currency system, stabilize exchange rates, and establish the NPR as legal tender.

Introduction of Pegged Exchange Rate

Nepal adopted parity with the Indian Rupee in 1960 after enactment of the Foreign Exchange Regulation Act, 1962. This act also imposed restrictions on foreign investment in 1964. As a substantial portion of transactions used INR, the economic benefit of currency issuance was captured by India, not Nepal (Adhikari, 2017). After years of managing a stable but floating rate, the Nepalese government formally established the first official peg in 1960, fixing the exchange rate at NPR 1.60 per one INR. This was a landmark decision intended to eliminate speculative pressures and provide a stable monetary environment to foster economic development and formalize the deep-rooted trade linkages with India (Maskay, 2007).

The stability of the 1960 peg was shattered on June 6, 1966, when India devalued the INR by 36.5% against the USD. Nepal initially broke the peg, revaluing its currency to NPR 1.0125 per one INR but returned to a pegged system at a new rate in December 1967. The subsequent two decades were marked by monetary instability and frequent adjustments eventually evolving into an adjustable or crawling peg. A significant devaluation occurred in November 1985, fixing the rate at NPR 1.45 per one INR to address a severe balance of payments crisis. (Nepal Rastra Bank, 2005)

Prior to the collapse of the Bretton Woods system, Nepal was following the system of fixed parity in line with the international practice, India then also adopted fixed exchange rate system. In addition to INR, exchange rate with United States Dollar (USD) was also fixed. In the beginning of 1980s, India delinked its currency from fixed parity with Sterling Pound and floated its currency. As a result, exchange rate of INR vis-a-vis USD started to change daily. NPR was having fixed parity both with INR as well as USD. This led to emergence of broken cross rates demanding correction of exchange rates in the form of devaluation or revaluation by the government. However, such process took its own time, so it was felt more expedient to leave matter of determination of exchange rate

to NRB through adoption of new system called currency basket system. (Nepal Rastra Bank, 2018)

With the adoption of currency basket system on 1 June 1983 until 4 March 1992, USD was assigned the status of intervention currency. All the other currencies' exchange rates were dependent on international cross rates with USD. First, rate of USD needed to be determined. Once USD exchange rate was fixed, rates of other currencies were determined. For determining the rate of USD, a basket was fixed. All the important currencies, including INR, which were significant for the economy were included in the basket. The movement of exchange rate of these currencies in the international market influenced the basket rate. NRB never published the composition of currencies in the basket and the weights assigned to them. Exchange rate with INR did not change daily as expected theoretically in the basket system though exchange rate with other convertible currencies used to change. (NRB, 1996)

Faced with a mounting economic crisis and pressure from the Bretton Woods institutions, Nepal embarked on its first Structural Adjustment Program (SAP) in 1985. Amid India's 1991 crisis, Nepal revised the exchange rate to Rs. 1.65 per one INR and NPR 42.70 per one USD to prevent arbitrage and preserve reserves. Finally on adoption of full convertibility in the current account from 12 February 1993, this practice of ratios ended with all transactions being undertaken at open market rate. The exchange rate with INR was re-valued from NPR 1.65 to NPR 1.60 per one INR (Nepal Rastra Bank, 2018).

B. 1990s: Current Account Liberalization

On 4 March 1992, Nepal introduced partial convertibility of the Nepalese Rupee, creating a dual exchange rate system: the NRB rate (for government transactions) and an open market rate (set by commercial banks). Imports by the private sector, except for petroleum, fertilizers, and industrial machinery, were conducted at the market rate. To support essential imports, banks were initially required to surrender 35% of their foreign currency earnings to NRB (reduced to 25% in July 1992), resulting in a composite exchange rate structure. (Nepal Rastra Bank, 2018)

On February 12, 1993, Nepal officially fixed the exchange rate back at its original 1960 level, NPR 1.60 per one INR. By tying the NPR to the INR, Nepal aimed to import the monetary policy credibility of the Reserve Bank of India (RBI), thereby anchoring domestic inflation expectations. Nepal adopted full current account convertibility, ending the dual system. Commercial banks gained autonomy to set exchange rates and manage their own foreign reserves, and assume related risks, with NRB intervening only to maintain stability (Nepal Rastra Bank, 2018).

The Foreign Investment and Technology Transfer Act, 1992 created a transparent legal framework for FDI for the first time, permitting up to 100% foreign ownership in most sectors guaranteeing 100% profit repatriation and establishing a "One Stop Service Centre" to streamline approvals (Bista, 2017). With the introduction of the Open General License (OGL) system, firms registered in Nepal could freely import eligible goods by opening Letters of Credit (L/C), while smaller imports were facilitated through Draft/TT, DAP, or DAA. For imports from India, payments were primarily made in Indian Rupees, though from 1992/93, selected raw materials could also be imported using convertible currencies via L/Cs to ease access to industrial inputs.

The 1987 amendment to the Foreign Exchange Regulation Act, 1962 allowed foreign exchange earners to open foreign currency accounts in commercial banks. Initially capped at 30% of earnings, this has since been expanded to 100%. While originally limited to foreign nationals and institutions, Nepali citizens and institutions can now also open such accounts, with simplified rules for deposits and withdrawals.

Until the early 1990s, only banks were authorized to conduct foreign exchange transactions, with limited exceptions for hotels and travel agencies. To align with liberalization and address difficulties faced by foreign tourists, NRB began licensing private sector entities in 1995. This led to the emergence of money changers, remittance companies, and expanded licensing for hotels, trekking agencies, airlines, and cargo firms to conduct specified foreign exchange activities (Nepal Rastra Bank, 2018).

C. 2000s and 2010s: Selective Capital Account Easing

The Nepal Rastra Bank Act, 2002 granted NRB greater autonomy in formulating foreign exchange policy. Amendments to the Foreign Exchange (Regulation) Act, 1962 further facilitated policy implementation.

Commercial banks were permitted to use derivative instruments for risk management in FX transactions since 2006/07. Commercial banks could trade derivative instruments under the criteria stipulated by their Board of Directors without having to take permission from the NRB. The policy of systematization of FX derivative trading has been taken through the Monetary Policy for FY 2012/13 (Nepal Rastra Bank, 2021).

Over this period, NRB continued to introduce foreign exchange policy reform measures. The limit of directly payable amount in USD to the individual or organization by the licensed bank and financial institutions for different purposes was raised to US$ 2,500 from US$ 1,500 in FY 2006/07 which subsequently got raised to 10000 US$ in FY 2012/13 (Annual Report, 2006/07). Likewise, Nepalese citizens going abroad for trade fairs and workshops for promoting business were provided foreign exchange facility up to USD 5,000 each time as passport facility (Annual Report, 2012/13).

However, NRB kept tight control on capital outflows and there were minimal changes in policy related to Outward Direct Investment (ODI). In 2015, NRNs were allowed to invest in convertible currencies in designated sectors (e.g., real estate, hydropower, tourism). Foreign Direct Investment (FDI) procedures were streamlined for selected sectors under automatic approval routes. Commercial banks could borrow from foreign banks and financial institutions in convertible foreign exchange to the extent of 25 percent of their core capital (Annual Report, 2017/18).

In 2011, Investment Board Nepal (IBN) was established through the Investment Board Act, 2011 to facilitate public-private partnership and private investments, particularly foreign direct investment (FDI) in Nepal and was reconstituted by introducing the Private Public Partnership and Investment Act, 2019. The IBN is responsible for approving investment of NPR six billion or above for infrastructure development and provides “hand holding” facilities to investors in Nepal (IBN, 2025). The act provides two broad

mandates to IBN:

a) To function as the national investment promotion and facilitation agency, providing 'one-stop service' for private sector investors,

b) To approve FDI of NPR 6 billion or above, conduct project studies, develop and manage (both solicited and unsolicited) projects under the public-private partnership (PPP) or private investment model as per the prevailing Act.

The IBN also approves investments for the development of energy projects with a capacity of 200 MW or above (IBN, 2025).

Similarly, The Government of Nepal set up a One Stop Service Center (OSSC) as envisioned by the Industrial Enterprise Act, 2020 and the Foreign Investment and Technology Transfer Act, 2019 to provide all investment related services from a single point for the convenience of the investors. (DOI, 2023) Foreign Exchange Facilitation Unit was established at One-stop Service Center functioning under Department of Industry, Ministry of Industry, Commerce and Supplies, Government of Nepal to increase the effectiveness of operations related to foreign direct investment (Annual Report, 2018/19).

Along with facilitating services, facilities, exemptions, and concessions, the OSSC also assists industries, entrepreneurs, and investors to obtain electricity, water, land, and other infrastructures required for establishment. The OSSC at DOI provides services related to FDI approval (less than NPR 6 billion), recommends visas for foreign investors, their authorized representatives, and experts; approves Initial Environmental Examination (IEE) and Environment Impact Assessment (EIA), and recommends foreign currency exchange facilities (DOI, 2023).

The Foreign Investment and Technology Transfer Act, 2019 was an attempt to address the long-standing procedural bottlenecks that had plagued the 1992 act. It sought to reaffirm the "single window" service, clarify the list of approved sectors, and streamline the approval and repatriation processes (Government of Nepal, 2019). It represented an effort to improve the quality of the existing FDI channel rather than opening new ones.

To encourage formal inflow of remittances and open investment avenues for NRNs,

NRB

- Allowed NRNs to invest remittance proceeds in government bonds, mutual funds, and IPOs.
- Relaxed limits on personal foreign currency payments for education, medical treatment, and travel.
- Banks authorized to offer NRNs designated foreign currency accounts for easier transactions.
- Liberalized remittance inflows by encouraging NRNs to bring funds through formal channels and allowing investment in government bonds and capital markets.

D. 2020s: Recent Developments

On March 21, 2021, the NRB allowed Nepali Commercial banks and National level Development banks to issue foreign-currency prepaid cards (dollar cards) with maximum limit of 500 USD for online payment to national and international transactions. (NRB, Forex Circular 10/2077-78) Nepal is now open to international online transactions that were previously not possible via cards issued by Nepali banks.

Just after the covid pandemic, NRB imposed tighter restrictions on outward foreign exchange flows and non-essential imports, to maintain strained FX reserves. In response, in 2022, the Government of Nepal imposed a blanket ban on the import of designated "luxury goods," including cars, expensive mobile phones, and alcohol, and the NRB tightened access to letters of credit (LCs) for other imports by the means of margin requirements and restrictions on credits for imports or margins (World Bank, 2023).

In 2023, NRB revised procedures to ease FDI approval. Recently in June 2025, the Nepal Rastra Bank amended the Foreign Investment and Foreign Loan Management Bylaws, 2021 to allow IT firms registered in Nepal to invest up to USD 1 million abroad or 50% of average export earnings (3-year average), whichever is less. NRB also enabled NRNs to bring in investment in Nepali rupees (previously only foreign currency).

The import limit for goods using Document Against Payment (DAP) and Document Against Acceptance (DAA) has been increased from USD 60,000 to USD 100,000.

Similarly, the limit for foreign exchange facility for importing goods through draft/telegraphic transfer (T.T.) has been increased from USD 35,000 to USD 50,000. For government agencies, the foreign exchange facility required for payments made under public procurement laws is exempt from the draft/T.T. ceiling, and multiple payment methods may be used for such transactions. Likewise, the exchange facility of USD 2,500 per trip currently available to Nepali citizens travelling to countries other than India, is increased to USD 3,000 (Monetary Policy, 2025/26).

The Securities Board of Nepal issued Directive on the Issuance and Allotment of Securities, 2025 now permits NRNs to subscribe to joint investment companies (NICs) in partnership with the Nepal government, with NRNs holding 10 % to 49 % equity, depending on criteria. Investment by NRNs through joint venture companies now has no minimum capital threshold, enabling small-scale diaspora investors to participate. Profit and capital repatriations are permitted—subject to tax compliance, NRB recording, and usually a one year lock in (3 years for promoter/non IPO shares). NRNs can open Depository Participant (DP) accounts and trade listed shares on NEPSE through licensed brokers. The joint investment companies must be registered at the SEBON prior to the issuance of their Initial Public Offerings (IPOs). With approval from the regulator, the IPOs can be floated only for NRNs for a minimum of four days and a maximum of 15 days. The sector's regulator, however, has put restrictions stating that these IPOs must involve at least 1,000 units and can only be traded among NRNs. Likewise, the subscribers cannot trade the IPOs for one year. The rights shares can also be transferred only between and among the NRNs.

2. Nepal’s Experience with FX Liberalization so far

Nepal's adoption of foreign exchange liberalization, primarily initiated in the mid-1980s and accelerated in the 1990s, was driven by a set of strategic objectives aimed at transforming its economic landscape, which included enhancing trade competitiveness, attracting foreign investment, promoting financial sector development, and ensuring efficient resource allocation (World Bank, 2023). The economic liberalization marked a departure from Nepal's earlier protectionist stance and was a key component of a broader structural adjustment program, supported by the World Bank and the International Monetary Fund (Shrestha, 2005).

One of the objectives of liberalizing the foreign exchange regime was the promotion of Nepal's international trade. A pivotal moment in this process was the move to full convertibility of the Nepalese rupee on the current account in February 1993. (Pant, n.d.). Another goal was to create a more predictable environment for foreign trade and investment. By transitioning from a dual exchange rate system to a unified one, policymakers aimed to reduce bureaucratic hurdles and enhance transparency in international transactions. The goal was to integrate the Nepalese economy more deeply into the global economic system (Shrestha, 2018).

The liberalization of capital account was guided by the dual objectives of attracting foreign direct investment (FDI) and safeguarding macroeconomic stability. Reforms in this area permitted up to 100% foreign ownership in most sectors and guaranteed the repatriation of profits and capital, aiming to create an investment-friendly environment (Bista, 2017; UNCTAD, 2003). Other goals were to attract technology, managerial expertise, and knowledge to bolster Nepal's industrial capabilities and competitiveness (Bista, 2020). The logic was that the entry of foreign firms would create a "demonstration effect," encouraging domestic companies to adopt modern technologies and improve their own operational efficiencies. Furthermore, FDI was viewed as a critical engine for job creation and overall economic advancement (UNCTAD, 2003).

The strategy was to actively encourage long-term, productive investments like FDI

while restricting more speculative, short-term capital movements. The ambition was to set Nepal on a trajectory of higher and more sustainable economic growth, propelled by a vibrant and competitive private sector. (Shrestha, 2005)

A. Outcomes of Liberalization

The immediate economic response was positive and seemed to validate the reformist agenda. The economy saw a growth spurt, reaching an impressive 8.6 percent in 1994 (Dhungel, 2023). This was accompanied by a noticeable increase in foreign direct investment (FDI), with investors responding favorably to the new, more welcoming legal framework (Bhattrai, 2008). The financial sector was transformed. The entry of private and foreign joint-venture banks broke the monopoly of state-owned banks, fostering competition, enhancing efficiency, and expanding the availability of credit and modern banking services.

While the legal framework for foreign investment is open, its implementation is crippled by a weak and inefficient bureaucracy, a lack of transparency, and pervasive corruption (The Annapurna Express, 2024; U.S. Department of State, 2024).

B. Trade and Openness

A primary success of the reforms was the increased integration of Nepal's economy with the global market. Studies indicate that trade liberalization led to a significant rise in the overall volume of foreign trade (Kharel et.al, 2021). The move towards a market-determined exchange rate and the convertibility of the rupee on the current account were instrumental in this process.

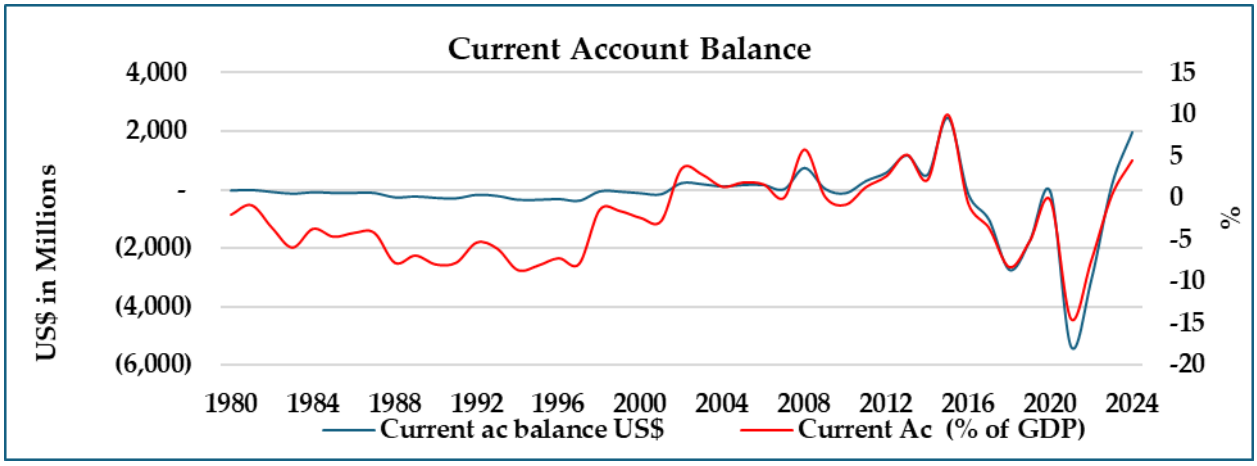
Current account convertibility and tariff reductions successfully opened the economy, causing international trade to surge. From 32.19% in 1990, it climbed to 59.50% by 1995 and has remained at a significantly higher plateau since.

Import consistently and substantially outpaced Export. For instance, in 2022, imports stood at 42.27% of GDP, while exports were only 6.70%. This growing gap resulted in a persistent and often widening current ac deficit, which reached -8.53% in 1994 and -7.49%

in 2022. This indicates that while liberalization boosted trade, it did not sufficiently enhance the competitiveness of Nepali exports to cover the rising import.

<Figure 3-1>

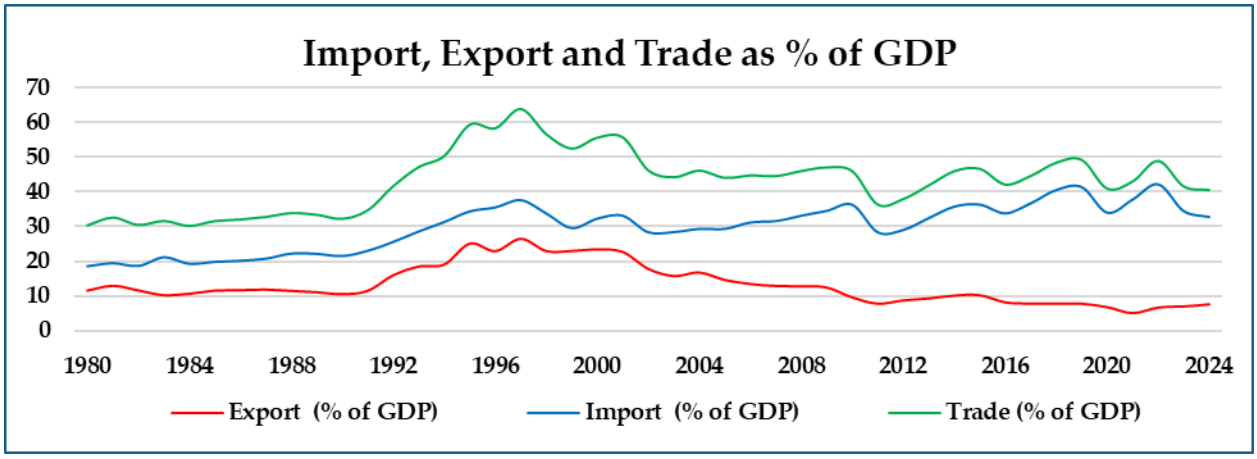
Nepal's Openness (1980-2024)



Data Source: World Bank

<Figure 3-2>

Nepal's Trade (1980-2024)



Data Source: World Bank

C. Foreign Direct Investment (FDI)

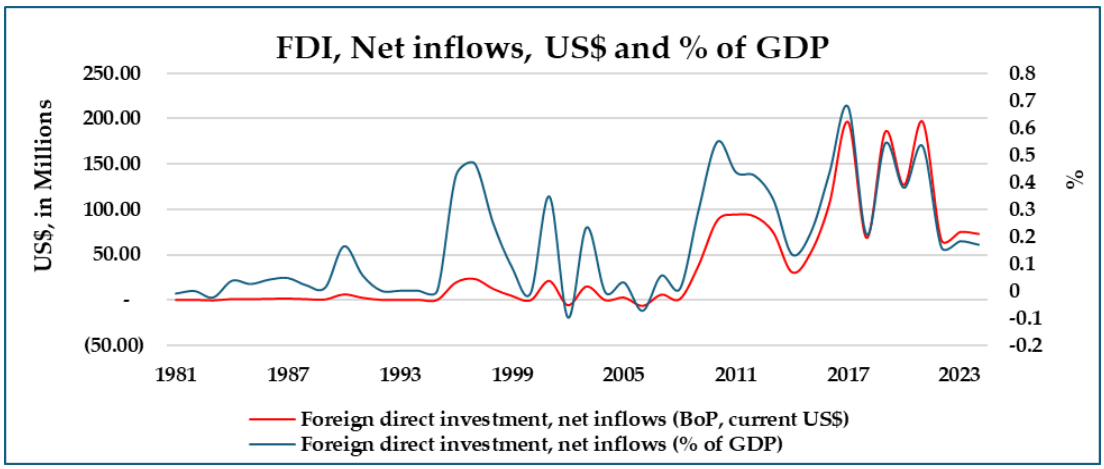
The adoption of liberal, investment-friendly policies initially encouraged inflow of FDI. During the first half of the 1990s, the flow of FDI projects was promising, driven by new facilities and guarantees for foreign investors (Bhattrai, 2008). This FDI contributed to job creation and, in some cases, introduced modern technologies and export products (UNCTAD, 2003).

Net inflows of FDI, show signs of transformation albeit slow. From just $5.94 million in 1990, inflows grew exponentially, reaching $94 million in 2011 and peaking at $196.27 million in 2017. This influx of foreign capital was a direct response to policies guaranteeing the repatriation of funds and signaled growing investor confidence.

Reforms were implemented in an environment plagued by weak governance, a cumbersome bureaucracy, corruption, and inconsistent enforcement of laws (U.S. Department of State, 2023; The Annapurna Express, 2024). These factors have consistently been cited by investors as major obstacles to doing business in Nepal (U.S. Department of State, 2024). The result has been a structural economic transformation that has regressed, with productivity levels falling back to those of the 1980s (Kharel, P., 2021).

<Figure 3-3>

Nepal's FDI (1980-2024)



Data Source: World Bank

3. Review of Current Foreign Exchange policy and Practice of Nepal

A. Foreign Exchange Rate Regime, FX market, and FX transaction

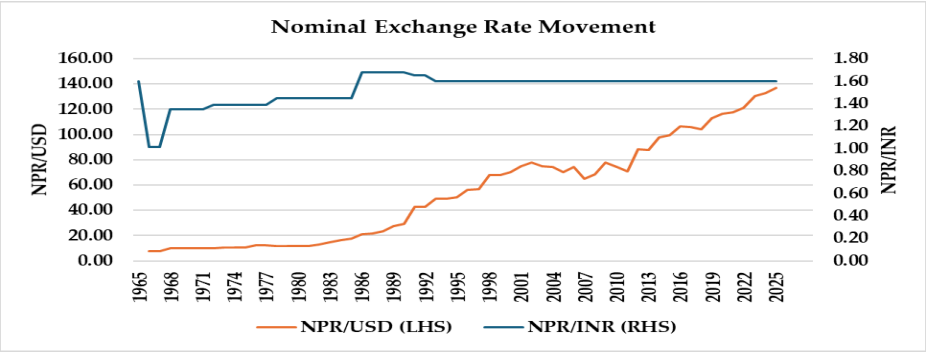
(1) Foreign Exchange Rate Regime

Prior to the establishment of NRB, there was widespread circulation of INR throughout Nepal. There was lack of legal provisions on currency circulation and NPR did not reach to all parts of Nepal. At the time, INR had served dual purposes of medium of exchange and store of value.

After the establishment of NRB, NPR was set up as a legal tender. Since February 12, 1993, the full convertibility in the current account was adopted and the exchange rate with INR was revalued to NPR 1.60 per one INR. Since then, the NPR has been pegged with INR. In this regime, the exchange rates of other convertible currencies (FCY), except for USD, are determined based on the USD/INR and USD/FCY currency exchange rate pairs. Exchange rate for USD is determined based on USD/INR rate multiplied by pegged NPR/INR rate. However, commercial banks could quote their buying and selling rates for FCYs based and demand and supply of those currencies in the market. Similarly, the open market exchange rates quoted by different banks may differ. NRB also publishes exchange rates for convertible currencies for transactions with public and certain government transaction purposes. The graph one plots movements of exchange rates of USD and INR against NPR.

<Figure 3-4>

Nepal's Nominal Exchange Rate Movement (1965-2024)



<Table 3-1>

List of Convertible Foreign Currencies

S.N.	Country	Currency
1.	United States of America	U.S. Dollar (USD)
2.	European Union	European Euro (EUR)
3.	United Kingdom	UK Pound Sterling (GBP)
4.	Switzerland	Swiss Franc (CHF)
5.	Australia	Australian Dollar (AUD)
6.	Canada	Canadian Dollar (CAD)
7.	Singapore	Singapore Dollar (SGD)
8.	Japan	Japanese Yen (JPY)
9.	China	Chinese Yuan (CNY)
10.	Saudi Arabia	Saudi Arabian Riyal (SAR)
11.	Qatar	Qatari Riyal (QAR)
12.	Thailand	Thai Baht (THB)
13.	United Arab Emirates	UAE Dirham (AED)
14.	Malaysia	Malaysian Ringgit (MYR)
15.	South Korea	South Korean Won (KRW)
16.	Sweden	Swedish Kroner (SEK)
17.	Denmark	Danish Kroner (DKK)
18.	Hong Kong	Hong Kong Dollar (HKD)
19.	Kuwait	Kuwaity Dinar (KWD)
20.	Bahrain	Bahrain Dinar (BHD)
21.	Oman	Omani Riyal (OMR)

Convertible Currencies

Currently, there are twenty-one convertible currencies, except for INR, authorized to be bought and sold in the country by licensed institutions at the exchange rates determined by them. Licensed institutions may decide the buying and selling rates of those convertible currencies, listed in <Table 2-1>, though NRB also publishes the exchange rates for its own purposes. The rates published by NRB are only indicative.

Although licensed institutions are free to decide the exchange rates for convertible currencies, NRB has set basic rules for exchange rate determination. While determining exchange rates for convertible currencies, the licensed institutions must ensure that the spread between the buying and selling rates should be within one percent. It means that if a commercial bank fixes a buying rate lower, the selling rate needs to be lower (or within permitted bid/ask spread) accordingly. However, in case of USD, the spread between buying and selling rate must not exceed NPR 0.60 (i.e., sixty paisa).

(2) Foreign Exchange Market

The foreign exchange market in Nepal makes up the NRB, commercial banks, development banks, finance companies, remittance companies, money changers, hotels, travel, trekking, cargo, airlines as well as exporters and importers. As of July 16, 2025, there are 20 Class A banks (commercial banks), 9 Class B banks (development banks), 7 Class C financial institutions (finance companies), 308 money changer companies and forty-eight remittance companies licensed to engage in forex transactions with public. Table 2 provides the number of listed entities classified by relevant NRB bylaws.

(a) NRB in the FX Market

NRB conducts foreign exchange transactions with BFIs, remittance companies, and money changers. The amount of foreign exchange bought or sold for all types of foreign exchange operations is based on the requests of the counterparties, accompanied by documents proving eligible transactions under Nepal's foreign exchange regulatory framework.

NRB only conducts spot transactions and does not conduct any non-spot (forward and FX swaps) transactions with any counterparties.

<Table 3-2>

Number of Licensed Entities for FX Transactions

Relevant Bylaws	Licensed Entities	Total
Foreign Exchange Transaction Licensing and Inspection Bylaw, 2020	Commercial Banks	20
	Development Banks	9
	Finance Companies	7
	Non-BFI Entities	2,261
	Casinos	8
Money Changer Licensing and Inspection Bylaw, *2020*	Money Changer Companies	308
Remittance Bylaw, 2022	Commercial Banks	19
	Development Banks	5
	Non-BFI Companies	24
Total		**2,661**

(b) Banks and Financial Institutions in the FX Market

Commercial banks, development banks and finance companies licensed by the Foreign Exchange Department under the Foreign Exchange Transaction Licensing and Inspection Bylaw 2020 are allowed to conduct the following transactions:

a. Buying and selling of Indian Currency
b. Buying and selling of convertible foreign currencies
c. Exchange facility against passport
d. Dealing with letter of credit

However, transactions relating to letter of credit can only be done by "A" class commercial banks and national level "B" class development banks.

"A" class commercial banks and national level "B" class development banks are also authorized to conduct the following transactions relating to hedging of foreign exchange risks, derivatives, and interest rate swaps:

a. Investment in bonds, certificate of deposits, and various instruments issued by international financial institutions and foreign governments, using convertible foreign currencies obtained from deposits or existing accounts. However, they are prohibited from taking loans from any foreign bank and financial institutions for making such investments.

b. Transactions relating to the derivatives instruments existing in the foreign exchange market such as forward, futures, options, and swaps.

(c) Other Institutions in the FX Market

Non-BFIs including hotel, travel agency, tours, trekking agency, cargo companies, airlines, and other institutions licensed by NRB for foreign exchange transactions under the FX Bylaw are authorized only to accept foreign currencies during business. Similarly, casinos licensed by NRB under this FX Bylaw may accept and make payment, as specified, in foreign currencies during business.

Money Changer Companies licensed by NRB under the Money Changer Licensing and Inspection Bylaw, 2020 may conduct the following transactions:

a. Buying and selling of Indian Currency only

b. Buying and selling convertible foreign currencies only

c. Buying and selling of both Indian Currency and convertible foreign currencies

d. Exchange facility against passports has been dropped for money changers, except for those operating within the premises of the international airport, based on the recommendation of Civil Aviation Authority of Nepal

Remittance Companies licensed under the NRB Remittance Bylaw, 2022 may conduct the following transactions:

a. Bringing foreign currency into Nepal (inward remittance) from abroad as pre-funding via banking system

b. Functions relating to Payment Service Provider and Payment System Operator through subsidiary company if the specified capital is maintained.

c. Remittance transactions through issuance of remittance card

The remittance companies are not allowed to send foreign currency from Nepal to abroad (outward remittance). In addition, they are not allowed to bring in the foreign currency relating to the capital nature transactions. However, these provisions are exempt from the banks and financial institutions licensed by NRB.

(3) Overview of Interbank FX market

Interbank FX market in Nepal consists of transactions between local banks. Currently, 20 Class A (commercial) banks and 9 Class B (development) banks participate in this market. Banks can engage in FX buy and sell transactions with other domestic banks or offshore banks. However, FX transactions involving INR or NPR currency pairs are restricted to dealings with the Nepal Rastra Bank (NRB) and onshore counterparties only. The Nepal FX market operates without brokers or a market-making system.

Banks in Nepal typically maintain either long or short positions based on their client transactions. Banks receiving remittance inflows have net FX purchases from clients, which they sell in the interbank market or to NRB during interventions. Conversely, banks that provide FX for importers tend to buy FX from the interbank market to meet client demand. The interbank market is dominated by USD/NPR and INR/NPR currency pairs, which comprised 79% and 20% of the market volume in 2024, respectively. The remaining 1% of market volume involves currencies such as JPY, EUR, CNY, GBP, AUD, and CAD.

The main characteristics of interbank FX buy/sell transactions among banks include:

- The terms for FX borrowing and lending, including aspects like collateralization, limits, and tenure, are set by mutual agreement between the banks involved.
- Although there is no formal upper limit on the duration of interbank FX borrowing/lending, accepted maximum duration is seven days.
- There is no formal platform for FX Transactions. Participants use email, chats, or

voice recordings between the banks for dealings.

Banks prefer not to hold large FX positions as it is easy to source FX from the interbank market or NRB when necessary. According to the Unified Circular-2025 for Licensed Institutions, net open positions on total foreign assets and liabilities are fixed at maximum 30% of a bank's core capital.

The derivatives market in the interbank FX segment is underdeveloped and NRB does not participate in forward contracts. Therefore, banks hedge forward contracts using synthetic swaps. As per the Unified Circular on FX Transactions, proprietary forwards outstanding at any time are limited to 20% of core capital. Commercial banks may offer forward contracts as a hedging instrument for clients with letters of credit (L/C), but NRB does not offer any such forward transactions.

(4) NRB FX Buy/sell and FX Market Intervention

(a) NRB FX Buy/Sell

Foreign Exchange Buying and selling are conducted by NRB as per provision set in Nepal Rastra Bank Foreign Exchange Buy Sell and Intervention Directives, 2021. As mentioned in the directives, the buy sale and intervention are two separate functions performed by NRB. The regular process of FX Buy Sale conducted by NRB is to manage commercial and development banks' FX position, while intervention is applicable when exchange rate is instable in the market. The graph two plots total volume of daily FX buy intervention over the years.

The primary goals of foreign exchange operations and market interventions include:

(i) supporting the execution of monetary policy objectives established by NRB,

(ii) supplying Nepalese Rupees for banking sector fund and liquidity management purposes, and

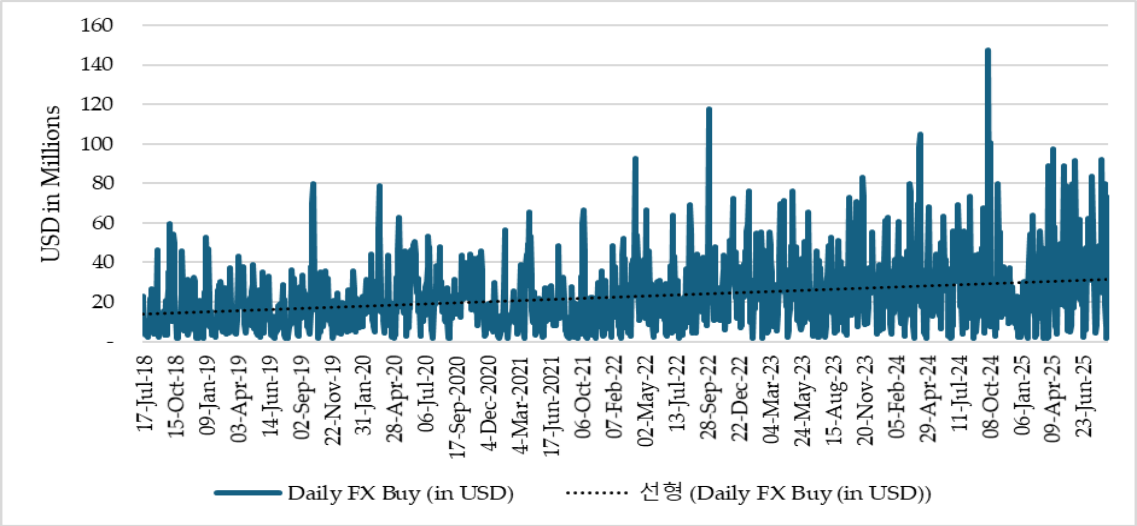
(iii) acquiring foreign exchange from commercial banks or distributing foreign exchange to commercial banks when necessary to maintain market stability and exchange rate equilibrium.

The directives also outline the procedures for FX buying, selling, and intervention

activities. Clause 13 of the directives emphasizes the importance of interbank FX buy/sell transactions, stipulating that banks should only request USD FX buy/sell support from NRB after they have fully explored options available in the interbank market. Currently, no additional legal framework exists beyond these Directives regarding interbank FX transactions; however, the Monetary Policy of 2025/26 has stated that the central bank would make special provisions for interbank FX trading.

<Figure 3-5>

Nepal's FX Buy (2018-2025)



(b) NRB's FX Intervention

At present, NRB separates its FX buying and selling interventions from routine FX buy/sell operations. Routine operations are focused on managing the FX positions of banks, while interventions are initiated in response to instability in the exchange rates of the NPR against other convertible currencies. The intervention is based on recommendations from the Foreign Exchange Management Department (FEMD). Intervention methodology and rates are determined by the Governor following FEMD recommendations. Foreign exchange transactions and market interventions occur Monday through Friday, excluding Nepalese public holidays. US Dollars serve as the exclusive currency for foreign exchange transactions and interventions.

NRB executes foreign exchange transactions (commonly referred to as market interventions) in two primary currencies: USD and INR. Inward remittances are the major source of foreign currency inflow in Nepal. Whereas INR-denominated imports take sizable chunks of outflows. NRB serves as a market facilitator through two principal intervention strategies. NRB sells INR to domestic banks for import financing, primarily for petroleum products denominated in INR. Initially, NRB acquires USD in exchange for NPR from domestic banks. Subsequently, NRB converts these USD holdings into INR through transactions with the Reserve Bank of India (RBI) or other institutions in India's foreign exchange market. The second form of intervention involves NRB selling INR to domestic banks for import financing, particularly for petroleum products denominated in INR, with settlements processed through bank accounts maintained at NRB. These NRB foreign exchange operations represent more than 70% of Nepal's wholesale foreign exchange market activity.

Foreign Exchange Transaction Process

The foreign exchange transaction procedure follows these steps:

- Commercial banks must inform NRB by 12:00 PM daily regarding their intended transaction volumes through the FXALL/Eikon Auction Platform provided by Refinitiv. Banks must specify their institution name, USD transaction amount (purchase or sale), settlement date, and designated Agency Bank.
- Transaction volumes typically remain fixed once confirmed by NRB, and the authorization process for transaction approval proceeds through established channels. Commercial banks must transact a minimum of USD 2 million per individual transaction.
- NRB communicates the transaction rate and settlement date to all participating commercial banks by 12:45 PM on the same day.
- Upon receiving NRB's notification regarding settlement dates and transaction rates, participating banks submit their final transaction details through Refinitiv's FXALL Platform. Each bank's final transaction amount must equal at least 75% of their initial quotation.

Exchange Rate Determination

The transaction rate is established using the USD/INR cross-rate available in India's foreign exchange market at 12:15 PM, which serves as the basis for determining the USD/NPR exchange rate.

NRB's purchase rate from commercial banks is derived by deducting five paisa (100 paisa = 1 rupees) from the reference rate, while the selling rate to commercial banks calculated by adding six paisa to the reference rate. If the average rate is unavailable at 12:15 PM, the next available average rate is used.

Settlement Date

Standard settlement occurs on T+1 (the next business day following the trade date). If T+1 falls on a holiday in the agency bank's country, settlement moves to the subsequent business day. When two or more consecutive holidays occur in Nepal or internationally after the trade date, or under exceptional circumstances, the trade date itself may serve as the settlement date.

Authorization Process

The FEMD's investment unit prepares documentation and submits it to the appropriate authority for transaction approval after receiving final requests from commercial banks. NRB maintains multiple authorization levels for approving foreign exchange transactions submitted by commercial banks.

Development banks may also participate in foreign exchange transactions under the directive's terms and conditions. Money transfer companies and finance companies authorized for money transfer services can sell USD to banks through the Nepal Remitters Association.

Commercial banks may request USD purchases from NRB but cannot request client forward sales or Non-Deliverable Forward square-up transactions.

Banks failing to deposit the agreed USD transaction amount to NRB's agency bank on

the settlement date face penalties as specified in the directives. These penalty provisions also apply to remittance companies and licensed finance companies.

B. FX Transactions Reporting System

The NRB has two systems for monitoring FX transactions. The first is the International Transactions Reporting System (ITRS), which is a reporting framework established by NRB to systematically capture information on cross-border financial transactions. The ITRS System uses the Supervisory Information System (SIS), principally used to record data banks' prudential compliance, to collect and process the data to be used primarily for publishing BOP statics. Under the system, all authorized dealers (ADs), primarily commercial banks and licensed financial institutions, are required to report foreign exchange transactions they conduct on behalf of their customers. The ITRS is designed as a periodic, transaction-level reporting platform that records both inflows and outflows, tagged by purpose codes defined in the NRB's ITRS guidelines. This ensures that data is captured at the point of transaction processing, reducing reliance on ex-post surveys or manual reporting.

Data collected through ITRS are transmitted electronically to the NRB through secure interfaces integrated into the reporting entities' core banking systems. Each transaction entry includes details such as currency, value, sector, counterparty, and purpose of payment, which are coded for consistency across reporting institutions. The NRB maintains a centralized ITRS database, where information from all ADs is aggregated. Automated validation checks are embedded in the system to ensure accuracy, detect anomalies, and flag suspicious entries for further review. This reduces reporting errors and enhances the quality of the dataset while providing a comprehensive and timely view of cross-border financial flows.

Once stored, ITRS data are used by NRB for multiple layers of analysis beyond balance of payments compilation. The centralized system allows for monitoring of external sector developments, sectoral and regional flow analysis, and early warning assessments of risks related to remittances and trade financing. The data can also link with compliance and

supervisory tools, supporting oversight of AML/CFT obligations and foreign exchange regulations.

The second system in use is the Foreign Exchange Licensing and Reporting System (FXOL) which was implemented by NRB in May 2017 to streamline the reporting of foreign exchange transactions by the licensed institutions. Initially, the system was accessible to the institutions licensed through FEMD. Presently, the institutions licensed by the provincial offices are also included in the system. The reporting entities are provided with unique usernames and passwords. They have also been given training from time to time regarding the reporting process. The institutions licensed to conduct foreign exchange transactions submit details of foreign exchange transactions through FXOL System.

The system has gone through continuous upgrade over the years. For instance, the exact geo-location of reporting companies is marked, and distinct categories of reporting entities can be filtered. The inspection module has been added to allow for listing inspections done by the department and provincial offices. Reports of remittance inflows by remittance companies have been added.

NRB is also trying to build and implement a new system for recording inflows of capital. This will especially help to track the repayment schedule and maturity of debt inflows, allowing better preparedness reserve management and help in constructing and reporting the International Investment Position (IIP). Considering this, a comprehensive system for recording all major aspects of FX transactions seems to be missing.

C. Foreign Exchange Market Regulation

Nepal's foreign exchange (FX) system is comprehensively regulated. The laws and regulations provide legal frameworks for governing FX transactions. The key act governing Nepal's foreign exchange system and FX transactions is the Foreign Exchange (Regulation) Act, 1962. The act sets out general principles on the conduct of FX transactions. To complement the act, regulations, rules (such as the Foreign Exchange (Regulation) Rules, 1963), bylaws, circulars, directives, and manuals have been issued

by the Government and the NRB. The Napal Rastra Bank Act, 2002 sets NRB as the authority responsible for formulating and implementing foreign exchange policies and determining the system of foreign exchange rates in Nepal.[1] Under the act, NRB has clear authority over all aspects of foreign exchange policy. To achieve its mandates, the NRB has issued Bylaws, circulars, directives, and manuals under the powers conferred by the act.

There are additional laws and regulations that are of relevance to the making of payments and transfers for international transactions. The Foreign Investment and Technology Transfer Act, 2019, together with the Foreign Investment and Technology Transfer Rules, 2020, mainly govern the inflow of capital specially conduct of foreign direct investment (FDI), private foreign debt, foreign private equity and venture capital (PEVC) operations, lease investment, portfolio investments or trading in securities. Additionally, they have provisions governing certain current transactions such as repatriation of earnings and interest payments, technology transfers, and some other aspects of service imports. There are other laws that often become relevant for jurisdictional analysis, such as the Industrial Enterprises Act, 2020, the Act Restricting Investment Abroad, 1964, which restricts outbound investment, the Non-Resident Nepali Related Act, 2008, the Public Private Partnership and Investment Act, 2019 and notices in Nepal Gazette.

The Foreign Exchange (Regulation) Act and the NRB Act provides the NRB authority to issue directives, bylaws, orders, or notices.[2] Using those powers conferred by the acts, the NRB has issued bylaws, circulars, and notices to regulate FX transactions and smoothen the process of approvals. To govern capital inflows related FX transactions, the NRB Foreign Investment and Foreign Loan Management Bylaw, 2021 sets out rules on FX loans and processes for foreign borrowing and profit repatriation. Regarding the regulation of exchange rates, the NRB has issued internal guidelines in the form of the Foreign Currency Buy Sell and Market Intervention Directive, 2021 and Foreign Exchange Rate

[1] Napal Rastra Bank Act, 2002, Section 5.

[2] Foreign Exchange (Regulation) Act, 1962, Section 12, and NRB Act, 2002, Section 63.

Determination and Publication Manual, 2022. Also, to ease the monitoring of FX market and transactions, provisions for licensing and supervision of authorized dealers and institutions has been issued in the NRB Foreign Exchange Transaction Licensing and Inspection Bylaw, 2020, the NRB Money Changer Licensing and Inspection Bylaw, 2020, the NRB Remittance Bylaw, 2022, and the NRB Remittance Transaction Inspection and Supervision Bylaw, 2022.

While laws, rules, and bylaws set the regulatory framework, circulars provide guidance on transactions at a more granular and operational level. Subsequently, circulars issued by the NRB are the principal regulatory instrument setting out detailed rules on the conduct of FX transactions in Nepal. In this regard, circulars governing different areas of the FX system have been issued by the NRB and these circulars have been compiled and issued as a comprehensive set of Unified Circulars.[3] The latest unified circulars, were issued as Unified circulars-2025 on April 5, 2025[4] and comprises all Circulars governing FX transactions, 29 in total and each of these Circulars is referenced by its number (e.g., Unified Circular 1, Unified Circular 2). This Unified Circular serves as the primary source of the Nepalese FX regulatory framework.

The Unified Circular has different rules for distinct types of FX transactions. There are limits on the amount of FX to be provided by banks and financial institutions (BFI) according to the type and nature of transactions. Whenever such limits are exceeded, the NRB's approval is required to provide additional FX. Given the availability of FX reserves, NRB revises the limits on the amount of FX for various transactions. Furthermore, recommendations from relevant regulatory bodies are often required as part of the bona fide verification of documents to obtain FX.

Unified Circular 1 is the main provision regulating importation of goods. Unified Circular 5 covers the export of goods. The payments for importation of travel, tourism,

[3] The NRB uses the term *Unified Directives* to refer to the prudential regulations issued by the Bank and Financial Institutions Regulation Department."

[4] Circular No: 07/2081-82 (2024-25), April 5, 2025.

promotion aboard, payment for digital services, and related services by residents and nonresidents are governed by Unified Circular 7. Unified Circular 11 regulates payments for the import of services by Nepalese firms through agreements with foreign service providers. Unified circulars also cover transactions of remittance companies, money changers, hotels, trekking, and travel businesses. They outline NRB arrangements of Indian Rupees (INR) oil payments, FX transactions by commercial banks (including rates, spreads, and publications), gold and silver imports, ACU settlements, FX derivatives and net open position limits, repatriation, and convertible foreign currency account operating rules.

D. Foreign Exchange Transactions and Related Regulations

The Nepal Rastra Bank Act, 2002 defines foreign exchange transactions as "the act of purchase and sale of foreign exchange or the act of borrowing, giving credits, and of accepting or providing foreign exchange in any manner whatsoever, and this expression also includes the act of granting approval for foreign exchange by the Bank".[5]

According to the Foreign Exchange (Regulation) Act, 1962, any person or institution must obtain licenses from NRB to conduct foreign exchange transactions and NRB is the sole authority to issue license under the NRB Act, 2002 or any other prevailing laws to the persons willing to deal in foreign exchange transactions.[6] The Foreign Exchange Management Department of NRB issues license for conducting foreign exchange transactions in Nepal.

