

POLICIES ON FOREIGN EXCHANGE AND BALANCE OF PAYMENTS: AN ASSESSMENT OF THE BACKGROUND FOR THEIR EFFECTIVE USES IN THE NEPALESE CONTEXT*

Gunanidhi Sharma

Central Department of Economics
Tribhuvan University

Introduction

The world economy today has a unique property of being so integrated that no nation is independent in setting its philosophical framework in relation with economic reforms and transformations. A consistent Country Specific Policy package, nevertheless, may be deduced based on certain specific working assumptions determined by national parameters which, in turn, reflect divergent socio-economic behaviours specific to the country under consideration. These parameters are either the manifestations of the degree of social change, the pattern of geographical, physical and demographic structure, or the socio-economic milieu. Group efforts at the international level, however, always exist for a unique world order evolving out of desire to achieve a common goal, say, a certain standard of social living.

This paper raises the question of international monetary reform during the decades following 1944, when a mutual understanding was reached internationally for an orderly arrangement of exchange relationships. The intent is to assess various policy approaches that have been initiated to overcome constraints of international reserve assets found in Nepal and elsewhere. The central focus is the policy problems facing Nepal, arising from the imbalances in Nepal's international account, the Nepalese style of tackling these problems and some specific but pertinent generalisations with their policy implications.

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A Brief Account of the Theory Related to Policy Issues

The mechanisms of receipts and payments sharply divide economic units here and abroad into individuals, business enterprises and the public sectors. This uniquely involves the use of currencies or some other money market instruments (or other proxies) serving as the means of exchange for the settlement of national as well as international debt. While the settlement of domestic debt leaves a little room for the use of various currencies, the international payments are made in terms of only those key currencies acceptable to all parties involved in trade and other official and private transactions. Those possessing sufficient means of exchange in current account have an easy but unrestricted right to own and dispose of purchasing power; those deficient in such international money must engage in more complex practices of exchange rationing. At the extreme, nations facing serious payments crises undergo rigorous measures in attempt to moderate the so called liquidity problem.

With time, when the world trade in goods, services and currencies is expanding, and the overall supply of the international means of exchange is unable to match this excessive increase in demand, a particular country has no choice but to maintain faith in its currency and prevent capital flight by taking stringent official measures influencing free market operations. These measures include exchange control, devaluation, and the direct regulation of physical and financial flows. These are, however, the extreme versions of official measures taken by a nation facing a serious payments crisis. A brief account of the sources of such trouble follows.

When the flows of services, materials, money, information and technology between countries are expressed in monetary values and recorded in a country's international account, it is easy to compare debits with credits. This helps identify the intensity of the liquidity problem. If the excess of payments over receipts is an indication of high economic inefficiency, as usually found in low income countries such as Nepal, the opposite is true for economies with a strong, efficient production base which remains as strong possibility for those nations with technological sophistication, often known as developed countries.

Of course, the origin of the payments problem has a strong foundation in the domestic gap of income and expenditure, monetary and financial imbalance, and the greater size of the fiscal deficit; all of which are experienced by Nepal. These gaps or imbalances are so interknit that all the real monetary, financial, fiscal, foreign, and other sectors experience simultaneous changes. Their behaviours, then, are determined within the Walrasian general equilibrium framework. While the "supply responds" hypotheses of Keynes, Friedman and the new classicists have a particular

mechanism of economic adjustment, the "demand responds" thesis of the classicists, structuralists and some others have differing views on the movement of variables. Altogether, if changes are introduced in one sector, the rest of the others react disproportionately, depending upon how much these sectors are sensitive to such changes, the length of the lag in variables' adjustment, and the values of parameters such as the propensity to consume, import, etc.

Whatever is the source of payments crisis (deficit), policy measures in any form - including the regulation of foreign assets, reserves, and exchange rate changes - mostly work through the channels of demand and supply forces in real sectors. These measures force the Balance of Payments line, or the IS curve, to shift on the right, or the LM curve to the left.

However, for a small and open economy like that of Nepal, which intends to keep demand and supply situations in proper order and, accordingly, to shift either of these curves, special attention is required, as this economy is sensitive to *exogenous* foreign shocks that keep domestic levels of activities out of policy control. This question will again be fully accounted in the following discussion.