(1) Current Account Transactions

Unified Circular 1 is the main provision regulating importation of goods. For payment for importation of goods, FX is provided by BFIs without limitation based on the bona fide verification of documents. Payments for the importation of goods are made primarily

[5] Nepal Rastra Bank Act, 2002, Section 2.

[6] Foreign Exchange (Regulation) Act, 1962, Section 4.

by means of Letter of Credit (L/C), Documents Against Payment (DAP) and Documents Against Acceptance (DAA) and Draft/Telegraphic transfer (TT). Unified Circular 5 covers the export of goods.

There are various provisions setting the amount of FX to be provided by BFIs for payments for import of services across the Unified Circular. For instance, the payments for importation of travel, tourism, promotion aboard, payment for digital services, and related services by residents and nonresidents are governed by Unified Circular 7. Similarly, Unified Circular 11 regulates payments for the import of services by Nepalese firms through agreements with foreign service providers. Limitations on the amount of FX available for service imports are not only based on the type of transactions but also whether the transactions are in Indian rupee (with India) or in convertible currencies (with third countries). The limitations on the amount of FX to be provided by BFIs for service transactions are indicative in nature. Requests for FX beyond the specified limits require the NRB's approval and are granted based on the bona fide verification of documents. However, certain types of payments for services are governed under other legal instruments such as the *Foreign Investment and Technology Transfer Act, 2019,* and the *Foreign Investment and Technology Transfer Rules, 2020,* and there are hard limits on such payments.

Customers must submit the standard list of documents as per their purpose of exchanging foreign exchange from BFIs. The standard checklist of documents varies for different purposes. For example, documents required for major transaction types are briefed here:

(a) Trade in goods and services

There is no limit on the use and transfer of foreign currency for import of goods and prior authorization of NRB is not necessary to make payments or transfers for current international transactions of goods. However, for the imports of services (intangibles), prior approval of NRB is required for amount exceeding USD 50,000 or equivalent.[7]

[7] Circular 11/2081 of Unified Circular 2081 B.S. (2024/25) issued by NRB.

(b) Travel

On individual level, foreign currency exchange is available under the passport facility for Nepalese Citizens. Nepalese citizens traveling abroad can exchange foreign currencies up to the given facility as per the circulars issued by Nepal Rastra Bank. Currently, the limit for travel expenses is USD 3,000 at a time.[8]

(c) Education

Students pursuing higher studies abroad may access the foreign exchange facilities from NRB as well as Class A (commercial) and Class B (development) banks upon submission of required supporting documents. The facility is provided to cover tuition fees, living expenses and accommodation.[9]

(d) Remittance

Remittance is the major source of foreign exchange earning in Nepal. The foreign currencies sent by Nepalese workers living abroad are collected by the remittance companies. These companies sell the foreign currencies to the commercial bank, and these banks sell those reserves to Nepal Rastra Bank, which accumulates and manages foreign exchange reserves of the nation.

(2) Capital and Financial Account Transactions

(a) Foreign Direct Investment (FDI) Inflows

Nepal has adopted a regulated regime for capital account transactions. Inflows are liberalized in the form of foreign investment and foreign loans while other inflows remain restricted. Additionally, all capital outflows are restricted except for that by Information Technology Industries and investments by means of technology transfer.

The *Foreign Investment and Technology Transfer Act*, 2019 positions that a foreign

[8] Circular 7/2081 of Unified Circular 2081 B.S. (2024/25) issued by NRB.

[9] Circular 8/2081 of Unified Circular 2081 B.S. (2024/25) issued by NRB.

investor may make foreign investment in any industry and derive gains from such investment.[10] A foreign investment can be made in the following forms as defined by the act.

a. Foreign investment can be made individually or jointly, or by setting up an industry jointly with an industry established in Nepal.
b. By acquisition of properties in any Nepalese industry or acquisition of shares up to 100% in such industries
c. Lease investment, through lease of aircraft, shipping line, machinery, construction equipment and others.
d. Through technology transfer made under an agreement between an industry and a foreign investor
e. By establishing a branch in Nepal
f. By establishing venture capital fund, registering on the Securities Board for trading in securities
g. By re-investing the profits earned by an industry with foreign investment

Foreign investment approval Nepal, is managed by the Department of Industry (DOI) or Investment Board Nepal (IBN), depending on project size. Projects costing NPR 6 billion or more require IBN approval, while those below this amount are overseen by DOI. For non-industries, approval is provided by sectoral regulatory agencies such as Nepal Insurance Authority.

Three other key features characterize foreign investment in Nepal. First, in line with Nepal's liberal policy on inflow of foreign investment, there is no prescribed maximum limit on investment. However, minimum investment thresholds apply in certain cases, such as NPR 20 million, with exceptions for IT sector investments under the automatic

[10] Foreign Investment and Technology Transfer Act, 2019, Section 3.

route.[11] Second, the definition of foreign investment includes technology transfer (but currently does not include foreign loans). Third, not all sectors are open to foreign investment. The areas which are closed to foreign investment in Nepal are spelt out in the schedule of *Foreign Investment and Technology Transfer Act (FITTA), 2019* and includes sectors such as micro, cottage, & small industries, retail, courier and catering business, real estate business, agriculture, personal care services, and tourism-related services etc.

Foreign investors are allowed repatriate 100% of profits and investment amount from Nepal in the same currency in which foreign investment has been made or other convertible currency with the approval of NRB. A foreign investor can repatriate the proceedings after paying tax liabilities under the prevailing laws.

(b) Foreign Loans

Foreign loans accepted by domestic individuals and entities fall under the domain for NRB. In this regard, the NRB has issued NRB Foreign Investment and Foreign Loan Management Bylaw, 2021. Section 7 of the bylaw stipulates that Nepali individuals and institutions should take prior approval from NRB for availing loan from outside Nepal, except as exempted by prevailing laws. The bylaw also outlines the provisions relating to foreign loans, addressing the eligible borrowers and foreign lenders, the applicable terms and conditions of foreign loan and the authority responsible for the approval of loan.[12]

(c) Portfolio Investments and Investments by NRN

Portfolio Investments by non-residents are not allowed. It is limited to PEVC space only. Even, NRNs must formulate a separate investment fund to invest in Nepalese capital markets. Though, NRNs can maintain deposits at Nepalese banks in FCYs. NRNs enjoy the same privileges as non-resident foreigners and can repatriate 100% of profits and investments in foreign currencies.

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[11] Nepal Gazette, November 14, 2022

[12] Schedule 10 of FIFL Bylaw, 2078 (including fourth amendment)

(d) FDI outflow

While foreign investment and foreign loans in foreign currency are allowed, outward investments by residents of Nepal were fully restricted until now. However, a recent amendment to the *Foreign Exchange (Regulation) Act, 1962* has allowed industries that are classified under Information Technology Sectors to invest abroad with certain conditions. Outward investments are allowed up to the lowest amount of *(a)* up to 50% of the three-year average foreign currency earnings from IT exports abroad, or *(b)* USD 1 million (or equivalent amount), with investment not exceeding firm's paid-up capital. This reflects that Nepal is adopting a measured and gradual approach to capital account liberalization.

4. Consensus on movement toward a fully open capital account

This section traces Nepal's policy journey and institutional deliberations on capital account liberalization over the past four decades. It reviews key economic reform programs, periodic plans, and major studies commissioned by Nepal Rastra Bank (NRB) and the International Monetary Fund (IMF), alongside parallel developments in India and internationally. The discussion highlights how the idea of capital account convertibility has repeatedly surfaced in Nepal's policy discourse—often delayed by political instability or external crises but consistently recognized as an eventual policy objective. By mapping these milestones chronologically, the section establishes that there is a broad, long-standing consensus in Nepal on moving gradually toward a fully open capital account, subject to appropriate preconditions and safeguards.

Nepal Rastra Bank has repeatedly conducted few studies on the exchange rate regime and capital account liberalization, both internally and through the International Monetary Fund (IMF).

A. Early Reform Initiatives

Nepal adopted its first major economic reform program in 1985 when it faced an

economic crisis triggered by unprecedented budget and current account deficits. This reform led to the adoption of full convertibility of current accounts in 1994. Among other things, economic liberalization also came with a cost in the form of widening trade and current account deficits in the early 1990s. Against this backdrop, NRB commissioned two studies in 1994, titled *"Balance of Payments Situation with India: A Medium-Term Proposal for its Correction"* and *"Capital Account Convertibility in Nepal: A Feasibility Study"*. These studies were conducted for NRB by the Institute for Sustainable Development.

The objective of the first study was to analyze the BOP problem with India, resulting from the huge trade deficit. The study recommended expanding the domestic supply and reducing imports from India through import-demand compression and selective import-substitution.

The second study aimed at gradually opening the capital account and reforming the exchange rate system to align it with an open capital account. It concluded that capital controls were ineffective and that capital account liberalization was in the country's interest. It also suggested the need for more competition, global intermediaries, and specialized services in the financial sector as foundations for a liberalized capital regime. The report recommended that capital account convertibility should be implemented in a phased manner after the prerequisites have been fulfilled. Additionally, the study prescribed that the exchange rate system be changed only during times of severe balance of payments crisis, and hence no reforms were initiated at the time.

The Maoist insurgency beginning in 1996 with an armed rebellion in Nepal, and the Asian Financial Crisis of 1997, ceased the implementation of these reports and the objectives did not materialize as planned.

The Ninth Plan (1997/98-2001/02) came just after Nepal made its current account fully convertible in 1994. This reform was seen as a step toward building the necessary infrastructure for future capital account convertibility. Against this backdrop, the Ninth Plan adopted the long-term concept of making the Nepalese currency fully convertible in capital account transactions gradually. The Ninth plan also aimed to gradually liberalize

the foreign exchange system, considering the importance of a flexible exchange rate for the economy. Furthermore, it emphasized building the necessary infrastructure toward full capital account convertibility, with gradual liberalization in areas that had adequate capacity.

In 1999, NRB commissioned another study on the capital account convertibility to facilitate the implementation of the Ninth plan, titled *"Implementation of Full Convertibility of the Nepalese Rupee in the Capital Account"*. This study, conducted by the Institute for Policy Research and Development (IPRAD), suggested that macroeconomic, financial, and exchange rate policies needed to be in place to sustain convertibility before moving toward an open capital account regime. The preconditions identified included fiscal deficit reduction, current account stability, low inflation, enhanced efficiency of financial institutions, improved monitoring and supervision, and legal reforms enabling capital flows.

The report explicitly suggested Nepal to begin liberalizing the capital account from 2002 and complete the transition within three years. Moreover, it emphasized liberalizing outflows and inflows in a balanced manner so that pressure on the exchange rate and money supply could be minimized. A gradual reform strategy was advised, beginning with removing controls on FDI and eventually allowing short-term capital flows with limits. The report also highlighted the need to gradually adopt a market-determined flexible exchange rate regime by adjusting the rate in small margins to make the open capital account sustainable.

B. Dawn of the Millennium: Periodic Plans and Policy Directions

The Eleventh Plan focused on evaluating the consequences of India's transition towards CAC for Nepal's foreign exchange management and economic stability and identify necessary measures for implementation. The Global Financial Crisis (GFC) of 2007-2008 slowed India's transition towards full CAC and provided Nepal with ample time to respond to developments in India.

The Thirteenth Plan (2013–2016) aimed to materialize liberalization policies and

significantly attract foreign capital inflows. To achieve this objective, the plan focused on making the capital account convertible across various economic sectors. In 2013, the IMF undertook a study aligned with the thirteenth plan titled *"Nepal Capital Account Liberalization: Options and Considerations"*. The study outlined prerequisites such as strengthening the financial sector, transitioning the exchange rate regime toward a market-based system, improving monetary policy implementation, adopting an inflation-targeting framework, strengthening the legal framework for Emergency Lending Assistance (ELA), improving the business environment, and developing hedging and derivatives markets in the financial sector. The report stressed that capital account reform should be completed in phases, only after these preconditions have been successfully implemented.

The Fifteenth Plan (2019/20–2023/24) revisited the long-ignored agenda of opening the capital account. It set two goals: first, the timely review of foreign exchange policy; second, the gradual and selective introduction of capital account convertibility, depending on feasibility and appropriateness, to attract sufficient foreign investment while also gradually opening outward investment for the country's benefit. Gradual conversion of the capital account was regarded as a much-needed economic policy reform in the Fifteenth Plan. Following its release, the National Planning Commission (NPC) commissioned a study by Nara B. Thapa (2019) on adopting a flexible exchange rate regime. While the focus was on transitioning to a market-determined exchange rate system, the study also explored implications for capital account convertibility and the monetary framework. The study recommended reforms in three phases:

- **Phase I:** Making necessary legal and regulatory amendments to enable integration of the domestic financial sector with the global system and gradually opening the capital account. Political consensus and a transitional exchange rate regime would also need to be decided, along with sequencing the order of capital account openness.
- **Phase II:** Carrying forward gradual opening of the capital account. One of three transitional exchange rate systems—currency basket, crawling peg, or exchange rate corridor—should be selected and implemented as an alternative to the existing regime.

- **Phase III:** Abolishing the existing exchange rate system and adopting a fully market-based floating exchange rate system. At this stage, an inflation-targeting monetary policy framework should be implemented.

The Sixteenth Plan (2024/25–2028/29) focuses on strengthening the foreign exchange system. It aims to review the exchange rate system of the Nepali currency based on need and suitability, establish institutional arrangements for hedging to manage exchange risk, and review the exchange rate periodically considering reserve management considerations. The plan seems relevant given Nepal's experience of a negative Balance of Payments (BOP) shock in 2021/22. However, the plan remains short of aiming towards capital account liberalization.

C. Recent Policy Breakthroughs

Until 2025, the Act Restricting Investment Abroad (Foreign Investment Prohibition Act), 1964, prohibited Nepali individuals (whether residing in Nepal or abroad) and entities established in Nepal from making any form of investment abroad.[13] While the Act empowered the Government of Nepal to exempt certain types of investment through notices in the Nepal Gazette, no such exemptions had ever been provided. This restriction prevented Nepali firms from investing abroad, and investments made by non-resident Nepalis remained outside the legal framework.

This changed on 13 January 2025, when the Government of Nepal introduced the *"Ordinance made to amend some Nepal Acts related to Financial and Corporate Environment Reform and Improvement"*. The ordinance, later promulgated as an Act on 31 March 2025, made landmark provisions to allow outward investment. Key changes included:

- Amendment to Section 2 of the *Foreign Exchange (Regulation) Act, 1962*, introducing the first legal definition of "Investment abroad" in Nepal.

[13] Section 3 (1) of the Act Restricting Investment Abroad, 1964.

- Recognition of outward investment in various forms, such as *(i)* investment in shares of limited liability partnerships (LLPs), firms, investment funds, or unlisted companies incorporated abroad; *(ii)* investment in shares of listed firms up to twenty percent of their total capital; *(iii)* investment made to open a branch office abroad; *(iv)* amounts deposited in a bank account abroad; and *(v)* reinvestments of income received from investment abroad.
- Addition of Section 10A "Regulation of Investment Abroad", explicitly allowing outward investment in *(i)* industries exempted by the Government of Nepal (GON) from restrictions on investment abroad, *(ii)* industries classified as information technology industries under the prevailing law, *(iii)* income earned by a Nepali citizen during his stay abroad, and *(iv)* amounts of foreign exchange received from technology transfer abroad.

Prior to the ordinance, Nepalese firms were not allowed to invest abroad in any form. Likewise, investments made by Nepali workers and students abroad were considered illegal. The ordinance legalized outward investment made in the form of technology transfer abroad, opened abroad investments for IT firms, and recognized investments made from money earned abroad. Furthermore, non-residents' investments in bank deposits or other assets are now recognized as foreign investment.

NRB was tasked with determining sectoral limits and provisions for outward investment by publishing public notice. Through amendments to its *Foreign Investment and Foreign Loan Management Bylaws, 2021*, NRB made provisions for foreign investment. Limits were capped at the firm's paid-up capital and the lower of 50% of average foreign currency earnings over three years or USD 1 million. Firms were also required to submit audited (or unaudited, in some cases) financial reports within six months of fiscal year-end. These reforms opened an era of capital outflows and thereby capital account openness.

D. High Level Economic Reforms Advisory Commission, 2025

To kickstart another wave of economic reforms and counter policy-induced slowdown,

the Government of Nepal formed the High-Level Economic Reform Advisory Commission (2025), led by Rameshwor Khanal (former Finance Secretary). The commission recommended among others:

- Reviewing Nepal's exchange rate policy, including conducting discussions, research, and preparations regarding adoption of a flexible exchange rate system.
- Preventing exchange rate misalignments, particularly overvaluation.
- Preparing for the gradual opening of the capital account.
- Allowing Nepali citizens and firms to invest abroad.
- Replacing the *Foreign Investment Prohibition Act, 1964* with a new Foreign Investment Regulation Act, specifying the areas of investment abroad, investment limits, approval methods, and regulation methods.

In addition to the information technology (IT) sector already open for investment abroad, the commission specifically proposed that firms engaged in exports of goods and services and tourism (hotels, restaurants, and related services) be allowed to invest abroad for strategic benefits such as accessing global networks, acquiring new technologies, sourcing raw materials, and enhancing competitiveness.

The Government approved the Commission's report and adopted a three-year Economic Reform Implementation Action Plan, covering 408 detailed reform points based on commission's recommendations to address structural and economic challenges.

To summarize, taking stock of developments over four decades gives some important messages. First, capital account openness and the adoption of a market-based exchange rate system have been a recurring theme in periodic plans during this period. Second, Nepal has consistently taken initiatives for studying external sector and exchange rate reforms. Lastly, the discussions above make a compelling case to argue that there exists a consensus among policymakers that capital account liberalization is an inevitable policy reform. With recent developments, Nepal has already embarked on that path.

5. Gap Identification and Way Forward for Nepal

The openness of the capital account should be understood in the context of Nepal's broader journey of policy reforms. In the 1990s, Nepal implemented reforms in liberalization, privatization, and globalization. These initiatives stimulated growth in banking, aviation, telecommunications, and tourism, and significantly increased the role of the private sector. Such reforms modernized the Nepali economy and paved the way for its present stage of development.

Nepal now stands at a crossroads, facing the need for second-generation reforms. The question is whether to continue with a closed capital account regime or to move towards capital account liberalization while aligning exchange rate and monetary policies accordingly. As argued in the previous section, capital account liberalization is an inevitable policy reform. This section identifies the gaps that need to be addressed before Nepal embarks on the path of opening its capital account.

A. Examining Economic Relevance

As India and other South Asian countries advance towards greater capital account openness, Nepal cannot remain isolated. Capital account reform is essential for Nepal's next wave of economic liberalization. Capital controls turn progressively ineffective, costly, and even distortive. Also, early reform—and reform when there is no crisis—provides the leisure to implement reforms in a phased and gradual manner, rather than adopting a sudden "big bang" approach, which can have severe economic costs.

Only relying on theory and other countries' practices is not enough. Identifying and examining what benefits an open capital account provides for the Nepalese economy is an ideal starting point. An economy-wide assessment program would also help policymakers build consensus among stakeholders and reduce reluctance of the public.

B. Identify Preconditions

Experts argue that the transition to CAC must be underpinned by strong economic fundamentals as these serve as safeguards against instability and dramatic shifts in macroeconomic policies. Key preconditions discussed in the literature include fiscal consolidation, a strengthened financial sector, and stable macroeconomic indicators.

Fiscal consolidation requires limiting the fiscal deficit, maintaining sustainable public debt, and preventing the central bank from participating in the primary issuance of public debt. At the same time, strengthening the financial sector requires fully deregulated interest rates, low levels of non-performing assets (NPAs), improved risk management, operational freedom of banks within the framework of prudential norms, and effective board oversight. Equally important is the maintenance of sound macroeconomic indicators, including low inflation, a stable balance of payments, and adequate foreign exchange reserves. In particular, the current account deficit (CAD) must remain at a level that can be sustained without external constraints.

Identifying and assessing these preconditions in the context of Nepal's economy and highlighting where gaps remain, and what reforms are needed will provide policymakers with a clear roadmap.

C. Deciding on Exchange Rate and Monetary Policy After CAC

An important coexistence in the process of CAC is the conduct of an appropriate exchange rate and monetary policy. A gap exists here in the form of preparing for the adoption of flexible exchange rate that is consistent with an open capital account.

Nepal may need to adopt a transitional exchange rate system while gradually reforming the capital account. Three options exist for transitional exchange rate systems. The first option is an exchange rate system based on a basket of currencies. A second option could be a crawling peg, which can be adjusted periodically according to currency misalignment or the price differential between domestic and foreign countries. A third transitional exchange rate option could be the announcement of a target exchange rate, i.e., a

horizontal band with a margin of plus or minus 2/3 percent. Choosing the best of the three and deciding on the length of the transition period is important before the CAC process is started.

Preparations should also be made to end the transitional exchange rate system and adopt an open-market-based floating exchange rate system that is compatible with a liberal economy and effective at allocation of resources. The monetary policy framework will also have to be decided to be compatible to sustain the capital account openness.

D. Legal Reforms

Apart from technical issues, capital account openness is also a political and psychological matter that requires national consensus, as it is linked to objectives such as achieving economic efficiency, promoting public welfare, and averting potential BOP crises. National consensus must therefore be sought in preparing the necessary legislative reforms.

The foreign exchange laws currently in force in Nepal were formulated almost 60 years ago. These acts were framed against the backdrop of controlling economic activity, which is not compatible with a liberalized capital account. Likewise, laws related to the economic sector need to be amended and updated. For instance, the Foreign Exchange Regulation Act, 1974 and the Foreign Investment Restriction Act, 1976 may be cited. Political consensus should be sought while amending and drafting such laws. Without coordination with the government and strong political will, CAC-related reforms will not be feasible.

E. Ensuring Institutional Readiness

CAC requires a well-functioning financial system, which can only be ensured when an effective supervisory regime is in place. A strong financial system is one in which capital adequacy standards and Basel norms are stringently enforced based on risk profiles. In such a system, weak entities are monitored more closely and frequently, supervisors can

detect early warning signals, and macroprudential as well as capital flow management measures are applied. To perform these functions effectively, the capacity of banking and capital market regulators—as well as the AML/CFT authority, tax authority, and related institutions—must be strengthened.

In addition to institutional strengthening, managing foreign exchange (FX) intervention in an open capital regime may pose significant challenges due to volatile capital flows. Non-intervention can result in currency appreciation unrelated to fundamentals, while intervention without sterilization may risk fueling inflation and asset bubbles. Sterilized intervention, on the other hand, may tighten interest rates and attract further inflows. Moreover, an asymmetry exists: appreciation can be resisted using domestic currency, but defending against depreciation is constrained by limited foreign reserves. Therefore, a clear intervention plan—highlighting capacity gaps, strategy, and preparedness for handling volatile capital flows—needs to be developed in advance.

Furthermore, the nature and volume of FX transactions will increase significantly under CAC. Thus, liberalizing the FX transaction regime, introducing more market participants such as FX brokers, dealers and transacting parties, strengthening their risk management capacity, and improving reporting requirements and data collection for FX transaction monitoring and balance of payments (BOP) statistics are essential.

F. Opening the Capital Account Sequentially

The opening of the capital account should be pursued sequentially—across sectors, institutions, and instruments. Alongside further liberalization of capital inflows, it is desirable to simultaneously ease controls on outflows, as this can serve as a counterbalance to inflows and help manage associated pressures. Restrictions on inflows and related outflows by nonresidents and residents are typically removed first, followed by the gradual relaxation of restrictions on outflows by residents. Among residents, corporates and non-bank institutions receive preferential treatment, followed by banks and, subsequently, individuals. During the transition to capital account convertibility

(CAC), most countries also kept certain controls on capital flows.

India implemented a sequenced strategy that included steps such as enabling corporate outward investment, relaxing restrictions on external borrowing, permitting exporters to retain foreign currency earnings, liberalizing portfolio flows, allowing banks and financial institutions to enter overseas markets, and gradually broadening participation in forward, futures, and money markets. In contrast, Nepal's current policies differ and show areas yet to be strengthened. Therefore, key gaps exist in the form of deciding upon timing and sequencing of capital account opening.

G. Implement Effective Risk Monitoring and Mitigation Measures

Capital flows may cause exchange rate misalignments relative to underlying economic fundamentals. At times, exchange rates overshoot in either direction in response to macroeconomic events that do not warrant such movements. As learned from the past, capital account convertibility (CAC) may lead to inflows of hot money, posing risks to macroeconomic stability. To mitigate these risks, capital flow measures (CFMs), macroprudential policy tools, and tax and fiscal policy tools need to be studied. Hot money flows can fuel asset bubbles, and sudden reversals of capital flows may create macroeconomic crises and risks to balance of payments (BOP) stability. To counteract these risks, macroeconomic policies are often accompanied by prudential measures and CFMs. Intervening in the FX market is also used if international reserves permit.

To manage these risks effectively in an open capital regime, monitoring information on diverse types of capital flows is of paramount importance. In this context, Nepal would have to revamp its statistical information system and improve its data management practices. All FX transactions for current and capital account purposes should be recorded in a central database accessible to NRB and other authorities. Moreover, to ensure tax compliance, Nepal would have to negotiate Double Taxation Avoidance Agreements (DTAAs) and Bilateral Investment Promotion and Protection Agreements (BIPAs) with other countries. Additionally, arrangements with other countries to share tax information

on a mutual basis would also be welcomed. These preparations remain a challenge.

H. Conclusion

It can be believed that the change in the foreign exchange rate system along with the capital account reform will improve the country's economic growth, expand the competitiveness of the economy, help in bringing efficiency in the allocation of resources, and help in increasing the efficiency of the financial sector. However, moving towards CAC is not devoid of challenges as significant gaps in institutional and legal framework, regulatory capacity, prudent planning, and oversight during transition process remain in Nepal’s journey toward capital account convertibility (CAC).

IV. Overview of Foreign Exchange Liberalization

1. Key Definitions

A. Foreign Exchange Liberalization (FX Liberalization)

Foreign exchange liberalization is the process of removing restrictions on foreign exchange transactions, enabling both residents and non-residents to freely convert domestic currency into foreign currency and vice versa. This approach allows market forces to dictate exchange rates and facilitates the easing of controls on capital and current account transactions, thereby strengthening integration with the international financial system and enhancing the real economy.

From an academic perspective, foreign exchange liberalization is considered a vital measure for improving market efficiency. Kapur (1983) defines this process as a means of minimizing government intervention and supporting a market-driven exchange rate determination mechanism. In this regard, foreign exchange liberalization transcends simple deregulation; it constitutes a structural reform that enhances the overall efficiency of the financial system.

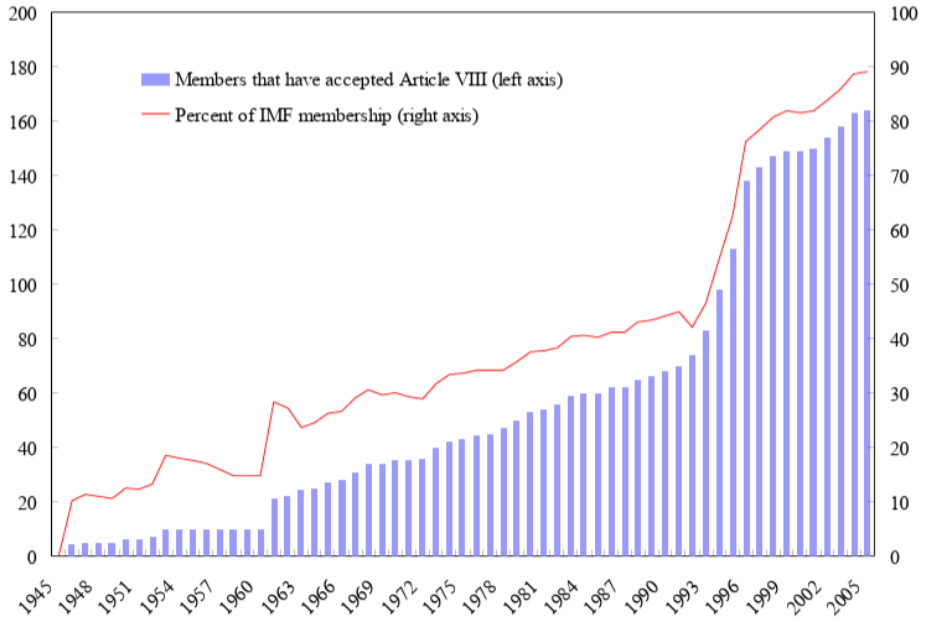
From a policy and operational standpoint, the International Monetary Fund (IMF) defines foreign exchange liberalization as the elimination of all restrictions on foreign exchange transactions, allowing residents and non-residents to exchange currencies freely at market-determined rates. Additionally, the IMF highlights the importance of accepting Article VIII obligations and abolishing multiple currency practices (MCPs) as key prerequisites for achieving full foreign exchange liberalization (IMF, 2006). This underscores the necessity of not only permitting free exchanges but also establishing an institutional framework that adheres to international standards.

Furthermore, foreign exchange liberalization carries significant political and economic implications beyond technical exchange rate policies. It enhances a country's credibility on the global stage and fosters integration with international capital markets. For

emerging economies that are heavily reliant on trade, foreign exchange liberalization is often considered an essential aspect of a comprehensive long-term growth strategy.

<Figure 4-1>

Number of countries that have accepted the provisions of IMF Article VIII (1945-2005)



Source: IMF (2006). Article VIII Acceptance by IMF Members.

B. Current Account and Capital Account

The current account is a key component of the balance of payments and serves as a representative indicator of a country's real economic performance. It comprises the trade balance (exports and imports of goods), the services balance, primary income (interest and dividends), and secondary income (such as remittances).

The capital account records the movement of international capital, encompassing transactions such as foreign direct investment (FDI), portfolio investment, cross-border lending, and derivatives trading. The degree of liberalization of cross-border capital flows is closely linked to financial stability.

C. Capital Account Convertibility

Capital account convertibility refers to the degree of institutional freedom that allows domestic financial assets to be freely exchanged for foreign assets, and vice versa. This can take various forms, ranging from full convertibility—where there are no price or quantitative restrictions—to partial convertibility with certain limitations (IMF, 1995). In particular, capital account liberalization represents a critical stage in achieving complete financial openness. For emerging economies, it entails balancing the risks of potential financial crises with the opportunities to unlock greater growth potential.

2. Motivations for Foreign Exchange Liberalization

A. Price Efficiency

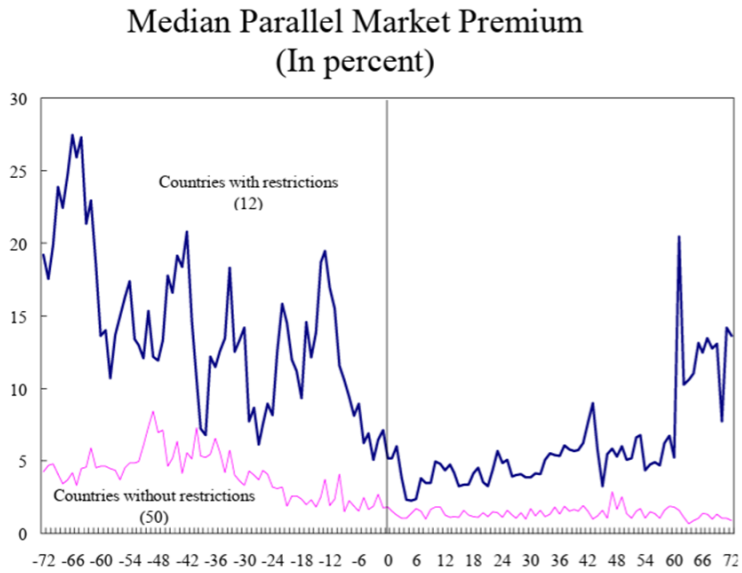
Liberalization plays a critical role in enhancing the price discovery function of foreign exchange and capital markets. It facilitates more efficient capital allocation, thereby enabling investors to make more informed decisions while concurrently reducing the cost of capital for both corporations and governments.

In 2006, the International Monetary Fund (IMF) conducted an empirical assessment of countries that embraced the obligations outlined in Article VIII, which relates to foreign exchange liberalization. The findings showcased compelling evidence that such liberalization significantly improves price efficiency.

Notably, countries that adopted the Article VIII obligations witnessed a substantial decline in black market exchange rate premiums when compared to those that had not yet implemented these liberalization measures, all without experiencing a surge in inflation. Moreover, the spreads on sovereign bonds relative to the United States remained significantly lower. It is also important to highlight that, following the acceptance of Article VIII obligations, foreign exchange reserves exhibited a marked upward trend.

<Figure 4-2>

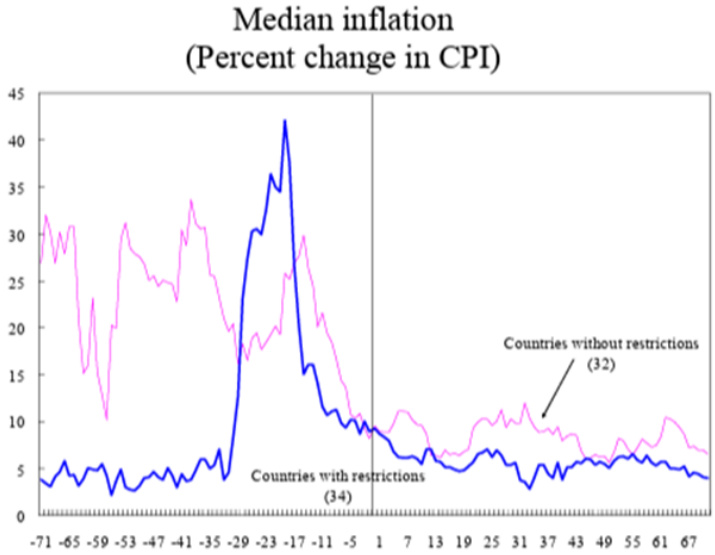
Comparison of Foreign Exchange Black Market Premiums Before and After Accepting IMF Article VIII Provisions (1995-2005)



Source: IMF (2006). Article VIII Acceptance by IMF Members.

<Figure 4-3>

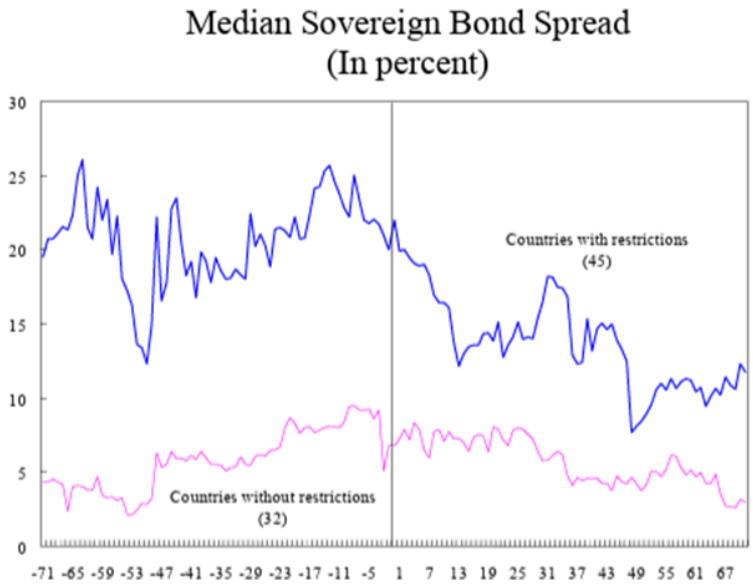
Comparison of inflation before and after the adoption of IMF Article VIII provisions (1995-2005)



Source: IMF (2006). Article VIII Acceptance by IMF Members.

<Figure 4-4>

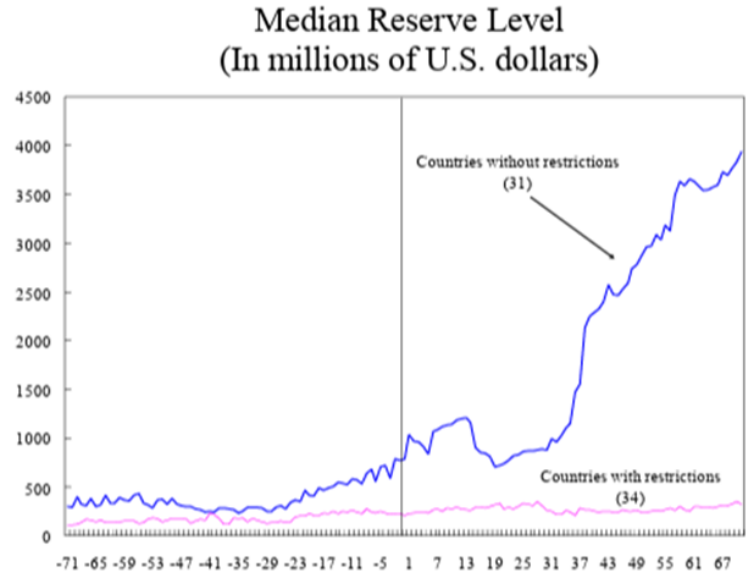
Comparison of Treasury spreads relative to the US before and after the adoption of IMF Article VIII obligations (1995-2005)



Source: IMF (2006). Article VIII Acceptance by IMF Members.

<Figure 4-5>

Comparison of foreign exchange reserves before and after the adoption of IMF Article VIII provisions (1995-2005)



Source: IMF (2006). Article VIII Acceptance by IMF Members.

B. Contribution to Real Economic Growth

Foreign exchange liberalization facilitates capital inflows, which enhances domestic investment and productivity. In the long term, it contributes to real economic growth by enabling technology transfer, modernizing the financial system, and increasing integration into global value chains (GVCs).

Edwards (1984) theoretically argued that foreign exchange liberalization and trade liberalization are complementary processes that jointly promote long-term economic growth. He emphasized that the liberalization of the current account should precede capital account liberalization, noting that expanding trade strengthens the foundations of the real economy, which in turn provides the resilience needed to absorb potential shocks from the financial sector. In practice, many emerging economies have first liberalized their current accounts as an initial step, followed by gradually opening up their capital accounts.

Quinn and Toyoda (2008), using long-term data from 1955 to 2004, provided empirical evidence that both current account and capital account liberalization have strong positive effects, not only in advanced economies but also in emerging markets. Their findings highlight that liberalization is beneficial not just for a select group of countries but can serve as a broadly applicable driver of growth under adequate institutional and political conditions.

Bekaert, Harvey, and Lundblad (2005) quantified the effects of financial liberalization, revealing that equity market liberalization increased annual real GDP growth by about one percentage point across a sample of 95 countries. This indicates that the opening of capital markets contributes not only to larger capital inflows but also to improved capital allocation efficiency and enhanced productivity through investment diversification.

Henry (2000) documented an "investment boom" following stock market liberalization, with private investment rising by an average of 22 percentage points. This provides concrete evidence that foreign exchange and capital liberalization stimulate corporate

investment activity, thereby supporting real sector growth. However, Henry also noted that capital account liberalization alone does not exhibit a strong direct correlation with investment growth, emphasizing that the benefits of financial liberalization depend on the institutional context and complementary policies.

Foreign exchange liberalization also directly affects the financing environment for firms. Desai, Foley, and Hines (2006), in their analysis of U.S. multinational corporations, discovered that subsidiaries operating in countries with capital controls faced borrowing costs that were 5.25 percentage points higher compared to loans from the same parent firm. This cost differential was equivalent to a 27 percentage point increase in corporate taxation, which weakened incentives for reinvesting retained earnings in host countries. As a result, firms tended to remit dividends to their headquarters rather than reinvest locally, constraining the host economy's growth potential.

In contrast, in countries that liberalized their capital accounts, multinational corporations significantly expanded their local investments. According to Desai et al. (2006), following liberalization, foreign subsidiaries' fixed assets (including land, plants, and equipment) grew 6.9 percent faster annually. This underscores capital account liberalization as a crucial channel for promoting foreign direct investment (FDI), technology transfer, and capital accumulation, thereby enhancing long-term growth potential.

However, the outcomes of foreign exchange and capital liberalization have not always aligned with the intended economic and policy objectives. Chari and Gupta (2008), in their examination of India's 1991 New Industrial Policy, observed that FDI liberalization was not uniformly applied across industries. State-owned enterprises and sectors with entrenched monopolistic power managed to resist foreign entry. This case illustrates that liberalization, rather than uniformly advancing social welfare, can be distorted by vested interests. Therefore, the effectiveness of liberalization heavily depends on the political economy context. To ensure that liberalization enhances overall efficiency, complementary reforms—such as reducing the dominance of state-owned enterprises, fostering market competition, and ensuring institutional transparency—are essential. This

highlights that liberalization policies are influenced not only by economic rationale but also by political and institutional conditions.

C. Others (political, economic, and institutional factors)

FX liberalization is influenced not just by economic factors but also by political motivations. Policy drivers often include the need to fulfill accession requirements for international organizations like the IMF and WTO, the goal of enhancing sovereign creditworthiness, and the aspiration to become a global financial hub.

Chari and Gupta (2008), in their analysis of India's experience, emphasized that the political interests of domestic firms significantly impact both the timing and adoption of foreign investment liberalization policies. Similarly, the IMF (2011) found that governments in emerging markets often choose a gradual and partial approach to liberalization when faced with surges in short-term capital inflows, mainly due to concerns about financial system stability. This cautious approach is closely tied to building institutional credibility and maintaining adequate policy flexibility.

In Nepal's case, the IMF (2024) report highlighted that foreign exchange liberalization and the gradual opening of the capital account are crucial for attracting foreign direct investment (FDI), boosting tourism revenues, and stimulating investments in hydropower projects. These developments illustrate that foreign exchange liberalization offers not only economic advantages but also broader policy significance for developing economies, particularly in facilitating structural transformation.

D. Implications from Climate risk

Climate risk can exert profound effects on Nepal’s economy and significantly weaken its external payment capacity. Climate-related disasters impair productivity and damage infrastructure, thereby constraining export capacity, while simultaneously worsening the current account and fiscal balances through increased reconstruction spending and the

inelastic import demand for essential goods.

Given Nepal's heavy reliance on tourism and agriculture, the economy is inherently highly exposed to climate change and natural disasters. Sharp declines in tourism receipts, reduced agricultural productivity accompanied by rising food prices, and expanded post-disaster reconstruction outlays can interact to generate substantial financial stress. When such shocks coincide with global monetary tightening and heightened risk aversion, higher external borrowing costs and a slowdown in capital inflows can undermine the financing of twin deficits, while eroding the economy's ability to defend its foreign exchange reserves. In particular, Nepal's economic structure—where foreign currency inflows are heavily concentrated in workers' remittances—renders the economy especially vulnerable to compound shocks, which may precipitate foreign exchange liquidity constraints at an early stage and intensify policy trade-offs among exchange rate stability, inflation control, and financial stability.

World Bank (2022) emphasizes that climate change exerts structural downward pressure on Nepal's economic growth, agricultural productivity, labor markets, and external sector, and estimates that, in the absence of adequate policy responses, Nepal's GDP could be approximately 7 percent lower by 2050 relative to the baseline scenario. The World Bank argues that Nepal should integrate climate action with its development objectives through a Green, Resilient, and Inclusive Development (GRID) strategy. However, binding constraints—including limited fiscal space, insufficient private and foreign investment, and underdeveloped financial markets—underscore the importance of public investment prioritization and the effective mobilization of private capital. To this end, the World Bank proposes four priority system transitions: (1) Integrated management of agriculture, water, and forests, including the adoption of climate-smart agriculture, expansion of water storage, and strengthening of community-based forest management; (2) An energy transition centered on hydropower, leveraging export-oriented hydropower development to generate foreign exchange while supporting low-carbon growth; (3) Sustainable urbanization, focusing on improved waste management, green building standards, and enhanced climate resilience of urban infrastructure; and (4)

Low-carbon and climate-resilient connectivity, through strengthening the climate resilience of road infrastructure and decarbonizing the transport sector.

Taken together, for climate-vulnerable economies such as Nepal—where tourism and agriculture play a central role—pursuing capital account liberalization in the absence of robust climate risk management within the financial system, adequate foreign exchange liquidity buffers and macroprudential frameworks, and well-established capital flow management tools for crisis periods, may instead structurally amplify risks to external payment capacity.

3. Capital Flow Managements (CFMs)

A. Risks of Free Capital Mobility

The free movement of capital can promote investment growth and more efficient resource allocation over the long term. However, in the short term, it can increase volatility and pose risks to the stability of the financial system. Historical events, such as the 1997 Asian financial crisis and the 2008 global financial crisis, demonstrate that sudden reversals of short-term speculative capital flows can lead to sharp fluctuations in exchange rates, a depletion of foreign reserves, and significant shocks to the real economy. Macroeconomic shocks: Sudden stops or capital flight can cause abrupt movements in exchange rates, a decline in foreign exchange reserves, and depreciation pressures on the domestic currency, which can heighten the risk of a currency crisis. Financial system vulnerabilities: Speculative attacks, the collapse of asset price bubbles, and maturity mismatches in banks' foreign currency liabilities can transmit shocks, leading to severe financial crises. Political economy risks: The process of liberalization may limit national policy autonomy, creating tensions between domestic financial policies and global economic conditions.

<Table 4-1>

Macroprudential vs Microprudential comparison

	Macroprudential	Microprudential
Short-term goals	Mitigating instability across the financial system	Mitigating instability in individual financial institutions
Ultimate (long-term) goals	Avoiding the social and macroeconomic costs of financial instability	Protecting investors and depositors
Nature of risks	"Endogenous"	"Exogenous"
Correlationships between financial institutions	Important	Irrelevant
Adjustments to soundness regulations	Top-down approach	Bottom-up approach

Source: Borio (2003), Galati & Moessner (2013)

B. Macroprudential Measures

According to Galati and Moessner (2013), macroprudential measures aim to safeguard the stability of the financial system as a whole rather than focusing solely on individual institutions. They serve as essential complementary tools to price-based and quantity-based capital flow measures (CFMs). Drawing on Weitzman's (1974) framework, they highlight the complementarity between price-based instruments, such as taxes, and quantity-based instruments, such as aggregate limits.

Research from the IMF and the BIS indicates that measures like loan-to-value (LTV) and debt-to-income (DTI) ratios, as well as reserve requirements, have proven effective in emerging markets for curbing excessive credit growth and stabilizing capital flows. Moreover, strengthening capital and liquidity regulations has been shown to reduce both the likelihood of financial crises and the economic costs associated with recessions.

<Table 4-2>

Macroprudential Instruments: Example

Category	Examples
Risk Measurement	Banks: Non-procyclical long-term risk measurement Supervisory authorities: Macro-stress testing, systemic vulnerability indicators
Financial Reporting	Less procyclical accounting standards, dynamic loan loss provisions, staggered disclosures
Capital Regulations	Pillar 1: Systemic capital surcharges, capital surcharges for derivatives transactions, and countercyclical risk weighting adjustments Pillar 2: Strengthened supervisory review based on economic conditions
Liquidity Regulations	Liquidity coverage ratio (LCR), net stable funding ratio (NSFR), foreign exchange lending regulations, and currency mismatch limits
Collateral Regulations	Countercyclical LTV ratios, conservative collateral valuation, and through-the-cycle margin calls
Risk Concentration Restrictions	Loan and exposure caps, specific loan rate surcharges, and financial institution breakup mandates
Business Restrictions	Prohibition on proprietary trading by systemically important banks (similar to the Volcker Rule)
Compensation System	Linking performance-based compensation to long-term risk, backloading of compensation payments, and strengthened supervisory enforcement

Insurance Mechanisms	Contingent capital, deposit insurance premiums based on systemic risk, and ex ante risk insurance
Insolvency and Dissolution Management	Stricter during economic booms Intervention criteria, differential supervision according to crisis point

Source: BIS/IMF reports, Galati & Moessner (2013)

C. Price-based CFMs

Price-based CFMs are policy tools designed to increase the cost of cross-border capital movements in order to discourage excessive or speculative short-term inflows. The most common forms of these measures include transaction taxes, such as foreign exchange transaction taxes—often referred to as the "Tobin tax"—and capital inflow taxes that are directly levied on transactions. A practical example is Brazil, which imposed taxes on external borrowing and foreign exchange transactions from 1993 to 1997 to curb short-term capital inflows (Ostry et al., 2011).

Other measures include unremunerated reserve requirements (URRs) on short-term foreign borrowing, which makes short-term debt less attractive, or applying differentiated tax rates based on investment types and maturities. A key advantage of such policies is that they do not completely block capital flows but instead guide the composition and maturity structure of inflows toward greater stability. However, potential challenges include opportunities for tax avoidance and the existence of circumvention channels for international capital movements.

D. Quantity-based CFMs

Quantity-based CFMs function not through price signals but by directly imposing quantitative restrictions on capital movements. Examples of these measures include setting limits on the shareholdings or bond holdings of foreign investors, imposing

aggregate limits on external borrowing, or restricting borrowing to a maximum maturity threshold. A specific case is Thailand, which placed annual limits on commercial external borrowing in 2006 to address a surge in short-term debt.

Another approach involves requiring mandatory reporting or approval for foreign exchange transactions that exceed a certain threshold. While such measures can effectively slow the pace of capital inflows or target specific risks in the short term, overly rigid enforcement could undermine investor confidence and hinder capital market development. For this reason, most emerging economies have tended to use quantitative restrictions as supplementary rather than primary tools of economic policy.

V. Economic Implications and Case Studies of Capital Account Liberalization

Capital account liberalization (CAL), the process of easing restrictions on the cross-border movement of capital, has been a subject of extensive debate among economists and policymakers for the past four decades. Proponents argue that it offers significant economic benefits, drawing parallels to the gains from free trade. However, empirical evidence has often presented a more complex and sometimes contradictory picture, with recurrent financial crises in emerging markets highlighting the substantial risks and vulnerabilities associated with unfettered capital flows.

Particularly under fixed exchange rate regimes, the sequencing, speed, and institutional preparedness of liberalization play a crucial role in determining whether CAL becomes a catalyst for growth or a trigger for crisis. Emerging economies in Asia and Latin America have experienced both trajectories, providing a diverse set of lessons for policymakers.

This chapter focuses on the comparative study of crisis-type and non-crisis-type countries. The former includes Thailand, Korea, Indonesia, Mexico, and Argentina, all of which underwent major financial crises after rapid liberalization. The latter includes Malaysia, China, Vietnam, Cambodia, Bangladesh, Hong Kong, and Bahrain, which either avoided major crises or managed liberalization more cautiously.

The objectives of this chapter are:

- To analyze the **economic implications** of capital account liberalization under fixed exchange rates.
- To review the **theoretical foundations**, including the Impossible Trinity and currency crisis models.
- To conduct **case studies** on selected crisis and non-crisis countries.
- To draw **policy lessons** that are applicable to contemporary emerging markets.
- To approach strategies for establishing a **financial safety net** at domestic, regional, and global levels.

1. Economic Implications

A. Benefits of Capital Account Liberalization

(1) Theoretical Benefits

The theoretical case for capital account liberalization is often rooted in the principles of perfect markets and intertemporal trade. Models of perfect markets suggest that international capital movements benefit both borrowers and lenders, much like free trade in goods benefits trading partners. For capital-poor countries, opening the capital account is expected to facilitate access to global savings at a lower cost than relying solely on domestic savings, thereby increasing investment and temporarily boosting the growth rate of GDP per capita, which in turn permanently raises the country's standard of living. This process is presumed to lead to a more efficient allocation of international capital, as funds flow to their most productive uses globally, and enables domestic economic agents to diversify their investment portfolios.

Beyond these direct effects, capital account liberalization is also theorized to yield significant indirect, or "collateral," benefits. These include fostering financial market development through the introduction of new financing instruments, improved regulations, and technological advances. International capital flows can also act as a catalyst for institutional improvements and better private and public governance, as countries compete for funds by enhancing their domestic business climates and ensuring macroeconomic discipline. The concept of the "golden straitjacket" suggests that the desire to attract and retain foreign capital can incentivize governments to adopt market-friendly policies and strengthen governance, thereby imposing a form of policy discipline. This implies that the indirect benefits related to institutional and policy improvements may be as, if not more, significant and tangible than direct growth effects for many developing countries.

(2) Empirical Evidence on Growth and Investment

Despite strong theoretical arguments, empirical evidence on the direct impact of capital account liberalization on economic growth and investment has been largely inconclusive and often contradictory. Many cross-country studies find few, if any, robust effects of liberalization on real variables. For instance, early empirical analysis by Rodrik[14] found no correlation between capital account openness and a country's investment level or growth rates, suggesting that the benefits, if they exist, are not readily apparent. Eichengreen's (2001) survey of the literature also concluded that evidence for a positive impact on growth is, at best, ambiguous.[15]

However, a critical reading of this literature reveals important nuances. Much of the early empirical work implicitly tested for a permanent impact of capital account openness on long-run growth rates across countries, which is not necessarily what neoclassical theory predicts. The neoclassical model forecasts a *temporary* increase in GDP per capita growth that leads to a *permanent* increase in living standards, rather than a permanent effect on the long-run growth rate itself. Studies employing a "policy-experiment" approach, which examine the effects of opening the capital account within a given country, have consistently found economically large and statistically significant effects on economic growth.

The benefits of liberalization are highly conditional on a country's initial conditions, particularly its level of financial and institutional development. Some research indicates that liberalization boosts growth in high-income countries but may slow it in low-income countries. Furthermore, an "inverted-U shaped relationship" has been observed, where the responsiveness of growth to capital account liberalization is strongest at intermediate levels of institutional quality.

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[14] Dani Rodrik and Arvind Subramanian (2009), "Why Did Financial Globalization Disappoint?"

[15] Barry Eichengreen (2001), "Capital Account Liberalization: What Do Cross-Country Studies Tell Us?"

Countries with very poor institutions may not benefit significantly due to high risks of expropriation, while those with already very good institutions may experience smaller marginal gains from further openness. This suggests that liberalization is not a one-size-fits-all policy but requires a certain baseline of institutional strength to yield positive outcomes.

Regarding investment, the impact is also unclear. Some studies found no discernible effect of capital account openness on the investment-to-GDP ratio. However, positive impacts on investment[16] have been observed when capital account openness is interacted with factors like risk-adjusted returns, suggesting that positive effects occur when liberalization effectively leads to capital inflows.

For emerging market and developing economies (EMDEs), investment growth has been positively associated with output growth and capital-flow-to-GDP ratios. Equity market liberalizations, specifically, have been linked to an annual increase of 1% in economic growth.

(3) Indirect Benefits

The indirect benefits of capital account liberalization, though harder to quantify directly, are increasingly recognized as critical for long-term development. These include the deepening and sophistication of domestic financial markets, improved financial supervision, and enhanced macroeconomic discipline. Foreign investors can act as a catalyst for institutional reforms, pushing for better governance practices and exerting greater monitoring pressure on the private sector to overcome information frictions. This can lead to an improvement in institutions at the country level, as the prospect of capital inflows creates an incentive for policy shifts towards foreign investors' demands for better governance.

The composition of capital flows plays a significant role in realizing these indirect benefits. Foreign Direct Investment (FDI) and equity flows are generally considered more

[16] Peter Blair Henry (2006), “CAPITAL ACCOUNT LIBERALIZATION: THEORY, EVIDENCE, AND SPECULATION”

beneficial than debt flows, particularly short-term debt. FDI, being long-term and often accompanied by technology and management transfers, is more likely to foster genuine institutional and financial sector development compared to volatile short-term portfolio flows, often referred to as "hot money". This suggests that policies should differentiate between types of capital flows, potentially favoring FDI to maximize sustained indirect benefits and minimize associated risks.

B. Risks and Vulnerabilities of Capital Account Liberalization

(1) Theoretical Risks

The theoretical arguments against unfettered capital account liberalization often invoke the "Theory of the Second Best." This theory posits that removing one distortion (e.g., capital controls) does not necessarily enhance welfare if other significant distortions are present in the economy. In developing economies, where market imperfections such as protected import-competing industries or downwardly inflexible real wages are common, capital inflows following liberalization can aggravate existing misallocations of resources. For example, if import-competing industries are still protected, capital might flow to sectors where the country lacks a comparative advantage, leading to "immiserizing effects"[17] and potentially reducing domestic incomes and welfare.

Information asymmetries in financial markets also pose substantial theoretical risks. Financial markets and transactions are inherently prone to such asymmetries, and these problems can be even more severe in international transactions due to greater physical and cultural distance, particularly in developing countries with less advanced capacities to process complex financial information. If financial liberalization proceeds in such an environment, it may not improve welfare and can even reduce it by leading to mispricing

[17] Immiserizing effect or "immiserizing growth" refers to a paradoxical economic situation where economic growth or expansion results in worsening welfare or increased poverty for certain segments of the population, especially the poor. Despite overall economic growth, the condition of some groups deteriorates, making them worse off than before growth occurred.

of risk, herd behavior among investors, and ultimately, financial instability. Weaknesses in the domestic financial sector can further limit authorities' ability to use interest rates to defend the currency, contributing to currency crises and making the economy vulnerable to sudden inflows and sharp reversals of capital flows.

(2) Empirical Evidence on Crises and Volatility

Empirical evidence strongly suggests that capital account liberalization is associated with recurrent emerging-market crises. These crises often manifest as "sudden stops" in capital inflows, leading to large drops in GDP, or as "speculative attacks" on the currency, which can trigger banking crises, especially when maturity mismatches are prevalent.[18]

A surprising finding in some cross-country studies is that capital controls, particularly outflow controls, may heighten currency crisis risk.[19] This seemingly counter-intuitive result is often interpreted as a negative signal to markets, suggesting that authorities are reluctant to commit to stability or willing to compromise investor rights, thereby potentially inciting capital flight. However, a crucial distinction exists between different types of controls: inflow controls have been found to reduce currency crisis risk, suggesting they can be seen as prudential measures, while outflow controls might signal desperation. This indicates that the effectiveness of capital controls is not absolute but depends on their specific type, the context of their implementation, and how they are perceived by markets.

Capital account liberalization also increases a country's exposure to global financial cycles. Emerging market and developing economies (EMDEs) exhibit significantly greater volatility in asset returns, and commonalities in these returns and flows across countries are particularly strong for EMDEs. While some theories suggest that countries can do little to decouple from the global financial cycle, empirical results indicate that

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[18] Calvo, G.A., & Reinhart, C.M. (2000), "When Capital Inflows Come to a Sudden Stop: Consequences and Policy Options"

[19] Barry Eichengreen (2001), "Capital Account Liberalization: What Do Cross-Country Studies Tell Us?"

more stringent capital controls can lead to smaller responses of interest rates and exchange rates to external shocks, such as U.S. monetary policy shocks, particularly for EMDEs.[20] This suggests that capital controls can serve as a buffer, offering a degree of policy autonomy and mitigating volatility transmitted from major economies.

<Table 5-1> Benefits vs Risks/Vulnerabilities

Aspect	Benefits	Risk/Vulnerabilities
Financial Efficiency	Improved capital allocation and investment quality	Exposure to volatile capital flows
Capital Market Depth	Deeper, more liquid capital and foreign exchange markets	Sudden stops and reversals can trigger crises
Currency Stability	Potential lowering of exchange rate volatility (medium-term)	Fixed exchange regime constrains policy flexibility
Macroeconomic Policy	Encourages sound macro policies and structural reforms	Vulnerability to external shocks and speculative attacks
Financial Stability	Strengthened banking sectors via better funding access	Maturity and currency mismatches increase crisis risk
Growth and Development	Facilitates economic growth through foreign investment	Risk of contagion from global financial shocks

(3) Structural Risks of Debt Composition

The composition of capital flows is a critical determinant of a country's vulnerability to crises. Liberalization of debt flows, particularly short-term, dollar-denominated debt flows, has been empirically shown to cause problems. Short-term portfolio capital, often termed "hot money," is highly reversible compared to more stable, long-term foreign direct investments (FDI). When domestic entities borrow heavily in foreign currency for long-term domestic currency investments, they create significant currency and maturity mismatches on their balance sheets. A sudden reversal of flows or a sharp currency depreciation can then lead to widespread insolvencies in the financial and corporate sectors.

[20] Rafael Cezar and Eric Monnet (2023), "Capital controls and foreign reserves against external shocks: Combined or alone?"

Meanwhile, under fixed exchange rate regimes, recent studies have identified crisis amplification risks arising from pecuniary externalities associated with capital account liberalization. Schmitt-Grohé & Uribe (2020) analyze that, under fixed exchange rates, a small shock triggers multiple equilibria switch through collateral constraints, where asset price declines induce individual deleveraging, which expands into an economy-wide deleveraging spiral, thereby amplifying financial crises. In contrast, Davis et al. (2020) argue that during sudden stops, which are abrupt halts in capital inflows, bank asset sales led to collateral price declines, transforming individual deleveraging into a collective deleveraging spiral that accelerates credit crunches and GDP collapse.

Capital controls can play a strategic role in managing the composition of capital inflows. Studies have found that controls can reduce the share of volatile portfolio and short-term capital flows in total inflows while increasing the share of FDI, without necessarily altering the overall volume of capital inflows. This ability to lengthen the maturity structure of foreign obligations can significantly reduce crisis risk. Therefore, targeted capital flow management measures, rather than blanket restrictions, can be a sophisticated tool for macroeconomic stability and development by improving the quality and stability of capital inflows.

2. Theoretical Review

A. The Impossible Trinity (Trilemma)

(1) Core Concept

The Impossible Trinity, also known as the Trilemma, is a fundamental concept in international macroeconomics, originating from the Mundell-Fleming[21] framework. It

[21] The Mundell-Fleming model, developed independently by Robert Mundell (1963) and J. Marcus Fleming (1962), is a foundational framework in international macroeconomics that analyzes how fiscal

states that a country cannot simultaneously achieve all three of the following policy goals: a fixed foreign exchange rate, free capital movement (absence of capital controls), and an independent monetary policy. A country must choose any two of these goals, necessarily sacrificing the third.

The mechanism behind this constraint is straightforward. If a country maintains a fixed exchange rate and allows free capital flows, its monetary policy becomes effectively tied to that of the anchor currency country. For example, if the domestic central bank attempts to set interest rates lower than international rates, investors will sell the low-yielding domestic currency to buy higher-yielding foreign currency, creating depreciation pressure. To defend the fixed exchange rate, the central bank must sell its foreign currency reserves. Since these reserves are finite, this defense is unsustainable in the long run. The only way for a country to maintain both a fixed exchange rate and an independent monetary policy is by preventing arbitrage in the foreign exchange market, which requires instituting capital controls on international transactions. Conversely, if a country desires free capital movement and an independent monetary policy, it must allow its exchange rate to fluctuate freely.

This Trilemma represents an inherent policy constraint, not merely a menu of choices. Attempting to achieve all three goals simultaneously is unsustainable and has historically led to financial crises. The framework dictates that policymakers must explicitly acknowledge and prioritize these objectives, as any attempt to circumvent the trade-off will ultimately prove futile.

(2) Policy Trade-offs

Impossible Trinity hypothesis has been empirically validated through various studies, with Maurice Obstfeld and Alan M. Taylor being instrumental in bringing the term into widespread use and developing methods for its empirical testing. Research using

and monetary policies affect a small open economy's output and exchange rate under different exchange rate regimes.

trilemma indexes[22]" that measure the degree of exchange rate flexibility, monetary independence, and capital account openness consistently confirms that the weighted sum of these three policy variables adds up to a constant, validating the notion of a fundamental trade-off.[23]

Historical observations illustrate how countries have navigated these trade-offs. After the early 1990s, many industrialized countries accelerated financial openness but reduced the extent of their monetary independence while sharply increasing exchange rate stability, a process that culminated with the introduction of the Euro. This demonstrates a clear choice to sacrifice monetary autonomy for financial integration and exchange rate stability.

However, since 2000, there has been a trend towards "managed flexibility," where countries use sizable international reserves as a buffer to retain some degree of monetary autonomy while allowing for some exchange rate flexibility. This suggests that while the theoretical Trilemma presents stark choices, real-world policy often involves managing trade-offs along a continuum, seeking to gain partial autonomy through various tools.

<Table 5-2> Impossible Trinity: Policy Combinations

Fixed Exchange Rate	Free Capital Movement	Independent Monetary Policy	Typical Explanation	Example Countries
Yes	**Yes**	No	Central bank gives up monetary autonomy.	Eurozone, Hong Kong
Yes	No	**Yes**	Capital controls used, monetary independence	China (periodically)
No	**Yes**	**Yes**	Floating exchange rate regime	USA, UK, Canada, Korea

[22] Trilemma indexes quantify the degree of achievement in three mutually incompatible policy goals under the policy trilemma: exchange rate stability, monetary policy independence, and capital account openness. These indexes measure how closely a country attains each dimension, with the sum of the three indexes constrained to a constant reflecting the fundamental trade-off among the policies.

[23] Maurice Obstfeld, Jay C. Shambaugh, and Alan M. Taylor, "The Trilemma in History: Tradeoffs among Exchange Rates, Monetary Policies, and Capital Mobility"

The Trilemma also provides a powerful analytical lens for understanding currency crises. Countries that attempt to maintain a fixed exchange rate and an open capital account often find their monetary policy constrained, making them vulnerable to speculative attacks when underlying economic fundamentals diverge or market confidence erodes. This direct causal link between policy choices and crisis vulnerability underscores the importance of aligning a country's macroeconomic policy mix with the constraints imposed by the Trilemma.

Dani Rodrik, a Harvard economist, has notably advocated for the use of capital controls (the third option) in his book "Globalization Paradox: Why Global Markets, States, and Democracy Can't Coexist" (2011)[24], emphasizing that world GDP grew fastest during the Bretton Woods era when capital controls were widely accepted in mainstream economics. He argues that the expansion of financial globalization and free capital movement are reasons why economic crises have become more frequent. This perspective highlights that capital controls are not inherently detrimental but can be a legitimate policy choice to enable monetary autonomy and exchange rate stability, as historical experience suggests.

B. Currency Crisis Theories

The theory on currency crises has evolved through several generations of models, each attempting to explain different facets of these disruptive events.

(1) First-Generation Models

First-generation currency crisis models, notably developed by Krugman (1979) and Flood and Garber (1984), primarily attribute the collapse of a fixed exchange rate regime to unsustainable fiscal policies. In these models, a government running a persistent

[24] Rodrik argues that there is a fundamental trade-off between globalization, national sovereignty, and democracy—only two of these three goals can be achieved simultaneously. He critiques "hyper-globalization," warning that unrestricted global markets undermine the ability of nation-states to protect their social arrangements and democratic decision-making.

primary deficit is forced to finance it by either depleting foreign reserves or borrowing indefinitely, which is ultimately unsustainable.

Rational speculators, anticipating the eventual exhaustion of foreign reserves, launch a speculative attack by selling domestic currency and buying foreign currency. This attack accelerates the depletion of reserves, forcing the authorities to abandon the fixed exchange rate and allow the currency to float or devalue. The core prediction of these models is that ongoing fiscal deficits, rising debt levels, or falling reserves precede the collapse of the fixed exchange rate regime.

First-generation currency crisis models help explain crises such as the Latin American debt and currency crises of the 1980s, including the 1982 Mexican crisis, as well as the 2001 Argentine crisis. These events were characterized by persistent fiscal deficits and unsustainable government debt in countries with fixed or pegged exchange rate regimes, which ultimately led to the depletion of foreign reserves and forced the abandonment of the exchange rate peg, triggering sharp currency depreciations and financial instability.

(2) Second-Generation Models

Second-generation currency crisis models emerged to address the limitations of their predecessors, particularly their inability to explain crises that were not clearly driven by unsustainable fiscal fundamentals. These models, exemplified by the work of Obstfeld (1994, 1996), introduce the concept of multiple equilibria[25] and emphasize the role of self-fulfilling expectations. In these frameworks, a government facing a fixed exchange rate has an explicit objective function, weighing the benefits of maintaining the peg (e.g., price stability, credibility) against the costs of defending it (e.g., high interest rates, recession). If fundamentals are in an intermediate range − neither strong enough to guarantee the peg's survival nor weak enough to necessitate its collapse − a speculative

[25] Multiple equilibria in second-generation currency crises mean the outcome depends on investor expectations. If investors trust the government will defend the fixed exchange rate, it can be sustained. But if they expect a devaluation, the government may abandon the peg to avoid costly economic impacts, causing the crisis. Thus, investor beliefs can trigger a crisis even without fundamental economic problems.

attack can occur simply because investors *expect* a devaluation. Their collective actions (selling the currency) then make that expectation a reality, pushing the economy into a "bad" equilibrium.

These models suggest that currency crises are not always "justified" by underlying fundamentals but can arise from shifts in investor confidence, herding behavior, or contagion. Contagion, where a currency crisis in one country triggers crises in others with seemingly weak economic links, is a key feature, as investors re-evaluate risks across a region following an initial crisis. This highlights the importance of market psychology and the fragility of intermediate exchange rate regimes, where even small shifts in sentiment can lead to large-scale capital outflows and crisis. This also implies that policy responses during a crisis must address market psychology and expectations, in addition to underlying economic conditions.

Second-generation currency crisis models explain crises as the result of government decisions influenced by self-fulfilling expectations and strategic interactions between investors and policymakers. For instance, the 1992 European Exchange Rate Mechanism (ERM) crisis saw speculative attacks on the British pound due to doubts about the UK government's willingness to maintain the fixed exchange rate amid economic recession and rising interest rates in Germany. Similarly, the 1997 Asian financial crisis involved sudden shifts in investor sentiment and multiple equilibria, where fears of potential devaluations triggered capital flight and currency collapses despite relatively sound economic fundamentals.

(3) Third-Generation Models

The 1997 Asian financial crisis, which defied easy explanation by first- and second-generation models, spurred the development of third-generation currency crisis theories. These models shift the focus from purely macroeconomic imbalances and self-fulfilling expectations to the critical role of the financial sector and the balance sheet effects of devaluations. A central idea is that banks and firms in emerging market countries often have significant currency mismatches on their balance sheets, borrowing heavily in foreign currency (e.g., U.S. dollars) and lending or holding assets in local currency.

When a devaluation occurs, the local currency value of their foreign currency liabilities soars, while their local currency assets do not keep pace, leading to widespread insolvencies and a credit crunch. This problem is exacerbated by maturity mismatches, where short-term foreign currency borrowing is used to finance long-term domestic investments.

The Asian crisis demonstrated that even countries with seemingly sound fiscal positions could be vulnerable if their domestic financial institutions were weak, lacked proper supervision, and were exposed to large, unhedged foreign currency liabilities. The interaction of weak domestic financial institutions with large capital inflows was a key vulnerability. This underscores the critical importance of robust prudential regulation, effective foreign exchange risk management, and careful capital flow management (especially concerning short-term, foreign-currency denominated debt) as preconditions for capital account liberalization. The models suggest that financial liberalization, if not properly sequenced and regulated, can create the very vulnerabilities that lead to severe crises.

<Table 5-3> Comparative Insights of Currency Crisis Models

Model	Mechanism	Representative Cases
First-Generation	Fiscal/monetary inconsistency	Mexico 1994, Argentina 2001
Second-Generation	Multiple equilibria, self-fulfilling attacks	ERM Crisis 1992, Thailand 1997
Third-Generation	Financial-sector weaknesses, balance-sheet effects	Indonesia 1997, Korea 1997

In summary, the Trilemma framework explains the fundamental incompatibility many economies face: fixed exchange rate regimes combined with capital account openness undermine monetary policy autonomy, increasing vulnerability. Currency crisis models reveal the transmission channels through which capital account liberalization triggers systemic breakdowns. Together, these theories emphasize that successful liberalization requires not only macroeconomic discipline but also robust financial institutions and credible policy frameworks.

3. Case Studies

The liberalization of the capital account under a fixed exchange rate regime resulted in divergent outcomes. Some countries experienced severe crises due to premature or improperly sequenced liberalization, while others succeeded in maintaining stability by combining gradual reforms with robust institutional safeguards.

This chapter analyzes cases of capital account liberalization by country, distinguishing between crisis and non-crisis types. The crisis type includes Thailand, Indonesia, South Korea, Mexico, and Argentina. The non-crisis type includes Malaysia, China, Vietnam, Cambodia, Bangladesh, Bahrain, and Hong Kong.

A. Crisis-Type Cases

(1) Thailand (1997 Asian Financial Crisis)

Thailand's experience in the 1997 Asian Financial Crisis, often referred to as the "Tom Yam Kung Crisis[26]," is a seminal case study of the risks of un-sequenced capital account liberalization.

(Capital Account Liberalization Policy)

Thailand underwent significant financial liberalization between 1989 and 1994, which facilitated easy access to foreign capital. Key steps included accepting IMF Article 8[27] obligations in 1990, opening its financial system to the international community, and

[26] The term "Tom Yam Kung Crisis" is used because the financial crisis originated in Thailand, and Tom Yam Kung (or Tom Yum Goong) is a famous spicy and sour shrimp soup widely associated with Thai culture. Foreigners named the crisis this way to symbolize its origin in Thailand, much like how the soup is distinctly Thai and known worldwide.

[27] IMF Article 8 requires member countries to avoid imposing restrictions on payments and transfers for current international transactions without IMF approval. This promotes the free convertibility of currencies and supports the smooth functioning of international trade and payments. Article 8 also prohibits discriminatory currency practices and multiple exchange rates to ensure fairness and transparency in the global monetary system. These obligations help maintain exchange stability and international monetary cooperation.

relaxing foreign exchange controls in 1991. A pivotal development was the government's permission for commercial banks to establish Bangkok International Banking Facilities (BIBF)[28] in 1992. These facilities enabled massive inflows of foreign capital, particularly through banks, which saw their share of capital inflows rise from 6.5% (1987-91) to 50.4% (1992-96). The IMF's broader advocacy for capital account liberalization in the 1990s also played a role in this trend.

(Monetary and Exchange Rate Policy)

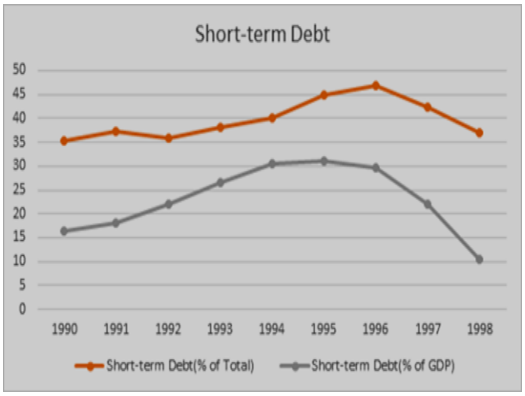
Prior to the crisis, Thailand maintained a fixed exchange rate of 25 Baht per U.S. dollar. This peg, while providing stability, encouraged domestic entities to borrow heavily in foreign currency without hedging exchange rate risks, as the perceived stability reduced incentives for risk management. The IMF repeatedly warned Thai authorities from mid-1995 onwards about the inconsistency of this fixed exchange rate regime with inflationary monetary and fiscal policies, exacerbated by the capital inflows it encouraged. The Fund urged greater exchange rate flexibility and fiscal tightening, but these warnings were often rejected or not acted upon with sufficient urgency. On July 2, 1997, facing intense speculative pressure and dwindling reserves, the Bank of Thailand was forced to float the Baht, marking the onset of the crisis.

(Capital Inflows and GDP)

Between 1988 and 1996, Thailand experienced the largest inflow of capital among ASEAN countries. This capital inflow led to a rapid increase in external debt, with short-term external debt accounting for 65% of total external debt and 70.4% relative to foreign exchange reserves as of the end of 1997.

[28] The Bangkok International Banking Facility (BIBF) was established in 1993 as an offshore banking center to attract foreign investment and increase foreign-currency-denominated loans in Thailand. It aimed to enhance competition in the banking sector by inviting reputable international banks and to promote Bangkok as a regional financial hub. BIBF also facilitated foreign banks to extend loans within Thailand and to the greater Indochina region, benefiting from regulatory and tax advantages. The rapid growth of BIBF loans contributed significantly to capital inflows before the 1997 financial crisis.

<Figure 5-1>Trends in Short-term Debt in Thailand



Source: IMF IFS and World Bank data

<Table 5-4> Short-term Debt to FX Reserves Ratio

	1994.6	1995	1996	1997.4
Korea	1.6	1.7	2.0	2.1
Thailand	1.0	1.2	1.2	1.5
Indonesia	1.7	1.9	1.8	1.7
Malaysia	0.3	0.3	0.4	0.6
Philippines	0.4	0.5	0.7	0.8

Source: BIS, IMF, Brookings Papers on Economic Activity

From 1987 to 1996, Thailand recorded a high economic growth rate averaging 7.5% per year, but the growth rate slowed to 6.4% in 1996. It then plunged sharply to 0.0% in 1997, followed by a negative growth of -4.1% in 1998. Real GDP per capita also fell by 12% in 1998, resulting in a severe economic recession.

(Key Vulnerabilities and Crisis Triggers)

The crisis was fundamentally a private sector debt crisis, rooted in a combination of factors: a persistent current account deficit, particularly after a significant decrease in exports in 1996; excessive foreign debt, largely short-term and unhedged; an excessive real estate bubble fueled by easy foreign borrowing; and a lack of efficiency and loose credit approval processes in financial institutions, leading to high non-performing loans (NPLs).

Financial and capital account liberalization progressed rapidly; however, the Thai economy became highly vulnerable to reversals in capital outflows due to the rapid accumulation of currency and maturity mismatches amid weak financial sector conditions and inadequate institutional and regulatory frameworks. The fixed exchange rate regime implicitly provided a guarantee against currency risk, encouraging borrowing foreign currency without exchange rate hedging, which ultimately led to moral hazard causing severe balance sheet effects when the fixed exchange rate regime collapsed.

(2) Indonesia (1997 Asian Financial Crisis)

Indonesia's experience in the 1997 Asian Financial Crisis shared many similarities with Thailand, particularly concerning the interaction of weak domestic financial institutions with large capital inflows.

Indonesia progressively liberalized its capital account in the late 1980s and early 1990s, resulting in substantial short-term capital inflows, rising from $15 billion in early 1990s to over $35 billion by 1997. The rupiah was initially managed under a crawling peg system but faced severe pressure due to overheating and external debt accumulation.

The hidden vulnerabilities inherent in such private debt suggest that even when seemingly sound macroeconomic fundamentals exist, unmanaged foreign exchange risk exposure in the private sector and a fragile financial sector can trigger a severe crisis.

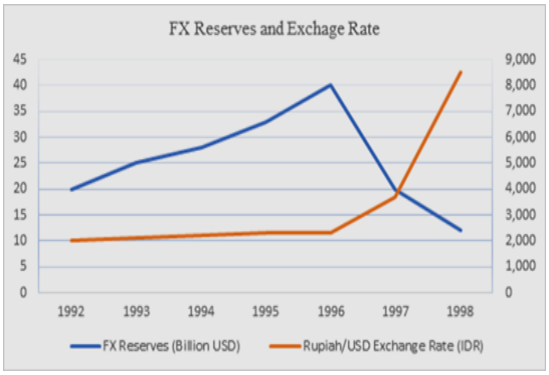
<Table 5-5> Key Macroeconomic Indicators in South East Asia (1990-1996)

		1990	1992	1994	1995	1996
Thailand	GDP Growth (%)	11.6	7.8	8.8	8.7	6.4
	Export Growth (%)	14.9	14.2	22.7	25.1	-1.8
	Current Account (Ratio to GDP, %)	-73 (-8.5)	-63 (-5.7)	-81 (-5.6)	-136 (-8.2)	-147 (-8.0)
Indonesia	GDP Growth (%)	7.2	6.5	7.5	8.2	8.0
	Export Growth (%)	15.9	16.6	8.8	13.2	9.7
	Current Account (Ratio to GDP, %)	-30 (-2.8)	-28 (-2.2)	-28 (-1.6)	-68 (-3.4)	-78 (-3.5)
Malaysia	GDP Growth (%)	9.7	7.8	9.2	9.5	8.6
	Export Growth (%)	17.4	18.5	24.7	26.0	6.0
	Current Account (Ratio to GDP, %)	-9 (-2.0)	-22 (-3.7)	-45 (-6.4)	-74 (-8.6)	-61 (-6.3)

Source: IMF IFS Yearbook 1997 and World Economic Outlook May 1998, Research Dept. of BOK

This phenomenon aligns with the third-generation crisis model. The initial response, characterized by reluctance to swiftly implement reforms and take decisive measures to restore confidence, exacerbated the crisis, and led to a financial market overshooting that could not be explained by economic fundamentals alone.

<Figure 5-2> Trends in Indonesia's FX Reserves & Exchange Rate



Source: IMF IFS and World Bank data

<Table 5-6> Trends in Short-term Debt

	1992	1993	1994	1995	1996
Thailand	41.8	52.7	65.5	83.2	90.8
Indonesia	88.0	89.2	107.8	124.4	129.0
Malaysia	20.0	26.1	29.3	34.3	39.8
Philippines	33.0	35.9	40.0	39.4	41.2

Source: World Bank, Research Dept. of BOK

(3) South Korea (1997 Asian Financial Crisis)

Korea experienced a crisis in 1997 despite sound macroeconomic fundamentals, due to the combination of structural vulnerabilities in the financial and corporate sectors and rapid capital account liberalization. While Korea's capital account liberalization case is detailed extensively in Chapter 5, this chapter examines Korea's situation before and after the 1997 foreign exchange crisis using macroeconomic indicators

<Table 5-7> Key Macroeconomic Indicators in Korea (1994-1999)

(**U$ in billions**, %)

	1994	1995	1996	1997	1998	1999
FX Rate (KRW/USD)	788.70	774.70	844.20	1,415.20	1,207.80	1,145.40
FX Reserves	25.7	32.7	33.2	20.4	52.0	74.1
Policy Interest Rate	5.00	5.00	5.00	5.00	3.00	4.75
Current Account	-4.8	-10.2	-24.5	-10.8	40.1	21.8
Total Foreign Debt	80.9	109.1	144.9	161.7	150.8	138.3
Short-term Debt	36.2	51.4	70.3	58.4	35.1	36.8
GDP Growth	9.3	9.6	7.9	6.2	-5.1	11.5
Inflation Rate	6.2	4.5	4.5	4.4	7.5	0.8
Unemployment	2.48	2.07	2.06	2.62	6.95	6.58

Source: BOK Statistics DB, IMF IFS

(4) Mexico (1994 Tequila Crisis)

The Mexican peso crisis, also known as the Tequila Crisis, was a financial turmoil that occurred in late 1994 and early 1995. It was characterized by the sudden devaluation of the Mexican peso, which led to severe economic instability in Mexico and widespread effects on global emerging markets.

In the early 1990s, Mexico rapidly liberalized its capital account, allowing significant foreign investment in government debt and securities. This liberalization attracted large short-term capital inflows, especially after Mexico signed the North American Free Trade Agreement (NAFTA). However, this created vulnerability as much of the financing was short-term and sensitive to changes in investor confidence.

Mexico maintained a fixed exchange rate regime by pegging the peso to the U.S. dollar through a crawling peg system. This policy was intended to control inflation and attract foreign investment. To defend the peg, the Mexican central bank intervened heavily in currency markets, issuing dollar-denominated debt (Tesobonos) to buy pesos. Despite these efforts, the peg caused the peso to become overvalued, contributing to a growing trade deficit and depletion of foreign exchange reserves.

Political instability, such as the Chiapas uprising and assassination of a presidential candidate, led investors to reassess risks. The U.S. increased interest rates, reducing the attractiveness of Mexican assets. As investors feared potential devaluation, capital began to flow out rapidly, putting downward pressure on the peso.

The key vulnerabilities in Mexico stemmed from an unsustainable external position characterized by a large current account deficit financed by volatile short-term capital inflows. The government's increasing reliance on short-term, dollar-indexed Tesobonos[29]

[29] Tesobonos are short-term Mexican government bonds issued in pesos but linked to the U.S. dollar exchange rate, so their value rises if the peso weakens. This protects investors from currency risk but increased Mexico’s debt burden during the peso crisis. Tesobonos are short-term Mexican government bonds issued in pesos but linked to the U.S. dollar exchange rate, so their value increases if the peso depreciates. This helped protect investors from currency risk but also worsened Mexico's debt burden during the peso crisis.

created a massive unhedged foreign currency exposure, making it highly vulnerable to a loss of investor confidence and an inability to roll over debt.

<Table 5-8> Key Macroeconomic Indicators in Mexico (1993-1996)

	1993	1994	1995	1996
GDP Growth (%)	2.0	4.4	-6.2	5.2
Inflation Rate (%)	9.7	7.0	35.0	34.4
Unemployment Rate (%)	3.4	4.4	7.1	5.5
Benchmark Interest Rate (%)	17.4	16.5	60.9	33.6
Exchange Rate (Peso/USD)	3.1	5.3	7.6	7.9
Current Account Balance (% of GDP)	-6.6	-8.0	-0.2	-0.5
External Debt (Billion USD)	131.5	142.1	169.6	163.6
FX Reserves (Billion USD)	25.1	6.3	16.9	19.4

Source: IMF, World Bank

The overvalued exchange rate, maintained within a narrow band, further exacerbated external imbalances. Political shocks (assassinations) triggered capital outflows and rapid reserve depletion. Other contributing factors included a decline in national savings and a weak domestic banking system.

The lack of transparency from Mexican authorities regarding foreign exchange reserves and Tesobono issuance, coupled with delayed and insufficient policy responses, amplified the crisis. The crisis demonstrated a "debt composition trap," where the specific instruments and currency denomination of capital inflows are critical vulnerabilities. It also highlighted the "new world" of crisis speed, with rapid contagion and less time for policy responses in a globalized financial system.

(5) Argentina (2001-2002 Currency Crisis)

Argentina's 2001-2002 crisis was a devastating event, largely attributed to the rigidities of its currency board regime and persistent fiscal imbalances, exacerbated by external shocks.

Argentina underwent significant capital account liberalization starting in the late 1980s and solidified through the 1990s. The government progressively removed restrictions on capital flows, allowing both private and public borrowing from international markets.

This included eliminating foreign exchange controls and trade restrictions accompanied by structural reforms like trade liberalization and the adoption of a currency board system in 1991, which pegged the peso to the US dollar at a fixed rate.

The Convertibility Plan of 1991 fixed the exchange rate at one peso per US dollar, essentially functioning as a currency board arrangement. The central bank was mandated to back a large portion of the monetary base with international reserves to maintain currency stability. This policy aimed to control hyperinflation but constrained monetary policy flexibility. Over time, later policies shifted toward more flexible exchange rates, but the peso remained highly vulnerable to external shocks.

Argentina without the monetary and exchange rate policy tools needed to cope with external shocks. The fixed exchange rate, combined with a lack of price and wage flexibility, led to real exchange rate overvaluation and current account deterioration, especially as the U.S. dollar appreciated and the Brazilian real devalued in the late 1990s. In January 2002, amid severe political and social unrest, Argentina formally abandoned the convertibility regime.

During the liberalization phase, Argentina saw substantial capital inflows, including foreign direct investment and sovereign debt issuance on international markets, especially after returning to global bond markets in the mid-1990s. The inflows initially promoted growth but also increased external debt and financial fragility, particularly with borrowing denominated in foreign currencies.

The fixed exchange rate initially contributed to economic stability and growth in the early 1990s. However, the peso was increasingly overvalued, leading to trade deficits and pressure on reserves. Eventually, the currency board system collapsed in 2001 after sustained fiscal deficits, loss of competitiveness, and capital flight. The crisis triggered a severe contraction in GDP and sharp depreciation of the peso, followed by a deep recession.

Key vulnerabilities included rigid exchange rate policy, large fiscal deficits financed by borrowing, high external debt mostly in foreign currency, and loss of confidence among investors. The immediate trigger was a sudden stop in capital inflows, combined with

political instability and mounting external debt obligations, leading to a balance of payments crisis and the abandonment of the currency board regime.

<Table 5-9> Key Macroeconomic Indicators in Argentina (1991-2002)

	1991	1993	1995	1997	1999	2000	2001	2002
Exchange Rate (Peso/USD)	0.999	0.999	1.000	1.000	1.000	1.000	1.000	3.320
FX Reserves (Billion USD)	6.0	13.8	14.3	22.3	26.3	25.1	14.6	10.5
Current Account (% of GDP)	-0.4	-8.0	-5.2	-12.2	-11.9	-8.8	-4.4	8.6
External Debt (% of GDP)	62.3	72.2	98.5	124.9	144.5	146.3	140.3	136.6
GDP Growth (%)	10.5	6.3	-2.8	8.1	-3.4	-0.8	-4.4	-11.0
Inflation Rate (%)	84.6	7.4	1.6	0.3	-1.8	-0.7	-1.5	41.0

Source: IMF database, Ministry of Economy of Argentina, Global Development Finance

B. Non-Crisis Type Cases

(1) Malaysia (Post-1997 Capital Controls)

Malaysia's response to the 1997 Asian Financial Crisis stands out for its controversial but ultimately effective imposition of capital controls, which allowed it to navigate the crisis differently from its neighbors.

(Capital Account Management Policy)

Prior to September 1998, Malaysia had a generally liberalized capital account. However, facing strong downward pressures on the ringgit during the Asian crisis, the Malaysian authorities introduced a wide range of capital controls[30] on September 1, 1998, alongside

[30] Capital controls were introduced to restrict portfolio outflows, block offshore ringgit trading, and require investments in ringgit assets to remain in the country for at least one year. Additionally, foreign trade transactions had to be settled in foreign currencies, and limits were placed on overseas investments by residents to curb speculative attacks and regain monetary policy independence.

pegging the exchange rate at 3.8 MYR/USD. The primary objectives of these controls were to close the offshore ringgit market in Singapore, reduce short-term exchange rate volatility, and crucially, to regain monetary independence to refocus monetary policy on domestic conditions. This move was highly controversial at the time but has since become accepted as a legitimate policy tool for crisis management. On July 21, 2005, Malaysia shifted from its fixed peg to a managed float system.

(Monetary and Exchange Rate Policy)

The decision to peg the exchange rate at RM3.80 per US dollar on September 1, 1998, combined with capital controls, effectively delinked domestic monetary policy from exchange rate movements. This allowed Bank Negara Malaysia (BNM) to pursue an aggressive fiscal policy for economic recovery without being constrained by external pressures or the need to maintain high interest rates, unlike other crisis-hit countries. This strategic choice of a fixed exchange rate and monetary independence, enabled by capital controls, is a direct application of the Impossible Trinity. After the shift to a managed float in 2005, BNM continued to manage the exchange rate and respond to capital flows.

The ringgit then depreciated rapidly (42.1%) from August 2014 to September 2015 due to changes in U.S. monetary policy, declining crude oil prices, and domestic political scandals.

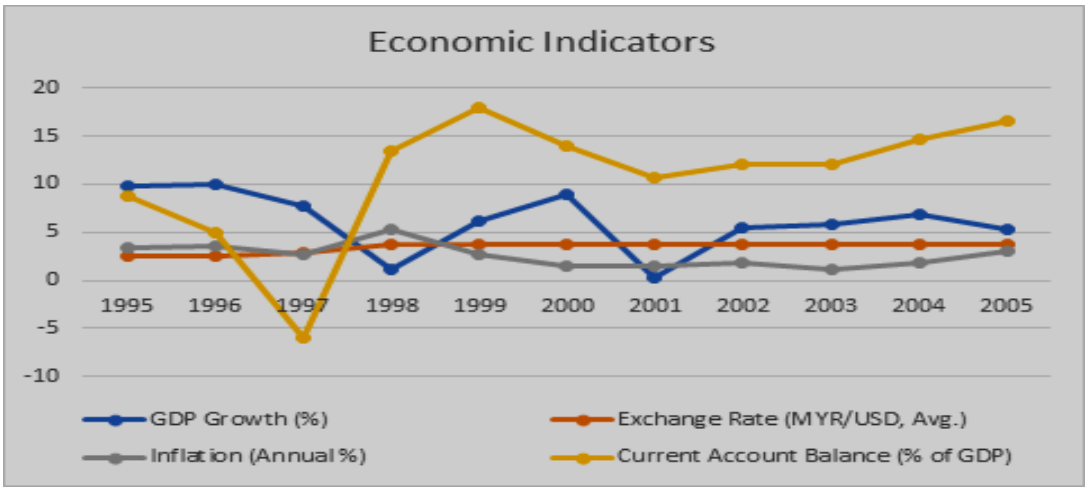
(Capital Inflows and GDP)

Inward FDI stocks in Malaysia increased rapidly in the 1990s, reaching 62.4% of GDP in 1998, before declining but remaining around 40%. Following the Global Financial Crisis, Malaysia experienced large capital inflows into its stock and bond markets due to quantitative easing in advanced economies, though this trend reversed with the "taper tantrum"[31] leading to financial account deficits.

[31] The taper tantrum was a sharp market reaction in 2013 when the U.S. Federal Reserve announced it would gradually reduce its bond-buying program known as quantitative easing. This caused a sudden rise in U.S. Treasury yields and increased market volatility due to fears that less monetary support would lead to higher interest rates. Despite the initial panic, markets eventually stabilized, and the economy

Malaysia experienced robust economic growth, averaging nearly 10% annually from 1988 to 1996. While it faced an economic downturn due to the Asian crisis, its GDP growth rate of 7.8% in 1997 and 1.1% in 1998 indicated a less severe contraction compared to its neighbors. The economy rebounded strongly after the crisis, driven by its export manufacturing sector.

<Figure 5-3>Trends in Macroeconomic Indicators in Malaysia (1995-2005)



Source: IMF IFS and World Bank

(Factors Contributing to Stability)

Malaysia's relative stability and swift recovery were largely attributed to its decision to impose selective and temporary capital controls, which proved effective in closing the offshore ringgit market and reducing short-term exchange rate volatility. This allowed Malaysia to regain monetary independence and avoid the credit crunch experienced by other crisis-hit countries, leading to fewer bankruptcies and reduced costs of financial sector restructuring. Deep macro-financial reforms transformed its financial system into a resilient, diversified, and sound one, with no bank closures, a high recovery rate on NPLs, and stronger banking institutions. The expansion of its bond market also provided a major financing source for corporations.

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continued to recover after the tapering began. This event highlighted the sensitivity of financial markets to changes in central bank policies.

(2) China (Gradual and Managed Liberalization)

China represents a unique case of capital account liberalization, characterized by a highly gradual, selective, and managed approach, enabling it to achieve rapid growth while largely avoiding major financial crises.

(Capital Account Liberalization Stages and Capital Controls)

China's capital control policies began with strict regulation over both the current and capital accounts during the early reform period (1978−1993), followed by current account liberalization after 1994, gradual capital account relaxation in the early 2000s[32], foreign direct investment regulations, macroprudential policies (since 2017), and continued controls[33].