The Nepalese Economic Framework for Policy Operation

Nepal has wide scope of using the vast potential of its geographical setting to provide a perpetual source of income from tourism: land that helps to grow food, industrial raw materials and exportable products, and a labour force which replaces capital in the process of building hard as well as soft infrastructure.

In order to mobilise these stocks of national wealth and provide a lubricant to the economy in the process of production by generating adequate surplus for reinvestment and capital formation, the only thing Nepal requires is technological transformations, as there is the immense scope for the introduction of new and appropriate technology in all the fields of agriculture, industry and services. The major issues, therefore, regard the economic exploitation of the given stock of wealth and the increased flow of income therefrom, and not the inferiority complex developed out of the psychology that Nepal is without an adequate resource base.

Nepal is equally rich in the availability of various other sources of energy like wind and water resources. These equally important sources of productivity growth can be uniquely exploited to ensure the supply of basic needs bundle and production inputs. This will also help satisfy household needs, afforestation, reduce the unemployment problem, increase foreign exchange earnings, save scarce vehicle currencies and accelerate the pace of overall development.

Of course, Nepal took steps in initiating planning and policy measures thirty years before and made several attempts in lifting this economy out of its low level equilibrium trap. The success, however, was so little that the country could neither reduce the size of absolute poverty nor limit overall excessive foreign dependence represented by higher ratios of external trade and aid and foreign economic influence on the sectoral policy package. Resources were wrongly diverted towards the sectors reaping immediate gains and away from agriculture and basic industries.

As most of the equilibrating mechanisms under the existing situation, such as prices, real interest rate, the market determined value of Nepalese money in terms of foreign currency, etc., are determined in the world market, the domestic economy finds itself at all times in a vulnerable and unstable position arising out of "maintained disequilibrium." More specifically, when the terms of trade between Nepal and the rest of the world are independent of domestic policy choices (as the degree of openness for this economy is high, say, almost one third of the GDP when defined in terms of the ratio of total trade to GDP), in no case is Nepal capable of keeping market forces in its favour. Unless policies in general are molded as per Nepal's unique features, and trade policy in particular is designed to support the domestic production base in industry and agriculture, this vulnerable position of the economy is likely to continue even if Nepal adopts a most-popular exchange rate regime like the one we have now.

Again, in view of the rough and inefficient working of the underdeveloped domestic market system and a failure to guide activities properly through wrongly handled official price changes, whose concern was with a multidimensional role, including their ex-ante effect on employment, industrial climate, social prestige and the distribution of assets in the hand of the weaker section of society, the unsystematic involvement of the public sector in the name of growth and social change was expected to make the state extravagant. It was indicated by the bigger size of public expenditure and the high ratio of government investment, which accounted for almost fifty percent of the total. More than a decade long sluggish trend was observed in private sector investment for several productive sectors. Financial indicators also acknowledged this reality in that even if the fund was held by various banking and non-banking financial institutions, the real economy was unable to demonstrate a market success. Planning failed either to determine an appropriate framework for desired structural changes in all the spheres of national life or to drive market forces to work for a healthy economic order.

The most vulnerable situation for Nepal is the country's geographical weakness which has always kept the economy in its regular disorder. Nepal is India-locked, even in policy choices and effects. A high but perfect

complementarity between the two economies and an absence of a competitive interdependence in their market structure have undoubtedly led the exchange system to work always in India's favour. Nepal experiences the status of a periphery nation whose job is to serve the interest of a centre extracting cheap labour and raw materials and, in turn, selling finished products. The regular trend of a growing deficit in Nepal's trade with India is an outcome of such "unequal exchanges."

Likewise, Nepal is hardly independent in exercising her third country trade policy, as the treaty of trade and transit with India in 1950 encroached into this area by restricting Nepal's right to determine additional taxes on Indian goods, and, thus, by undermining a situation where imports from a third country can compete in Nepal's market. With this, the trade diversification policy of Nepal has completely collapsed into an Indian monopoly over Nepalese foreign trade.