(Monetary and Exchange Rate Policy)

China's monetary policy has historically been tightly managed, with the yuan initially pegged rigidly to the US dollar. Since 2005, China moved to a managed floating exchange rate mechanism, guided by a basket of currencies, thereby allowing for increased flexibility. The People's Bank of China balances exchange rate management with inflation control and economic growth objectives, using monetary tools alongside capital controls to maintain overall economic stability.

Since the introduction of exchange rate reforms in the 1990s, the Chinese yuan has generally appreciated against major currencies, reflecting China's growing economic strength. Stable exchange rates have been instrumental in supporting export-led growth and enhancing China's competitiveness in global markets. The exchange rate policy is calibrated carefully to respond to external shocks while maintaining steady GDP growth.

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[32] The Qualified Foreign Institutional Investor (QFII), Qualified Domestic Institutional Investor (QDII), and Stock Connect systems were introduced to allow limited and controlled foreign portfolio investment.

[33] By continuously managing, restricting, and guiding international capital movements through administrative regulations, tax policies, and macroprudential tools, capital flight is prevented and economic stability is maintained.

(Capital Inflows)

China has seen substantial inflows of foreign direct investment and portfolio capital, which have supported its rapid industrialization and economic expansion. However, these inflows are closely monitored and regulated to prevent speculative surges and overheating in financial and real estate markets. The government implements measures to ensure that capital inflows contribute positively to sustainable economic development.

(Factors contributing to Stability)

China's financial stability is underpinned by strong capital controls, large foreign exchange reserves, and prudent regulatory oversight. These measures provide the government with the ability to manage capital flows effectively and to protect the domestic economy from external financial shocks. Gradual capital account liberalization, coordinated monetary and exchange rate policy, and ongoing financial sector reforms collectively contribute to maintaining macroeconomic and financial stability.

(3) Vietnam (Emphasis on Gradualism and Controls)

Vietnam's economic transformation is a remarkable development success story, largely underpinned by a strategy of gradual financial sector reforms and the maintenance of capital controls.

(Capital Account Liberalization Stages and Capital Controls)

Since the late 1980s, Vietnam has implemented comprehensive and gradual financial sector reforms. These reforms included transitioning to a two-tier banking system, establishing joint stock banks, restructuring state-owned commercial banks, and progressively liberalizing interest rates. By 2002, commercial banks gained the legal ability to set lending and deposit rates according to market conditions. These reforms led to a significant deepening of the financial system, with the M2 to GDP ratio increasing from about 25% in the mid-1990s to over 70%.

Crucially, Vietnam has maintained capital controls throughout this period, successfully restricting short- and medium-term capital inflows. The only sizeable capital inflows have

been foreign direct investments (FDI) and remittances from Vietnamese living abroad. While Vietnam accepted IMF Article VIII obligations in October 2005, committing to current account convertibility, this did not entail full capital account liberalization. This deliberate gradualism, coupled with active capital controls, has allowed Vietnam to pursue high growth while mitigating the risks associated with volatile capital flows.

<Table 5-10> Stage of Capital Account Liberalization in Vietnam

Period	Stage	Key Developments and Policies
1986-1994	Initial Reform and Opening	Introduction of Doi Moi reforms; establishment of legal framework for FDI in 1987; cautious capital inflows allowed.
1995-2006	Transition and Market Building	Focus on expanding foreign investment and market economy foundations; gradual capital account liberalization with risk management.
2007-Present	Integration and Deepening Liberalization	WTO accession (2007) boosts FDI inflows; increased regulatory frameworks for capital flows; ongoing reforms to enhance capital mobility while controlling risks

(Monetary and Exchange Rate Policy)

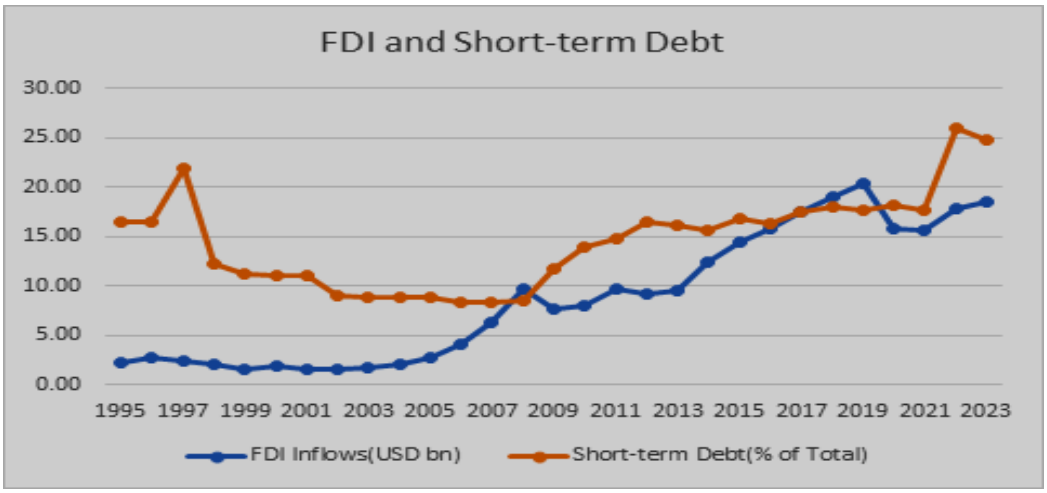
Vietnam's monetary policy has been instrumental in stabilizing the economy. Restrictive monetary and fiscal policies played a key role in bringing down hyperinflation in the late 1980s and early 1990s. The State Bank of Vietnam (SBV) operates a managed floating exchange rate system, which has functioned like a de facto fixed exchange rate system since mid-2004, with an announced target to limit DONG depreciation against the U.S. dollar (e.g., below 1% in 2004). The SBV actively intervenes in the foreign exchange market to achieve its exchange rate target. While this policy has contributed to stability, it has also led to a strong increase in foreign currency borrowing by enterprises, creating potential currency mismatches. The primary goal of monetary policy has de facto been economic growth.

(Capital Inflows and GDP)

Capital inflows primarily consisted of FDI and remittances. The Dong has followed a path of relatively gradual depreciation, averaging around 2% per year since 1998, with even less depreciation (under 1%) in 2004 and 2005.

Vietnam has demonstrated strong economic performance since the early 1990s, with an annual average growth rate of 7.4%. It has consistently maintained one of the highest growth rates in East Asia.

<Figure 5-4> FDI Inflows and Short-term Debt in Vietnam (1995-2023)



Source: IMF and World Bank

(Factors Contributing to Stability)

Vietnam's non-crisis trajectory is largely attributable to its deliberate strategy of gradual financial sector reforms and the successful restriction of volatile short-term capital inflows. This approach allowed the country to maintain a de facto fixed exchange rate and pursue growth-oriented monetary policy without succumbing to speculative attacks. The containment of the fiscal deficit also played a role. While dollarization is present, it is on a moderate scale, and a tendency to keep money in domestic currency deposits due to interest differentials and stable exchange rates has contributed to stability.

The acceptance of IMF Article VIII for current account convertibility, without full capital account liberalization, underscores a cautious and strategic approach to integration. This case highlights that gradualism, coupled with active capital controls, can be a viable strategy for achieving high growth and macroeconomic stability, particularly for countries with developing financial systems.

(4) Cambodia (Capital Controls and Reserve Accumulation)

Cambodia's economic development has been marked by strong growth, managed within a highly dollarized environment, with a policy emphasis on capital controls and reserve accumulation.

(Capital Account Policy)

In the 1990s, participation in IMF programs among developing countries was closely linked with capital account liberalization, with the IMF generally recommending external openness. In contrast, Cambodia adopted a strategic capital account policy combining capital controls and an expansion of foreign exchange reserves.

Using administrative regulations, tax policies, and macroprudential tools, international capital movements have been continuously managed, restricted, and guided to prevent capital flight and maintain economic stability.

(Monetary and Exchange Rate Policy)

Cambodia's economy is highly dollarized, meaning it effectively "imports" U.S. monetary policy, with domestic interest rates moving alongside those in the U.S. The National Bank of Cambodia focuses on exchange rate stability to keep prices stable and protect the local currency's purchasing power.

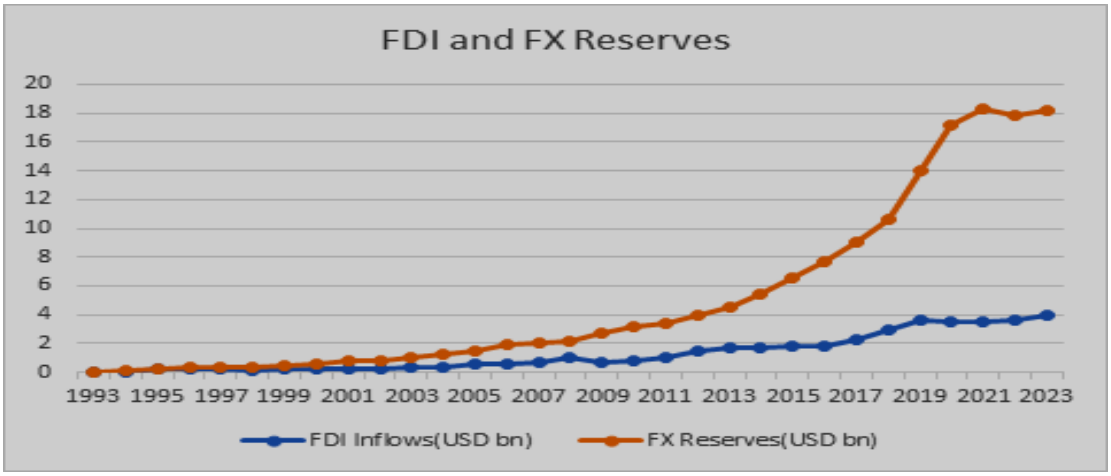
The central bank is gradually normalizing monetary policy while ensuring enough liquidity and working to improve the policy framework to better support de-dollarization. Because of high dollarization and free capital movement, Cambodia has a de facto fixed exchange rate and limited independent monetary policy, illustrating a key trade-off in the Impossible Trinity. Due to high dollarization, the exchange rate is largely stable, with policy targeting this stability.

(Capital Inflows and GDP)

Capital inflows have contributed to the expansion of broad money, driven by improved foreign currency deposits. Foreign direct investment (FDI) net inflows as a percentage of GDP were 9.5% in 2024.

From 1995 to 2019, the Cambodian economy recorded a high average annual growth rate of 7.6%, emerging as one of the fastest-growing countries in the world. The real GDP growth rate is projected to rise from 5.5% in 2024 to 5.8% in 2025.

<Figure 5-5> FDI Inflows and FX Reserves in Cambodia (1993-2023)



Source: IMF and World Bank, National Bank of Cambodia

Cambodia's economy has experienced strong growth, averaging an annual rate of 7.6% between 1995 and 2019, making it one of the fastest-growing economies globally. Real GDP is projected to grow from 5.5% in 2024 to 5.8% in 2025. Inflation is projected to remain contained, picking up from 0.5% in 2024 to 2% in 2025.

(Factors Contributing to Stability)

Cambodia's stability is largely due to its "strategic capital account policy," combining capital controls with reserve accumulation, which has been shown to contribute to growth. High dollarization limits monetary autonomy but provides a stable U.S. dollar anchor, aiding price stability and investment. Strong growth in tourism, manufacturing, real estate, and construction, along with low public debt (under 30% of GDP), also contribute. The IMF supports Cambodia's efforts to develop its domestic government bond market for more diversified financing. This case demonstrates that for highly dollarized economies, active capital account management and reserve building can be a proactive strategy for long-term growth and stability.

(5) Bangladesh (Exchange Rate Management and IMF Assistance)

Bangladesh's economic journey has been marked by periods of market-determined exchange rates and later by managed floats, with significant implications for its international competitiveness and recent reliance on IMF assistance.

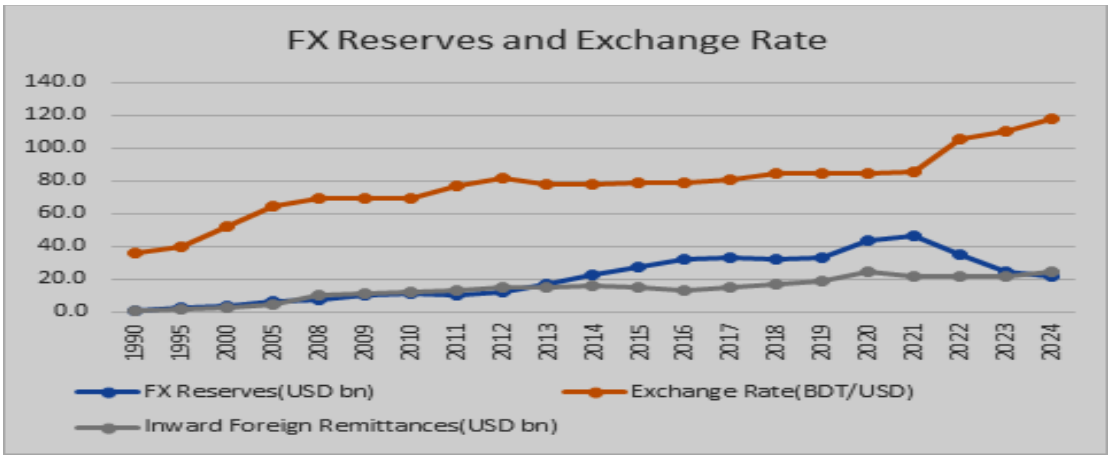
(Capital Account Policy)

The IMF's proposal in September 1997 to make capital flow liberalization a goal was, however, dropped after the Asian crisis. Bangladesh applies gradual liberalization with careful regulation of capital flows. Foreign investors are allowed to keep foreign currency in special accounts for up to one year, which helps manage inflows and supports capital expenditures. Full capital account convertibility is not yet in place to avoid financial instability from erratic capital movements.

(Monetary and Exchange Rate Policy)

Since the end of military rule in 1991, Bangladesh's exchange rate management has gone through two distinct phases. From 1992 to 2006, the Bangladeshi Taka largely floated, with its exchange rate determined by market conditions, depreciating from 39 in 1992 to 68.9 in 2006. This market-driven adjustment was consistent with domestic inflation and the inflation rates of its trading partners.

(Figure 5-6) FX Reserves and Exchange Rate in Bangladesh (1990-2024)



Source: IMF and World Bank, Bangladesh Bank

However, from 2006 onwards, the Taka has been subject to various interventions, including managed float, fixed, and modified fix/crawl regimes. This shift was largely influenced by a rapid increase in worker remittances, which significantly boosted foreign exchange reserves, providing authorities with the perceived ability to manipulate the exchange rate. The Taka's real appreciation from 2006 to 2010, driven by exchange rate manipulation, undermined Bangladesh's international competitiveness.

Bangladesh Bank (BB) believed it could stably operate a crawling peg, but excessive interventions led to a sharp depletion of foreign exchange reserves starting at the end of 2021, which prompted an urgent IMF support request.

In February 2023, the IMF approved a support program worth 4.7 billion dollars to restore macroeconomic stability and rebuild foreign exchange reserves, and in line with IMF recommendations, Bangladesh Bank adopted a crawling peg system with a band range.

(Factors Contributing to Stability)

Strong regulatory frameworks and prudent fiscal management have played key roles in maintaining macroeconomic stability. Financial sector reforms, coupled with efforts to diversify the economy and improve infrastructure, have supported steady growth. Additionally, policies to control inflation and improve foreign exchange reserves are crucial for sustaining long-term stability.

This case underscores the importance of allowing exchange rates to adjust to market forces, even in the presence of large non-trade related inflows, to maintain competitiveness and avoid long-term economic distortions.

(6) Bahrain (Long-standing Fixed Exchange Rate and Open Capital Account)

Bahrain provides an example of a small, open economy that has successfully maintained an open capital account alongside a long-standing fixed exchange rate regime, primarily due to its unique economic structure and strong institutional credibility.

(Capital Account Policy)

Bahrain maintains a largely open capital account, which is at a relatively advanced stage of liberalization. This means there are minimal restrictions on the flow of capital into and out of the country. This policy facilitates foreign investment and allows for a free flow of funds. The open capital account is supported by a robust financial sector and a well-regulated banking system.

(Monetary and Exchange Rate Policy)

Bahrain's monetary policy is conducted by the Central Bank of Bahrain (CBB) with the primary goal of maintaining price stability. The CBB's key policy tool is setting interest rates on its various lending and deposit facilities. The country's exchange rate policy is a peg to the US dollar at a fixed rate of BHD 1 = USD 2.65 (0.376 BHD/USD). This peg has been in place since 1980, providing stability and predictability for both domestic and foreign investors. The CBB must align its monetary policy with the US FRB's interest rate decisions to maintain this peg.

The fixed exchange rate removes the exchange rate as a tool for economic adjustment. The CBB cannot devalue the currency to boost exports or make them more competitive. Instead, it must rely on other policies, such as fiscal measures and structural reforms, to manage economic fluctuations.

(Capital Inflows and GDP)

Bahrain's fixed exchange rate policy has a significant impact on its economy. The stable exchange rate and open capital account attract foreign investment, as investors are protected from currency risk. High oil prices and a strong global economy generally led to increased capital inflows. These inflows can increase liquidity in the banking system, potentially leading to inflationary pressures if not managed effectively.

The stable exchange rate fosters economic growth by creating a predictable environment for businesses and investors. It encourages long-term planning and investment in non-oil sectors like finance and real estate. The stability also helps control inflation, protecting the purchasing power of consumers and contributing to overall

economic health.

(Reasons for Not Experiencing a Financial Crisis)

Bahrain has not experienced a currency crisis despite significant speculative pressures on the US dollar. This resilience can be attributed to several key factors, including the dollar peg fixed exchange rate system adopted since 1980, adequate foreign exchange reserves, robust regulatory frameworks, a sophisticated financial hub, and fiscal soundness reforms.

(7) Hong Kong (Linked Exchange Rate and Open Capital Account)

Hong Kong's economic success story is closely tied to its unique linked exchange rate system (LERS) and completely open capital account, a model that thrives on extreme flexibility in factor markets.

(Capital Account Policy)

Hong Kong is one of the most open capital account regions in the world, which is a key factor defining its identity as an international financial hub. There are essentially no government restrictions on capital movements, enabling foreign investment attraction and free capital mobility. These policies have solidified Hong Kong's status as a global financial hub and act as positive factors in attracting foreign banks and investment institutions.

(Monetary and Exchange Rate Policy)

Hong Kongʼs monetary policy is operated under a linked exchange rate system, which is a form of a currency board arrangement, fixing the Hong Kong dollar (HKD) to the US dollar (USD) within a narrow band of 7.75 to 7.85 HKD/USD. The Hong Kong Monetary Authority (HKMA) issues currency fully backed 100% by the corresponding amount of US dollar reserves, directly linking the money supply to dollar liquidity. Therefore, Hong Kong lacks monetary policy autonomy, and its interest rates are tied to decisions made by the US Federal Reserve.

(Capital Inflows and GDP)

A stable exchange rate regime removes exchange rate risk, thereby encouraging active inflows of foreign capital, which during periods of low interest rates can lead to asset bubbles centered on the real estate market due to massive inflows.

Additionally, with no adjustment in the exchange rate, export competitiveness depends on productivity improvements and the external economic environment. However, a stable exchange rate creates a predictable business environment that promotes trade and investment, contributing to GDP growth. On the downside, the absence of independent monetary policy makes the economy vulnerable to external shocks.

(Reasons for Avoiding a Currency Crisis)

Hong Kong was able to avoid a foreign exchange crisis despite having a fully open capital account and a strict exchange rate regime. This resilience is attributed to factors such as the dollar peg system maintained since 1993, substantial foreign exchange reserves, a sound and transparent financial system, and full capital mobility.

As examined earlier, Thailand, Indonesia, and South Korea experienced foreign exchange crises during rapid capital account liberalization due to excessive short-term capital inflows, increased short-term external debt, and inadequate financial supervision. In contrast, China, Vietnam, and Bangladesh avoided financial instability through gradual and cautious approaches to capital account liberalization. Meanwhile, according to IMF analysis, India delayed short-term capital opening due to an immature financial system, while Chile, reflecting lessons from its rapid opening in the late 1970s that led to a banking crisis and exchange rate collapse, strengthened capital outflow controls and supervisory frameworks, achieving stable liberalization despite external shocks in the 1990s.

<Table 5-11> Comparative Matrix of Case Analysis

Country	Exchange Rate Regime	Liberalization Pace	Dominant Inflows	Crisis Outcome
Thailand	Dollar peg (basket)	Rapid (1990s)	Short-term debt	1997 crisis
Indonesia	Crawling peg	Rapid (1990s)	Bank loans	1997–98 crisis
Korea	Narrow band to USD	Partial, rapid	Short-term debt	1997 crisis
Mexico	Crawling band	Rapid (1990–94)	Portfolio flows	1994 crisis
Argentina	Dollar peg (1:1)	Rapid (1990s)	Debt inflows	2001 collapse
Malaysia	Peg+capital control	Moderate	Portfolio flows	Avoided crisis
China	Managed peg	Gradual	FDI	No crisis
Vietnam	Crawling peg	Sequenced 3stages	FDI	No crisis
Cambodia	Dollarized peg	Early liberalization	FDI	No crisis
Bangladesh	Managed float	Cautious	Low FDI	No crisis
Hong Kong	Currency board	Full	Portfolio flows	Stable
Bahrain	Dollar peg	Full	FDI/portfolio	Stable

In summary, comparative studies of crisis-hit and non-crisis countries under fixed exchange rate regimes provide valuable insights into the economic, institutional, and policy prerequisites that determine the success or failure of capital account liberalization.

4. Lessons learned

Drawing upon both Asian and Latin American experiences, this section synthesizes cross-country lessons into general principles and country-specific takeaways. The goal is to develop an informed framework that can guide policymakers in sequencing and managing capital account liberalization within the constraints of fixed exchange regimes.

Before deriving lessons learned from the case studies, key points of crisis and non-crisis cases can be summarized in the below table.

<Table 5-12> Summary of Key Points from Crisis vs Non-Crisis Cases

Crisis Cases	Non-Crisis Cases
Rapid, Un-sequenced Liberalization + Weak Supervision	Gradual Sequencing, Prioritizing FDI
Rigid Pegs without FX Reserves	Flexible or Credible Pegs with Buffers
Excessive Foreign Borrowing + FX Mismatch	Conservative External Borrowing
Loss of Credibility in Exchange Rate Policy	Institution-building and Governance Strength

A. General Lessons

The diverse experiences with capital account liberalization offer several critical general lessons for policymakers.

(1) Tailored Approach to Capital Account Liberalization

Capital account liberalization should be tailored to the specific economic and institutional context of each country. There is no universal model that fits all situations. Countries with strong economies and institutions can liberalize more quickly, while

others need a slower, careful process. Rushing liberalization risks financial instability, whereas a gradual, managed approach enhances economic resilience. Flexibility and timing, based on readiness, are crucial.

(2) Essential Preconditions for Successful Capital Account Liberalization

Robust macroeconomic fundamentals, including fiscal discipline and low inflation, form the bedrock for successful capital account liberalization. Equally critical is a resilient and well-supervised financial sector capable of managing increased capital flow volatility. Good governance and institutional quality reduce the risks of mismanagement and financial instability. Historical crises in emerging markets underline that liberalization without these preconditions exacerbates economic vulnerabilities and undermines policy objectives.

(3) Sequencing Reforms in the Liberalization Process

Sequential capital account liberalization allows the economy to gradually permit capital flows after adapting to trade and foreign exchange liberalization, thereby avoiding abrupt shocks, and maintaining macroeconomic stability. Additionally, opening the capital account after strengthening the domestic financial market base can achieve these effects.

However, if regulation and supervision are inadequate at each stage, it may lead to exchange rate and asset price volatility due to sudden inflows and outflows of short-term capital. Moreover, inappropriate pace and sequencing of liberalization can expose vulnerabilities in the domestic financial market, increasing the risk of a currency crisis, as seen in South Korea's 1997 foreign exchange crisis.

(4) Managing the Policy Trilemma in Capital Account Liberalization

The well-known "Impossible Trinity" or policy trilemma posits that a country cannot simultaneously maintain a fixed exchange rate, free capital mobility, and independent monetary policy. Policymakers must prioritize two of these objectives and accept constraints on the third to maintain macroeconomic stability. Failure to acknowledge and manage these trade-offs can result in currency crises, capital flight, and loss of monetary control. Strategic policy design should explicitly address these inherent conflicts.

(5) Ensuring Quality of Capital Flows and Enhancing Transparency

The composition of capital inflows significantly shapes economic outcomes, with short-term, debt-driven flows posing greater risks than stable, long-term foreign direct investment (FDI). Policies should encourage high-quality inflows and manage the maturity profile to reduce vulnerability. Transparent, timely data on reserves, external debt, and financial sector health are indispensable for informed policymaking and crisis prevention. Additionally, reducing moral hazard by eliminating implicit government guarantees helps mitigate excessive foreign borrowing risks.

B. Specific Lessons

Beyond these general principles, specific country experiences offer unique insights.

(1) The Fixed Exchange Trap (Thailand, Indonesia, Mexico, Argentina)

Fixed exchange rates may encourage excessive unhedged foreign currency borrowing by creating an implicit currency risk guarantee. When the peg fails, sudden devaluation causes severe balance sheet damage and widespread insolvencies, as seen in Thailand, Indonesia, Mexico, and Argentina. Argentina's currency board curbed inflation but removed monetary policy tools, increasing vulnerability to external shocks. This highlights the danger of fixed rates without strong financial supervision and capital controls.

(2) Effective Use of Capital Controls (Malaysia)

Malaysia's selective, temporary capital controls in 1998, alongside a pegged exchange rate, restored monetary policy autonomy and stabilized the economy. This approach avoided the high interest rates seen in other crisis-hit countries, demonstrating that timely, targeted capital controls can be a valuable crisis management tool when integrated within broader policies.

(3) Gradual Liberalization Strategy (China, Vietnam)

China and Vietnam illustrate how a pragmatic, gradual, and selective liberalization combined with sustained capital controls and exchange rate management can deliver rapid growth and stability. This strategy balances attracting beneficial foreign direct investment while maintaining policy autonomy and mitigating volatile short-term capital flow risks, though it may reduce long-term market transparency.

(4) Dollarization as an Exchange Rate Anchor (Cambodia)

Cambodia's highly dollarized economy effectively imports U.S. monetary policy, serving as a de facto fixed exchange rate that stabilizes prices but sacrifices monetary independence. Combining capital controls and reserve accumulation helps prevent over-borrowing and supports competitiveness in such highly dollarized contexts.

(5) Managing Dutch Disease and Exchange Rate Intervention (Bangladesh)

Large non-debt inflows like remittances can cause "Dutch Disease," appreciating the real exchange rate and harming exports. Bangladesh's managed float shift, influenced by remittances, led to reserve depletion and economic harm, showing the risks of excessive intervention and the need for exchange rates to adjust to market forces.

(6) Credibility of Hard Pegs with Free Capital Flow (Bahrain, Hong Kong)

Bahrain and Hong Kong exemplify economies maintaining credible fixed exchange rates paired with open capital accounts by sacrificing independent monetary policy. Such a model is viable when backed by strong fundamentals, institutional credibility, and flexible labor markets, enabling absorption of external shocks.

C. Implication of Lessons for Nepal

Nepal can gradually implement the liberalization of its capital account by considering the lessons learned from the above case studies. Before initiating the process of capital account liberalization, it is crucial for Nepal to assess its administrative capacity, financial infrastructure, institutional frameworks, and political stability.

Since the 1990s, Nepal has pursued gradual economic liberalization and financial

reform, triggered by its participation in the IMF's Structural Adjustment Program. Currently, discussions on further opening of the capital account have been gaining momentum. However, the enforcement of existing capital controls and related regulations remains limited, and weak administrative capacity undermines the effectiveness of capital flow management.

A formal, legally mandated governance framework for joint policy decision-making regarding capital account liberalization is typically absent. The central bank, as an adviser to the government, generally provides policy advice and opinions regarding government programs. However, if the government decides to further liberalize the capital account, the central bank will also need to make certain institutional and policy arrangements, such as strengthening prudential regulation and refining monetary policy tools. In this regard, the central bank is a major stakeholder in implementation rather than in decision-making.

Alongside economic reforms, Nepal has been working to strengthen its financial infrastructure and improve institutional frameworks, yet vulnerabilities remain particularly in anti−money laundering, counterterrorism financing, and other aspects of the financial system. Stable financial conditions, enhanced supervisory capacity, and stronger macroeconomic fundamentals are necessary prerequisites for gradual capital account liberalization. This underscores the need for systematic capacity building among administrative and research personnel.

Political stability remains a crucial determinant of policy continuity. In recent years, frequent changes in coalition governments, conflicts among political parties, and declines in external aid have created an unstable political environment that hampers economic development and policy execution. Consequently, addressing political uncertainty and strengthening leadership within the government are essential tasks to ensure consistent and sustained implementation of capital account liberalization policies.

Therefore, Nepal's path toward capital account liberalization must be gradual and strategically sequenced. Strengthening administrative capacity, financial infrastructure, and institutional frameworks is essential to support effective implementation. The central bank's role in policy execution, coupled with enhanced regulatory tools, will be critical.

Above all, sustained political stability and leadership are necessary to ensure policy continuity and mitigate systemic vulnerabilities.

5. Establishment of Financial Safety Net

The recurrent financial crises in emerging markets following capital account liberalization underscore the critical need for robust financial safety nets. Even with sound macroeconomic policies and prudential regulations, these economies remain vulnerable to sudden shifts in global capital flows, speculative attacks, and contagion effects, as demonstrated by the Asian and Latin American crises.

A. Rationale

Theoretical concepts like information asymmetries and the "Theory of the Second Best"[34] suggest that financial markets are inherently prone to failures, which can be magnified by international openness. The speed and scale of modern financial crises mean that domestic policy responses alone are often insufficient to stem capital flight and restore confidence.

Therefore, a well-designed financial safety net serves as a crucial line of defense, providing liquidity, preventing systemic collapse, and mitigating the severe economic and social costs of crises. Ultimately, it acts as insurance against the inherent volatility of global capital markets.

B. Approaches

Establishing an effective financial safety net requires a multi-layered approach,

[34] The Theory of the Second Best means that when one optimal economic condition cannot be met, trying to fix other distortions individually might not improve overall efficiency and can sometimes make things worse. This theory shows that partial corrections in an imperfect market do not necessarily lead to a better result and careful analysis is needed before intervening.

combining national, regional, and international mechanisms.

(1) National Level Measures

As previously analyzed, foreign exchange (FX) reserves serve as a crucial buffer to prevent or mitigate potential crises arising from capital account liberalization under a fixed exchange rate regime. However, various other measures must also be implemented domestically to complement the accumulation of FX reserves.

(Strong Foreign Exchange Reserves)

Maintaining adequate levels of foreign exchange reserves provides a buffer against sudden capital outflows and allows central banks to intervene in foreign exchange markets to smooth volatility. China's massive reserve accumulation is an example of this strategy.

(Prudential Regulation and Supervision)

A robust domestic financial system with effective prudential regulation and supervision is paramount. This includes strict capital adequacy requirements, sound risk management practices, and vigilant oversight of banks' and corporations' foreign currency exposures and maturity mismatches.

These policies aim to mitigate systemic risk by targeting financial vulnerabilities across the entire financial system. Examples include limits on foreign currency lending, loan-to-value ratios, debt-to-income limits, and dynamic provisioning. For instance, South Korea and Poland have implemented limits on foreign currency lending to households and corporations to reduce their exposure to exchange rate risk.

(Capital Flow Management Measures)

As discussed in the case studies, targeted and temporary capital controls, particularly on short-term or unhedged inflows, can be a legitimate tool to manage capital flow volatility and alter the composition of flows towards more stable forms like FDI. The IMF's evolving view increasingly recognizes the role of CFMs in addressing financial stability risks.

For example, Chile's unremunerated reserve requirement (URR) and Malaysia's capital controls during the Asian Financial Crisis are often cited as historical examples of using CFMs to manage short-term capital inflows and outflows, respectively.

(Flexible Exchange Rate Regimes)

While fixed exchange rates can provide a nominal anchor, they increase vulnerability to speculative attacks in the presence of open capital accounts. A more flexible exchange rate regime can act as a shock absorber, allowing the currency to adjust to external pressures and reducing the need for costly reserve interventions.

(Fiscal Discipline)

Sound fiscal policy, characterized by sustainable debt levels and sufficient fiscal space, reduces a country's vulnerability to external shocks and enhances its ability to respond to crises without jeopardizing investor confidence.

(2) Regional Financial Arrangements (RFAs)

RFAs, such as the Chiang Mai Initiative Multi-lateralization (CMIM)[35] in Asia, provide a regional layer of financial support through currency swap arrangements. These can offer faster and more tailored liquidity assistance than global institutions, leveraging regional knowledge and fostering cooperation.

In particular, it serves as an effective first line of defense against sudden stops risks arising from capital account liberalization under fixed exchange rate regimes, and the CMIM, with enhanced IMF linkages, provides a total of $240 billion in liquidity support to enhance financial stability for ASEAN+3 countries

[35] The Chiang Mai Initiative Multilateralization (CMIM) is a regional financial safety net among ASEAN+3 countries, established in 2010 to provide liquidity support and crisis prevention mechanisms. It evolved from bilateral swap agreements into a multilateral framework designed to enhance financial stability in East Asia.

<Table 5-13> Regional Financial Arrangements

Agreement Name	Year of Est.	Remarks
AMF: Arab Monetary Fund	1976	Middle Eastern Arab Monetary Fund
FLAR: Fondo Latino Americano de Reserves	1989	Latin American Reserve Fund
CMIM: Chiang Mai Initiative Multi-lateralization	2010	Multilateral Agreement of the Chiang Mai Initiative in Asia
ESM: European Stability Mechanism	2012	European financial stability mechanism
EFSD: Eurasian Fund for Stabilization and Development	2015	Eurasian Regional Stabilization and Development Fund

Source: Bank of Korea

(3) Global Safety Nets

Global financial safety nets are a set of systems and agreements, conceptualized as insurance, that allow for the withdrawal or provision of foreign currency liquidity to mitigate the impact of financial crises.

(IMF Lending Facilities)

The International Monetary Fund (IMF) serves as the core of the global financial safety net, providing financial assistance to countries facing balance of payments difficulties. The evolution of IMF facilities (e.g., Flexible Credit Line, Precautionary and Liquidity Line) aims to provide more flexible and rapid support.

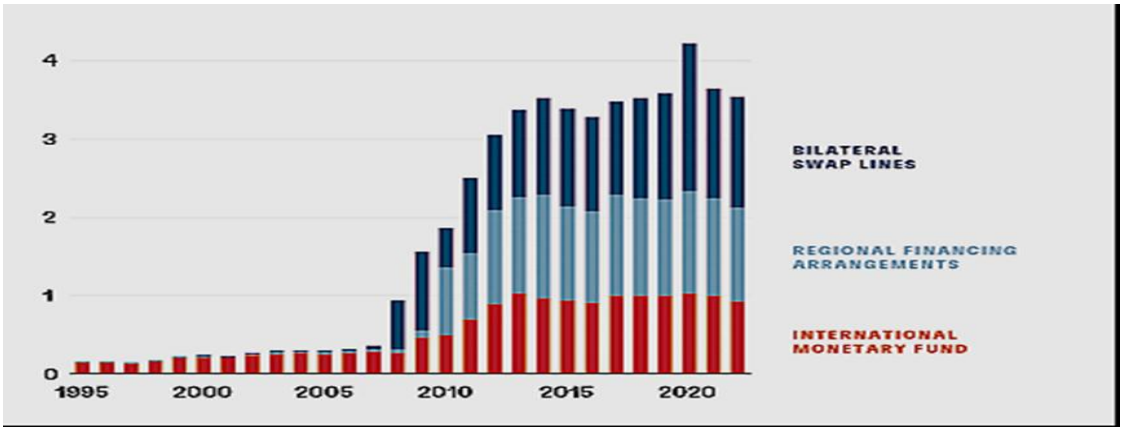
(Bilateral Swap Lines)

Central banks, particularly those of major reserve currency countries, can establish bilateral swap lines with other central banks to provide liquidity during times of stress. This mechanism serves as a rapid and direct means of liquidity provision in times of crisis, playing a complementary role within the global financial safety net.

(Enhanced Surveillance)

International organizations like the IMF, World Bank, BIS, and AMRO[36] play a crucial role in global surveillance, identifying vulnerabilities, and providing policy advice to prevent crises. Early warning systems and candid assessments of risks are vital.

<Figure 5-7> Trends in Global Financial Safety Nets



Source: IMF, Bank of Korea

(Orderly Debt Restructuring Mechanisms)

In cases of sovereign debt distress, orderly debt restructuring frameworks are crucial for managing a nation's inability to service its debt. These mechanisms provide a structured and predictable process that prevents a chaotic default, such as the one experienced by Argentina[37], and helps to minimize economic disruption. A key function is to ensure equitable burden-sharing among all creditors and the debtor nation, a step vital for restoring debt sustainability. By providing a clear path to resolution, these frameworks allow the country to return to economic stability and future growth, acting as a crucial component of the global financial safety net.

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[36] AMRO (ASEAN+3 Macroeconomic Research Office) functions as the regional surveillance unit for ASEAN+3, monitoring macroeconomic developments, supporting the Chiang Mai Initiative Multi-lateralization, and providing policy advice to enhance financial stability.

[37] In the early 2000s, Argentina defaulted on its sovereign debt, leading to a chaotic and prolonged crisis. The country's failure to negotiate with all creditors, particularly a small group of "holdout" bondholders, resulted in a drawn-out legal battle.

<Table 5-14> Example of Establishing Financial Safety Nets

Layer	Safety Net	Target	Remarks
1st Layer	Foreign Exchange Reserves	Each Country	Can be used as a priority during crises
2nd Layer	Bilateral Currency Swap	Member Countries	Signed for liquidity supply with key currency countries, mutual economic cooperation, etc.
3rd Layer	Regional Financial Agreements	Member Countries	Includes CMIM of ASEAN+3, ESM of Europe
4th Layer	International Financial Institution Support	Worldwide Countries	Fund support systems centered around IMF, World Bank, and other development financial institutions

Source: Bank of Korea

In summary, the establishment of a comprehensive and multi-layered financial safety net is an ongoing challenge, requiring continuous adaptation to the evolving nature of global capital flows and financial markets. It involves a delicate balance between promoting the benefits of capital account liberalization and effectively managing its inherent risks. Looking ahead, the ongoing challenge lies in adapting these safety nets to new forms of financial risks, such as those posed by non-bank financial intermediaries and climate-related shocks.

VI. Sequencing of Capital Account Liberalization

1. Preconditions for capital account liberalization

Capital Account Liberalization (CAL), which entails the relaxation of restrictions on cross-border capital flows, not only enables the mobilization of foreign funds at lower costs (through reduced interest rates) compared to domestic sources but also fosters the development of domestic financial and foreign exchange markets. However, persistent inflows of foreign capital may induce monetary expansion, sharp currency depreciation, and the formation of asset price bubbles. To mitigate such potential risks, careful ex-ante preparation is indispensable. While CAL provides various benefits, it is also accompanied by inherent risks; hence, the generally acknowledged preconditions include macroeconomic stability, a sound financial system, an appropriate exchange rate regime, effective financial regulation and supervision, and the establishment of market-oriented mechanisms. Among these, the development of a robust legal and institutional framework requires substantial time, thereby necessitating a meticulously phased preparation strategy and continuous adjustments to both the sequencing and pace of implementation.

This chapter examines the experiences of Korea and other major economies in pursuing capital account liberalization since the 1980s, along with an assessment of Nepal's process of capital account opening, in order to propose an optimal sequencing strategy for CAL and effective policy responses for the Nepal Rastra Bank (NRB). In a more detailed analysis, the following subtopics can be distinguished.

A. Macroeconomic Stability as a Precondition for Liberalization

Before opening the capital account, it is essential to ensure domestic macroeconomic stability, including low inflation, fiscal soundness, and external balance. An unstable macroeconomic environment may attract speculative capital flows and heighten the risk

of crisis. Capital account liberalization can be implemented effectively only when supported by stable macroeconomic policies. In contrast, in the absence of a solid economic foundation, external shocks may not be readily absorbed, thereby increasing the likelihood of abrupt and volatile capital inflows and outflows.

(i) A sustainable fiscal position, characterized by fiscal discipline and manageable budget deficits, is indispensable to avoid excessive dependence on foreign capital and potential debt crises.

(ii) Maintaining low and stable inflation is crucial to preventing relative price distortions and discouraging destabilizing capital movements.

(iii) A credible monetary policy framework, including a reliable interest rate structure, provides the policy basis for effectively managing domestic liquidity fluctuations driven by capital movements and preventing excessive credit expansion.

B. Strengthening the Financial System

Capital account liberalization requires the establishment of robust banking supervision, risk management, and regulatory systems. Rapid liberalization without such safeguards may encourage vulnerable banks to take on excessive risks.

(i) A resilient banking system—characterized by adequate capitalization, prudent lending practices, and effective risk management—is essential to withstand potential shocks from increased capital flows.

(ii) A strong regulatory and supervisory framework is necessary to oversee financial institutions, prevent excessive risk-taking, and safeguard financial stability.

C. Development of Domestic Financial Markets

The existence of deep and liquid bond and equity markets is instrumental in absorbing incoming capital effectively and managing volatility. Moreover, developed domestic financial markets enhance flexibility in interest rates and exchange rates. A well-

diversified financial system also helps channel capital inflows into productive investments while reducing the risk of misallocation of credit.

D. Exchange Rate Flexibility and Reserve Accumulation

A fixed or rigid exchange rate regime increases vulnerability to speculative attacks under a liberalized capital account. Hence, adopting a flexible exchange rate regime and building sufficient foreign exchange reserves are recommended. Exchange rates should primarily reflect market supply and demand conditions to avoid prolonged one-sided expectations of depreciation or appreciation. If the exchange rate deviates significantly from economic fundamentals, speculative capital flows are likely to intensify, driven by expectations of exchange gains or losses. In the event of capital outflows, foreign exchange market intervention becomes inevitable; thus, maintaining an adequate level of reserves is critical.

E. Legal and Institutional Framework

The successful implementation of capital account liberalization requires transparent rules governing cross-border investment, effective data monitoring, and a reliable legal framework to ensure market-based capital flows.

(i) Effective governance, transparency, and the rule of law are essential for attracting foreign investment and ensuring efficient market functioning.

(ii) A clear and predictable legal system regarding contract enforcement and property rights constitutes a critical condition for foreign investment.

(iii) A strong monitoring system is indispensable for identifying potential risks, assessing the impact of capital flows on the economy, and taking timely corrective measures.

F. International Financial Safety Nets

At the national level, it is crucial to establish international financial safety nets to cope effectively with the risks of sudden capital reversals. Capital account liberalization increases interdependence among countries, not only in terms of current account transactions but also through cross-border capital flows and the transmission of financial risks. Accordingly, measures include:

(i) Establishing bilateral currency swap arrangements;

(ii) Utilizing swap lines from international and regional financial institutions;

(iii) Adopting global guidelines on capital inflows and outflows.

<Box 6-1> Importance of preparedness (Japan's case)

1. Overview

Japan served as a significant reference country for Korea, offering practical lessons for financial openness policies, including capital account liberalization, due to the numerous similarities in laws, institutional frameworks, and practices between the two countries. Japan began its capital liberalization process in the early 1960s and completed it over a period of approximately two decades. Examining the preparatory stages for implementing capital account liberalization by motivation reveals the following characteristics:

In the early 1960s, Japan focused primarily on facilitating capital inflows rather than outflows, driven by domestic and international interest rate differentials and expectations regarding growth potential. This cautious approach was motivated by concerns that rapid capital inflows could generate macroeconomic challenges, including difficulties in monetary management, inflationary pressures, current account deficits resulting from currency appreciation, increased consumption, stock market overheating, and excessive domestic credit expansion. Unlike foreign direct

investment, which tends to be committed to real investment and is less susceptible to short-term reversals, portfolio capital inflows raised concerns over potential rapid outflows and external debt repayment problems in response to changes in the investment environment.

2. Preparatory Process and Policy Implications

First of all, Japan's capital liberalization was initiated primarily under external pressure. Following its defeat in World War II, Japan enjoyed exceptional conditions, including economic benefits stemming from the Korean War, which resulted in sustained large trade surpluses. Despite maintaining a relatively low exchange rate for an extended period, Japan faced increasing pressure from Western countries to liberalize its financial markets. Notable external pressures included the United States' requirements for Japan's compliance with the IMF's Article VIII obligations in 1964, OECD accession, the revision of the Foreign Exchange Law in 1980, and the establishment of the U.S.-Japan Yen/Dollar Committee in 1983.

Second, Japan pursued liberalization gradually over an extended period. Although external pressures played a role, Japanese policymakers internally recognized that a closed economy would struggle to respond effectively to the evolving international environment. Capital liberalization, formally initiated with OECD accession, moved toward greater openness in principle with the implementation of the revised Foreign Exchange Law in 1980. However, the process was carried out progressively, accompanied by gradual deregulation of the financial sector, in coordination with activities of the Yen/Dollar Committee.

Third, Japanese financial authorities formally endorsed the liberalization of the capital account; however, they consistently maintained a somewhat ambiguous and flexible stance. Although the Foreign Exchange Law was revised in 1980, it included precautionary provisions and left the legal basis for certain regulations unclear. For instance, in the case of capital account transactions, prior approval was required under circumstances such as:

① Situations that could jeopardize Japan's balance of international payments,

② Instances causing abrupt fluctuations in the yen exchange rate, or

③ Large-scale capital movements from abroad that might adversely affect Japan's financial and capital markets.

No specific quantitative criteria were provided, allowing the authorities to exercise discretionary judgment and implement quasi-regulatory measures as necessary. Furthermore, Japan occasionally adopted flexible measures that effectively represented temporary reversals in liberalization. Examples include:

① Maintaining a low-interest-rate policy until the liberalization of interest rates was fully implemented,

② In August 1971, in response to yen speculation following the Nixon Shock, shifting to a "capital inflow-restraining and outflow-promoting" exchange control policy, and alternately restricting or relaxing foreign investment in domestic bonds depending on monetary conditions.

Forth, Domestic financial liberalization supported the policy of capital account opening. Japan adhered to the economic theory that financial liberalization should precede capital market liberalization in order to mitigate potential adverse effects. By the time Japan embarked on full-scale liberalization, it had already established a foundation of stable economic growth, allowing for a complementary relationship between domestic financial liberalization and capital account openness.

Finally, Japan was able to open its capital markets under conditions of current account surpluses and stable economic growth, relying on a flexible exchange rate system and selective easing of restrictions on capital outflows. Even in the face of short-term fluctuations in capital movements, authorities could respond through exceptional measures within the framework of liberalization.

2. General consensus on sequencing the convertibility of capital

A. General Consensus

The A general consensus among most economists, international organizations such as the IMF, and countries with experience in market liberalization is that full capital account convertibility (CAC) should be implemented gradually and sequentially rather than abruptly. This is because premature convertibility or liberalization can exacerbate macroeconomic and financial instability.

Most countries that have opened their financial markets pursue capital account liberalization while carefully managing associated risks. They adopt a systematic approach that aligns with the country's institutional and financial development, emphasizing gradual, phased, and targeted opening of real and financial sectors.

Capital account liberalization (CAL) can fundamentally be regarded as part of the broader process of economic reform and regime change. As such, it is essential to minimize adjustment costs while maintaining international consistency in domestic economic policies. The sequencing and pace of CAL are crucial in reducing these adjustment costs. A common principle is that sectors with slower adjustment speeds should be liberalized earlier, as this helps lower costs and maintain economic balance.

On this basis, it is generally more effective to liberalize the real sector—particularly trade, where adjustment occurs more slowly—ahead of the financial sector.

The general consensus derived from global financial liberalization since the 1980s also emphasizes "gradual, phased, and conditional" liberalization rather than a "big bang" approach. Preconditions include macroeconomic stability and preparedness of the financial sector, with no universal "panacea" for the optimal sequence of liberalization applicable to all countries. Gradual market opening for CAC is particularly effective where domestic vested interests opposing liberalization are weak and where the economy exhibits sufficient price flexibility and adaptability in supply and demand. Conversely, in cases where political resistance to liberalization is strong and domestic markets are characterized by monopoly or oligopoly structures with rigid prices, a more radical

liberalization approach may be justified to overcome structural constraints. In the early stages of economic development, legal and market rigidities often necessitate some degree of rapid or radical liberalization to achieve meaningful reforms.

Meanwhile, policy experiences across countries also indicate that prior to capital account liberalization, many nations ensured sufficient legal and institutional foundations to support the smooth implementation of current account liberalization (e.g., free trade in goods and services, travel, remittances) and the development of the domestic financial sector. In terms of capital flows, priority was generally given to long-term, productive flows (e.g., foreign direct investment, equity inflows) over volatile short-term speculative flows (e.g., short-term debt, portfolio inflows). Non-resident inflows were typically liberalized first, while domestic outflows were allowed more cautiously.

As noted by the IMF (2012), a comprehensive approach is essential to reduce risks and maximize benefits of capital account liberalization. Well-planned and sequenced institutional and reform policies do not necessarily require gradual liberalization; in some cases, faster liberalization may be preferable. Rapid opening of capital markets can weaken entrenched vested interests and government-controlled monopolies, thereby generating reform momentum. Moreover, capital liberalization can foster competition and increase the scale of capital flows, thereby promoting domestic financial market development and institutional reforms.

B. Sequencing of Capital Account Liberalization under a Strict Exchange Rate Regime

In countries that have maintained a long-standing and rigid fixed exchange rate regime, such as Nepal, it is advisable to pursue capital account liberalization in a gradual and differentiated manner after first enhancing policy adaptability through the softening of the peg, in order to safeguard macroeconomic stability, including exchange rate stability. A rigid fixed exchange rate regime reduces uncertainty in exchange rate fluctuations, but it necessitates the separate regulation of capital transactions and foreign exchange policies

to mitigate economic shocks arising from volatile capital flows.

Experience from countries that transitioned from fixed to multiple and then to single currency exchange rate regimes—such as Korea, China, India, and Chile—shows that they generally followed a conventional sequencing of capital account liberalization. Under either a fixed exchange rate or a tightly managed crawling-peg regime, increased capital flows resulting from liberalization can exacerbate domestic and external imbalances, which are difficult to resolve through exchange rate adjustments. This underscores the critical importance of maintaining macroeconomic stability and a sound financial system. From the perspective of external debt management, liberalization should proceed gradually, prioritizing long-term corporate and financial institution borrowing over short-term or individual borrowing. To stabilize the foreign exchange supply, initial liberalization should focus more on easing restrictions on domestic firms' capital outflows (through direct investment or securities) rather than encouraging capital inflows.

The typical path followed by these countries involved incorporating the domestic currency into a multi-currency basket, transitioning to a multiple-currency exchange rate system, and ultimately achieving full capital account convertibility (CAC) through a single, market-based exchange rate regime. This sequencing helps reduce discrepancies between the exchange rates applied to current account and capital account transactions. Experience from Korea and other countries indicates that while a fixed exchange rate can be maintained temporarily under full capital account liberalization, it is difficult to sustain in the long term due to the inherent tensions between capital mobility and exchange rate rigidity.

C. Sequencing of Capital Account Liberalization and Exchange Rate Flexibility under Interest Rate Liberalization

Capital account opening (CAO) represents a key external economic policy instrument considered by many developing countries, including Nepal, to promote economic growth, attract capital, and diversify financial risks. Rapid or poorly designed market

liberalization carries inherent risks, such as financial instability, foreign exchange crises, and sudden capital outflows, which necessitate careful liberalization of the financial sector. The IMF (1998) emphasizes that capital account liberalization and financial sector reform are mutually complementary, and their coordinated implementation significantly enhances the likelihood of successful reform. Accordingly, the sequencing and combination of related policies are critical for achieving reform objectives.

As capital mobility increases, the management of domestic and international interest rate differentials, exchange rate volatility, monetary aggregates, and foreign reserves becomes increasingly important. In countries like Nepal, which maintain fixed or tightly managed crawling-peg exchange rate regimes, heightened capital mobility creates potential inconsistencies between exchange rate and interest rate policies. Experiences from Korea, Chile, and Thailand demonstrate that the speed and sequence of capital account liberalization and financial sector reforms vary considerably, and the level of institutional preparedness and regulatory capacity significantly influences the stability of outcomes. For example, in Chile, financial market liberalization, interest rate deregulation, and banking reforms were implemented prior to or concurrently with capital account liberalization. In contrast, Thailand liberalized capital flows ahead of financial sector reforms and supervisory capacity enhancements, which heightened the risk of currency and financial crises.

(1) Importance of Policy Sequencing

From a central bank perspective, the sequencing of capital account liberalization relative to interest rate liberalization and exchange rate flexibility is crucial for maintaining monetary policy autonomy. A key issue arises because these three policy dimensions—interest rates, exchange rates, and capital flows—can create consistency challenges.

First, liberalizing capital flows under interest rate and exchange rate controls can trigger massive capital movements due to domestic-foreign interest rate differentials. To absorb the resulting shocks, authorities may need to enhance exchange rate flexibility or advance

interest rate liberalization, highlighting the necessity of capital controls if both rates and exchange rates remain regulated.

Second, interest rate regulation, exchange rate flexibility, and capital liberalization need not conflict. A flexible exchange rate can absorb capital flow-induced shocks, allowing the pursuit of independent interest rate policy. However, persistent real interest rate differentials may overload the exchange rate, causing excessive exchange rate volatility.

Third, under a fixed exchange rate, interest rate liberalization and capital liberalization are not necessarily contradictory. Permitting capital flows aligns domestic and foreign interest rates, precluding independent monetary policy. Unlike the second case, however, adjustment pressures from capital flows are borne entirely by interest rates, leading to higher interest rate volatility.

In contrast, when interest rate independence is not pursued and international parity mechanisms are allowed to operate, adjustment pressures from capital flows are shared between exchange rates and interest rates, resulting in lower exchange rate volatility than in the second case.

(2) Korea's Experience

Korea's government historically managed the financial sector as a tool of industrial policy. As the economy grew and became more sophisticated, the efficiency of financial intermediation became critical for supporting the real economy. With Korea's transition to an open economy and ongoing capital account liberalization, enhancing the price signaling function of interest rates and exchange rates became essential to improve economic efficiency. Interest rate liberalization aimed to strengthen market functions, promote financial efficiency, and enhance the international competitiveness of the financial sector.

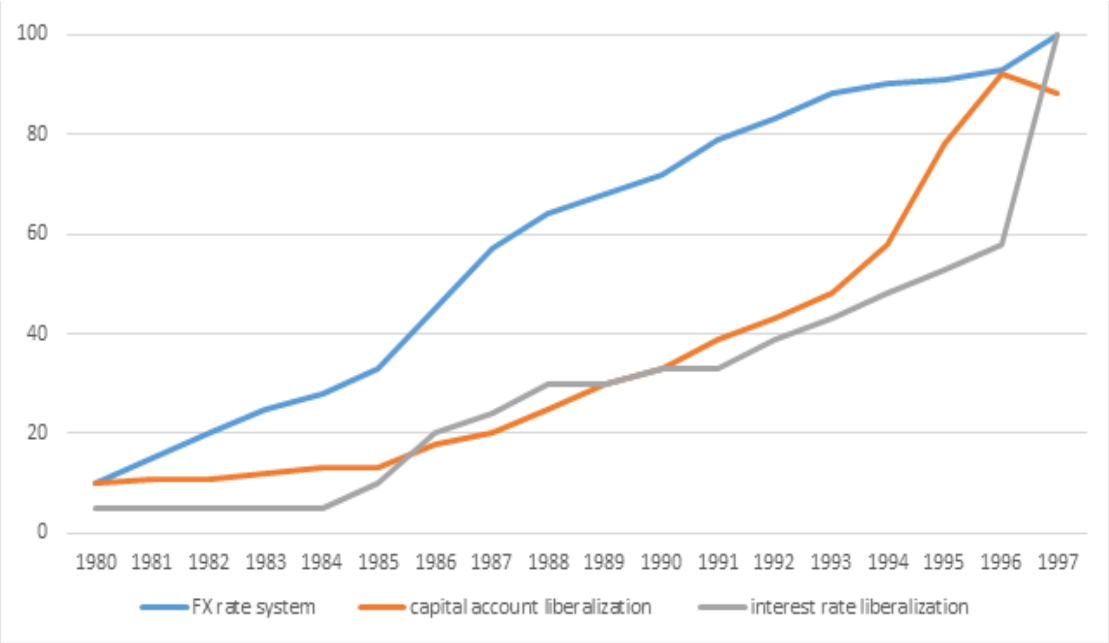
Following the Interest Rate Liberalization Plan announced in August 1991, Korea implemented the first phase of gradual, staged interest rate liberalization in November 1991, considering real economy conditions, financial market developments, and economic agents' adaptive capacity. Under Korea's fixed exchange rate regime, gradual

capital account liberalization increasingly constrained the central bank's ability to maintain monetary autonomy—a manifestation of the "Impossible Trinity." Capital inflows from foreign investors to domestic asset markets caused exchange rates, income, and interest rates to adjust more rapidly than goods prices, resulting in a divergence between the real exchange rate and purchasing-power-based rates. This underscored the importance of effectively sequencing interest rate liberalization, capital account opening, and exchange rate flexibility to maintain macroeconomic stability.

To stabilize both exchange rates and prices, Korea sought to control capital mobility while intervening in foreign exchange markets and reducing domestic credit through sterilized interventions, such as issuing monetary stabilization bonds. Consequently, from the 1980s onward, Korea carefully sequenced the three policies rather than pursuing them simultaneously. Simplified policy sequencing followed the order: interest rate liberalization → exchange rate flexibility → capital account liberalization (particularly short-term capital accounts). Each stage was subdivided into multiple phases to ensure partial, gradual liberalization. Early interest rate liberalization allowed price signals to respond to changes in capital inflows and outflows. Exchange rate policy maintained a flexible quasi-fixed system (e.g., multiple-currency basket or market-average rates) until the mid-1990s. Subsequently, rapid short-term capital inflows outpaced the pace of exchange rate flexibility, contributing to a surge in short-term foreign debt and the 1997 Asian financial crisis, which ultimately prompted the adoption of a fully flexible exchange rate system.

Capital account liberalization reached full liberalization of short-term capital only in the late 1990s, accelerating after Korea's OECD accession in 1996, surpassing the pace of interest rate liberalization and exchange rate adjustments. Figure 6-1 visualizes the relative speed of interest rate and exchange rate liberalization by indexing regulatory intensity and exchange rate regime changes.

< Figure 6-1 > Evolution curve of CAL, Interest rate liberalization, and FX rate flexibility



Footnotes :

a. The degree of capital account liberalization is measured using the KAOPEN index, developed by Chinn and Ito (2008) in their study
b. Interest Rate Liberalization Index: Scored on a 0–1 scale, based on OECD sources, the IMF Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER) (interest rate items), and BOK data (chronology of interest rate liberalization). Scores are assigned as follows: 0.0 = fully regulated, 0.3 = partially liberalized, 0.6 = largely liberalized, and 1.0 = fully liberalized.
c. The Exchange Rate Liberalization Index is measured on a 0–1 scale, utilizing information from the IMF's AREAER and the Bank of Korea's historical records on exchange rate regimes. The scoring scheme is defined as follows: 0.0 corresponds to a fixed exchange rate regime; 0.3 to a managed floating regime with strict control over fluctuation bands; 0.6 to a managed floating regime with broader fluctuation bands; and 1.0 to a freely floating exchange rate regime.

D. Characteristics and Policy Considerations of Korea's Capital Account Liberalization

(1) Overview

Since the 1980s, Korea pursued capital account liberalization over a period of approximately fifteen years leading up to the opening of its financial markets. During this period, the country adhered to a gradual, real-sector–oriented approach to liberalization. In the early stages, while extensive discussions took place regarding the necessity and inevitability of financial market opening, the domestic macroeconomic policy environment required to support capital account liberalization remained underdeveloped. Specifically, reforms to enhance flexibility and liberalization of interest rates and the exchange rate system, the deregulation of financial markets, and improvements in the conduct of monetary and credit policy were insufficient.

This situation can be partly attributed to the vested interests of beneficiaries of low interest rates, undervalued exchange rates, and policy-directed finance. For these groups, financial liberalization in the area of capital transactions would effectively mean relinquishing significant privileges, and their lobbying efforts exerted considerable influence on government policy. However, the background for shifting from a gradualist approach to a more rapid liberalization of capital markets can be found in Korea's accession to the OECD and the Asian financial crisis. These developments compelled the government to accelerate economic liberalization and deregulation, while at the same time asserting greater policy leadership over entrenched interest groups despite the heightened burden of meeting the higher standards of openness.

A distinctive feature of Korea's capital market opening was the prioritization of institutional reforms ahead of liberalization. Strengthening financial supervision, developing capital market institutions, and improving the domestic financial system were pursued in advance. Korea also sought to control capital flows and adjust the exchange rate regime in line with macroeconomic conditions. Furthermore, financial reforms, foreign exchange system adjustments, and sequential regulations on capital inflows and

outflows were introduced in a phased manner. External shocks—such as OECD membership and the Asian financial crisis—further accelerated capital account liberalization, in tandem with corporate and financial restructuring and reforms of the foreign exchange regime.

<Table 6-1> The Process of Capital Liberalization in Korea

Year	Major Policy Measures
1980s	● Limited liberalization, including permission for domestic firms to invest in overseas securities.
1988	● Formulation of the Capital Market Internationalization Plan, allowing securities companies to invest in foreign stock markets.
1992	● Partial opening of the domestic stock market to foreign investors.
1993	● Acceleration of interest rate liberalization and relaxation of financial regulations.
1996	● Korea's accession to the OECD increased the need to attract foreign capital, leading to expanded capital market opening.
1997	● The Asian Financial Crisis underscored the importance of foreign capital, prompting large-scale liberalization of the stock, bond, and short-term money markets.

(2) The Characteristics of Korea's Capital Liberalization and Policy Implications

(a) Capital Liberalization through Stakeholder Adjustment

Since the 1990s, Korea's liberalization of capital movements has proceeded in a manner consistent with the integrated approach, advancing carefully sequenced financial reforms

against the backdrop of sound and stable macroeconomic policies. This sequencing strategy sought to maximize the benefits of capital mobility while mitigating its attendant risks, implementing liberalization in line with the country's institutional and financial development levels within a systematic and coherent framework.

The opening of Korea's financial markets and the process of capital account liberalization (CAL) exerted profound distributional effects across different stakeholders, including domestic banks, export-oriented firms, conservative policy experts, and low-skilled labor. In response, the Korean government positioned itself as an active mediator, endeavoring to ease tensions among these groups and thereby ensure the successful implementation of CAL. For example, in order to support domestic banks, which were structurally disadvantaged in terms of capital adequacy and scale compared to foreign financial institutions, the government promoted bank recapitalization and mergers. For export firms, which feared that exchange rate volatility could undermine their price competitiveness, the authorities introduced a gradual framework for exchange rate flexibility while expanding the availability of foreign exchange derivatives. Conservative policy experts' concerns over financial instability were addressed by postponing the liberalization of speculative short-term capital until the final stage, while simultaneously reinforcing safeguard mechanisms such as monitoring systems and prudential regulations. At the same time, the government framed capital market reforms as part of a broader national development strategy, formulating medium- and long-term plans for financial market modernization, advancing OECD accession, and cultivating the financial sector as a strategic industry.

(b) Capital Liberalization in Accordance with Current Account Developments

Since the 1980s, Korea's trade and capital flows expanded rapidly in line with the global surge in both trade volume and cross-border capital movements. During the 1990s, net capital inflows were more than five times greater than those recorded in the early 1980s. These inflows were primarily driven by the need to finance current account deficits, resulting in significant shifts in both the patterns of capital flows and the composition of

capital account items depending on the state of the current account balance.

When Korea experienced current account surpluses, the authorities focused on liberalizing capital outflows; conversely, during deficit periods, the emphasis was on relaxing restrictions on capital inflows. For instance, in the late 1980s, a period characterized by current account surpluses, liberalization measures targeted outward foreign direct investment (FDI) and overseas portfolio investment. However, compared with other developing economies, FDI inflows to Korea remained strikingly low, accounting for only about 10 percent of total capital inflows. At the same time, regulations on overseas real estate investment were eased, while external commercial borrowings (ECBs) by the public and corporate sectors were repaid in advance. In the early 1990s, when the current account shifted back into deficit, the government considerably liberalized inward FDI and foreign portfolio investment in the private sector. As a result, long-term capital inflows played an important role in offsetting the foreign exchange demand arising from current account deficits, while long-term capital outflows and short-term capital flows steadily expanded in accordance with the overall liberalization trend.

(c) FDI Attraction Strategies for Protecting Domestic Firms

From the 1980s, when Korea began to accelerate capital liberalization, the government maintained a relatively cautious stance toward attracting foreign capital on the grounds that liberalization for domestic firms remained insufficient. Consequently, the share of FDI in total capital inflows into Korea remained exceptionally low—around 10 percent—throughout the 1980s, a level notably below that of other East Asian economies. This reflected, on the one hand, Korea's declining competitiveness as a labor-intensive assembly base due to rapidly rising domestic production costs, and, on the other hand, the country's development strategy, which had relied heavily on external borrowing since the early stages of economic development in the 1960s.

The Korean government feared that full-scale opening to FDI could expose domestic industries to foreign dominance and increase the economy's dependency on external capital. Such concerns, combined with a particular wariness toward Japanese direct

investment, meant that active FDI inflows remained limited until the late 1970s. Instead, Korea preferred arrangements such as minority-owned joint ventures and selective introduction of physical assets, opting to rely on foreign loans for capital financing and licensing agreements for technology acquisition rather than opening widely to FDI.

(d) Asymmetric Liberalization: Prioritizing Capital Outflows over Inflows

The liberalization of portfolio capital that began in the late 1980s and early 1990s aimed at the broader opening of Korea's financial system, yet restrictions on capital outflows were eased before those on capital inflows. In this process, external imbalances were managed primarily through current account surpluses. From the mid-1990s until the eve of the IMF crisis, Korea progressively relaxed restrictions on portfolio inflows, including foreign investment in equities and bonds. In the stock market, ceilings on foreign ownership were gradually raised (1992: 10% → 1995: 15% → 1996: 20%), while the bond market was also opened. Simultaneously, limits on overseas investment by domestic firms, financial institutions, and individuals—including investment in foreign equities and bonds—were expanded.

The stepwise foreign exchange and capital liberalization plan announced in the run-up to Korea's OECD accession in late 1996 maintained a gradualist stance in both scope and pace of reforms. Policymakers recognized that liberalizing capital inflows without ensuring sufficient ease of capital outflows could trigger excessive capital surges, and therefore synchronized the pace of inflow liberalization with that of outflow liberalization. Outward FDI and overseas portfolio investment were included in the second stage, while capital inflows such as export prepayments, deferred import payments, and foreign equity investment were liberalized more gradually in the third stage. However, in contrast to equities, the opening of the bond market—perceived as carrying relatively lower investment risks—was allowed only in a limited manner until the third stage (1999). This cautious approach reflected concerns that, under conditions of significant interest rate differentials between domestic and international markets, full liberalization of bond inflows could invite rapid surges of speculative debt finance.

In addition, non-trade current account payments were liberalized in the second stage, while expenditures related to overseas travel and emigration were liberalized only in the third stage. However, this atypical sequencing—where liberalization of portfolio capital outflows preceded that of inflows—eventually gave rise to unintended vulnerabilities by the mid-1990s. The sharp increase in foreign investment in Korean equities and bonds led to the accumulation of short-term external debt and a widening imbalance between capital inflows and outflows. These developments contributed to foreign exchange mismatches and, in turn, became one of the underlying factors that set the stage for the foreign exchange crisis at the end of 1997.

(e) Acceleration of Capital Liberalization under External Pressure

Capital liberalization in Korea began to accelerate markedly following two critical turning points: the country's accession to the OECD in December 1996 and the foreign exchange crisis of December 1997. In line with the commitment to comply with the OECD Code of Liberalization of Capital Movements, the government intensified the pace of sequential liberalization, aiming to achieve a degree of capital mobility comparable to the OECD average level by around 2010.

In the aftermath of the foreign exchange crisis, the expansion of foreign exchange reserves emerged as a top national policy priority, heightening the need to attract foreign capital and to improve the efficiency of managing foreign currency assets. As previously noted, during the negotiations with the IMF for financial support immediately following the crisis, Korea agreed to pursue a bold liberalization of the capital account as part of the IMF-supported program.

Accordingly, at the end of December 1997 and in May 1998, ceilings on foreign investment in Korean bonds and equities were abolished, and in September 1998, foreign direct investment was converted to a simple reporting system, effectively liberalizing both foreign direct and portfolio investment. Limits on residents' overseas securities investment, which had been introduced in 1994, were also removed, and the range of eligible foreign securities was expanded. From a legal and institutional perspective, major

reforms were undertaken, including the revision of the Foreign Exchange Transactions Act (April 1999), the Foreign Investment Promotion Act, and the Financial Investment Services and Capital Markets Act, further supporting the framework for full capital account liberalization. To ensure the efficient management of foreign exchange reserves and to enhance national wealth, the Korea Investment Corporation Act was enacted in March 2005, establishing a sovereign wealth fund.

(f) Institutional Capacity Should Precede the Sequencing of Liberalization

The foreign exchange crisis at the end of 1997 revealed that behind the rapid outflows of capital lay an excessive accumulation of short-term capital (short-term external debt) that had occurred during the earlier stages of capital liberalization. This vulnerability was exacerbated by the government's guarantee schemes, inadequate risk management within domestic banks, and instability in international financial markets. These factors underscore that strengthening institutional and regulatory capacity should take precedence over the sequencing of liberalization in order to mitigate systemic risks.

These observations indicate that the sequencing of capital market liberalization at the individual country level should be designed within a comprehensive framework that takes into account domestic and external conditions, including potential institutional weaknesses in emerging markets and the inherent instability of international financial markets due to volatility in short-term capital flows. In the aftermath of the 1997 foreign exchange crisis, Korea recognized that capital account liberalization should not focus solely on sequencing. Rather, it needed to proceed while fully meeting preconditions for effective liberalization, including the strengthening of institutional frameworks for capital market liberalization, reinforced financial supervision, enhanced risk management capacities of firms and banks, and the promotion of long-term capital inflows.

Beyond the order of liberalization, had sufficient financial regulation and supervision, robust voluntary risk management systems within enterprises and financial institutions, and measures addressing structural risks such as currency, maturity, and asset-liability mismatches been in place, exchange rate fluctuations alone would not have precipitated

a crisis. Traditionally, liberalization has proceeded from current account transactions to capital account transactions, and from long-term to short-term capital. Yet more important than strict sequencing is attention to the volatility of short-term capital flows and the resulting financial instability. In other words, the incentives of all relevant stakeholders—including domestic and foreign financial institutions and corporations involved in capital movements—must be carefully considered.

A critical vulnerability in Korea's liberalization process lay not in the sequencing itself, but in the fact that short-term borrowing through the banking sector (primarily domestic branches of foreign banks) far exceeded long-term borrowing. Furthermore, insufficient consideration of the economic shock resulting from a potential reversal of massive capital inflows contributed to the onset of the foreign exchange crisis. This underscores the importance of the structure of external debt in emerging market crises: if mismatches in maturity and currency are not adequately addressed, a sudden loss of external credibility can trigger not merely a foreign exchange crisis, but a sharp economic contraction stemming from capital reversals.

Although long-term capital inflows had been constrained prior to the crisis, this did not imply that all short-term capital movements were fully restricted. In practice, liberalization applied mainly to corporate trade finance and short-term bank borrowing. Does this mean that the optimal policy is to tightly control these channels? The answer is largely negative, as constraining short-term bank transactions entails considerable costs. More crucial is strengthening the supervision of financial institutions and establishing voluntary risk management systems within both banks and firms to properly hedge the currency risks of external debt. Even in the presence of significant exchange rate appreciation, currency risk can be mitigated if maturity and currency mismatches in external debt are addressed. However, in the absence of an adequate supervisory framework, individual financial institutions and corporations lacked sufficient incentives to hedge these risks.

The key lesson from Korea's experience with capital liberalization, particularly in the wake of the foreign exchange crisis, is that the primary shortcoming was not the sequence

of liberalization per se, but the lack of institutional mechanisms necessary to maximize the benefits of liberalization while managing associated risks.

<Table 6-2> Phased Capital Account Liberalization Plan by Type of Funds

Category	Phase 1 (1993)	Phase 2 (1994–1995)	Phase 3 (1996–2000)
Foreign Direct Investment (FDI)	Simplification of procedures for outward FDI and relaxation of investment restrictions	Expansion of open sectors and expansion of FDI subject to notification	- Establishment of notification-based system for inward FDI (1997) - Full liberalization of outward FDI through conversion to notification system (1997)
Overseas Securities Investment	- Expansion of eligible institutional investors and investment ceilings - Allow indirect overseas investment by retail investors	- Full liberalization of overseas securities investment by institutional investors - Expansion of permissible scope of overseas securities investment by retail investors	
Equity Market	Abolition of per-stock investment ceiling (10%) for foreign investors in firms with over 50% foreign ownership	Expansion of foreign ownership limits in domestic equities	Further expansion of foreign ownership limits → Full removal of limits (2000)
Bond Market	Permission for international organizations to issue KRW-denominated bonds	Permission for direct investment in equity-linked bonds	- Permission for direct investment in long-term unsecured bonds of SMEs (1996) - Full liberalization when interest rate differential (domestic vs. foreign) narrows to within 2%
External Financing and Trade Credit of Corporates	Inclusion of high-tech service firms among foreign-invested firms eligible for short-term borrowing	- Expansion of eligibility for short-term borrowing to general manufacturing firms - Extension of deferred import payment period (up to 180 days)	

3. Where does Nepal stand?

A. Process of Capital Account Liberalization in Nepal

Nepal initiated economic liberalization in the 1980s in response to a balance of payments deficit. In this process, the government sought support from the IMF and the World Bank and implemented "Structural Adjustment Programs" (SAPs) to absorb excess liquidity and advance reforms. These reforms included deregulation of markets, privatization of state-owned enterprises, trade liberalization through replacement of import quotas with an open general license system and tariff reductions, and foreign exchange reforms allowing partial and gradual convertibility of the currency. The overarching goal of liberalization was to transition the government's role from that of a direct controller to a facilitator promoting private sector growth and market functions.

Nepal experienced a planned economy for approximately fifty years beginning in 1956. Initially following an import substitution policy, the country adopted an export promotion strategy from "the Fourth Five-Year Plan" (1969–1974) onward. Significant reforms were implemented after 1991/92, resulting in substantial liberalization across taxation, industry, trade, finance, foreign investment, and foreign exchange policy. Interest rates were deregulated and generally determined by market forces, while the Nepalese rupee became fully convertible for current account transactions as of February 12, 1993. Tariff rates were substantially reduced to align with global levels, and foreign investors were granted the same privileges as domestic investors.

In the early 1990s, Nepal had already embarked on a gradual process of capital account liberalization. "The Foreign Investment and Technology Transfer Act" of 1992, amended in 1996, guaranteed full repatriation of equity sales, profits and dividends, and interest on external debt. Foreign exchange earners were allowed to retain 100% of their earnings and maintain foreign currency deposits in domestic banks. Exporters were permitted to borrow in foreign currency from domestic banks, and exchange limits for small international transactions through commercial banks were increased from USD 1,500 to

USD 2,500. Nevertheless, most of Nepal's economic fundamentals were neither strong nor stable enough by the early to mid-2000s to transition immediately to full capital account convertibility (CAC).

From the 2000s to the 2010s, certain capital account relaxations were introduced, including allowances for foreign direct investment (FDI), foreign exchange derivatives, and external borrowing. In the 2020s, following the COVID-19 pandemic, the government has pursued further gradual liberalization, including measures to curb foreign exchange outflows, restrict luxury imports, and permit overseas investments by IT companies (up to USD 1 million), alongside relaxed regulations for Non-Resident Nepali (NRN) investments.

These gradual efforts in foreign exchange liberalization contributed to the expansion of international trade, with trade as a share of GDP rising from 32% in 1990 to 59% in 1995. FDI inflows also increased sharply, from USD 5.9 million in 1990 to USD 190 million in 2017. Additionally, the entry of private and joint-venture foreign banks enhanced competition in the financial sector. However, chronic trade and current account deficits persist due to rapid import growth, while bureaucratic inefficiencies, corruption, and weak law enforcement continue to impede improvements in the investment environment. Domestically, productivity stagnation and delays in structural economic transformation remain significant challenges.

B. Assessment of Preconditions for Capital Account Liberalization

Nepal has been gradually developing the institutional foundations necessary for full capital account convertibility (CAC). Since the 1990s, multiple studies and policy plans have discussed the prospect of fully opening the capital account. Recently (2025), the government has taken historic steps, including permitting overseas investments by IT companies and repealing/amending the Foreign Investment and Prohibition Act (1964). The country's fiscal stability and adequate foreign exchange reserves constitute significant strengths, while ongoing improvements in financial supervision and structural

reforms are positive developments. However, challenges remain, particularly in enhancing flexibility in the exchange rate regime, deepening the financial market, and resolving price distortions. Consequently, Nepal is not yet fully prepared to implement CAC.

(1) Macroeconomic Stability: *Partially Met*

Inflation has been relatively stable within a certain range (approximately 4–5%), but the economy remains vulnerable to external shocks due to a weak export base and high import dependence.

(2) Fiscal Soundness: *Largely Met*

According to the IMF, Nepal's primary fiscal deficit was a concern in the early 2000s due to high deficit ratios and public expenditure pressures. In recent years, however, the deficit has been maintained at roughly 2–3% of GDP. Major revenue sources are relatively stable. In FY25, the overall fiscal deficit is projected to remain around 2.5% of GDP, with expenditure growth lagging behind revenue growth, bringing the fiscal balance closer to equilibrium. Nepal has avoided large-scale fiscal deficits, satisfying a key precondition for CAC in terms of fiscal sustainability.

(3) Sound Monetary Policy and Exchange Rate Flexibility: *Partially Met (Exchange Rate Reform Needed)*

Monetary policy is managed with consideration of growth objectives and economic stability, controlling both the money supply and liquidity. As of FY24/25, the upper-bound interest rate is approximately 7%, while the policy rate is set at 5%. Growth rates for money supply and private credit are controlled at approximately 12% and 12.5%, respectively.

Regarding exchange rate management, 21 major foreign currencies are allowed to float in the market. However, the Nepalese Rupee (NPR) has been pegged to the Indian Rupee (INR) at 1.6:1 since 1992. Foreign reserves are sufficient to cover approximately 10–16

months of imports. While the level of reserves is adequate, the fixed exchange rate limits the country's ability to respond to external shocks. The Nepal Rastra Bank (NRB) mainly intervenes in USD and INR to manage remittance inflows and import payments.

(4) Efficient and Sound Financial Sector: *Partially Met (Structural Weaknesses Remain)*

Since the early 1990s, Nepal has encouraged the establishment of commercial and private financial institutions and strengthened banking supervision. Examples include the relaxation of regulations on financial company establishment in 1992 and the introduction of stable regulations for commercial banks. The Nepal Rastra Bank (NRB) has been implementing reforms such as Basel II-based capital requirements, risk-based supervision, liquidity regulations (LCR), and enhanced on-site and off-site monitoring.

However, persistent inefficiencies in state-owned banks, high non-performing loan (NPL) ratios, liquidity pressures, and limited market structure (e.g., underdeveloped capital markets) remain. Although the financial sector has improved significantly compared to the past, structural vulnerabilities—such as asset quality and market depth—must be addressed before full capital account convertibility (CAC) can be achieved.

(5) Institutional and Legal Framework Affecting Resource Allocation: *Partially Met*

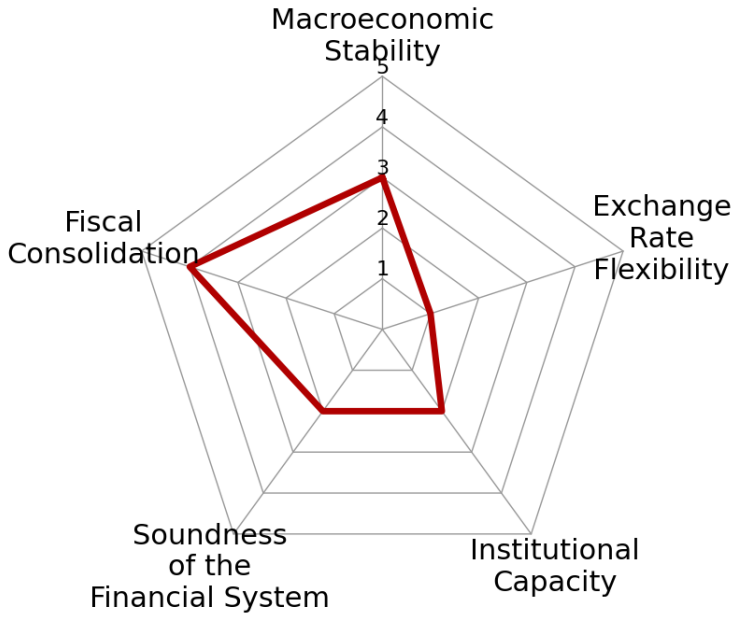
Recent budgets indicate efforts to reduce government spending through subsidy cuts and tax reforms, alongside trade liberalization, removal of barriers to foreign investment, and market-based reforms. Detailed regulations for foreign exchange transactions, including the Unified Circulars (2025), have been recently established. External policies, such as easing import restrictions and strengthening tariff revenues, have also partially mitigated market distortions.

Despite these improvements, legacy laws—such as the Foreign Exchange Regulation Act (1962), the Nepal Rastra Bank Act (2002), prohibitions on portfolio investment, and other regulatory restrictions—remain in place. Therefore, significant structural

adjustments are still required to fully restore market mechanisms and achieve efficient resource allocation.

<Figure 6-2>

Degree of Compliance with Capital Account Liberalization Preconditions



Note: The degree of capital account liberalization is expressed numerically on a scale from 0 (closed) to 5 (fully liberalized).

C. Challenges and Policy Recommendations

Nepal has recently embarked on a path of gradual capital account opening through its reform efforts, achieving meaningful progress in both foreign exchange and capital account liberalization. Nevertheless, challenges remain, including a persistent trade deficit, institutional shortcomings, and continued political instability. The pursuit of capital account liberalization constitutes a policy task that must strike a balance between aligning the domestic financial system with the global financial order and strengthening the domestic growth base through broader reform and opening. In this sense, it represents a critical challenge for Nepal's future economic growth and competitiveness.

In proposing an appropriate sequencing strategy for capital account liberalization, it is essential to take into account the differences in initial conditions and institutional capacity between Korea and Nepal (Table 6-3). For Nepal, the period beginning in the 1980s appears to be the most relevant reference point for applying the Korean policy experience. However, whereas Korea had already achieved a certain level of industrial development, export structure sophistication, and financial-sector maturity prior to opening, Nepal's institutional foundations and export-oriented manufacturing base remain considerably underdeveloped for an open-economy environment.

In this regard, the liberalization of the capital account and market opening should emphasize sequencing and institutional safeguards in the financial and foreign exchange systems, rather than the speed of liberalization. A central challenge lies in managing the macro-financial vulnerabilities associated with Nepal's remittance-dependent economy—particularly the possibility that rising remittance inflows may exacerbate real exchange rate appreciation, strengthen consumption and import dependence, reinforce a domestic-demand-driven growth pattern, weaken export competitiveness, and ultimately delay structural transformation (a dynamic consistent with Dutch disease effects; see IMF, 2025).

Furthermore, any liberalization strategy must be considered in conjunction with Nepal's broader macroeconomic structure, including how to effectively regulate short-term capital flows and how to link such regulation to policies for attracting FDI aimed at technological upgrading and export competitiveness.

<Table 6-3>

Differences in Economic Conditions at the Onset of Capital Account Liberalization: Korea vs. Nepal

	Korea (1980s)	Nepal (Recent)	Key Differences
Economic Structure	Export-oriented manufacturing base; large-scale industrialization	Agriculture, tourism, and remittance-dependent economy	Higher volatility of capital flows upon opening
Current Account & FX Earning Capacity	Rising exports strengthened autonomous FX-earning capacity	25–30% of FX depends on remittances	Remittance fluctuations directly affect financial stability
Financial Market Depth	Bank-based system with industrial financing and policy finance	Low financial depth; underdeveloped bond/capital markets	Rapid opening increases interest/exchange rate volatility
Government & Institutional Capacity	Strong central government; gradual reform after financial repression	Weak institutional capacity; inconsistent policies; limited supervision	Sequencing is a critical success factor
Foreign Exchange Management	Gradual FX liberalization; export sector absorbs FX shocks	Small FX market with limited shock-absorption capacity	Early opening raises risk of speculative flows

Since 1993, the Nepalese Rupee has been fully convertible for current account transactions, while the capital account has seen partial liberalization, including measures allowing foreign investors to repatriate profits, maintain foreign currency deposits, and permitting exporters to access foreign currency loans. Recently, the High-Level Economic Reform Commission has recommended gradual exchange rate flexibility, phased capital account liberalization, and permitting overseas investments.

Currently, Nepal remains in an intermediate stage (phases 2–3) toward full CAC. Some preconditions—particularly macroeconomic stability and market liberalization—are partially satisfied. However, rigidities in the exchange rate regime, outdated foreign exchange laws (over 60 years old), limited financial supervisory capacity,

underdeveloped financial system stability, weakened export competitiveness, insufficient foreign exchange market infrastructure, and lingering subsidies and regulatory constraints indicate that achieving full CAC will require substantial time.

In addition, Nepal's transition toward full capital account convertibility in the medium to long term will require an appropriate policy mix between interest rate liberalization and greater exchange-rate flexibility. This calls for a phased roadmap that enables the domestic economy to absorb capital-flow-induced volatility and advances liberalization in an orderly and gradual manner.

Core Principles for Gradual, Sequenced Capital Account Liberalization in Nepal

- Sequence first, liberalize later
- Manage remittance-driven structural features
- Ensure financial system stability & regulatory alignment
- Increase FX flexibility & maintain reserve buffers
- Clarify objectives of liberalization

4. Stepwise opening up of capital accounts

As discussed in Section 2, there is no universally applicable "ideal" roadmap for opening up capital markets internationally. Given differences in economic development stages, industrial structures, and institutional capacities, it is crucial for each country to adopt a gradual and prudent sequencing strategy rather than a "big bang" approach. This allows the domestic economy to maintain stability while minimizing the risk of financial crises arising from external liberalization. At the same time, it enhances market efficiency, maximizes the benefits of capital account openness, and fosters investor confidence, thereby promoting stable, long-term inflows of foreign capital. Moreover, a careful sequencing approach contributes to the strengthening of domestic financial institutions and market infrastructure, supporting sustainable economic growth.

The process of capital account liberalization offers potential benefits—such as increased capital inflows, reduced financing costs, broader financial markets, and enhanced growth—but also carries significant risks, necessitating orderly implementation. Reforms such as Capital Account Liberalization (CAL) require robust financial safety nets, strong supervisory and regulatory frameworks, high-quality accounting and disclosure systems, and well-designed monetary and exchange rate policy frameworks.

In order to successfully open the capital account, it is essential to maximize benefits while minimizing risks. This requires developing institutional capacity in the medium term, combined with an accurate assessment of the economic situation and the establishment of concrete, step-by-step implementation plans in the short term.

A. Medium- to Long-Term Liberalization Strategy (Modality)

(1) Maintaining a Gradual and Conditional Liberalization Approach and Strengthening Market-Oriented Legal Frameworks

Capital market liberalization should be implemented only after the domestic financial market has sufficiently matured and stabilized. It is preferable that this process be

conducted in a phased and orderly manner. To maximize the benefits of capital account liberalization, a comprehensive, market-oriented approach should be adopted to minimize sectoral conflicts of interest while strengthening financial and foreign exchange legal frameworks.

A thorough assessment of macroeconomic stability, financial sector soundness, regulatory and supervisory capacity, and market infrastructure should be conducted, with phased objectives established accordingly. To enhance the economy's resilience against external shocks, credible monetary and fiscal policies should be ensured, adequate foreign exchange reserves maintained, and structural vulnerabilities (e.g., public debt composition, external debt maturity profiles) identified and addressed.

If the financial system remains fragile, institutional weaknesses must be rectified prior to liberalization. Long-term and stable capital flows should be liberalized first, while highly volatile capital inflows may be regulated temporarily through targeted "speed-bump" mechanisms.

(2) Interest-Rate-Centric Monetary Policy and Transition to a Flexible Exchange Rate Regime

Prior to full capital market liberalization, interest rate deregulation, the transition to indirect monetary policy, and strengthened regulatory and supervisory frameworks for banks and capital markets are necessary. Relaxation of interest rate controls, expanded exchange rate flexibility, and the development of foreign exchange hedging instruments should be implemented to ensure that exchange rate volatility does not destabilize foreign reserves or the banking system, but is instead absorbed by market mechanisms.

(a) Harmonizing Capital Market Liberalization with Domestic Financial Reforms

Financial reforms should be sequenced and risk-based to promote domestic market development, starting with low-risk reforms that have significant impact. Capital account liberalization may amplify domestic market volatility and vulnerabilities; hence, it should be leveraged as a tool to complement institutional and market reforms rather than as an

end in itself. Strengthening financial supervision, enhancing capital and liquidity buffers, improving clearing, settlement, and custodial systems, and developing domestic bond and equity markets as well as hedging instruments are crucial.

The interdependence and layered risk structures of domestic financial markets must be recognized, and liberalization should be accompanied by risk management measures (IMF, 2003). Coordination between domestic financial reforms and capital account liberalization is critical to prevent policy distortions and uncoordinated capital controls. Monetary and exchange rate policies should be continuously reoriented to appropriately manage capital inflows and outflows.

(b) Emergency Response Capability and Communication Strategy

Contingency planning should include stress-test scenarios, central bank emergency liquidity lines, currency swap agreements, and clear rules for temporary re-imposition of regulations. A robust public communication strategy should also be established to prevent sudden capital outflows triggered by unexpected announcements.

B. Phased Implementation Plan

Based on experiences from successfully liberalized economies, the sequence of capital market liberalization should generally proceed as follows: deepening domestic financial and foreign exchange markets → allowing long-term capital inflows → liberalizing short-term capital transactions (IMF, 2004).

The pace of liberalization should be adjusted according to the country's initial conditions. External liberalization often encounters unforeseen events, necessitating a stepwise roadmap with ongoing reassessment of risks and adjustment of planned liberalization speed and sequencing.

Stepwise Roadmap:

- **Stage 1**: Open to the least volatile forms of capital, such as foreign direct investment (FDI) and strategic long-term equity investments.
- **Stage 2**: Permit non-residents to invest in listed equities with registration and disclosure requirements.
- **Stage 3**: Allow portfolio investments in local-currency government bonds once domestic debt market depth and settlement/custody infrastructure are adequate.
- **Stage 4** (Most Cautious Stage): Permit short-term external borrowing and cross-border lending by banks, and allow residents' short-term capital outflows only after sufficient buffers and hedging instruments are in place.
- **Stage 5**: Full liberalization.

C. Sector-, Institution-, and Capital-Type-Based Liberalization Strategy (Best Practice: Korea)

South Korea's experience is widely regarded as a best-practice model. Recognizing that abrupt, full liberalization could destabilize the real economy and financial markets, Korea adopted a phased and partial liberalization strategy beginning in the 1980s, ultimately pursuing full liberalization.

- Sectoral Sequence: Corporates → Financial sector → Households.
- Institutional Sequence: Domestic enterprises → Financial institutions → Foreign investors.
- Capital-Type Sequence: FDI → Long-term finance → Securities markets → Short-term financial markets.

Sectoral Opening: Initially, corporate external debt inflows dominated during the 1960s–1970s. From the 1980s, FDI inflows were encouraged. The financial sector

permitted foreign currency borrowing from domestic financial institutions gradually from the mid-1980s onward. In the 1990s, foreign financial institutions (banks and securities firms) were allowed entry. Household overseas investment in real estate and equities was liberalized last, in the late 1990s.

Institutional Opening: Domestic enterprises were allowed external borrowing and foreign direct investment first. Domestic financial institutions were subsequently permitted foreign borrowing, establishment of overseas branches, and joint ventures with foreign financial institutions, before full liberalization. Foreign investors were allowed limited equity investment from the late 1980s, with full domestic equity market access granted in 1992. Gradual opening of government and public institutions to foreign bond investment and the domestic government bond market was also implemented.

Capital-Form Opening: Initially limited in the 1960s and expanded in the 1980s, FDI—being stable and long-term—was liberalized first. Long-term borrowing for corporations and financial institutions followed, with portfolio investment in equities and bonds liberalized later. Full stock market liberalization occurred in 1992, and bond market liberalization took place in the late 1990s. Short-term capital was liberalized last due to its volatility and crisis-inducing potential. Rapid short-term capital inflows in the 1990s were among the main causes of the 1997 Asian Financial Crisis.

5. Policy Responses of moving towards an Open Capital Account Regime

A. Diversification of Sterilization Policy Instruments

In the case of Nepal, where the exchange rate is pegged to the Indian Rupee (INR) while allowing limited fluctuations against other trading currencies, sterilization policies can be diversified to mitigate the liquidity effects of foreign exchange interventions and minimize their impact on domestic interest rates.

Particularly under a fixed exchange rate regime, where remittances from overseas workers continue to increase, central bank intervention in the spot foreign exchange market through direct purchases of foreign currency can serve as an effective policy tool. For instance, when foreign exchange inflows (or outflows) are converted into domestic currency, the money supply in the domestic market expands (or contracts), thereby exerting downward (or upward) pressure on the exchange rate. This process can be illustrated as follows:

- Foreign exchange inflow → Central bank purchases foreign currency → Increase in domestic currency supply in the market → Liquidity expansion.
- Foreign exchange outflow → Central bank sells foreign currency → Withdrawal of domestic currency from the market → Monetary contractionary pressure.

However, if such interventions are conducted without sterilization, the domestic money supply will fluctuate sharply, potentially destabilizing prices, interest rates, and overall economic conditions. Hence, sterilization is required to neutralize the monetary effects of foreign exchange interventions.