These factors, together with "open border," "free trade only in Indian goods," and the "one but open window" trade policy (described earlier) of Nepal arranged by treaties with India over the years, have set the patterns of our underground economy, industrial and agricultural growth, and the overall development philosophy. We are thus India-locked in all ways.

There were basically two flaws in our past decisions about the choice of development philosophy. While, on the one hand, we did not over years go against a liberal trade policy for one or another political reasons, the inherent weakness in Nepali thinkers, on the other hand, was the faith in the Keynesian type of "supply responds hypothesis." These philosophical mistakes eventually led the economy to reap little gain in terms of the growth of domestic activities like income, private investment, employment, export surplus, etc., and of its sustainable character. Everything here was governed by uncertain supply positions not responding to demand as created by unprecedented growth of a tertiary sector enjoying mostly foreign goods and competing with the household consumer in the domestic market. In most cases, a high liquidity position of the economy, together with market gaps, hoarding, and bottlenecks on the supply side, opened room for speculation which led to further market uncertainty. Foreign exchange rates (except for IC) too were susceptible to this money and goods market situation, for which the deviations of the margin of market rates from the actual official rates was significantly high. From this, not only real investment suffered, but also the society was sharply divided between privileged and underprivileged groups of people. As the latter compete with the former in same market place but possess money with different utility, the nation experienced a net welfare loss; the majority of people in the country are poor, underfed, illiterate, unhealthy and unemployed.

Apparently, unless some effective measures are worked out and national perceptions are rightly proposed for a better future, the economy is expected to remain incapable of insulating itself from external shocks and overcoming internal market dichotomies which exert their adverse and unpredictable impact on domestic levels of economic activities, including foreign exchange earnings in the private sector accounts. A special treatment, however, is required for dealing with the unrestricted movement of Indian currency, whose value in terms of Nepalese Rupees is fixed, as this practice has given birth to the problem of capital flight to India, as well as to the transmission of Indian inflation equiproportionately into Nepal.

Nepal's Policies on Trade, Foreign Exchange and the Balance of Payments

The foreign sector in Nepal has remained as the balancing factor, and this role in particular is an outcome of its inability to adjust between domestic demand and supply of goods and services at a time when the economy is incapable of working anywhere near the maximum capacity level (almost ninety percent of industrial and other capitals in Nepal are working below capacity level). This problem of capacity utilisation has, of course, deprived the nation of opportunities for enjoying an economy of scale; hence, the economy is fragmented in character.

Of the various foreign accounts balances of Nepal, such as current, trade, transfer, capital, etc., the current account balance has been found to be a critical factor determining overall economic stability. Balances in the other accounts have remained either positive or are the expost effects. Means, foreign official borrowings, and drawing on international reserves are the only consequences of a deficit in the current international account (the main item of which is visible trade). The size of foreign commercial capital too is small less than ten percent of total investment, owing to low attraction.

Although historically Nepal's effort was directed to achieve a balance in the growth and expansion of exports and imports, trade and current account deficits have never been overcome. Instead, their size is growing with time. As a consequence, the inflow of aid from both official and unofficial sources has been increasing. This has led to additional implications of monetary, budgetary, employment and price factors. In this sense, the foreign sector in Nepal has been playing a predominant role in promoting growth or achieving stability or both.

For trading purposes, goods in Nepal are classified into three categories: (a) completely banned, (b) subject to quantitative restrictions, and (c) free of restrictions. Of the items traded, imports comprise mainly of capital goods, raw materials and consumer goods. The distribution pattern of imports is

presented here, percentage-wise.

	Construction material	Capital equipment	Fuel	Rest of others	Total
1980/81	11.86	7.44	12.36	68.33	100.00
1986/87	12.90	22.55	9.60	54.95	100.00

Source: Department of Customs, H.M.G., Foreign Trade Statistics (Various Issues)

These figures show that the proportion of essential goods imported in total must not be less than sixty percent.

Major exports, however, are composed of ready made garments, woollen carpets, pulses, goat skins, cardamom, raw jute, handicrafts, hides, herbs and raw materials.