In this regard, the issuance of central bank securities can be an effective instrument, allowing the monetary authority to conduct sterilization in a more flexible and timely manner. This not only strengthens the effectiveness of monetary policy and exchange rate management, but also provides greater stability in the financial system.

(1) Issuance of Monetary Stabilization Bonds by the Bank of Korea

The Monetary Stabilization Bonds (MSBs) issued by the Bank of Korea represent market-based liabilities of the central bank and serve as a primary instrument for short-term interest rate management as well as for sterilization policy. Initially introduced in November 1961, MSBs were increasingly utilized after 1986, when Korea shifted to a current account surplus, as a means to absorb excess liquidity supplied from external sources through open market operations.

In particular, during the early stages of capital market liberalization, MSBs played a critical role as a sterilization instrument to mitigate monetary expansion and contraction arising from cross-border capital inflows and outflows. However, as the process of capital liberalization advanced, the effectiveness of MSBs varied depending on the prevailing external sector conditions and domestic financial market environment.

Since the 1980s, Korea gradually pursued foreign exchange and capital account liberalization, during which the exchange rate increasingly came to perform its role as a price signal. However, the authorities frequently faced situations in which price stability and exchange rate stability conflicted. In such instances, short-term sterilized interventions in the foreign exchange market were employed.

In the early phase of financial liberalization, when the substitutability between domestic and foreign financial assets was still incomplete, these sterilized interventions were effective in stabilizing the exchange rate without causing significant fluctuations in the domestic money supply. To strengthen the short-term effectiveness of such sterilization measures, the authorities advanced indirect monetary control by emphasizing interest rate–based open market operations (OMO). This entailed the regular issuance and repurchase of short-term government securities at market-determined interest rates, thereby fostering a functioning OMO environment.

Moreover, this institutional evolution effectively linked the Bank of Korea's discount rate—its official lending rate—to prevailing market rates, marking a crucial starting point for substantive interest rate liberalization.

(2) Role and Limitations as a Monetary Policy Instrument

Since 1979, Korea has pursued a dual policy framework in which the authorities simultaneously set and managed a target growth rate of the monetary aggregate (M2) while seeking to stabilize the exchange rate. To this end, the Bank of Korea intervened in the foreign exchange market by purchasing (or selling) foreign currency, while conducting offsetting operations in the domestic financial market through the sale (or purchase) of domestic assets.

Such sterilized interventions were primarily carried out through the issuance and redemption of Monetary Stabilization Bonds (MSBs), which are short-term central bank liabilities (with maturities mostly limited to one year). In this process, the net foreign assets of the central bank either remained relatively stable or declined (increased) during periods of exchange rate depreciation, but showed a rapid increase (decrease) during episodes of appreciation pressure.

During the late 1980s, Korea experienced substantial capital inflows, largely driven by debt instruments, on the back of robust macroeconomic fundamentals such as high economic growth, sustained current account surpluses, and a high domestic savings rate. In the early 1990s, additional waves of large-scale foreign capital inflows occurred, fueled by the global low-interest-rate environment, rising global risk appetite, the expansion of loan guarantees by domestic financial institutions, and an increasing influx of foreign equity investment.

As a result, liquidity supplied from the external sector expanded significantly. In response, the authorities conducted sterilized foreign exchange market interventions to both manage the target growth rate of the monetary aggregate and maintain exchange rate stability. With the Korean won becoming increasingly overvalued and the current account deficit widening, the authorities implemented a policy of restrained sterilization to counteract these pressures. Consequently, in the early 1990s, the effectiveness of sterilization policy was found to be particularly pronounced. Subsequently, until the onset of the Asian financial crisis in 1997, Korea continued to expand capital account liberalization in parallel with interest rate liberalization, which facilitated large-scale inflows of short-term capital.

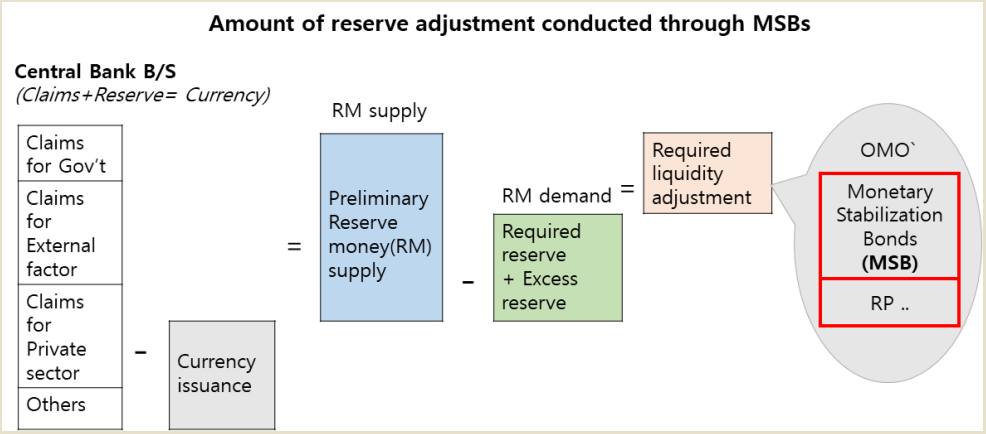
This sterilization mechanism contributed in the short run to stabilizing the exchange rate while simultaneously achieving monetary targets. However, it also generated inflationary pressures in the near future. In order to counteract such pressures, the Bank of Korea expanded the issuance of Monetary Stabilization Bonds (MSBs), the outstanding balance of which surged to over KRW 200 trillion by the mid-2010s, thereby incurring substantial quasi-fiscal costs. This expansion of MSB issuance led to mounting interest

payment burdens on the central bank and exerted upward pressure on short-term interest rates, distorting the term structure of interest rates and functioning as an automatic source of base money supply.

Following the global financial crisis of 2008, as Korea's capital market reached a more advanced stage of liberalization, the scale and speed of capital flows intensified. While sterilization through MSB operations remained effective in the short term, it revealed limitations in the longer term, as interest rate differentials and exchange rate expectations triggered additional capital inflows and outflows. Consequently, reliance on MSB issuance alone proved insufficient to ensure the independence and effectiveness of monetary policy. In response, the conduct of open market operations through MSB issuance and redemption has increasingly been supplemented with macroprudential measures, such as the introduction of foreign exchange stability levies.

<Box 6-2> Open Market Operation Using Monetary Stabilization Bonds

The Bank of Korea conducts open market operations(OMO) to adjust reserve supply in order to resolve excesses or shortages in reserves, thereby guiding the call rate toward the policy rate target. For instance, when capital inflows increase and the resulting rise in foreign exchange (dollar) supply pushes the exchange rate below its appropriate level, the Bank of Korea intervenes by purchasing foreign currency. This intervention raises the demand deposits of commercial banks that sold foreign exchange, thereby increasing reserve supply. When this supply exceeds reserve demand (required reserves plus excess reserves), an oversupply emerges in the reserve market. The Bank of Korea then absorbs the excess liquidity through open market operations to restore balance.



Source : Bank of Korea

B. Transition towards a Market-Friendly Exchange Rate Regime

(1) Promoting Greater Flexibility in the Current Pegged Regime

(a) Limitations of the INR-Centered Peg Arrangement

The Government of Nepal has maintained a fixed exchange rate of NPR 1.6 per INR for more than 33 years, placing the Nepali rupee within the so-called "rupee zone," with the objective of stabilizing domestic prices and external transactions in light of the country's long open border with India and its high degree of trade dependence. The fixed exchange rate regime has contributed to price stability by reducing the volatility of import prices, while also simplifying trade contracts and facilitating remittances as well as informal cross-border transactions.

However, when the peg was introduced in the early 1990s, it functioned primarily as an institutional device and credibility anchor to compensate for Nepal's limited capacity to conduct independent macroeconomic policy. At that time, Nepal was a small developing economy highly dependent on India, with approximately 60–70 percent of its imports originating from India, and faced substantial constraints in implementing autonomous monetary policy.

Although the Nepali economy has continued to grow to some extent, the gap with the Indian economy in terms of productivity, industrial base, technological capability, and infrastructure has steadily widened. Under a rigidly fixed exchange rate, this divergence has resulted in a structural overvaluation of the Nepali currency. Consequently, import dependence has intensified, manufacturing development has been constrained, and export competitiveness has gradually weakened. Moreover, fluctuations in the Indian economy—such as sharp movements in the INR—have been transmitted to Nepal as external or "imported" shocks, regardless of domestic economic conditions. At the same time, external and internal imbalances have been difficult to correct through exchange rate adjustment, undermining the effectiveness and autonomy of monetary policy

instruments such as interest rates and money supply control, consistent with the implications of the "impossible trinity."

Recent empirical research by Suresh Kumar Dahal and Raju (2022) finds that movements in the INR/USD exchange rate exert a stronger influence on fluctuations in the NPR/USD rate than Nepal's own macroeconomic fundamentals. Their findings strongly suggest the possibility of exchange rate misalignment and identify the inappropriateness of the fixed INR–NPR peg ratio maintained over the past 27 years as a key underlying cause. The authors warn that a persistent deviation of the peg from economic fundamentals may increase the risks of shadow economy expansion, declining competitiveness, and potential currency crises. As policy responses, they recommend periodic reassessment and adjustment (revaluation/devaluation) of the exchange rate in the short to medium term, and a gradual transition toward a soft peg or a floating exchange rate regime over the longer term.

Nepal aims to attain middle-income status by 2030 and recognizes the need to attract substantial investment from countries beyond India to achieve this objective. Accordingly, under the direction of the National Planning Commission (NPC), the government has been undertaking internal preparations to revise its existing policy framework and explore the introduction of more flexible exchange rate arrangements—such as a crawling peg or other non-India-pegged regimes.

The Government of Nepal increasingly perceives the long-standing fixed exchange rate arrangement with India, maintained for over three decades, as a potential constraint on attracting foreign direct investment (FDI). The Nepal Rastra Bank (NRB) has also assessed that the depreciation of the Nepali rupee against the US dollar is influenced more strongly by the fixed peg with the Indian rupee than by Nepal's own trade volumes

The South Asia Watch on Trade, Economics and Environment (SAWTEE), a regional monitoring organization specializing in trade, economic, and environmental issues in South Asia, has likewise recommended reconsidering and reforming the current peg to the Indian rupee.

(b) Assessment of the NPR-INR Peg Level

The exchange rate of the Nepali rupee, fixed at NPR 1.60 per INR, appears less an economically "optimal" rate than a second-best, administratively manageable choice given Nepal's institutional capacity and structural conditions at the time of adoption. Over time, however, this peg has generated increasing structural costs as the economic gap between Nepal and India has widened. These costs imply the need for a realignment (devaluation) of the external value of the Nepali rupee in order to correct distortions between economic fundamentals and the real exchange rate, and to improve the broader structural conditions of the Nepali economy.

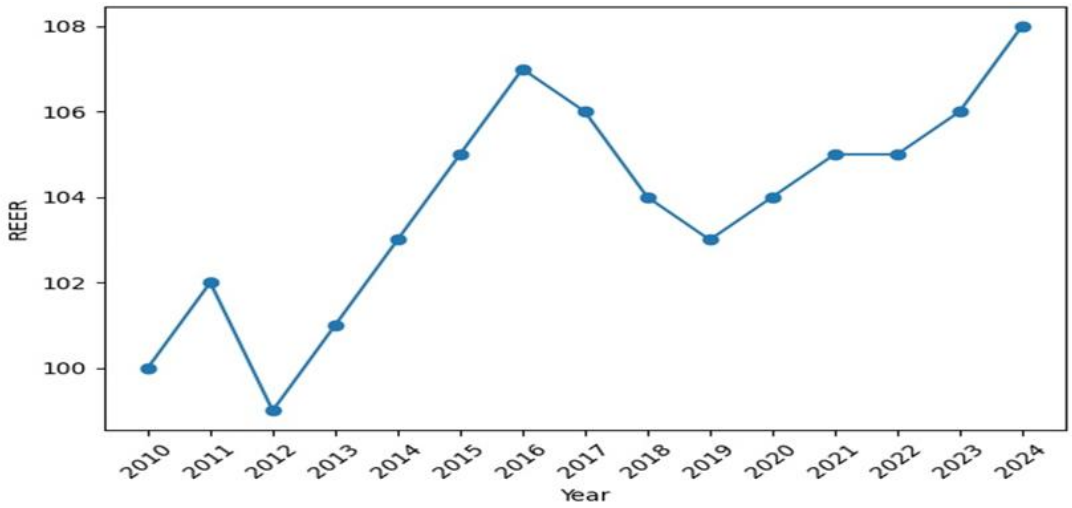
It is not easy to identify clearly quantified empirical estimates of the extent to which the current pegged level of the NPR is overvalued under PPP or REER benchmarks. PPP-based assessments tend to underestimate the real purchasing power of currencies in most developing economies, as domestic price levels are typically lower than those of advanced or emerging trading partners. For this reason, a more meaningful evaluation can be drawn from REER-based time-series analysis—taking into account relative inflation, price levels, and trade weights—as well as from international experiences of exchange rate adjustments under fixed regimes, including the case of Korea.

From a REER perspective, Nepal exhibits structural pressures toward real appreciation. Remittance inflows amounting to the mid-20 percent range of GDP, persistent inflation driven by services, real estate, and domestic demand, and limited productivity gains collectively contribute to an upward trend in the real exchange rate—reflecting a structure consistent with a combination of the Balassa–Samuelson effect and Dutch disease dynamics. According to the World Bank's REER index (2010 = 100), Nepal's recent REER appears to be overvalued by approximately 8 percent relative to its equilibrium level. IMF estimates based on the EBA-lite and BEER methodologies similarly suggest that Nepal's REER is overvalued by roughly 8 to 18 percent. Furthermore, IMF reports on remittance-dependent economies such as Nepal, Bangladesh, the Philippines, and Pakistan consistently note that "remittances tend to appreciate the real exchange rate and

weaken tradable sector competitiveness.”

<Figure 6-3>

Nepal’s Real Effective Exchange Rate (REER) (2010-2024)



Source : World Bank Real effective exchange rate index—Nepal (2010=100)

By way of comparison, Korea’s experience with adjustments under a fixed exchange rate regime provides a useful reference. In May 1964, in order to overcome the limitations of the fixed exchange rate system and improve the balance of payments, Korea implemented a large-scale devaluation, adjusting the exchange rate from KRW 130 per U.S. dollar to KRW 256.5—an effective depreciation of approximately 96.8 percent. Thereafter, from 1965 onward, Korea began designing a more flexible exchange rate framework that reflected market conditions. This process involved the abolition of the multiple exchange rate system and the acceptance of gradual, incremental devaluations.

However, amid severe external shocks—including the oil crisis—and persistently high domestic inflation, Korea undertook another sharp devaluation in 1971. These two episodes of substantial devaluation represent cases in which the authorities adjusted the fixed exchange rate in a single, discrete step in response to an emergency situation characterized by a rapidly widening current account deficit, a surge in raw material imports, and a sharp decline in foreign exchange inflows following reductions in U.S.

development assistance. The post-adjustment exchange rate can be interpreted as a policy-determined equilibrium, balancing the outcomes of negotiations with the United States against the need to minimize economic and social disruption.

Subsequently, until the introduction of a managed floating exchange rate regime in the late 1970s and early 1980s, Korea pursued a strategy of gradual depreciation of the won against the U.S. dollar as part of its transition toward a more flexible regime. As a general principle, the government adjusted the value of the won by approximately 5–10 percent per year (around 7 percent in 1974) and, in response to adverse economic conditions, allowed somewhat larger adjustments of around 10–15 percent (approximately 17 percent in 1980).

(c) Scenarios for Adjusting the Peg Level

Based on existing theoretical models, empirical evidence, and policy experiences with exchange rate adjustments, a depreciation of approximately 5–15 percent is generally considered a reasonable adjustment range for the NPR under non-crisis conditions. This implies that the current peg of NPR 1.60 per INR could be adjusted to a range of approximately NPR 1.70–1.85 per INR. Using 5-percentage-point increments as benchmarks, a 5 percent adjustment would imply a new rate of NPR 1.68 per INR, a 10 percent adjustment NPR 1.76, and a 15 percent adjustment NPR 1.84.

The transition to each adjustment level should, however, be carefully designed in relation to prevailing economic conditions and associated risks. In particular, it would be desirable for such adjustments to be undertaken only when key preconditions for political, fiscal, and financial stability are adequately met. A gradual recalibration of the peg, combined with the establishment of appropriate policy response mechanisms at each level, should be pursued as part of the NRB's medium- to long-term foreign exchange policy framework. At the same time, this process should be understood as a preparatory stage for a future transition toward a managed or more flexible exchange rate regime.

(2) Transition to a Managed Floating Exchange Rate Regime

(a) Necessity of Transition

As noted earlier, over the past three decades Nepal has pursued a range of strategies aimed at strengthening its external position and attracting investment, including the accumulation of foreign exchange reserves through remittance inflows, diversification of trade, promotion of the tourism and IT sectors, and expansion of hydropower infrastructure. In contrast, India's economy has evolved toward a structure centered on services, private consumption, and IT-related manufacturing. As a result, the degree of similarity between the two economies in terms of economic structure and business cycles has diminished, leading to an increasing divergence between the NPR and the INR.

Nevertheless, Nepal continues to maintain a long-standing fixed peg with the Indian rupee adopted in 1992, while having gradually shifted toward a managed floating exchange rate regime with respect to other major currencies. With regard to currencies other than the INR, Nepal may partially accommodate exchange rate movements by adjusting the permissible fluctuation range of cross rates based on the INR/USD exchange rate. While widening the fluctuation band may provide Nepal with some degree of monetary policy autonomy, it ultimately conflicts with the objective of maintaining the external stability of the NPR. Moreover, consistently managing such an artificially determined fluctuation band poses significant challenges.

Looking ahead, as Nepal plans to advance capital account liberalization, the continuation of this dual exchange rate system is likely to create further complications. In particular, beyond current account transactions, irregular and volatile capital flows in the portfolio sector may exert destabilizing pressures. Any attempt to constrain exchange rate volatility under such conditions would intensify the policy trade-offs, further undermining Nepal's capacity to exercise independent monetary policy, especially in terms of interest rate and liquidity control.

Korea, prior to its full transition to a market-determined exchange rate regime, also

adopted a multi-currency basket exchange rate system that combined both rule-based principles and discretionary adjustments. This system was intended to mitigate the problem of dynamic inconsistency in exchange rate policy arising from different types of capital flows. The operational experience of Korea's basket system in the mid-1980s—before the adoption of the Market Average Exchange Rate (MAR) system—provides several medium-term lessons for Nepal.

Drawing on Korea's experience, the Nepal Rastra Bank may consider implementing a managed floating exchange rate regime anchored to a basket composed of four major global currencies—namely, the Indian rupee (INR), Chinese yuan (CNY), U.S. dollar (USD), and euro (EUR). Such a basket arrangement should be calibrated with reference to Nepal's prospective major trade partners as well as sources of portfolio capital flows. Incorporating the INR into the basket would help offset its volatility vis-à-vis other global currencies, thereby allowing the NRB to achieve greater flexibility in exchange rate management.

This approach could enhance both foreign exchange market stability and the effectiveness of monetary policy. Furthermore, it would lay the groundwork for a more market-oriented exchange rate framework, ultimately advancing the development of a sovereign monetary system that aligns with Nepal's long-term financial and economic objectives.

(b) The Multi-Currency Basket Exchange Rate System (The Korean Case)

Korea initially operated a dollar-peg system from October 1945 until May 1964, but subsequently evolved its exchange rate regime toward a more market-oriented framework in line with domestic economic conditions and changes in the global financial environment. Between February 1980 and February 1990, Korea adopted a multi-currency basket system, under which the won–U.S. dollar exchange rate was determined based on the weighted average of effective exchange rates derived from two baskets: (i) the SDR basket, consisting of six major trading partners (the United States, the United

Kingdom, Japan, Germany, Canada, and France), and (ii) Korea's own independent basket composed of its other principal trading currencies.

The mechanical operation system of the multi-currency(5 nations) basket :

Exchange rate = αSDR basket + βTWB + *P*

where α+β = 1, TWB: Trade weighted basket, *P*: policy variable (adjustment factor).

(c) Considerations When Introducing a Multi-Currency Basket System in Nepal

Even in Korea, the introduction and practical operation of a multi-currency basket system did not come without challenges in achieving the original objectives of exchange rate policy.

First, under the operational mechanism, the nominal exchange rate was managed in a manner that offset relative price movements with major trading partners in order to minimize fluctuations in the real effective exchange rate (REER).

However, it should be noted that there was always a lag in policy implementation due to delays in the availability of price statistics. Owing to such limitations, the basket system often considered only nominal exchange rate movements. Korea eventually recognized that, when exchange rate policy aims at trade balance stability, stabilizing the REER is a highly rational policy objective.

Nevertheless, during the 1980s, it was difficult for the Korean won exchange rate management to fully offset relative price changes with trading partners, and fluctuations in the nominal REER were not significantly reduced. In the early 1980s, this led to an overvaluation of the won, while during the trade surplus period from 1985 to 1997, it resulted in undervaluation, and after the balance of payments returned to equilibrium in 1988, the won became overvalued again, exhibiting notable volatility. Thus, in the initial implementation phase of the 1980s, the stability of Korea's REER was far from fully achieved.

For a small, open economy like Korea, maintaining the real equilibrium exchange rate

at a satisfactory and stable level amid domestic inflation and unexpected external shocks became increasingly challenging as capital account liberalization progressed. From this experience, it can be inferred that the authorities may have relied excessively on the "adjustment factor" in the exchange rate determination process, which limited the effectiveness of REER stabilization.

Korea's multi-currency basket system employed two types of baskets—a SDR basket and a domestic currency basket—whose weights needed to be adjusted in response to changing external conditions rather than being fixed at a single point in time.

If Nepal were to adopt a similar multi-currency management system, it would need to carefully consider its own economic conditions and starting point. First and foremost, attention should be paid to the selection of currencies for the basket—whether to follow Korea's approach of including the six SDR constituent currencies, focus on major trading partners, or even include competitor countries. Additionally, the weights of the currencies must be determined based on trade shares, transaction currency shares, or policy objectives, and the base year should be selected carefully, for instance, whether it should correspond to a period when the trade or current account was near balance, or another reference point. And to prevent excessive distortion of the domestic exchange rate, the foreign exchange authorities should avoid overusing the adjustment factor (p) in the determination of the won exchange rate. This necessitates designing an appropriate basket composition from the outset.

Moreover, even in the longer run—when NRB eventually transitions from a market-average exchange-rate system to a fully flexible regime—it will remain essential that any basket-peg framework, if retained, be used in line with its original purpose: to stabilize the real effective exchange rate (REER). Maintaining REER stability should constitute the primary objective of foreign-exchange intervention under such an arrangement.

(d) Process of Transition to a Managed Currency Regime

A gradual and flexible adjustment of the rigid peg in line with economic conditions

would help enhance Nepal's competitiveness and correct exchange rate misalignment relative to underlying fundamentals. In this sense, more flexible management of the peg represents an intermediate stage toward a market-based exchange rate regime, as it allows the exchange rate to increasingly reflect market conditions. Such a transition can also enable markets to play a more active role, alongside the government, in facilitating a phased approach to capital account liberalization.

However, moving toward an exchange rate regime that appropriately and timely reflects market conditions requires careful ex ante preparation through the following sequential steps.

Stage 1: Preparatory Work and Policy Objective Setting

The objectives of exchange rate policy under the peg regime should be redefined. A shift toward a basket-based system should not be treated merely as a technical institutional change, but rather as a fundamental transformation in the paradigm of monetary policy operations. To strike an appropriate balance between exchange rate stability and monetary policy autonomy, policymakers should establish a clear inflation anchor, ensure current account stability, and develop policy frameworks to mitigate financial crisis risks.

Stage 2: Currency Basket Composition and Technical Design

For the initial configuration of the currency basket, it is advisable to include the INR, USD, and CNY as core currencies, while using the EUR and JPY primarily as reference indicators.

- The INR should remain in the basket due to its strong relevance for trade, remittances, and political-economic linkages, as well as to preserve continuity with the existing peg.
- The USD should be included given its dominant role in global trade and finance, its relevance for Nepal's foreign reserves, and its importance for remittance flows.
- The CNY should be incorporated as a strategic currency in light of Nepal's medium- to long-term trade prospects and geopolitical-economic orientation.

At the initial stage, the EUR and JPY should be used mainly as reference currencies for

reserve management and exchange rate monitoring.

Example: Basket Exchange Rate Formula (Weighted Average Method)

$$NPR = w_1 \cdot INR + w_2 \cdot USD + w_3 \cdot CNY$$

where w denotes the weight assigned to each currency.

Korea's experience with operating an SDR-based basket regime suggests that the more critical policy issue is not simply *which currencies are included* in the basket, but *how the system is operated*. Nonetheless, the criteria for currency selection and the methodology for determining weights should be transparently designed and publicly disclosed to ensure credibility and predictability. Publication of the basket formula and clear rules for adjustment are essential for anchoring market expectations.

In addition, the transition strategy should consider the consistency between crawl-like adjustments, capital account management, and recent changes in the global financial and payment environment, including the growing role of stablecoins and dollarization dynamics.

Stage 3: Strengthening the Institutional and Legal Framework

The legal and institutional framework should clearly define foreign exchange market rules and the authority of the central bank (and government). The objectives of exchange rate policy should be explicitly stated in law, and the respective responsibilities and coordination mechanisms between monetary policy and foreign exchange policy should be carefully designed.

Stage 4: Building Foreign Reserve Capacity and Market Infrastructure

Once the basket and reference currencies are determined, the composition of foreign exchange reserves should be adjusted accordingly. This implies a gradual shift away from excessive reliance on the INR toward increased holdings of USD and CNY, in order to secure sufficient liquidity for effective foreign exchange market intervention.

To cope with higher exchange rate volatility during the early transition phase, Nepal

should also deepen foreign exchange market infrastructure by expanding instruments such as FX forwards, swap arrangements, and other risk management tools.

Stage 5: Market Testing and Gradual Introduction

Based on the experience gained from previous peg adjustments, a pilot phase should be introduced. Exchange rate flexibility can be expanded gradually through mechanisms such as a target zone (band system) or a crawling peg. For example, authorities may initially manage the exchange rate within a ±1–3 percent band around a central parity and later widen the daily fluctuation range. Such a managed transition can help mitigate abrupt shocks while enhancing policy credibility.

At the same time, monitoring capacity should be strengthened to assess market and investor responses and to evaluate the extent of deviation between exchange rate movements and underlying economic conditions.

Stage 6: Official Adoption and Operationalization

Once Stages 1–5 have been sufficiently established, the Government of Nepal can officially announce the adoption of a basket-based regime and publish its exchange rate objectives and operational mechanisms. The NRB would then manage deviations between the basket-based central rate and the market exchange rate within a predefined range.

To reduce the risk of speculative attacks and foster rational market expectations, authorities should enhance communication with markets through regular policy briefings and transparent disclosure of relevant data.

Stage 7: Evaluation, Adjustment, and Institutional Consolidation

Finally, the authorities should continuously evaluate market reactions and the macroeconomic effects of the transition to a managed floating regime. Regular monitoring of inflation, macroeconomic indicators, foreign reserves, and capital flows is essential, and policymakers should remain flexible in adjusting the system when

necessary. For instance, the width of the exchange rate band, basket weights, or even the composition of the basket may need to be revised in response to excessive volatility or changing economic conditions.

<Table 6-4> Changes in Korea's Exchange Rate Regime

Year	Exchange Rate Regime
1980	Introduction of a Multi-Currency Basket System (with a High Weight on the U.S. Dollar)
1981~83	Maintaining the Currency Basket System and Securing Export Competitiveness through Currency Depreciation
1984~85	Adjustment of Currency Weights within the Basket
1986~88	Introduction of the Market Average Exchange Rate System (1986) — The exchange rate was determined based on the average rate in the interbank market, though government intervention remained substantial.
1989~90	Maintaining the Market Average Exchange Rate System with a Narrower Fluctuation Band
1991~92	Relaxation of the Volatility Band
1993~94	Slight Flexibility Introduced in the Exchange Rate Determination Mechanism
1995	WTO Accession with No Significant Changes to the Exchange Rate System
1996	OECD Accession (29th Member) — Acceptance of Obligations for the Free Movement of International Capital

First Half of 1997	Market Average Exchange Rate System with a Narrow Band — Effectively Pegged to the U.S. Dollar
1997.12	Transition to a Freely Floating Exchange Rate System

Finally, Nepal's long-standing de facto peg to the Indian rupee (INR), combined with its efforts to maintain stability vis-à-vis major currencies such as the U.S. dollar and the Chinese renminbi—its potential "optimal anchor currencies"—reflects several structural characteristics of the Nepalese economy. Nepal's heavy import dependence on India and China, together with large cross-border labor mobility, substantial remittance inflows, and an open land border, has limited the economy's ability to absorb exchange-rate volatility. As Oh (2025) notes, in the early stages of development, many emerging economies experience rising import demand for capital goods needed to initiate export growth; under such conditions, a fixed exchange-rate regime can help mitigate exchange-rate burdens on import-dependent firms.

However, the long-persistent peg has also constrained macroeconomic management. Monetary-policy autonomy has been significantly reduced, and both foreign-invested firms and export-oriented domestic enterprises—whose competitiveness is sensitive to movements against third-country currencies—have had limited opportunities to accumulate experience in managing currency risk. Moreover, the peg has reinforced Nepal's structural dependence on remittances and hindered the development of import-substituting industries and export competitiveness.

Against this backdrop, a gradual transition toward a more market-based exchange-rate framework would be desirable. The Nepal Rastra Bank could first adjust the NPR to a level more consistent with macroeconomic fundamentals relative to major trading-partner currencies. As an initial step, adopting a multi-currency basket arrangement would allow the authorities to diversify exchange-rate anchors and gain operational experience while maintaining short-term stability. Over time, NRB could progressively widen the fluctuation band and eventually move toward a band-type market-average exchange-rate

system, which would help minimize disruptions in the domestic foreign-exchange market while enhancing Nepal's resilience to external shocks.

C. Introduction of the Foreign Investor Registration System

During its phased capital account liberalization, Korea established a strict regulatory framework for foreign portfolio investment inflows through the Foreign Investment Management System (FIMS). At the initial stage of acquiring listed securities, foreign investors were required to complete mandatory registration. In cases where global asset managers executed trades on behalf of multiple investors in domestic securities, omnibus accounts were established to consolidate foreign holdings. Moreover, over-the-counter (OTC) transactions by foreign investors were subject to prior approval, while on-exchange transactions were prioritized as the standard practice.

In 1992, Korea introduced the Foreign Investor Registration System (FIRS) as part of its capital account liberalization process. The system combined partial market opening with a registration requirement, functioning as a "safe accelerator" for gradual liberalization and serving as an effective risk management mechanism. Under FIRS, foreign investors seeking to invest in Korean equities or bonds were required to register in advance with the financial supervisory authority and obtain a unique investment registration number. During registration, investors were obliged to provide detailed information, including nationality, investment purpose, and institutional affiliation, allowing all transactions to be traceable through the assigned number. The system applied not only to foreign direct investment (FDI) but also to portfolio investments.

FIRS was introduced in the same year that Korea allowed foreign participation in the domestic equity market (with equity share restrictions) while excluding access to the domestic bond market. The system enabled the government to monitor foreign capital flows in real time and respond immediately to sudden surges or withdrawals of foreign investment. At the time, Korea had not yet implemented a freely floating exchange rate or full interest rate liberalization, making the economy vulnerable to financial instability

caused by rapid inflows of short-term speculative capital. Through FIRS, authorities could identify the sources, volumes, and actors of foreign capital inflows, thereby allowing policy measures such as taxes or regulatory interventions targeting speculative funds.

<Table 6-5> Foreign Investor Registration System

Identification Method	● **Upon registering for foreign investment, a Foreign Investor Registration Certificate is issued.** ✓ It is used as an identity verification document when opening an account with financial institutions. ✓ The investment registration number indicated on the certificate is utilized in the Foreign Investment Management System (FIMS) as the means of identification.
Taxation	● **Nationality information recorded in the FIMS is utilized for the taxation of source income.** ✓ Depending on the nationality of foreign investors, relevant provisions of bilateral tax treaties are applied.
Acquisition Limits	● **For listed corporations engaged in key industries (33 firms), restrictions are imposed on the acquisition of shares.** ✓ When foreign investors place buy or sell orders, the FIMS verifies the remaining acquisition quota in advance for securities subject to such limits.
Monitoring	● **Information collected in the Foreign Investment Management System (FIMS) is utilized to monitor foreign investment trends.** ✓ Transaction records in FIMS are employed for market surveillance, short-selling monitoring, and the publication of investment trend reports.

Moreover, FIRS enhanced transparency and trust among domestic financial institutions,

regulators, and foreign investors, while providing foreign participants with a clear legal status and standardized procedures, effectively lowering entry barriers to the Korean market.

D. The Main Bank System and the Introduction of the Real-Name Financial Transactions System

In the early stages of current account liberalization during the 1960s and 1970s, Korea relied primarily on public or commercial loans rather than foreign direct investment (FDI) as a means of capital inflow. During this period, the Korean government introduced the main bank system, under which each major strategic domestic enterprise was assigned a designated commercial bank to serve as its primary financial intermediary. This system was designed to ensure a stable and concentrated supply of foreign exchange to key industries. Beyond facilitating efficient foreign exchange management, it also enabled the collection and auditing of firm-level information and played a role in corporate restructuring.

As financial liberalization and capital market opening progressed, the principle of international credibility became increasingly important. Moreover, with the advancement of capital account liberalization in the early 1990s—including interest rate deregulation, the allowance of foreign equity investment, and the relaxation of restrictions on outward direct investment—capital flows surged, particularly with the inflow of short-term speculative funds. Consequently, the government recognized the urgent need to stabilize foreign exchange supply and demand and to control cross-border movements of non-trade-related capital. Non-identifiable financial transactions made it difficult to trace capital inflows and outflows, thereby undermining the effectiveness of exchange rate policy and capital account management. Within financial institutions, the absence of verified identification led to illicit foreign exchange transactions, informal currency exchanges, and disguised remittances, all of which distorted the transmission channels of monetary policy.

In response, on August 12, 1993, the government issued the Presidential Emergency Decree on Real-Name Financial Transactions and Confidentiality, thereby fully implementing the real-name financial transaction system. This measure was not merely aimed at enhancing tax transparency; it was a macroeconomic policy designed to improve the transparency of capital movements and to institutionalize the financial system.

The introduction of Korea's Financial Real-Name System (FRNS) initially triggered unintended side effects—such as rapid withdrawals of financial assets—that temporarily amplified the costs of capital-account liberalization. Over time, however, the FRNS laid a pivotal foundation for enhancing the efficiency of the financial system and improving the transparency of cross-border financial transactions. In particular, the system enabled the authorities to identify transaction-level funding flows by economic agents, thereby strengthening the government's capacity to implement capital controls and sequence capital-account liberalization in a more disciplined manner. Following the introduction of the FRNS, the foreign-currency positions and FX transactions of domestic financial institutions became substantially more transparent, allowing the Bank of Korea and supervisory authorities to improve the monitoring of short-term external debt and foreign-exchange liquidity risks. This, in turn, contributed to preserving monetary-policy autonomy and maintaining exchange-rate stability during the broader liberalization process.

In Nepal's case, however, the continued prevalence of informal remittance channels such as *hundi*, the dominance of cash-based transactions among traders and small businesses, low financial inclusion in rural and mountainous areas, and the fragmented nature of identity-verification systems could render the immediate adoption of a real-name system challenging. In the short run, such a reform may even risk strengthening informal remittance channels and reducing formal foreign-exchange inflows. Nevertheless, from a longer-term perspective, a phased introduction—supported by incentives for account opening, restrictions on large-value cash transactions, and the establishment of a national ID framework—would help ensure that a real-name system functions as an institutional safeguard during the later stages of capital-account

liberalization for households and the private sector.

E. Policy Responses to the Potential Expansion of Remittance and Payment Services through Cryptocurrencies

(1) The Rationale for a Preemptive Approach

Nepal's economy is structurally dependent on remittances from its overseas workers, which account for approximately one-forth of its GDP, and this share has been steadily increasing. As of 2024, it is estimated that around 60,000 Nepali migrant workers reside in Korea. Their remittances to Nepal are carried out through a combination of official channels—such as banks and licensed money transfer operators (e.g., Western Union, MoneyGram, and SBI Cosmoney)—and informal remittance networks, including mobile applications, local money changers (hundi), and private brokers. In recent years, however, there has been a gradual shift toward low-cost fintech-based remittance services that offer faster transfer times and reduced fees.

Amid this trend, Korea, like other advanced economies, has initiated legislative discussions on the potential issuance of a Korean won-denominated stablecoin. At the global level, regulatory frameworks for stablecoins are already taking shape. The European Union has enacted the Markets in Crypto-Assets (MiCA) regulation; the United States is advancing legislative efforts such as the GENES Act; and Hong Kong has introduced its own jurisdiction-specific regulatory system.

Stablecoins, when integrated with existing fintech remittance services, offer advantages in reducing both transaction time and cost. For example, in Southeast Asian countries such as the Philippines and Vietnam, remittance fees often exceed 10 percent of the transaction amount, with processing times typically ranging from three to five business days. By contrast, remittances using stablecoins can be completed within an hour, with transaction costs reduced to less than 2 percent.

Recent reports suggest that potential demand for a Korean won-based stablecoin is

expected to be particularly strong among foreign residents in Korea. The number of foreign workers in the country now exceeds 1.01 million, and they have become an increasingly integral part of the Korean economy. For Nepalese monetary authorities, the growing use of foreign currency–denominated stablecoins for cross-border remittances is likely to pose significant policy challenges.

Unrestricted capital inflows and outflows can heighten exchange-rate volatility and expand the scale of foreign-exchange transactions occurring outside the formal financial system. This, in turn, increases the risk of illicit fund transfers and consumer harm by circumventing supervisory oversight. As remittance costs and procedural barriers fall, short- and medium-term capital movements are likely to accelerate, thereby undermining the orderly and sequenced approach required for safe capital-account liberalization.

Against this backdrop, the introduction of a Korean-won–denominated stablecoin would offer efficiency gains—such as lower remittance costs and enhanced financial inclusion for Nepalese residents in Korea—but it would also entail significant risks, including exchange-rate volatility, AML/CFT vulnerabilities, and increased supervisory burdens. Consequently, an optimal strategy would involve, in the short run, recalibrating risk-management frameworks and regulatory pathways, and, in the longer run, scaling up public investment in payment infrastructure. In particular, Nepal should prioritize establishing a legal and regulatory foundation for stablecoin-based remittances—drawing on crisis-experienced jurisdictions such as Korea—while implementing immediately actionable measures such as strengthened monitoring and reporting systems, large-transaction reporting thresholds, and enhanced supervisory protocols.

(2) Policy Responses

(a) Korea's Current Policy Response

Cryptocurrencies and stablecoins circulating within Korea are presumed to be issued offshore, as domestic issuance remains prohibited. The daily trading volume of U.S. dollar–denominated stablecoins is estimated to exceed KRW 500 billion—equivalent to more than 1 percent of the spot foreign exchange market turnover—suggesting a non-negligible scale of capital outflows. In particular, stablecoins have increasingly been used for offshore crypto-asset transactions and cross-border remittance purposes, allowing domestic users to acquire them without formal reporting or the involvement of regulated financial institutions. They are also utilized in trade- and capital-related transactions, enabling transfers of value between onshore and offshore markets. As a result, dollar stablecoins have emerged as an alternative channel for overseas capital outflows that bypasses the official foreign exchange monitoring system.

Against this backdrop, concerns are growing that the expanding circulation of dollar-denominated stablecoins—used to circumvent existing foreign exchange regulations—could exacerbate foreign exchange market instability through increased capital outflows. Moreover, if a Korean won–denominated stablecoin were to be introduced, regulatory arbitrage could become even easier, potentially intensifying these risks. In its 2025 report, *"Key Issues and Policy Responses Regarding Stablecoins,"* the Bank of Korea noted that the proliferation of dollar stablecoins has facilitated illegal transactions that circumvent foreign exchange regulations and has posed significant challenges to effective oversight and control.

Meanwhile, Korea's Foreign Exchange Transactions Act is primarily designed to regulate traditional foreign exchange transactions based on fiat currencies and does not clearly define or explicitly cover blockchain-based digital assets such as stablecoins. Consequently, there have been growing calls to legally recognize certain virtual assets—particularly those whose value is pegged to domestic or foreign currencies and that are

used as means of payment among the general public—as "means of payment" under the Foreign Exchange Transactions Act.

In addition, policy discussions are under way to introduce a regulatory framework that would impose ex ante registration and reporting obligations on cross-border transfers and remittance transactions involving stablecoins and crypto-assets, and require the submission of transaction data to the Bank of Korea and financial authorities for review and monitoring. Legislative proposals have already been introduced to amend relevant laws in order to establish monitoring and capital flow management mechanisms comparable to those applied to foreign exchange transactions, including provisions concerning issuer eligibility and supervisory authority.

With respect to a potential Korean won–denominated stablecoin, the government is seeking to institutionalize its framework through the enactment of a Digital Asset Basic Act. However, there remains an ongoing debate regarding the appropriate issuer and supervisory authority: one view holds that issuance should be limited to banks and oversight confined to the central bank, while another advocates for a consortium-based model that includes non-bank entities under the supervision of a broader regulatory body. Relevant authorities, including the Ministry of Economy and Finance, the Financial Services Commission, and the Bank of Korea, are currently engaged in inter-agency consultations to establish a concrete regulatory framework for cross-border transactions involving stablecoins.

(b) Implications for Nepal's Remittance-Based Economy and Policy Directions

Nepal maintains a strict policy that comprehensively prohibits cryptocurrency trading and payments. Accordingly, the use of crypto-assets as an official channel for remittances is either legally prohibited or remains in a regulatory grey area. While peer-to-peer (P2P) transfers are technically feasible in informal markets, they are subject to a high risk of regulatory sanctions and pose significant money laundering concerns. In countries such as Nepal, where formal financial infrastructure remains limited, crypto-assets could in

principle serve as an alternative technological solution; however, the prevailing legal environment effectively prevents their legitimate adoption.

Although precise data are unavailable, it is reasonable to expect that in high-remittance economies such as Nepal, even where crypto-based remittances are not officially permitted, the expansion of crypto-assets—particularly USD-denominated stablecoins—would not eliminate demand for such services. On the contrary, they could enhance financial inclusion and improve the efficiency of P2P transactions by providing greater accessibility. The trade-off, however, would likely be a weakening of authorities' capacity to control foreign exchange inflows, conduct independent monetary policy, and manage capital flows.

At present, Nepal maintains stringent controls on capital flows and crypto-asset transactions, suggesting that significant disruptions are unlikely in the short term. Nevertheless, once stablecoins are formally recognized as payment instruments in major host countries for Nepali migrant workers—including Korea—fundamental changes in remittance structures can be expected over the medium to long term. While remittance fees and transaction speeds would improve substantially, the traditional banking channel for simple remittance services would likely weaken, and informal remittance mechanisms (such as hundi) could be partially displaced by crypto-based alternatives.

A further concern is that remittance inflows may no longer automatically translate into official foreign exchange supply. Funds received in USD-denominated stablecoins may not be immediately converted into NPR, thereby weakening the Nepal Rastra Bank's (NRB) capacity to monitor and control capital flows. Given the absence of constraints related to borders, transaction hours, or bank accounts, small but frequent capital movements could become pervasive. During periods of domestic or external stress, residents may increasingly shift from NPR into dollar stablecoins. In effect, this would amount to an early and de facto liberalization of the household capital account, which under conventional sequencing frameworks is typically undertaken only at the final stage of capital account liberalization.

Moreover, if no effective limits exist on the amounts that can be converted from bank

deposits into foreign currency–denominated stablecoins, or on foreign exchange purchases and transfers, capital outflows could be amplified both in scale and speed. Increased short-term liquidity movements could undermine the effectiveness of earlier-stage liberalization measures aimed at promoting long-term investment, such as foreign direct investment (FDI). For a country like Nepal that operates a pegged exchange rate regime, widespread adoption of USD-denominated stablecoins could also weaken the effectiveness of the INR peg. This could give rise to a form of quasi-dollarization alongside the existing peg, resulting in a "double anchoring" problem whereby the monetary system is simultaneously influenced by the INR peg and USD-linked digital instruments.

From this perspective, Nepal may consider policy responses such as adopting a system similar to Korea's Overseas Remittance Integrated System (ORIS), which enables real-time, centralized monitoring of cross-border remittance transactions across the financial sector (see Box <6-3>). Another relevant case is that of the Philippines. On November 21, 2025, the Bangko Sentral ng Pilipinas (BSP) announced a plan to support a stablecoin-based remittance system (PHPC) through a partnership between the country's largest crypto exchange, "Coins.ph," and the global remittance service provider "Remitly." Under this arrangement, remitters' fiat currency can be converted into stablecoins and rapidly credited to local wallets linked to PHP-denominated stablecoins. BSP has granted PHPC a regulatory sandbox approval and is expected to expand this toward full authorization if the pilot proves successful.

Drawing on such experiences, Nepal may need to consider linking its ongoing central bank digital currency (CBDC) initiatives with a remittance-oriented stablecoin framework. At the same time, maintaining an outright ban risks pushing crypto-based remittance demand further underground, thereby increasing supervisory blind spots and consumer protection risks. A regulatory approach that combines clear registration requirements, AML/KYC obligations, and a sandbox framework—similar to the Philippine model—may offer a more pragmatic pathway for integrating crypto-based remittances into the formal system while developing Nepal-specific regulatory safeguards.

In this regard, the BIS (2025) also emphasizes that the risks posed by global stablecoins (GSCs) cannot be adequately captured within existing financial regulatory frameworks alone and argues that they should be regulated as a distinct category of payment instruments. The BIS further notes that cross-border supervision of multinational stablecoin arrangements is particularly challenging due to heterogeneity in national rules regarding redemption, custody, disclosure, and reserve asset requirements.

<Box 6-3> Key Changes in Korea's Documentation-Free Overseas Remittance System

1. Key Elements of the Reform

- Launch of the Overseas Remittance Integrated System (ORIS)
  The Korean government, in cooperation with the central bank, has introduced the Overseas Remittance Integrated System (ORIS), which enables real-time, centralized monitoring of overseas remittance transactions across the entire financial sector.
- Integration and Increase of Documentation-Free Remittance Limits
  Previously, remittance limits were differentiated by institution type—USD 100,000 per year for banks and USD 50,000 per year per institution for non-bank providers. Under the reform, these limits have been unified into a single annual limit of USD 100,000 per customer across all financial institutions.

2. Areas Requiring Additional Measures Following the Reform

- Redesign of STR (Suspicious Transaction Report) Rule Scenarios
  Under the previous system, a designated bank was responsible for monitoring each customer's total annual remittance activity. Following the reform, customers can now use multiple banks and fintech providers simultaneously. This change necessitates the development of new types of suspicious

transaction scenarios that go beyond institution-specific monitoring rules.

- Enhanced Detection of Cross-Institution “Smurfing” Attempts

  Although ORIS will block transactions exceeding the annual limit, money launderers are likely to seek system vulnerabilities by attempting multiple concurrent transfers across different institutions. Accordingly, new monitoring rules should be introduced to identify abnormal behaviors, such as accounts with recent remittance rejections at other institutions or excessively frequent limit inquiries within a short period.

- Intensified Monitoring of Many-to-One Transaction Patterns

  With the introduction of a unified annual limit per individual (USD 100,000), there is a heightened risk that illicit actors may mobilize multiple nominees to channel funds to a single overseas beneficiary. Monitoring frameworks should therefore be refined to identify transactions in which multiple senders transfer funds to the same recipient (e.g., identical beneficiary account details, addresses, or contact information), leveraging not only internal data but also shared information from ORIS.

- Reinforcement of Customer Due Diligence (CDD) Procedures

  When customers who have already exhausted their documentation-free limit attempt additional transfers, financial institutions should not process such transactions automatically as documentation-free remittances. Instead, they should strengthen internal controls by re-verifying the source of funds and the purpose of the transaction through enhanced CDD procedures.

VII. Capital Flow Management in Liberalized Capital Account Regime

1. Risks Associated with Capital Account Liberalization

A. Risks Associated with Capital Account Liberalization

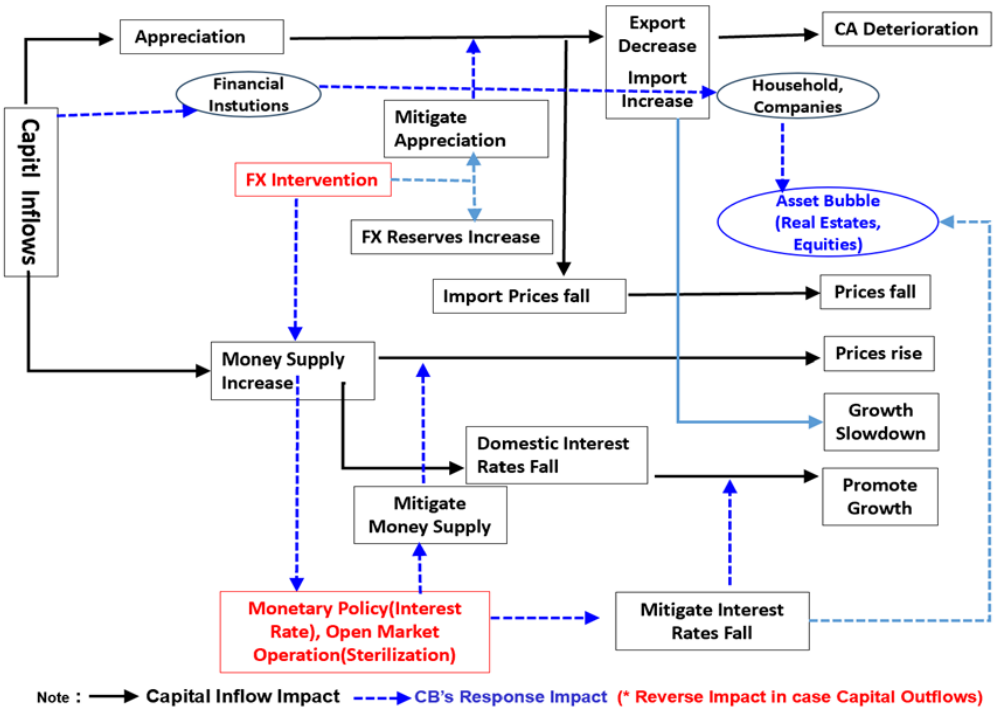
Capital account liberalization has positive aspects in that it can promote economic growth by lowering corporate funding costs in domestic and international financial markets and thereby stimulating investment. However, rapid capital inflows and outflows can cause various adverse effects that may undermine the stability of the economy.

When capital inflows are temporarily excessive, side effects such as exchange rate appreciation (domestic currency strengthening), an increase in money supply through the external sector, a deterioration in the current account balance, inflationary pressures, and sharp rises in asset prices such as stocks and real estate may occur. Conversely, a sudden outflow of capital may lead to a sharp increase in exchange rates and interest rates, thereby disrupting domestic financial and foreign exchange markets and potentially causing an economic downturn.

As observed in past foreign exchange crises, such adverse effects tend to be more pronounced in emerging market economies. As shown in <Figure 7-2>, the external shock factors that generate risks related to capital account liberalization are diverse. When capital inflows resulting from liberalization cause an emerging country's currency to remain at a level misaligned with its fundamental economic conditions, this may lead to adverse effects on the country's macroeconomy. Ultimately, as illustrated by Korea's experience during the 1997 foreign exchange crisis (Figure 7-3), an overvalued exchange rate can become one of the factors triggering a currency crisis. Therefore, such risks must be carefully considered when pursuing capital account liberalization.

<Figure 7-1>

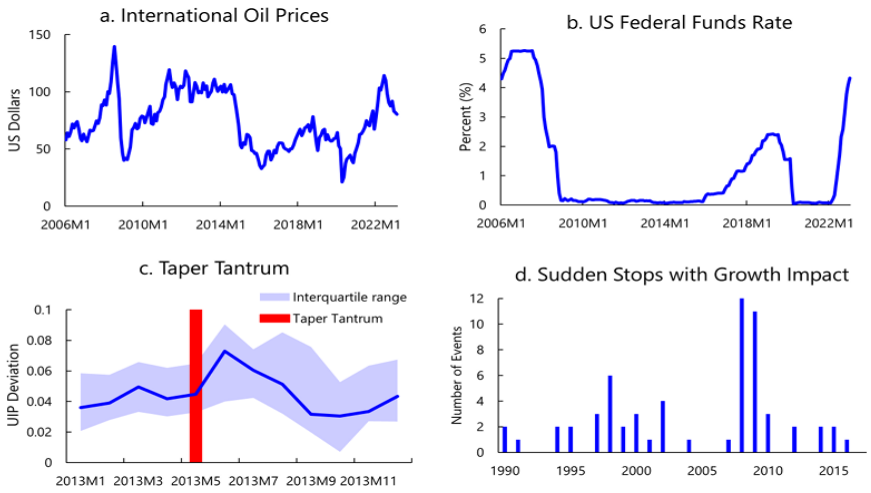
Transmission Channels of Capital Inflows to the Domestic Economy*



* Prepared by the author expanding the transmission channels presented by Yoon, Bo-il et al. (1999), p.2

<Figure 7-2>

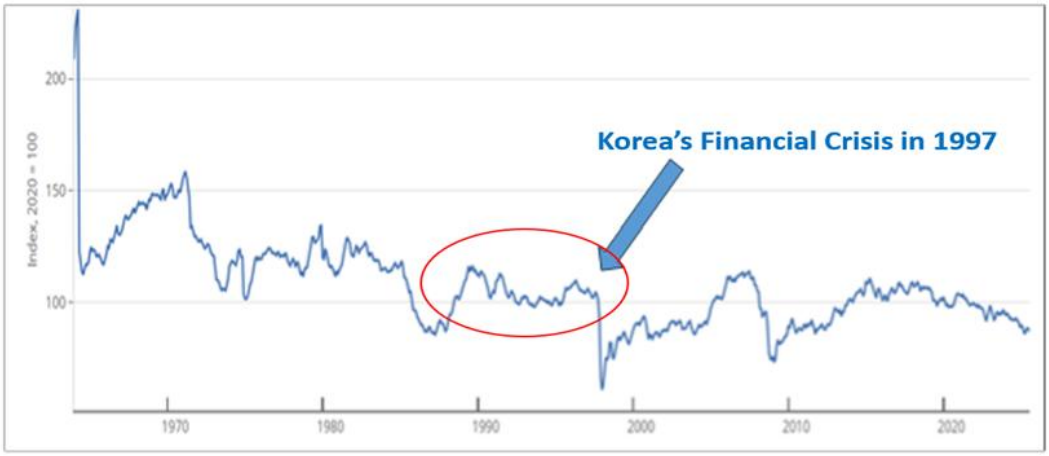
Examples of External Shocks Related to CA Liberalization



Source: Basu, Suman et *al*.(2024), p. 2

<Figure 7-3>

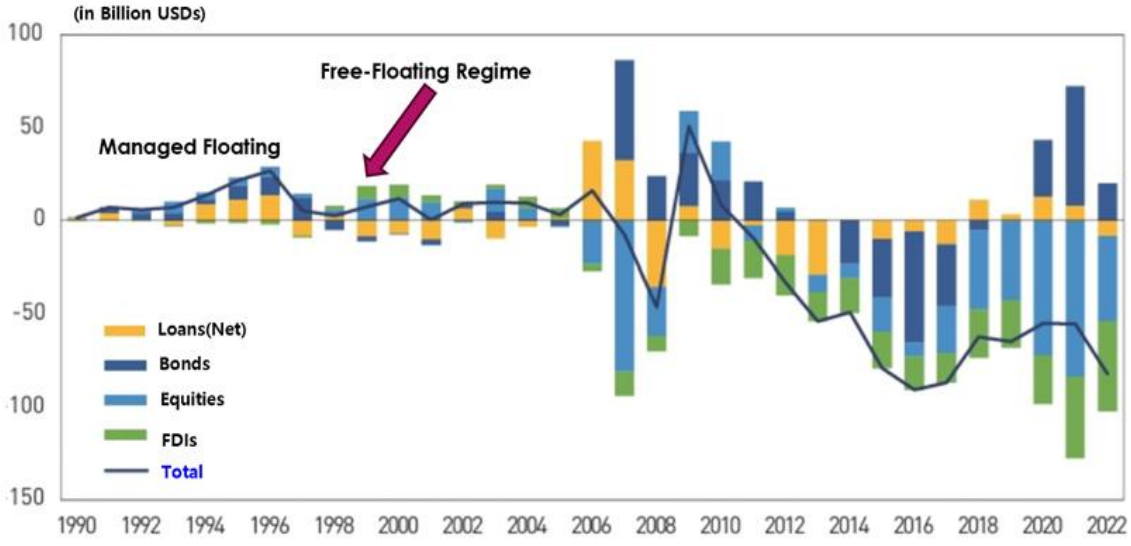
Trend of Korea's REER of the Korean Won



Source: BIS (above 100: Appreciation)

<Figure 7-4>

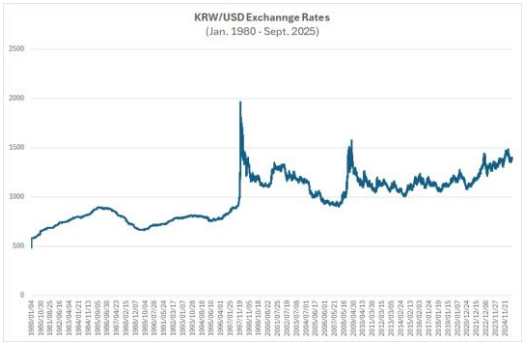
Trends in Korea's Capital Inflows and Outflows



Source: ECOS, BOK

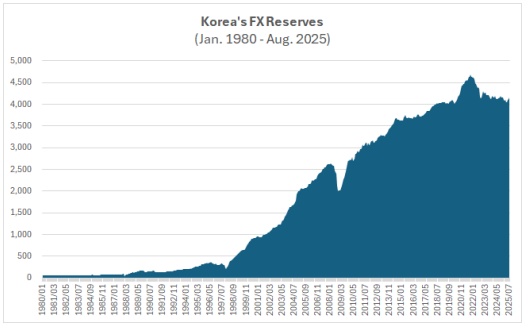
<Figure 7-5>

Trends in Korea's Exchange Rates(KRW/USD)



Source: ECOS, BOK

Trends in Korea's Foreign Reserves



Source: ECOS, BOK

B. Measures for Managing Risks from Capital Account Liberalization

Since the global financial crisis of the 2010s, international organizations such as the IMF and BIS, along with academic circles, have increasingly reached a consensus that for emerging market economies without reserve currencies, it is desirable to adopt an Integrated Policy Framework (IPF) that supplements inflation targeting with a combination of diverse policy tools. This approach is viewed as an effective means to conduct monetary policy and to mitigate the side effects of capital account liberalization.[38]

In particular, since the 2010s, the IMF has recognized the Integrated Policy Framework (IPF) as an appropriate analytical and policy tool and has come to acknowledge the effectiveness of measures that it had previously been reluctant to endorse—namely foreign exchange intervention (FXI) and capital flow management measures (CFMs). Through the adoption of its Institutional View (IV) in 2012,[39] the IMF officially shifted its stance to recognize capital flow management measures with macroprudential purposes

39) Lee, Chang-Yong(2024 b), p.1

40) IMF(2012)

(CFM/MPMs) as legitimate policy instruments.

For non-reserve currency countries, the sensitivity to global financial conditions is high, leading to greater volatility in capital flows and exchange rates. Furthermore, because their role as a lender of last resort in the foreign exchange market is limited, such countries face significant constraints in achieving both price stability and financial stability solely through monetary policy.[40]

Accordingly, international organizations such as the IMF and BIS have begun to analyze how non-reserve currency countries can achieve price stability and financial stability more effectively by employing an Integrated Policy Framework (IPF) that combines multiple policy instruments. In particular, they have come to recognize that the application of an integrated framework is especially effective in situations where the traditional policy objectives of price stability and financial stability are in conflict.

In embracing the Integrated Policy Framework, the IMF—taking into account the lessons learned from the Asian Financial Crisis and the Global Financial Crisis—has gradually expanded the scope of its recognized policy tools to include capital flow management measures (CFMs) and foreign exchange interventions (FXI) as legitimate policy instruments.

Under the IMF's Integrated Policy Framework (IPF), the available policy instruments are broadly classified into four categories: monetary policy, macroprudential policy measures (MPMs), capital flow management measures (CFMs), and foreign exchange intervention (FXI). Monetary policy includes tools such as interest rate adjustments and liquidity provision. Macroprudential policies encompass credit control measures such as loan-to-value (LTV) and debt service ratio (DSR) regulations. Capital flow management measures refer to policies that restrict or regulate cross-border capital movements — in Korea's case, examples include the regulation on forward FX positions and the levy on non-core FX liabilities, both implemented in 2010.

41) Lee, Chang-Yong(2024 b), p.1.

<Table 7-1>

Structure of the Integrated Policy Framework (IPF)

Monetary Policy (MP) (Interest rate adjustment, liquidity provision)	**Macroprudential Policy Measures (MPM)** (Credit control measures such as LTV and DSR regulations)
Capital Flow Management Measures (CFM) (Measures to restrict capital movements) Korea: Regulations on forward FX positions, FX soundness levy, etc.	**Foreign Exchange Intervention (FXI)**

Source: Lee, Chang-Yong(2024 a), p.2.

In 2019, the OECD amended its *Code of Liberalization of Capital Movements* to recognize that certain capital flow management measures (CFMs) could be consistent with the Code. The amendment allowed limited discrimination by nationality and currency when pursuing macroprudential objectives. As a result, Korea's *Foreign Exchange Soundness Levy*, which had previously been interpreted as a violation of the original Code, was reclassified as a "reservation item," effectively resolving the issue.[41]

In the same year, the IMF began research on country cases of policy responses to external shocks and the policy trade-offs involved in different policy combinations. Between July and October 2020, it published theoretical papers and policy reports outlining the *Integrated Policy Framework (IPF)*. Theoretical foundations were presented in Adrian et al. (2020) and Basu et al. (2020), while the policy framework was summarized in IMF (2020).

Subsequently, in March 2022, the IMF released a revised version of its *Institutional View (IV)* reflecting the IPF perspective, recommending that countries be allowed to

42) Lee, A-rang et al.(2023), p.86

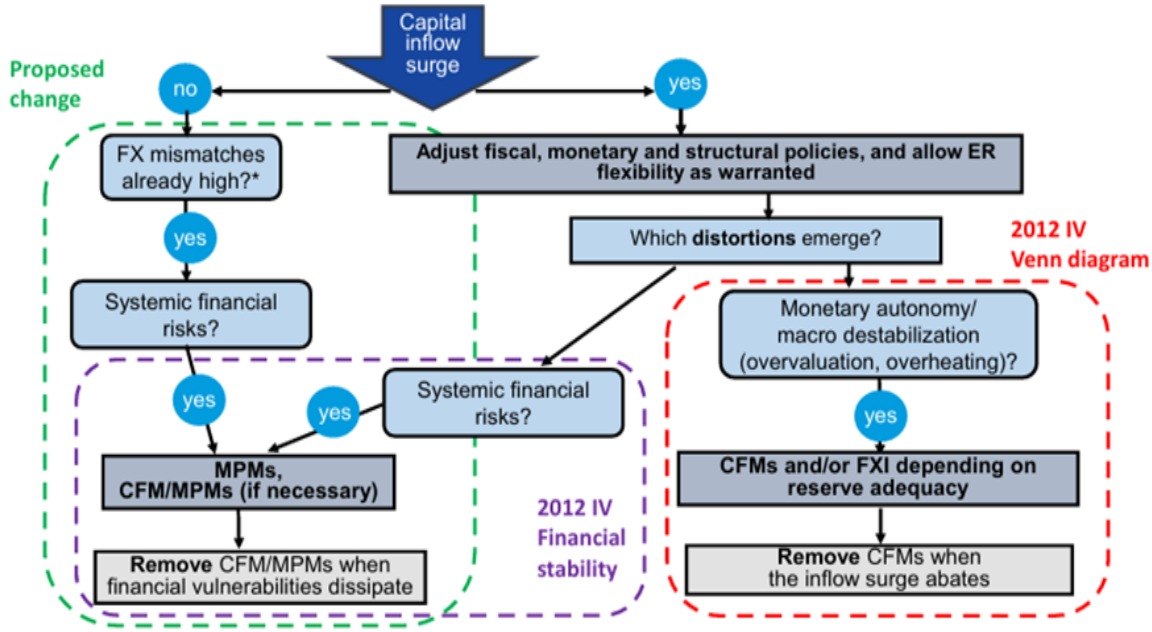
introduce macroprudentially motivated capital flow management measures (CFM/MPM) preemptively—not only during periods of capital surges but also under normal conditions when certain criteria are met.[42]

Meanwhile, the BIS also carried out discussions of a similar nature. In its *Annual Report* published in June 2019, it emphasized the need to establish a policy framework that reflects the policy responses of emerging economies with inflation-targeting regimes to capital flow volatility and exchange rate shocks. Following this, the BIS developed the *Macro-Financial Stability Frameworks (MFSF)* and submitted its final report to the G20 Finance Ministers and Central Bank Governors Meeting in July 2022.

A summary comparing the contents and revisions of the IMF's *Institutional View (IV)* related to the *Integrated Policy Framework (IPF)* is as follows.

<Figure 7-6>

IMF's Revised Institutional View (2022)



Source: IMF(2022), p. 8

43) IMF(2022)

Meanwhile, in 2023, the IMF released detailed principles regarding the role and timing of *Foreign Exchange Intervention (FXI)*—one of the key components of the *Integrated Policy Framework (IPF)*. (IMF, 2023)

<Table 7-2>

Comparison between the IMF's IV and IPF

Category	Policy Tool	Institutional View (2012)	**Institutional View (2022)	**IPF (2020)
Capital Inflows	**CFM**	- Introduced in the event of an inflow surge - Removed once inflow pressures subside	- Same as 2012 view	-Recommends **precautionary CFMs** even in normal times[6]
	CFM / MPM	- Introduced during inflow surges[3] - Can be maintained after pressure subsides - Requires periodic review	- Allows **preemptive** use of measures ' even in normal times - Requires periodic review	- **Precautionary CFMs** similar in intent to CFM/MPMs under the IV
	FXI	- Use allowed **only in crisis situations**	- Same as 2012 view	- FXI can help **reduce excessive volatility and risk/interest rate premia** - Reserves can be accumulated in advance to support FXI
Capital Outflows	**CFM, FXI**	- Applicable during **crisis or risk from outflows**	- Same as 2012 view	- **CFM**: Consider if FX markets are impaired even with sound macro policies - **FXI**: Helps reduce pressure, volatility, and premia

Source: Lee, A-rang et *al*.(2023), p. 89

Through this, the IMF classified the use of FX intervention into three broad categories as follows.

<Table 7-3>

Circumstances for the Use of FX Intervention (FXI)

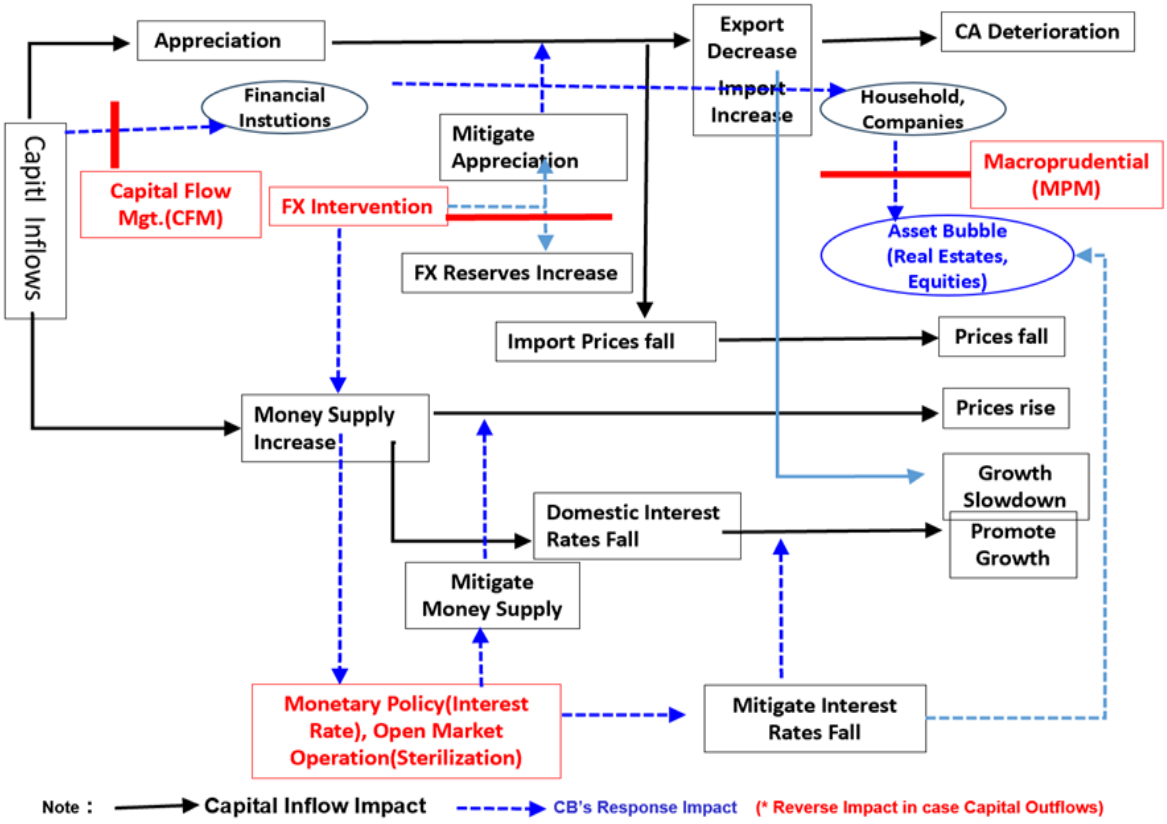
	A. FXI to Smooth Destabilizing Premia	B. FXI to Counter Risks from FX Mismatch	C. FXI to Address Risks to Price Stability
Type of shock	• Inefficient financing orhedging premia from private capital flow shocks.	• Sharp exchange rate depreciation from real or financial shocks.	• Sharp exchange rate depreciation from real or financial shocks; persistent appreciation.
Frictions	• Arbitrage frictions from foreign investors' balance sheet constraints.	• Unhedged FX liabilities in the private sector (households, firms, financial sector).	• Nominal frictions that generate nonlinear effects from exchange rate to inflation expectations.
Other policy instruments	• CFMs and CFM/MPMs to counter "surges", in line with IV • Structural policies to deepen FX and LC bond markets.	• MPMs and "preemptive" CFM/MPMs. • Structural policies to develop hedging markets.	• Monetary policy is the first line of defense. • CFMs in the appreciation case, in line with IV.
Key challenges	• Identify premia, and judge inefficient movements in premia, in real time. • Target FXI to the market that is experiencing the frictions. • Identify whether change in premia is due to inappropriate monetary and fiscal policies.	• Identify size and distribution of FX mismatches and assess the impact of shocks on financial stability. • Assess trade-off between using FXI to reduce default risks by limiting depreciation, versus providing FX liquidity to sectors with binding financial constraints.	• Identify de-anchoring of inflation expectations due to exchange rate movements. • Identify situations where trade-offs for monetary policy are sharp enough to warrant FXI. • Identify whether the de-anchoring of inflation expectations is due to inappropriate monetary and fiscal policies.
Main drawback	• Reduction in private trading volume, and market development.	• Moral hazard from use of FXI or provision of FX liquidity.	• Risk of confusion regarding the nominal anchor.

Source: IMF(2023)

The *Integrated Policy Framework (IPF)* proposed by the IMF can be utilized as a means to manage the risks that may arise from capital account liberalization. Depending on the transmission channels through which capital inflows and outflows affect the domestic economy, the framework can be applied in a tailored manner at each stage as follows.

<Figure 7-7>

Transmission Channels of Capital Inflows and the Corresponding IPF*



* Based on the policy response framework presented by Basu, Suman et al. (2024, p. 8), the author has further expanded and integrated it with the transmission channels of capital account liberalization.

The IMF's *Integrated Policy Framework (IPF)*, grounded in theoretical models, empirical analyses, and country case studies, presents optimal policy combinations among monetary policy, exchange rate policy, macroprudential policy, and capital flow management measures. The appropriate policy mix depends on the nature of the shock

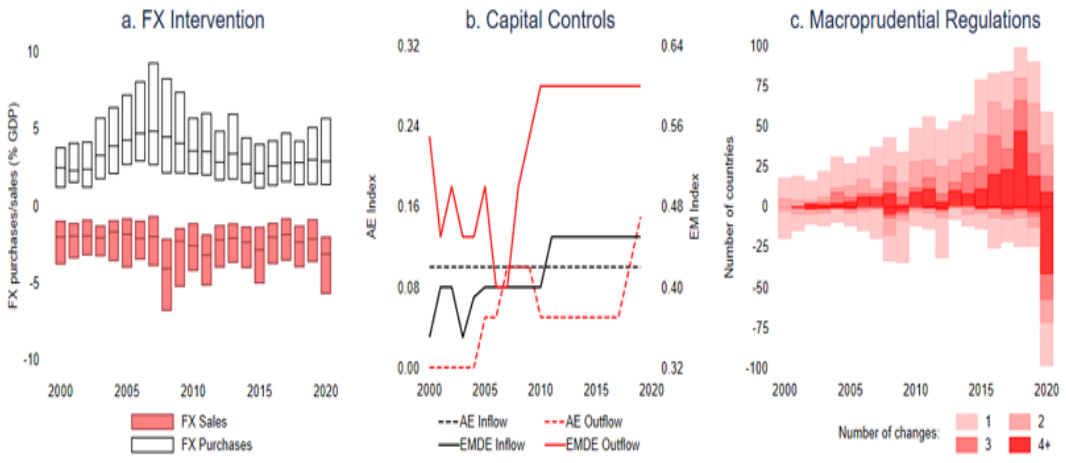
(real or financial), country-specific circumstances, and the trade-offs among policy tools.

According to the IPF, advanced economies with well-anchored inflation expectations and mature foreign exchange markets can achieve macroeconomic and financial stability primarily through conventional monetary policy and a freely floating exchange rate regime. In contrast, emerging market economies with less developed FX markets may need to deploy foreign exchange intervention and capital flow management measures in response to external financial shocks to safeguard the autonomy of their monetary policy. (Lee Arang et al., 2023, pp. 87–90)

In particular, the need for the *Integrated Policy Framework (IPF)* becomes greater in countries where trade is heavily conducted under the *Dominant Currency Paradigm* or where the degree of *currency mismatch* is significant, and where the foreign exchange market lacks depth or inflation expectations are not well anchored.

<Figure 7-8>

Utilization of Policy Response Instruments



Source: Basu, Suman et *al.*(2023), p. 2

A higher degree of currency mismatch between the private sector's foreign-currency assets and liabilities increases the likelihood that currency depreciation will lead to domestic financial instability and economic contraction. Moreover, when the FX market

is small or has limited accessibility, market inefficiencies tend to arise, and exchange rate volatility in response to external shocks becomes more pronounced.

As for the policy effects under the IPF, *foreign exchange intervention (FXI)* is most effective when the FX market is shallow enough for interventions to have a tangible impact on the exchange rate. FXI tends to be more effective during episodes of capital inflows or outflows when inflation expectations are not well anchored. Accordingly, these countries can mitigate excessive tightening of external borrowing constraints during domestic currency depreciation through FX sales (intervention to support the currency), while in normal times, they can accumulate precautionary foreign exchange reserves through FX purchases to build a buffer against future capital outflows.

Meanwhile, regarding *Capital Flow Management Measures (CFMs)*, the IPF distinguishes between measures on *capital inflows (inflow CFMs)* and those on *capital outflows (outflow CFMs)*.

During normal times, inflow CFMs—when implemented together with macroprudential policy measures (MPMs)—can help mitigate the buildup of financial stability risks. When applied countercyclically, they can also reduce the impact of external shocks on domestic demand. However, it is important to note that the prolonged use of CFMs may, in the long run, hinder the development of the FX market and the broader financial system.

In contrast, outflow CFMs can help relieve upward pressure on the exchange rate caused by expansionary monetary policy. Nevertheless, given the significant reputational risks associated with such measures, they should be used only during *crisis times*. They may be warranted when the available level of FX reserves is insufficient, or when external shocks are expected to persist long enough that FX intervention (FXI) would otherwise consume an excessive amount of reserves.

Since the IMF's formal recognition of an integrated policy framework in 2012, an increasing number of central banks have adopted CFMs and MPMs—alongside FX intervention (FXI)—as risk management tools to mitigate the side effects of capital account liberalization. The Bank of Korea, too, has applied the IPF principles both around 2010 and more recently.

Furthermore, in its 2022 *Institutional View (IV)* review of the CFM, the IMF outlined the prerequisites for emerging market economies seeking to advance capital account liberalization. It emphasized that if a country lacks sufficient capacity to manage the side effects of liberalization, CFMs should be employed as a safeguard. In cases where liberalization has already taken place but adverse effects arise due to changing conditions, the IMF recommends that CFMs be temporarily reinstated to address such vulnerabilities.

<Table 7-4>

Potential Indicators Suggesting Premature Capital Account Liberalization

Unstable macroeconomic and financial conditions due to liberalization ➢ Credibility of the exchange rate arrangement in doubt ➢ Weak macroeconomic policy frameworks ➢ Asset bubbles ➢ Inadequate FX reserves ➢ Inadequate FX flexibility ➢ Credit boom	**Inability of financial sector to handle inflows or capital flow volatility** ➢ Shallow financial markets and generally low financial development ➢ Lack of reliable hedging markets ➢ Weak governance and risk management in financial institutions ➢ Lack of resilience of financial institutions' balance sheets
Weak governance and disclosure ➢ Weak adherence to international accounting standards ➢ Low levels of shareholder protection ➢ Inadequate governance standards	**Weak financial sector regulatory standards and ineffective supervision** ➢ Inadequate micro-, securities-, and/or macroprudential regulations and policies ➢ Weak cooperation across regulators ➢ Inadequate deposit insurance ➢ Weak crisis management and resolution

Source: IMF(2023)

2. Korea's Legal and Institutional Framework for Capital Flow Management

Korea's legal framework governing foreign exchange transactions can be divided into two categories: (1) **primary laws** directly aimed at the management of foreign exchange, and (2) **related laws** that are indirectly connected to foreign exchange transactions. The former includes the *Foreign Exchange Transactions Act*, its *Enforcement Decree*, and the *Foreign Exchange Transactions Regulations*. The latter category encompasses laws such as the *Foreign Trade Act*, the *Foreign Investment Promotion Act*, and the *Status of Forces Agreement (SOFA)* between Korea and the United States. (Bank of Korea, 2023, pp. 217–219)

A. Basic Legislation

Korea's principal law governing foreign exchange transactions, the *Foreign Exchange Transactions Act*, was enacted and promulgated in September 1998 and came into effect in April 1999. This Act is a comprehensive statute that applies to all external transactions related to foreign exchange. It sets out only general provisions, while the detailed rules are specified in subordinate regulations, such as the *Enforcement Decree* and other implementing regulations.

In practice, the *Foreign Exchange Transactions Regulations* serve to operationalize the *Act* and its *Enforcement Decree* by specifying matters such as reporting requirements for individual foreign exchange transactions. These regulations are revised promptly when necessary to accommodate the fluid nature of foreign exchange activities and to respond effectively to rapidly changing domestic and international economic conditions.

B. Related Legislation

While it may be desirable to manage all external transactions under a unified legal framework, historical particularities in the evolution of Korea's legal system and other economic circumstances have led to the establishment of separate laws governing trade

transactions, as well as direct and indirect foreign investments. The main laws closely related to the *Foreign Exchange Transactions Act* are as follows:

The *Foreign Trade Act* was enacted in July 1987 through the consolidation of the *Trade Transactions Act*, the *Export Promotion of Industrial Equipment Act*, and the *Export Cooperative Association Act*. The purpose of the *Foreign Trade Act* is to promote the development of the national economy by fostering foreign trade and establishing a fair trading order to achieve balance in the international payments and to expand trade. To this end, it stipulates matters primarily related to the international movement of goods, such as approval and licensing of exports and imports, and the maintenance of orderly trading practices. In other words, while the *Foreign Trade Act* governs the conduct of export and import transactions, the *Foreign Exchange Transactions Act* regulates the methods of payment for those transactions. The *Foreign Investment Promotion Act* replaced the former *Foreign Investment and Foreign Capital Inducement Act* and came into effect in November 1998.

The purpose of this Act is to contribute to the sound development of the national economy by promoting the attraction of foreign investment through various forms of support and facilitation for foreign investors. According to the *Foreign Investment Promotion Act*, when specific provisions are established under this Act regarding foreign exchange or external transactions—such as the acquisition of domestic securities related to foreign direct investment or the provision of long-term loans to domestic enterprises—those provisions take precedence over the *Foreign Exchange Transactions Act*.

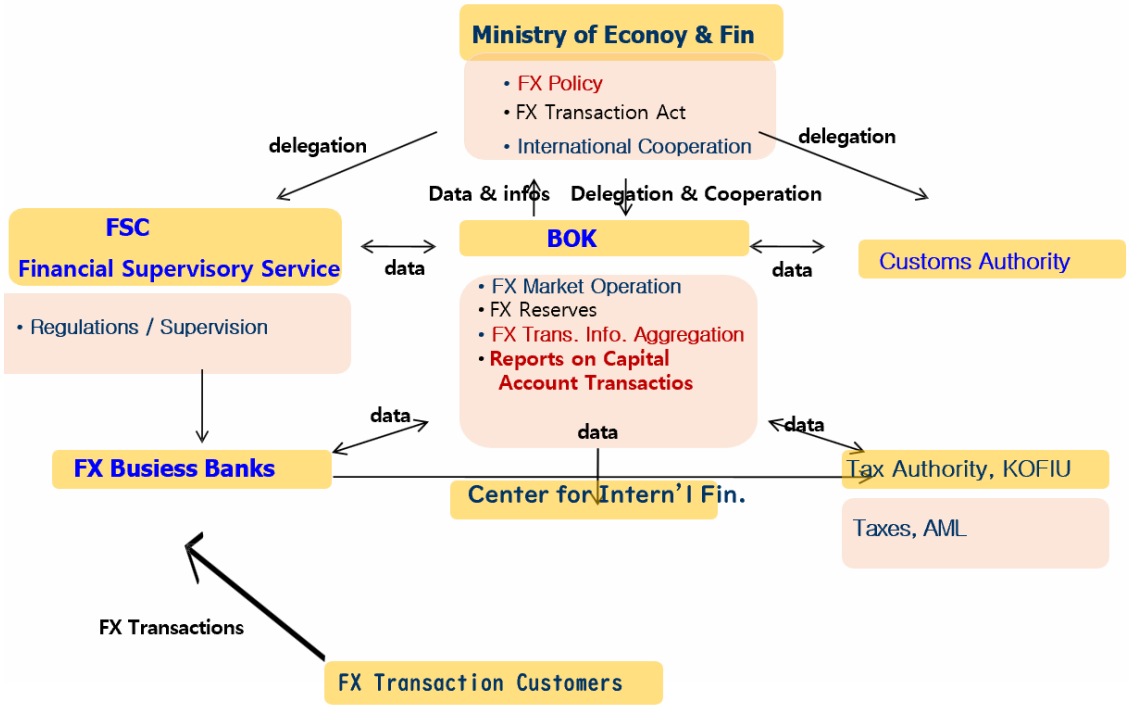
In addition, other laws such as the *Bank of Korea Act* and the *Financial Investment Services and Capital Markets Act* are also related to the *Foreign Exchange Transactions Act*.

C. Institutional Framework for Foreign Exchange Transactions

Korea’s policy and supervisory authorities related to foreign exchange transactions are as follows. Each institution exercises authority under the *Foreign Exchange Transactions Act*.

<Figure 7-9>

Korea's Institutional Arrangement for Capital Flow Management



(1) Ministry of Economy and Finance (MOEF)

The Minister of Economy and Finance holds the ultimate authority and responsibility for the formulation and implementation of foreign exchange policy and the stability of the foreign exchange market.

Under the *Foreign Exchange Transactions Act*, the Minister has powers that include:

- Registration of foreign exchange business institutions,
- Operation and management of the Foreign Exchange Equalization Fund,
- Imposition of restrictions or approvals on FX transactions, and
- Issuance of emergency suspension orders for FX transactions.

The Minister may supervise the operations of foreign exchange business institutions and issue directives necessary for such supervision. Furthermore, to ensure market stability and the soundness of these institutions, the Minister may impose business

restrictions when deemed necessary.

Some of the Minister's powers are delegated to the Governor of the Bank of Korea, the Financial Services Commission (FSC), the Commissioner of the Korea Customs Service, and the Governor of the Financial Supervisory Service (FSS).

(2) Bank of Korea (BOK)

As part of its core functions, the Bank of Korea engages in foreign exchange operations, including:

- Holding and managing foreign currency funds,
- Accepting foreign currency deposits from the government and domestic financial institutions,
- Receiving deposits from foreign central banks and financial institutions, and
- Borrowing and lending foreign currency funds.

Under the *Bank of Korea Act*, the Bank also plays a consultative role in the government's exchange rate policy, foreign currency liquidity management, and foreign exchange position policies.

Additionally, the BOK is designated as the *Foreign Exchange Information Center*, responsible for collecting and managing FX transaction data from authorized FX institutions through the national FX information network.

The Minister of Economy and Finance delegates certain powers under the *Foreign Exchange Transactions Act* to the BOK Governor. These delegated tasks include:

- Receiving reports on external payments and capital transactions,
- Supervising foreign exchange brokerage firms,
- Inspecting authorized FX institutions,
- Conducting post-management of FX transactions,
- Administering the Foreign Exchange Equalization Fund, and
- Enforcing prudential measures such as the FX soundness levy imposed on FX institutions.

(3) Korea Customs Service (KCS)

The Commissioner of the Korea Customs Service, under delegation from the Minister of Economy and Finance, is responsible for receiving reports on the export and import of means of payment exceeding USD 10,000, verifying and imposing restrictions on such transactions, handling registrations and inspections of currency exchange businesses, and inspecting or imposing sanctions on trade-related service or capital transactions.

- In connection with this, the heads of authorized foreign exchange institutions are required to notify the Commissioner of the Korea Customs Service by the 10th day of the following month in cases where a single FX transaction exceeds USD 10,000 — including the purchase or sale of foreign currency, payment or receipt of export/import proceeds, payment or receipt for services, or remittance of migration expenses exceeding USD 10,000.

(4) National Tax Service (NTS)

To prevent illegal capital flight following the two stages of foreign exchange liberalization implemented in April 1999 and January 2001, the reporting system for foreign exchange transactions to the National Tax Service was strengthened.

The heads of authorized FX institutions must report to the Commissioner of the NTS by the 10th day of the following month any FX transaction exceeding USD 10,000 per case, including purchases, sales, or payments, as well as annual payments exceeding USD 100,000 for overseas study or long-term stays abroad.

- Additionally, when the Governor of the Bank of Korea or the head of a designated foreign exchange bank approves the acquisition of overseas real estate or similar assets, they must report the related FX transaction details by the 20th of the following month to the Commissioner of the NTS, the Commissioner of the KCS, and the Governor of the Financial Supervisory Service.

(5) Korea Financial Intelligence Unit (KoFIU)

Following the September 2001 terrorist attacks in the United States, global cooperation

to combat terrorism financing intensified. In response, Korea established the *Financial Intelligence Unit (FIU)* in November 2001 to prevent illegal fundraising through financial institutions and to curb unlawful outflows of foreign currency.

Under the *Act on Reporting and Using Specified Financial Transaction Information*, financial institutions must report to the KoFIU any cash transactions amounting to KRW 10 million or more made under the same name in a single day.

(6) Foreign Exchange Information Analysis Agency

The Minister of Economy and Finance may operate an agency responsible for analyzing data related to foreign exchange transactions and payments. For this purpose, the ***Korea Center for International Financial Center(*KCIF)** has been designated as the *Foreign Exchange Information Analysis Agency*, which can access FX transaction data collected by the *Foreign Exchange Information Center*.

(7) Authorized Foreign Exchange Institutions

To enhance administrative efficiency in foreign exchange management, the Minister of Economy and Finance delegates certain administrative powers—such as verification, reporting, and post-management of FX transactions—to the heads of authorized foreign exchange institutions, including designated foreign exchange banks.

(8) Foreign Exchange Brokerage Firms

A foreign exchange brokerage firm engages in the intermediation of the purchase, sale, exchange, or lending of foreign currencies, as well as derivative transactions based on foreign currencies or related activities.

Currently, licensed FX brokerage firms include *Seoul Money Brokerage Services, Korea Money Brokerage Corporation, KIDB Money Brokerage*, and *IPS Foreign Exchange Brokerage*.

- To conduct FX brokerage business, firms must obtain authorization from the Minister of Economy and Finance by submitting documentation verifying their

capital, facilities, and professional personnel. The requirements include:

- Paid-in capital of at least KRW 4 billion,
- Adequate IT systems capable of handling FX brokerage operations and related reporting, and
- At least two qualified professionals for the conduct of such business.
- The Minister of Economy and Finance delegates supervisory authority over FX brokerage firms to the Governor of the Bank of Korea, including the power to issue supervisory orders and impose business restrictions or suspensions in case of legal violations.

  If a brokerage firm commits a serious breach, the Governor of the Bank of Korea may recommend to the Minister of Economy and Finance that its authorization be revoked.

(9) Financial Services Commission (FSC) and Financial Supervisory Service (FSS)

The Financial Services Commission and the Financial Supervisory Service (to which the FSC delegates certain supervisory functions, except for small-value remittance service providers directly supervised under MOEF delegation) are entrusted by the Minister of Economy and Finance to carry out the following:

- Supervision and inspection of authorized foreign exchange institutions and specialized FX service providers,
- Examination of small-value overseas remittance providers,3Inspection and enforcement related to service or capital transactions not linked to import/export trade, and
- Post-management of foreign exchange transactions.

3. Korea's Policy Responses to Capital Account Liberalization

Korea has applied the IMF-recommended Integrated Policy Framework (IPF) to manage the risks associated with capital-account liberalization, notably during periods of external vulnerability such as around 2010, when shipbuilding exporters experienced a boom that led to excessive FX hedging and a surge in short-term foreign borrowing by domestic financial institutions, and again in late 2022, when financial and foreign-exchange markets became unstable.

(Introduction of Macroprudential Policy Measures in the Foreign-Exchange Sector, 2010)

In response to the 2010 export boom in Korea's shipbuilding and related industries, which caused exporters' excessive FX hedging and an increase in banks' short-term foreign borrowings, the Korean authorities introduced and operated several foreign-exchange-related macroprudential policy measures (MPMs):

- Forward-position limits (October 2010) restricting banks' FX-derivative positions;
- The FX liquidity levy (August 2011) imposed on banks' non-deposit foreign-currency liabilities; and
- Restrictions on the use of foreign-currency loans (July 2010) to ensure they were used only for genuine overseas-funding needs.

These measures were designed to strengthen the resilience of the financial system against volatile capital flows and external-funding risks.

In addition, Korea implemented foreign-currency liquidity regulations in January 2010, revising the maturity standard for calculating the ratio of medium- and long-term foreign-currency funding from "over three months" to "over one year", and subsequently raising the required ratio to 100% in August 2010.

Furthermore, beginning in January 2017, Korea introduced regulation on the foreign-currency Liquidity Coverage Ratio (LCR) — defined as the ratio of high-quality liquid foreign-currency assets that can be converted into cash quickly without loss of value. The

foreign-currency LCR requirement started at 60% in 2017 and was increased by 10 percentage points each year, reaching 80% in 2019.

According to the Bank of Korea (2023, p.156), these macroprudential measures in the foreign-exchange sector, introduced after the global financial crisis, have played a significant role in reducing external debt, improving its maturity structure, and mitigating imbalances and vulnerabilities in the FX sector, thereby effectively containing systemic risks that could arise from abrupt capital inflows and outflows.

<Box 7-1> Korea's FX-related Macroprudential Policy Measures(MPM)

1. Banks' FX Forward Position Limits (introduced in October 2010)

(Background)

Around 2006–2007, Korean shipbuilding companies and asset management firms sold their future export proceeds in advance to banks through FX forward contracts in order to hedge against the risk of exchange rate appreciation (i.e., a decline in the exchange rate) on export receivables and overseas securities investment funds to be received in the future.

Banks that purchased these FX forwards, in turn, borrowed U.S. dollars at the time of the forward purchase (thereby increasing external debt) and sold them in the spot FX market to manage exchange rate risk, and later repaid the borrowings upon receiving dollars from shipbuilders and other counterparties at the maturity of the FX forwards. As such transactions increased, they became a major factor behind the rise in short-term external debt and heightened systemic risk in the Korean economy during the 2008 global financial crisis.

At the time, banks were subject only to regulation on their overall FX position, which included both spot and forward positions. Even if a bank purchased FX forwards, it could sell a corresponding amount in the spot market, allowing it to purchase FX forwards without limitation regardless of its overall position. As a result, there was an insufficient

regulatory mechanism to control banks' FX forward purchases.

* The combined spot and forward FX positions were required to be maintained within 50% of the bank's equity capital.

(Regulatory Measures)

In order to manage foreign currency inflows and outflows through foreign exchange banks at an appropriate level, the Ministry of Economy and Finance introduced and implemented limits on banks' FX forward positions. *

* These limits cover all currency-related derivatives, including FX forwards, FX and currency swaps, and non-deliverable forwards (NDFs).

- At the time of introduction, domestic banks were subject to a limit equivalent to the existing overall FX position limit, set provisionally at 50% of equity capital as of the end of the previous month.

  * Securities firms and merchant banks were subject to the same 50% limit as domestic banks.

- For branches of foreign banks, the limit was set at 250%, taking into account the average FX forward position of foreign bank branches (301% as of end-April 2010).
- Thereafter, the limits were adjusted flexibly in line with economic conditions and market developments, including periods of quantitative easing in advanced economies, Brexit, the COVID-19 pandemic, and the presidential impeachment process. In December 2025, reflecting upward pressure on the exchange rate stemming from increased overseas securities investment by individual investors and pension funds, the limits were partially relaxed for certain foreign bank branches established in Korea.