Even if the growth rates for these exports and imports are not that completely unsatisfactory, the import to export ratio is fast growing over time. This indicates that Nepal is experiencing an increase of its trade gap through time, and that the size of deficit for trade with India is substantial. This is an outcome of an open economic structure that Nepal has with respect to India. Even though Nepal's trade with the rest of the world is more or less controlled, the size of this is increasing too, as the domestic requirement for consumption and investment is substantially high. Consequently, the adjustment burden in the foreign sector has mostly been borne by government through either official agreement or changes in policy choices. Officially, the government has been insisting on meeting the savings gap through an inflow of aid from both bilateral and multilateral sources. Mostly, donors have assisted our economy by financing expenses related entirely to projects, experts and import surplus (foreign exchange gap). Policy choices like devaluations, on the other hand, have been introduced with infrequent changes; and the only regular practice has been to impose quantitative restrictions (regulations), especially in our trade with third countries. This latter practice virtually shapes our trade related policy on foreign exchange (i.e. convertible). Quantitative restrictions on services import, as well, are commonly exercised through a regulation of exchange availability rights for buying health, education, travel and other services abroad.

So far Nepal has a trade and hence exchange relation (agreement) with more than fifty countries, with India as the major trade partner. In the SAARC region, the second place is occupied by Bangladesh. The trade relation with other SAARC members is not so significant or substantial. Recently, trade transactions with the rest of the world have been gaining momentum.

In effect, India's share in Nepal's trade has come down from almost one hundred percent in early the 1960s to around forty percent during recent years. Even then, there is rarely any improvement in the current account balance, as the Indian import to export ratio is growing over time.

In all, the aims of Nepal's trade, aid, balance of payments and foreign exchange policies may be summarised as:

- a. Transform Nepalese society into a modern one and reduce excessive dependence on Indian for trade.
- b. Achieve a material balance. That is, the policies are expected to work the way that these serve as the factors stabilizing economic activities.
- c. Promote the productive base of all the sectors inclusive of agriculture, industry and services, and increase thereby the size of the cake to be distributed.
- d. Strengthen the export base and explore mechanisms for export promotion and import substitution.
- e. Acquaint the economy with foreign or modern technology more productive and less expensive and train manpower required to handle development problems.
- f. Encourage the private sector and keep state trading activities within the limits set for the supply of essential goods like petroleum products.
- g. Restrict trade of certain goods like drugs, jewellerys, weapons and explosive material, wireless sets, cigarettes, etc., and regulate trade according to the national interest.
- h. Help simultaneously supply service inputs like banking, insurance, transport, communications, etc. and expand trade in goods and services.

The government of Nepal, accordingly, takes direct as well as indirect measures affecting the international flows of goods, services, aid, foreign currencies and the financial fund. While direct measures include the issue of licences, the fixation of quotas, specification of goods and services free of quantitative restrictions, the grant of permission for moving commercial capital, fixation of the amount of foreign exchange affecting the trade in goods and services, the agreement for project aid with donor, specification of the rules and areas for the effective utilization of foreign exchange, determination of subsidies and tariff rates for traded goods, etc., the indirect measures cover the set of macro as well as micro-economic policies needed for raising economic efficiency and for improving the balance of payments. The latter also include the quotation of foreign exchange rates for major currencies.

In recent years, the country has initiated a new economic reform programme (namely SAP) with the aim to increase economic efficiency,

maintain stability, liberalise economic activities and improve the international reserve position and balance of payments. All of the macro-economic policies, inclusive of monetary, fiscal, trade and foreign exchange, have been brought under this reform programme. Various other sectoral and micro-economic policies are also devised for overcoming bottlenecks, rigidities and supply shocks. Mainly, policies are expressed in terms of liberalization or decontrol of fiscal, monetary and financial reform packages.