(Measures Effects)

Contributed to restraining foreign currency inflows or expanding foreign currency supply capacity in line with market conditions.

Trends in Adjustments to Banks' FX Forward Position Limits

(as a Percentage of Equity Capital)

Adjust. Date	Initial '10.10	1st '11.7	2nd '13.1	3rd '16.7	4th '20.3	5th '24.12	6th 25.12.18
Domestic Banks	50%	40%	30%	40%	50%	75%	75%
Foreign Banks	250%	200%	150%	200%	250%	375%	375%*

* Adjustment on December 18, 2025: The limit was relaxed to 200% for foreign banks established in Korea that had previously been subject to a 75% limit.

Source: Ministry of Economy and Finance; Financial Services Commission; Bank of Korea; Financial Supervisory Service (2020), p. 2.

2. Korea's FX-related Macroprudential Levy (introduced in August 2011)

(Background)

During the 2008 global financial crisis, the Korean economy experienced a systemic crisis as foreign currency funds flowed out rapidly in response to external shocks, despite otherwise sound economic fundamentals.

Accordingly, the government and the Bank of Korea formulated a range of measures to preemptively manage sharp fluctuations in cross-border capital flows, including the "Measures to Mitigate Volatility in Capital Flows," with the aim of preventing similar crisis situations.

- As part of these efforts, the authorities pursued the introduction of the macroprudential levy on foreign exchange liabilities to curb excessive growth in foreign currency debt among financial institutions and other entities.

(Implementation Process)

To establish the legal basis for the levy, the Ministry of Economy and Finance completed amendments to the Foreign Exchange Transactions Act (April 30, 2011), revisions to its

Enforcement Decree (July 25, 2011), and the preparation of related subordinate regulations, and implemented the levy starting in August 2011.

(Key Features)

- **Entities subject to the levy**
  - The levy is imposed on the banking sector, taking into account banks' roles in the financial market and the scale of their foreign currency liabilities.
- **Tax base**
  -The levy is applied to the outstanding balance of non-deposit foreign currency liabilities (total foreign currency liabilities minus foreign currency deposits).
- **Levy rate**
  - Applied on a differentiated basis by maturity, with a ceiling of 0.5%.

Source: Ministry of Economy and Finance press releases (August 2011).

(Period of Financial and Foreign Exchange Market Instability in the Second Half of 2022)

In the second half of 2022, Korea's financial and foreign-exchange markets faced instability. Following the COVID-19 pandemic, global supply shocks were compounded by the Russia–Ukraine war and the resulting surge in international oil prices, which drove rapid inflation across major advanced economies from early 2022.

In response, the U.S. Federal Reserve and other major central banks began aggressively raising policy rates, and the Bank of Korea also implemented a series of monetary tightening measures, increasing its policy rate at the fastest and largest pace in its history to bring inflation back to target.

During this process, as the Fed's tightening stance became much stronger than initially expected, the Korean won depreciated sharply against the U.S. dollar. At the same time, financial instability emerged domestically, beginning with stress in the short-term money market, particularly in real estate project-finance (PF) funding, and this loss of confidence quickly spread to the corporate bond market, amplifying overall financial tensions.

Facing a situation in which the goals of price stability and financial stability conflicted, the Bank of Korea explored various combinations of domestic and external policy measures (Lee Chang-Yong, 2024b, pp. 2–4).

In October 2022, to moderate the rapid depreciation of the Korean won against the U.S. dollar, the Bank of Korea implemented a second consecutive "big-step" rate hike (+50 basis points)—following the one in July—and simultaneously conducted foreign-exchange market interventions as part of its coordinated policy mix.

Given that Korea's FX-derivatives market is relatively small and dominated by short-term instruments, a sharper-than-expected rise in the exchange rate can trigger margin calls on derivative and hedging transactions, which in turn intensify upward pressure on domestic interest rates, creating a vicious cycle.

Therefore, rather than aiming to defend any specific exchange-rate level, the Bank of Korea's FX interventions focused on moderating the *pace* of depreciation, thereby giving market participants time to adjust their expectations and contributing to greater stability in the foreign-exchange market.

This policy mix of monetary tightening and foreign-exchange intervention represents a good example of how the IMF's Integrated Policy Framework (IPF) can be applied in countries where the FX market is relatively less developed.

Although the KRW/USD exchange rate surged sharply above KRW 1,400 per dollar in the second half of 2022, Korea was able to respond more flexibly than in past episodes. This resilience reflected both the ample level of foreign-exchange reserves—exceeding USD 400 billion—and structural changes in the domestic FX market, which reduced the adverse impact of currency depreciation compared with earlier periods.

Korea had accumulated substantial foreign-exchange reserves, providing the authorities with room to respond to FX-market volatility. In addition, as resident overseas investment increased, Korea became a net external creditor after 2014, holding a large amount of net foreign assets. This shift to a creditor position significantly reduced the risks of default or financial crisis associated with adverse balance-sheet effects during episodes of depreciation, thereby enhancing the shock-absorption capacity of Korean financial

institutions.

Moreover, the ratio of short-term external debt has remained low since the global financial crisis, improving the overall quality of Korea's external liabilities and further strengthening the resilience of its financial system.

4. Korea's Capital Flow Monitoring System (Foreign Exchange Information System, FEIS) in Response to Capital Account Liberalization

After the 1997 foreign exchange crisis, Korea shifted its foreign-exchange policy framework toward a system that guaranteed freedom of foreign-exchange transactions, promoted market-based mechanisms, and facilitated smooth external transactions with the dual objectives of achieving balance-of-payments stability and exchange-rate stability.

To this end, Korea liberalized its stock and bond markets, fully opened the economy to foreign direct investment (FDI), and in April 1999 replaced the former *Foreign Exchange Management Act* with the new *Foreign Exchange Transactions Act*, which greatly expanded foreign-exchange liberalization.

However, with full market opening and the liberalization of foreign-exchange transactions, the Korean economy became more exposed to volatility stemming from frequent capital inflows and outflows in response to changes in external conditions. Consequently, the need arose to establish an infrastructure for the centralized collection and utilization of foreign-exchange transaction data, enabling early detection of adverse effects and timely policy responses.

In March 1999, the Korean government designated the Bank of Korea (BOK) as the central institution for foreign-exchange information management, and in April 1999, the BOK established the Foreign Exchange Information System (FEIS) — a comprehensive database designed to collect and analyze FX transaction and market information rapidly and effectively.

The FEIS centralizes data on foreign-exchange transactions executed by authorized foreign-exchange institutions, and the Bank of Korea promptly provides this information to various relevant government and financial institutions. Building on this foundation, the FEIS has enabled the rapid monitoring of domestic and cross-border foreign-currency flows, the formulation of policy responses for market stabilization, the compilation of key foreign-exchange statistics such as the balance of payments and external debt, and the investigation of illegal FX transactions.

In addition, by integrating and consolidating various FX-related reports previously collected separately by different institutions into a single reporting channel through the FEIS, the system has reduced the reporting burden on financial institutions, while enhancing data sharing and utilization among policymaking agencies.

Subsequently, as financial-market linkages deepened and external openness expanded, the Bank of Korea launched a comprehensive FEIS modernization project in 2012 to reflect evolving domestic and global conditions and replace the aging IT infrastructure. The upgraded system, known as “FEIS 2.0,” was officially launched in January 2015, providing a more robust platform for integrated foreign-exchange information management. The FEIS centralizes data on foreign-exchange transactions executed by authorized foreign-exchange institutions, and the Bank of Korea promptly provides this information to various relevant user institutions.

On this basis, the FEIS has established the foundation for the swift monitoring of domestic and cross-border foreign-currency inflows and outflows, the formulation of policy measures to stabilize markets, the compilation of key external-sector statistics such as the balance of payments and external debt, and the investigation of illegal foreign-exchange transactions.

In addition, by integrating and streamlining multiple FX transaction reports previously collected separately by different institutions into a single reporting channel through the FEIS, the system has reduced the reporting burden on financial institutions and enhanced data sharing and utilization among policy authorities, thereby improving the overall effectiveness and efficiency of foreign-exchange information management.

Subsequently, to reflect changes in domestic and external conditions—including the increasing interconnectedness of financial markets and the expansion of external openness—and to replace its aging IT infrastructure, the Bank of Korea launched a comprehensive project in 2012 to rebuild the FEIS. The new system, "FEIS 2.0," was officially implemented in January 2015.

The rebuilt FEIS incorporates advanced IT technologies, enabling users to collect and access information more quickly and easily. It also features enhanced personal data protection and a disaster-recovery system designed to ensure operational continuity in the event of system failures.

Meanwhile, as long-term operation of the FEIS led to issues such as aging servers and communication equipment, as well as insufficient data-storage capacity, the Bank of Korea initiated another infrastructure replacement and application upgrade project in January 2022. This project aimed to strengthen system stability and expand capacity to meet the growing demand for information, and it was successfully completed in December 2022.

Participants in the FEIS are broadly classified into three categories: the foreign-exchange information central agency, reporting institutions, and user institutions. All participants are interconnected through an electronic network, enabling the swift exchange of data centered around the central agency.

As the foreign-exchange information central agency, the Bank of Korea operates the FEIS and is responsible for the collection, transmission, and management of FX-related information.

- Reporting institutions are entities required to report data on foreign-exchange transactions—including their own transactions and those conducted on behalf of clients—to the central agency. These include authorized foreign-exchange banks and other licensed FX institutions.
- User institutions are agencies that receive and utilize FX transaction data from the Bank of Korea. They include the Bank of Korea, Ministry of Economy and Finance (MOEF), Financial Services Commission (FSC), National Tax Service

(NTS), Korea Customs Service (KCS), Korea Financial Intelligence Unit (KoFIU), Financial Supervisory Service (FSS), Korea Deposit Insurance Corporation (KDIC), and the Korea Center for International Finance (KCIF).

As of end-September 2023, there were 1,845 FEIS participant institutions. Of these, 113 institutions were directly connected to the Bank of Korea's FEIS, while 1,732 institutions were indirectly connected through intermediary organizations.

The FEIS collects over 110 types of reports covering a wide range of transactions, including remittances, foreign-currency deposits, foreign borrowings and loans, securities, derivatives, foreign-currency funding and operations, export bills and letters of credit (L/Cs), overseas real estate, and foreign credit-card usage.

When user institutions finalize the data items required for their respective reports, the Bank of Korea, as the central agency, develops and supports the system infrastructure to ensure smooth data collection through the FEIS.

Most reports are received and managed directly by the Bank of Korea, but some are collected at the request of specific user agencies—for instance:

- The Financial Supervisory Service (FSS): foreign-currency funding and operation by maturity of financial institutions;
- The National Tax Service (NTS): loans from residents to nonresidents;
- The Korea Customs Service (KCS): reports on netting, clearing, and third-party payments or receipts.

Through the FEIS, the Bank of Korea continuously monitors foreign-currency inflows and outflows, including foreign investment in Korea, Korean investment abroad, and borrowing and repayment activities of domestic financial institutions, as well as overall FX and foreign-currency funding markets. It also uses FEIS data for compiling external-sector statistics such as the balance of payments, managing FX positions and reserves, and processing FX transaction reports and post-verification tasks.

The Ministry of Economy and Finance actively utilizes FEIS data in formulating foreign-exchange policy. The National Tax Service and Korea Customs Service use the information on trade-related transactions, FX sales, and large-value remittances to detect

and investigate smuggling, tax evasion, and other illegal transactions. The Financial Intelligence Unit (KoFIU) relies on FEIS data—such as foreign remittance records—to detect money-laundering activities, while the Financial Services Commission, Financial Supervisory Service, and Korea Deposit Insurance Corporation use the system for supervising and assessing the soundness of financial institutions.

Meanwhile, in April 1999, the Korean government established the Korea Center for International Finance (KCIF), composed primarily of private-sector international finance experts, with the aim of promptly identifying global financial market developments and formulating appropriate policy responses.

The KCIF monitors trends in both the domestic foreign-exchange market and international financial markets through various communication channels and the Foreign Exchange Information System (FEIS). The information and analytical materials it gathers are then provided to relevant policymaking institutions to support timely and informed decision-making.

5. Structure of the Foreign Exchange Market and Determination of the Exchange Rate under a Free-Floating Exchange Rate System

A. Definition of the Foreign Exchange Market

The foreign exchange market (FX market), in a narrow sense, refers to the specific place where the demand for and supply of foreign exchange meet and transactions occur. In a broader sense, it encompasses not only this spatial concept but also the entire set of mechanisms involved in the formation, execution, and settlement of foreign-exchange transactions.

Under a floating exchange rate system, the exchange rate fluctuates according to foreign-exchange supply and demand conditions, thereby performing the function of adjusting the current account balance. For example, when a current account deficit occurs,

excess demand for foreign exchange causes the domestic currency to depreciate. This depreciation improves the price competitiveness of exports, which can help correct the current account imbalance.

The FX market also provides economic agents, such as corporations and financial institutions, with instruments to hedge against risks arising from exchange-rate fluctuations. Through various derivative transactions traded in the FX market—such as forward contracts, currency futures, and currency options—these participants can effectively manage and mitigate foreign-exchange risks.

B. Participants in the Foreign Exchange Market

In the Seoul foreign exchange market, participants include customers, authorized foreign-exchange banks, foreign-exchange brokerage firms, and the central bank, each engaging in transactions for different purposes.

Customers refer to entities such as corporations engaged in export–import or financial transactions, and individuals undertaking overseas travel, who participate in the FX market primarily for the exchange of goods and services. For example, exporting firms act as suppliers of foreign exchange, while importing firms serve as demanders of foreign exchange. Likewise, when travelers exchange their domestic currency for foreign currency before going abroad, they become buyers of foreign exchange in the market.

Thus, exporters or travelers are not engaged in FX transactions to pursue short-term speculative gains from exchange-rate fluctuations but rather to fulfill real economic needs such as trade payments, overseas remittances, or travel expenses. They are therefore regarded as real demanders or suppliers of foreign exchange.

Authorized foreign-exchange banks play a central role in the FX market, acting as counterparties to customers' FX transaction requests and facilitating the smooth execution of trades. As a result, any changes in a bank's foreign-exchange position—defined as the difference between its foreign-currency assets and liabilities—are adjusted through the interbank market. In addition, authorized foreign-exchange banks actively

engage in FX transactions aimed at gaining profits based on exchange-rate forecasts.

In particular, large banks act as market makers in the FX market, simultaneously quoting bid and offer prices (two-way quotes) for specific currencies and thereby leading market price formation. The spread between the bid and offer rates serves both as a source of income for banks and as a key reference for price determination within the market.

A foreign-exchange broker is an intermediary who, for a commission fee, facilitates interbank transactions. Banks use brokers to quickly and efficiently identify optimal buying and selling exchange rates, which fluctuate continuously across global FX markets. Conducting transactions through brokers also allows banks to avoid disclosing their FX position information to counterparties. Since brokers merely relay real-time bid and offer quotes among banks and do not conduct FX trades on their own, they are not exposed to exchange-rate risk.

As the foreign-exchange authority, the central bank—in coordination with the government—works to maintain stability in the FX market. It may also participate directly as a market participant, buying or selling foreign exchange when necessary. For example, if the won/dollar exchange rate rises (or falls) too rapidly, the central bank may sell (or buy) foreign currency in exchange for domestic currency to stabilize market conditions.

C. Foreign Exchange Transaction Procedures (Interbank Foreign Exchange Market)

In the Seoul foreign exchange market, participants include corporate, individual, and government customers, authorized foreign-exchange banks, foreign-exchange brokerage firms, RFIs and foreign-exchange authorities.

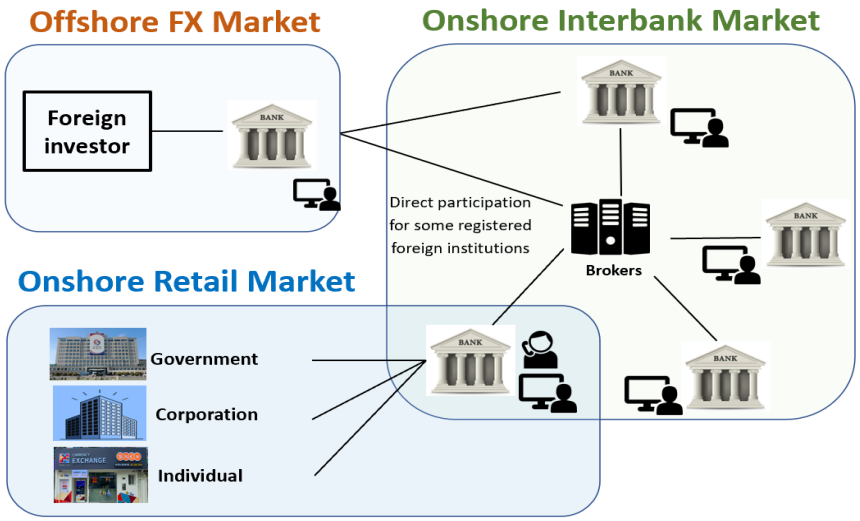
As of December 10, 2025, participants in the interbank spot FX market include 17 domestic banks (commercial banks, specialized banks, and regional banks), 26 domestic branches of foreign banks, 15 securities companies, one merchant banking corporation, and 69 overseas foreign exchange business institutions (Registered Foreign Institutions, RFIs).

The interbank market is divided into two segments: one where authorized foreign-exchange banks trade directly with each other, and another where they trade through foreign-exchange brokerage firms.

The traded currencies are the U.S. dollar and the Chinese yuan, with minimum transaction sizes of USD 1 million and CNY 1 million, respectively, and trades conducted in multiples of those units. The quotation units are ₩0.10 (10 jeon) for KRW/USD transactions and ₩0.01 (1 jeon) for KRW/CNY transactions, with the value date set as T+2 (value spot). Previously, FX market trading hours were from 9:00 a.m. to 3:30 p.m. on business days. However, under the FX market advancement measures, trading hours have been extended until 2:00 a.m. Korea Standard Time since July 2024, allowing overseas foreign exchange business institutions (RFIs) to participate in the market.

<Figure 7-10>

Korea's FX Market Structure



In October 2002, foreign-exchange brokers introduced an electronic brokerage system in addition to the traditional telephone-based brokerage method. Under this system, FX dealers at banks can input buy or sell orders directly via dedicated terminals, which are then automatically matched and executed through the broker's electronic network. Today, the vast majority of trades are conducted electronically, although telephone orders are still used in exceptional cases.

In 2021, an Application Programming Interface (API) was introduced to electronically link the interbank brokerage system with each bank's client trading system (MMS; Market Making System) via a dedicated communication line. This integration allows for real-time quotation provision, trade execution, and data retrieval between trading platforms. As a result, corporate clients can now view real-time FX quotes through electronic trading platforms provided by banks, while banks can automatically offset the resulting FX positions in the interbank market.

Meanwhile, the Seoul Foreign Exchange Market Committee, a self-regulatory body comprising major market participants such as banks and brokerage firms, has been established to foster dialogue and cooperation on measures to develop and enhance the efficiency of the Korean FX market.

<Box 7-2> Korea's FX Market Structure Reform Measures

The foreign exchange (FX) market advancement initiative being pursued by the Ministry of Economy and Finance and the Bank of Korea focuses on improving the structure of the FX market. Through measures such as expanding foreign participation in the FX market (including the introduction of the RFI framework—Registered Foreign Institutions, i.e., foreign financial institutions engaged in FX business overseas that are registered with the FX authorities upon meeting certain requirements), extending trading hours, enhancing the efficiency of settlement systems, and improving related systems and market practices, the initiative aims to develop the market to global standards, mitigate exchange rate volatility, and enhance overall FX market efficiency. The initiative has been promoted since February 2023 and has been implemented since July 2024, with the ultimate objective of increasing market transparency and liquidity and thereby enhancing the attractiveness of Korea's financial markets.

Key Measures

- **Expansion of participation by foreign financial institutions (RFIs):** Opening the door for foreign financial institutions to directly participate in the domestic FX market, thereby increasing market depth and liquidity.
- **Extension of trading hours:** Extending FX market trading hours until 2:00 a.m. to narrow the time gap with global markets and improve trading convenience for foreign investors.
- **Modernization of settlement systems:** Enhancing transaction safety by improving the efficiency of settlement systems, including the advancement of securities market settlement frameworks.
- **Improvements in systems and market practices:** Aligning FX market–related regulations and practices with international standards to enhance market transparency.
- **Market monitoring and response:** Continuously monitoring domestic and global financial market conditions and, in cooperation with financial institutions, working to stabilize the market in the event of excessive volatility.

Expected Effects

- **Enhanced market efficiency and transparency:** Improving market efficiency through broader participation and an improved trading environment.
- **Mitigation of exchange rate volatility:** Contributing to the alleviation of excessive exchange rate fluctuations through a deeper and broader market.
- **Strengthened international standing:** Enhancing competitiveness as a leading FX market in Asia.

As a result of these measures, one year after implementation, in July 2025, average daily FX trading volume increased by 16%.

Source: Ministry of Economy and Finance press releases (February 2023; July 2024).

D. Self-Regulatory Organization of the Foreign Exchange Market (Seoul Foreign Exchange Market Committee)

The Seoul Foreign Exchange Market Committee (hereinafter referred to as the "Committee") is a self-regulatory organization of foreign-exchange market participants, established in December 1982 to promote the stable development and efficient operation of the Korean foreign-exchange market.

The Committee is composed of participants in the FX market, including commercial banks, specialized banks, foreign bank branches, and FX brokerage firms. It operates four standing subcommittees—the *Market Practice Improvement Committee*, *Market Surveillance and Dispute Resolution Committee*, *FX Derivatives Committee*, and *KRW–CNY Committee*—as well as one ad hoc committee, the *FX Transaction Arbitration Committee*.

These subcommittees perform functions such as coordinating opinions and formulating guidelines related to FX transactions, exchanging information on market operations, and sharing data on violations of FX trading guidelines as part of the market's self-regulatory framework.

Furthermore, the Committee participates in international discussions as a member of the Global Foreign Exchange Committee (GFXC).

Main Functions

- Formulation and revision of the Seoul Foreign Exchange Market Code of Conduct
- Discussion and research to enhance the stability and efficiency of the FX market
- Study of trading practices and conventions in the FX market
- Investigation, mediation, and sanctions for violations of the Code of Conduct
- Close coordination with the Korea Forex Club
- Establishment and revision of the Committee's operating regulations
- Participation in Global Foreign Exchange Committee (GFXC) meetings
- Other matters related to the operation and development of the FX market and the Committee

Key Milestones

- **Dec. 1989:** Established *Guidelines for Interbank Foreign Exchange Transactions in the Seoul FX Market*
  – Defined general trading principles, trading hours, tradable currencies, minimum trading units, and transaction procedures
- **Dec. 2001:** Adopted the *Seoul FX Market Code of Conduct*
- **Feb. 2002:** Established the *Market Practice Improvement* and *Market Surveillance & Dispute Resolution Committees*
- **June 2002:** Introduced the *Electronic Brokerage System*
- **Nov. 2003:** Revised trading hours for FX transactions via brokers
- **June 2006:** Established the *FX Transaction Arbitration Committee*
- **July 2007:** Formed the *FX Derivatives Committee*
- **Dec. 2014:** Launched the *KRW–CNY Direct Trading Market*
- **Apr. 2015:** Established the *KRW–CNY Committee*
- **Jan. 2024:** Revised the *Seoul FX Market Code of Conduct*

E. Market Stabilization Measures by the Korean FX Authorities

Under its free-floating exchange rate regime, Korea allows the exchange rate to be determined autonomously by the foreign exchange market in principle. However, when excessive market imbalances occur, the authorities implement market stabilization measures (smoothing operations). These measures refer to actions by the foreign exchange authorities to purchase or sell foreign currency assets in the FX market in exchange for the domestic currency (KRW). They also include verbal intervention, whereby officials from the Ministry of Economy and Finance or the Bank of Korea publicly express their views on exchange rate movements.

Through such market stabilization measures, the FX authorities influence the balance of foreign exchange supply and demand, domestic liquidity conditions, the relative scale of foreign currency assets, and market participants' expectations, thereby affecting

exchange rate volatility and cross-border capital flows.

Market stabilization measures by the Korean FX authorities are implemented in a limited manner and only under the following circumstances:

- When the exchange rate rises or falls rapidly within a short period;
- When exchange rate volatility increases sharply due to heightened uncertainty; and
- When market liquidity declines, leading to a concentration or imbalance in foreign exchange supply and demand.

6. Policy Recommendation for the Nepal Rastra Bank (NRB)

Korea began with a fixed exchange rate regime pegged to the U.S. dollar and subsequently moved through managed exchange rate systems—including a multiple-currency basket system and a market average exchange rate system. During this period, the exchange rate was rigidly maintained at an overvalued level, effectively resembling a fixed exchange rate regime. As a result, mismatches in foreign exchange hedging by domestic financial institutions contributed to the 1997 currency crisis, after which Korea transitioned to a free-floating exchange rate regime.

Through its experience of the foreign exchange crisis, Korea learned that in order to respond effectively to capital inflows and outflows, it is essential to regularly assess the appropriate level of the exchange rate so that the domestic currency does not remain persistently overvalued or undervalued. At the same time, the exchange rate should be managed flexibly so that it is fundamentally determined by foreign exchange supply and demand in the market, thereby allowing the exchange rate to perform its automatic balance-of-payments adjustment function.

As the Central Bank of Nepal (NRB) seeks to expand capital-account liberalization under its peg exchange-rate regime, it should proceed carefully to avoid exposure to risks associated with capital liberalization. In doing so, NRB can draw on the IMF's Integrated Policy Framework (IPF) and the Bank of Korea's experience. The following points merit

particular attention:

First, given Nepal's socio-economic conditions, it is assessed that maintaining a pegged exchange rate regime will be unavoidable for the time being. As Nepal pursues capital account liberalization while maintaining a pegged exchange rate system, any capital outflows that arise would inevitably need to be addressed primarily through foreign exchange market intervention. Accordingly, it is necessary to build up an adequate level of foreign exchange reserves in advance, prior to the occurrence of capital outflows. As Korea's recent experience suggests, deeper capital account liberalization can constrain reserve accumulation during capital outflows. Nepal should accordingly leverage periods of strong remittance inflows to keep foreign exchange reserves above adequacy thresholds, while balancing the opportunity costs of reserve accumulation and applying the IMF's ARA framework for reserve adequacy assessment.

In addition, revision of the pegged exchange rate to the current equilibrium level before initiating reforms could be appropriate.

Nepal can learn from Hong Kong's experience during the 1997 Asian financial crisis, when speculative forces attacked the Hong Kong dollar. Despite not implementing any separate Capital Flow Management (CFM) measures, Hong Kong successfully defended its currency—thanks to ample foreign-exchange reserves, which provided strong support.

Second, with respect to foreign exchange reserve accumulation, as capital account liberalization advances, it is important not only to strengthen foreign reserve buffers but also to maintain international cooperative arrangements—such as currency swap agreements with the central banks of key neighboring trading partners, including India—to help preempt the risk of abrupt capital flow reversals and to contain volatility effectively.

In response to the Global Financial Crisis (GFC), finance ministers of member countries of the South Asian Association for Regional Cooperation (SAARC) agreed in 2009 on the need for bilateral arrangements to tackle short-term credit contractions and financial market disruptions. In 2012, the Reserve Bank of India (RBI) responded by launching a self-funded USD 2 billion swap framework in USD, EUR or INR for all

SAARC member nations to provide a backstop line of credit to fight any balance of payments and liquidity crises with the aim of promoting regional economic stability.[43] [44] The facility is available to the central banks of requesting countries, subject to the signing of a bilateral swap agreement. Bhutan, Maldives, and Sri Lanka used the RBI's SAARC swap framework to sign and activate bilateral swaps at various points between 2012 and 2022, including during the COVID-19 pandemic, to meet dollar liquidity needs.

The SAARC framework helped borrowing central banks maintain exchange rate stability, provide short term foreign exchange liquidity, and facilitate downstream lending programs.[45] The RBI with the concurrence of the Government of India has decided to put in place a revised Framework on Currency Swap Arrangement for SAARC countries for the period 2024 to 2027 on June 27, 2024. A separate INR Swap Window has been introduced with various concessions for swap support in Indian Rupee under the Framework for 2024-27. The total corpus of the Rupee support is ₹250 billion (approximately equivalent to US$ 2.8 billion). The RBI will continue to offer swap arrangements in US$ and Euro under a separate US Dollar/Euro Swap Window with an overall corpus of US$ 2 billion.

Despite India's proposal, Nepal has not made use of a central bank currency swap, as sustained remittance inflows from overseas Nepalese workers have reduced the need for additional foreign exchange liquidity. However, as demonstrated by the effectiveness of the Bank of Korea's currency swap arrangements with the U.S. Federal Reserve during the 2008 global financial crisis and the 2020 COVID-19 pandemic, maintaining cooperative arrangements through currency swap agreements with the central banks of major trading partners can be an effective means of stabilizing the exchange rate and

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[43] Salil Gupta. 2023. "India: SAARC Swap Framework, 2012 ", Journal of Financial Crises Volume 5 Issue 1.

[44] The Reserve Bank of India (RBI). 2012. "Reserve Bank of India Announces SAARC Swap Arrangement" (Press Release), May 16, 2012.

[45] Salil Gupta. 2023. "India: SAARC Swap Framework, 2012 ", Journal of Financial Crises Volume 5 Issue 1.

foreign exchange markets without depleting foreign exchange reserves as capital account liberalization advances.

Going forward, taking into account progress in capital account liberalization as well as developments in the current and capital accounts, Nepal needs to consider utilizing a currency swap arrangement with the Reserve Bank of India if a need to secure foreign currency liquidity is anticipated. In light of the close trade relationship between the two countries, Nepal may also consider exploring the possibility of expanding the size of such a swap arrangement when needed.

Third, emerging-market economies need to closely monitor capital-flow dynamics to prevent the adverse side effects of liberalization. Nepal should therefore establish a foreign-exchange information system modeled on Korea's Foreign Exchange Information System (FEIS), utilizing its existing transaction-reporting infrastructure. This would require legal provisions authorizing data collection and budgetary allocations to develop the necessary system.

In addition to its two existing systems for obtaining foreign exchange transaction information, the NRB should seek to develop and introduce a new system to record capital inflows. This system should be expected, in particular, to track the repayment schedules and maturities of debt inflows, thereby enhancing preemptive foreign exchange reserve management capabilities and improving the compilation and reporting of the International Investment Position (IIP). In developing this system, the NRB could leverage the Bank of Korea's experience and know-how in building its foreign exchange information system (FEIS) through exchanges with relevant Bank of Korea staff.

Fourth, if adverse effects arise during the capital account liberalization process, NRB should deploy a coordinated policy mix under the Integrated Policy Framework (IPF), combining foreign exchange intervention (FXI), capital flow management measures (CFMs), macroprudential policy measures (MPMs), and monetary policy, as exemplified by Korea's policy responses in 2010 and 2022.

Fifth, drawing lessons from Korea's 1997 currency crisis, where a mismatch in the hedging of short-term external debt among financial institutions exacerbated the crisis

despite high levels of borrowing, Nepal should monitor and manage the increase in short-term external debt of its financial institutions and introduce regulatory frameworks to mitigate related risks during the liberalization process.

Sixth, as a deeper foreign-exchange market can better absorb shocks from capital liberalization, Nepal should broaden the range of FX-related instruments and encourage greater participation in the interbank FX market.

To this end, the NRB may draw on Korea's experience with foreign exchange market structural reforms aimed at advancing and modernizing the FX market. While Nepal may not be able to allow foreign financial institutions to participate in the domestic interbank FX market to the same extent as Korea, it could nonetheless consider measures that Korea has used to invigorate FX trading, such as expanding the range of FX market participants, extending FX trading hours, publishing bank-by-bank FX trading rankings, and providing incentives to banks with high trading volumes.

In particular, FX swaps are useful instruments for market participants to manage exchange rate risk and adjust foreign currency liquidity, and accordingly the Bank of Korea participates not only in the spot FX market but also in the FX swap market. At present, NRB does not currently participate in the FX swap market. For the further development of Nepal's FX market, it would therefore be necessary for the NRB to participate in the FX swap market on a limited basis in order to promote more active FX trading. In addition, it would be necessary to enhance the efficiency of foreign exchange transactions by improving the FX market infrastructure through the introduction of an FX broker system that actively intermediates interbank foreign exchange trading.

Seventh, to promote FX market development, Nepal should consider establishing a self-regulatory FX Market Coordination Council (tentatively named the "Kathmandu FX Market Council"), modeled on Korea's Seoul FX Market Committee, in which policymakers and market participants jointly discuss development strategies. Such a self-regulatory body would enhance policy coordination, incorporate market participants' ideas, and increase ownership and participation in market development initiatives, thereby fostering a more resilient and efficient foreign-exchange market.

VIII. Conclusion

1. Summary of Suggestions

This report presents an appropriate sequencing of capital account liberalization for Nepal Rastra Bank, along with capital flow management measures under a liberalized capital account regime. First, the key proposals related to the sequencing of capital account liberalization, including the stepwise for opening capital accounts, can be summarized as follows.

- (Core principles for gradual, sequenced capital account liberalization) Liberalization and opening of capital account should adhere to the "sequencing-before-opening" principle, in which the order matters more than the speed. It is necessary to manage the structural characteristics of Nepal's remittance-based economy, strengthen the stability of the domestic financial system and consistency with global regulations, and establish greater exchange rate flexibility together with a foreign exchange reserve buffer strategy.
- (Stepwise roadmap for capital account liberalization)

  Stage 1 involves opening foreign direct investment (FDI) and strategic long-term equity investment. Stage 2 allows non-residents to invest in listed equities. Stage 3 permits investment in local-currency-denominated government bonds after sufficient liquidity in the domestic bond market and adequate custody and settlement infrastructure are established. Stage 4 allows short-term external debt and cross-border borrowing by banks.

  Stage 5 represents full liberalization.
- (Sector-based, institution-based, and capital-type-based opening strategies) By sector, liberalization should proceed in the order of the corporate sector → financial markets → household sector. By institution, the process should distinguish among domestic firms, financial institutions, and foreign investors. By capital type,

liberalization should proceed in the order of FDI → long-term finance → securities markets → short-term financial markets.

- (Medium- to long-term opening strategy) Over the medium to long term, the strategy should include maintaining a gradual and conditional liberalization stance, improving a market-oriented legal framework, transitioning to an interest-rate-focused monetary policy and a flexible exchange rate regime, ensuring consistency between capital market opening and domestic financial reforms, and establishing emergency response capabilities and communication strategies.
- (Diversification of sterilization policy instruments) By issuing central bank securities (for example, Monetary Stabilization Bonds), the central bank can conduct sterilization policy more swiftly and flexibly, thereby enhancing the effectiveness of monetary and exchange rate policies.
- (Implementation of a market-friendly exchange rate regime) Following efforts to introduce greater flexibility into the current pegged exchange rate system, it would be worth considering a transition toward a managed floating exchange rate regime. The fixed exchange rate of 1 Indian rupee to 1.6 Nepalese rupees was established in 1993 and no longer reflects the economic realities between Nepal and India. A recalibration of the peg level, including a devaluation of the NPR, is therefore necessary based on analyses using purchasing power parity (PPP) and the real effective exchange rate (REER). In addition, over the medium term, the existing India-rupee-centered peg system could be replaced by a managed floating exchange rate regime that fixes the exchange rate based on a currency basket, with the Indian rupee, Chinese yuan, and U.S. dollar serving as core currencies, and the euro and Japanese yen included as reference currencies.
- (Introduction of a foreign investor registration system) The Foreign Investor Registration System (FIRS) can serve as a “safe accelerator” for capital account liberalization by combining partial opening with a registration requirement during the liberalization process.

- (Introduction of a main bank system and financial real-name system) Through the introduction of a main bank system, commercial banks can be designated as transaction banks for key strategic firms, thereby encouraging stable and concentrated provision of foreign exchange. In addition, a financial real-name system would enable identification of fund flows by transaction entity, strengthening the government's capacity to implement capital control policies.
- (Response to the potential expansion of remittance and settlement via cryptocurrencies) There is a need to establish legal frameworks related to remittances via stable coins by referencing the experiences of countries that have faced financial crises, as well as to introduce immediately actionable measures such as monitoring and reporting systems and reporting thresholds for large transactions.

The improvement measures related to capital flow management under a liberalized capital account regime can be summarized as follows.

- (Accumulation of an adequate level of foreign exchange reserves) Given that maintaining a pegged exchange rate regime is unavoidable for the time being, and that foreign exchange market intervention would be the primary response to capital outflows during the process of pursuing capital liberalization under a peg, it is necessary to build up sufficient foreign exchange reserves in advance, while balancing the opportunity costs of reserve accumulation and applying the IMF's ARA framework for reserve adequacy.
- (Currency swap arrangements with neighboring central banks such as India) In relation to reserve accumulation, it is necessary to maintain international cooperative arrangements in order to prevent sharp capital inflows and outflows ex ante and to effectively contain them if they occur.
- (Establishment of a foreign exchange information system) To prevent adverse side effects associated with capital liberalization, emerging market economies need to closely monitor capital flow trends. For this purpose, it is necessary to establish a

foreign exchange information system similar to Korea's Foreign Exchange Information System (FEIS).

- (Implementing a coordinated policy mix under the Integrated Policy Framework (IPF)) When adverse effects arise during the capital liberalization process, it is necessary to implement a coordinated policy mix under the Integrated Policy Framework (IPF), combining foreign exchange market intervention (FXI), capital flow management measures (CFMs), macro-prudential policy measures (MPMs), and monetary policy tailored to prevailing conditions as exemplified by Korea's policy responses in 2010 and 2022.
- (Management of short-term external debt) It is necessary to prevent short-term external debt from increasing rapidly over a short period and to introduce related foreign exchange risk regulatory frameworks.
- (Continuous expansion of FX-related products and participants in the interbank FX market) To promote the development of the foreign exchange market, measures such as expanding market participants, extending FX trading hours, publishing bank-level FX trading rankings, and providing incentives to banks with high trading volumes should be considered.
- (Establishment of a self-regulatory FX market organization) To foster the development of the foreign exchange market, it is necessary to establish a self-regulatory organization in which policy authorities and FX market participants jointly participate (tentatively named the "Kathmandu FX Market Operations Council") to collectively discuss measures for FX market development.

2. Further Considerations

This report presents a phased procedure for capital account liberalization and measures for capital flow management under a liberalized capital account regime for Nepal Rastra Bank. The report proposes step-by-step implementation measures, including short-term improvement measures that can be immediately utilized after considering legal, economic, and social conditions for each agenda, as well as medium- to long-term improvement measures that can be implemented through institutional changes.

In January 2025, Nepal introduced groundbreaking provisions allowing overseas investment through an emergency ordinance and established a high-level economic reform advisory committee to initiate discussions on the gradual opening of capital account transactions. Given the reality that Nepal's capital account liberalization is expected to be implemented in earnest, it is considered necessary to seek broad changes in the framework for capital flow management. However, under the current exchange rate regime pegged to the Indian rupee, the effects of capital account liberalization are inevitably limited, and ultimately, discussions on reforming the exchange rate regime must precede the realization of medium- to long-term improvement measures.

The peg to the Indian rupee has the advantage of ensuring exchange rate stability and enhancing predictability in trade and investment transactions. However, it comes at the cost of sacrificing monetary policy autonomy and entails a structural limitation whereby external shocks transmit the effects of the Indian economy directly to Nepal. Moreover, the fixed exchange rate of 1 Indian rupee (INR) = 1.60 Nepalese rupees (NPR), which was established in 1993, has been criticized for failing to reflect the current economic realities of both countries in a context where the gap in economic growth rates between them has widened and commonalities in their business cycles have diminished. By contrast, exchange rate arrangements among other major currencies have transited to a managed floating exchange rate regimes. Therefore, maintaining the current dual system could significantly intensify policy challenges in managing domestic interest rates and liquidity in the event of irregular and highly volatile capital flow shocks beyond the

current account as capital liberalization progresses. While abolishing the peg to the Indian rupee may be an option, it is not easily feasible in practice. Therefore, as a first step, it is necessary to recalibrate the peg level to reflect a depreciation of the Nepalese rupee against the Indian rupee, based on analyses using purchasing power parity (PPP) or the real effective exchange rate (REER). Subsequently, it would be appropriate to explore a managed floating exchange rate regime that fixes the exchange rate based on a basket composed of three major global currencies—the Indian rupee, Chinese yuan, and U.S. dollar.

Above all, the implementation commitment of Nepal Rastra Bank regarding the recommendations presented in this report is of critical importance. The BOK-KPP project for Nepal Rastra Bank has been continuously conducted across various fields, including payment and settlement regulation and supervision, stress testing for financial stability, and private sector credit growth, and has presented appropriate improvement measures in each area. While it is unclear to what extent the recommendations from previous BOK-KPP projects have been reflected in policy, it is estimated that most of the proposed solutions have not come to fruition. It is hoped that Nepal Rastra Bank will take a more proactive stance in seeking practical implementation measures for the recommendations presented in this report. Nevertheless, the specific timing and methods of implementation may be determined flexibly in accordance with prevailing circumstances. The research team expresses its willingness to continue providing advisory support in response to requests from Nepal Rastra Bank officials even after the conclusion of the project and hopes to maintain ongoing communication channels in the future by leveraging the network established during the project period.

From the perspective of Nepal Rastra Bank, which has taken its first steps toward capital account liberalization, interest in identifying capital account liberalization stages appropriate to Nepal's foreign exchange environment and in understanding the necessity of capital flow management accompanying such liberalization is inevitably significant. It is hoped that this report will serve as a valuable reference in formulating foreign exchange policies related to capital account liberalization for Nepal Rastra Bank (NRB).

Appendix

A. Due Diligence Questionnaire

Due Diligence Questionnaire

1. General issues

1.1. What is the key background behind the fact that Nepal Rastra Bank(NRB) has chosen ‘the Foreign Exchange Policy and Foreign Exchange Liberalization’ as the theme of the Bank of Korea's KPP project this year?

1.2. How much do you expect the changes in Korea's foreign exchange policy or exchange rate system to be useful to Nepal and in what sectors?

1.3. What are the main contents of the Nepal government’s ‘16th National Development Plan’ that starts this year?

1.4. What changes are taking place in the Nepalese economy compared to the past in terms of economic dependence on India and economic policy? What are the main countermeasures, especially in terms of monetary policy and exchange rate policy?

1.5. What are the mid- to long-term phased implementation plans of Nepal Rastra Bank (NRB) for foreign exchange policy and foreign exchange liberalization?

1.6. What are the main provisions of the Foreign Exchange Regulation Act(1962) and the "Foreign Exchange Management and Regulatory Guidelines" of Nepal?

2. Specific issues on FX policy management

2.1. Does the Nepal government have any step-by-step plans to ease the Indian rupee peg? What are the limitations of operating a peg to the Indian rupee that has been

maintained for a long time in terms of macroeconomic stabilization?

2.2. Recently, as trade with China increases, have you ever considered a peg basket that simultaneously considers the Indian rupee and the Chinese renminbi?

2.3. What are your views on transitioning to a managed floating exchange rate system (so called ‘soft pegging system like a market average exchange rate system in China) with major reserve currencies such as the Indian rupee, US dollar, euro or Chinese renminbi?

2.4. What do you think about the Bangladesh, Laos, and Cambodia models that have promoted foreign exchange system liberalization for your references?

2.5. What are the foremost key prerequisites for the step-by-step liberalization of the exchange rate regime?

2.6. How much do you think the current pegging system restricts the autonomy of monetary policy?

2.7. Does the NRB have any plans to issue foreign exchange stabilization bonds like Korea or China to stabilize the foreign exchange market?

2.8. In terms of quantitative vs. qualitative criteria, what are the key variables in determining the timing and size of central bank intervention in the foreign exchange market?

2.9. Are there any plans to establish a public/or private foreign exchange bank to procure and operate foreign currency funds?

2.10. What about ways to increase foreign exchange reserves and diversify sources of inflow (such as exporting domestic hydroelectric-power)? What is the current evaluation method for the appropriate level of foreign exchange reserves and the strategy for increasing the investment efficiency of foreign exchange reserves?

2.11. Does the Central Bank of Nepal set and apply separate ESG guidelines when providing foreign exchange loans?

2.12. What is your perception of crypto-currency investment in the foreign exchange reserve portfolio? What is the government's position on the use of crypto-currencies such as dollar stable-coins to facilitate remittances from Nepalese citizens living abroad as a key source of capital inflow?

3. Specific issues on FX market and information system

3.1. Please elaborate on the amendments to various acts facilitating capital outflow from Nepal for investments, effective January 2025, along with the corresponding bylaws to be issued by Nepal Rastra Bank (NRB) to implement these changes.

3.2. Please provide details on the size and structure of Nepal's foreign exchange (FX) market, including daily trading volumes (spot and derivatives), key market participants in the interbank and retail markets, and overall market dynamics.

3.3. Currently, how does Nepal Rastra Bank (NRB) monitor the foreign exchange (FX) market? Does NRB have any channels to communicate with interbank players or brokers to monitor developments in the FX market?

3.4. How does Nepal Rastra Bank (NRB) monitor demand and supply in the foreign exchange (FX) market? Does NRB have a system that connects the central bank with market participants? Is there a reporting system in place for market participants to submit FX transaction data to NRB? Does NRB utilize ITRS(International Transaction Reporting System) or FXOL(The Foreign Exchange Online Reporting System) for the purpose of monitoring FX market?

3.5. What is the institutional relationship between NRB and the government in the formulation and implementation of FX rate policy and market operations?

3.6. How does the central bank coordinate foreign exchange (FX) market operations with monetary policy? Please elaborate on the coordination process, including how the Foreign Exchange Management Department (FEMD) determines the size and timing of FX operations, and how the Monetary Policy Department implements sterilization measures to offset their impact on domestic liquidity.

3.7. What criteria and indicators does the Bank use to evaluate whether the prevailing level of the Nepali Rupee (NPR) is appropriate, in the context of determining the need for foreign exchange market intervention?

3.8. What measures are being considered in Nepal to respond to a foreign exchange crisis or financial crisis that may arise from the promotion of foreign exchange and capital liberalization?

3.9. Is there a regular channel for discussions with the central banks of South Asian countries such as India and Pakistan on monetary policy and foreign exchange policy?

3.10. As you may know, according to the Impossible Trinity Theory, it is not possible to simultaneously implement all three of the following: a fixed foreign exchange rate, an independent monetary policy, and free capital movement. In light of further capital market liberalization in Nepal, does the Government of Nepal or the Nepal Rastra Bank (NRB) have any roadmap to enhance financial system soundness, improve external debt management, or address related challenges?

3.11. Does the NRB currently have any currency swap agreements with foreign countries such as India? If not, are there any plans to establish such agreements in the future?

3.12. With regard to the gradual liberalization of the capital market in Nepal, does the NRB have any benchmark country it refers to?

4. Previous BOK-KPP consultations

4.1. Since the last BOK-KPP consultations since 2017, you may have implemented or introduced newly any ideas from the consultations in terms of risk management, investment process, performance evaluation etc.

(1) Please share with us what you have changed based on BOK-KPP's proposals.

(2) If you have any difficulties in implementing the proposals, what are your concerns?

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