Of course, this is a significant departure spelled out in terms of a need for structural change. The question, however, is how effective the programme would become in the context of our economic framework described in section three above. This doubt is meaningful given that the supply response to price and exchange rate changes is very low, owing to various institutional and structural deficiencies, inclusive of trade and transit provisions in treaties with India that regulate Nepal's export to India but provide free Indian export to Nepal, geographical barriers, weak export base, higher propensity to import, an unrestricted flow of Indian currency across the border that encourages illegal activities and capital flight from Nepal, fixed rate of exchange between NC and IC in view of the system of all other exchange rates daily adjusted with international rates for currencies in the basket, etc. A recent economic report by the Nepal Rastra Bank also supports this thesis when it explicitly proves that this economy is not obeying the rules set for the new reform programme; hence there is no indication for its structural change. Indicators that fail to confirm the support the reform program are: the unexpected increase in prices of all goods and services, especially of essentials, the growing size of the current account deficit, the excessive dependence on international borrowing, decrease in the proportion of development expenditure of the H.M.G, the increasing size of the gap for trade with India, excessive dependence of HMG on Nepal Rastra Bank for internal borrowing, higher proportion of indirect taxes in total tax revenue, traditional dependence on weather of agricultural production, high liquidity position of the economy caused by excessive growth of money supply, stagnating trend of financial savings represented by fixed account deposits with banks, and so on. Neither is there an improvement in trade and current account balances nor the display of any structural change by the economy. The only improvement is in capital account balance. An economy which regularly borrows, but fails to increase the capacity for debt servicing, will obviously be unable to sustain the development process. Nepal now belongs to this category. The effect of the depreciating value of NC on the size of public and private budget - when both these sectors need greater spending for essential import, is further a matter of anxiety. Prices go up, interest rates increase, wages increase and the foreign exchange reserves decrease. Eventual

effects are increased costs of production, unfavourable terms of trade and a weak balance of payments position.

Conclusion

Official regulations on the uses of foreign exchange are the necessary steps taken by any state whose concern is with the productive and economic utilisation of available resources and the reversal of adverse trends in its balance of payments. The need for such regulations arise when the automatically adjustable market system fails to remain effective in mitigating the so-called liquidity crisis generated out of import surplus.

The balance of payments, of course, has now been a policy problem. It's resolution also requires a package of other measures changing the rate of exchange, the interest rate structure and some other viable mechanisms affecting both the aggregate demand and supply. The precondition for a successful operation of these official shocks, nevertheless, is a competitive but plastic (sensitive) economic framework.

Nepal, of course, lacks such a 'built-in system' of the market structure and, hence, is in favour of regular public intervention in almost all the markets, including that of foreign exchange which aims at an effective management of liquidity crisis. The approach, however, is not independent of the development philosophy long established from during the 1940s, although there were several amendments in view of the change in world economic situation, needs and perceptions.

However, the basic feature of Nepal's economy is that it experiences a strong centre-periphery relationship between Nepal and India, a very weak integration of Hill-Terai and east-west economies, the rural-urban dichotomy, the free and open but cost free movement of people, material, information and financial funds across the southern border, unsystematic intervention in the public sector, inconsistencies in various industrial, trade, foreign exchange and other policies, the high development requirement of building social and economic infrastructure, a difficult topography pressing always for higher costs of production, and the working of the economy. The Nepalese market system is fully distorted. As the economy is highly susceptible to market speculations of price changes for goods, foreign exchange and the real estate, the allocation of investible resources is mainly for hoarding, and not for promoting the industrial and agricultural base which helps sustain long term growth and income distribution. Thus, trade in goods, services foreign exchange and real estate has occupied a significant place in the Nepalese economy. This has put the government in a great trouble, in that it should either choose an interventionist approach for tackling the problems through changes in the structural and institutional background, or leave the economy

to operate freely. While the former choice, the regulation of the vast demand and supply forces with their domestic vis-a-vis foreign origin, is too ambitious, the latter causes social injustice in that those few who control most of the resources and official decisions will take all advantage at the expense of the majority's happiness. Unless we strike a plausible balance between the interests of politicians, administrators and the business financiers, the productive sectors will find themselves further underdeveloped, for which external over-dependence may continue in future years. The question, therefore, is not of demand management as such, but of the change in economic structure to make the economy more provocative for self-reliance and competitive interdependence. The policies to-date on foreign exchange and balance of payments are inadequate in that they are not helpful in our drive towards the achievement of these goals. Hopefully, we shall be moving in the right direction.

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