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Bank Regulation in Dollarized Economies in Nepal

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ABSTRACT

This paper examine how a financial sector affects the economy direct financial claims suggested with effect of dollarization in Nepal claims held by ultimate savers which are liabilities of those who invest in real assets. The exposition is further simplified by introducing a second sector in the economy. Assume that firms specialize in investing in real assets financed by issuance of direct financial liabilities, while households specialize in saving and investing in these direct financial claims. Financial claims are reflected in the flow of funds accounts as liabilities of firms, but, as assets of households. Real assets, however, appear only on the balance sheet of the sector which owns them. Sector relationships can be seen by aggregating all members of a sector together with respected to some developing countries.

Introduction

After the gold standard was abandoned at the outbreak of World War I and the Breton Woods Conference following World War II, some countries were desperately seeking exchange rate regimes to promote global economic stability and hence their own prosperity[Basso, H.S. et.al.2011]. Countries usually peg their currency to a major convertible currency. "Hard pegs" are extreme exchange rate regimes that demonstrate a stronger commitment to a fixed parity (i.e. currency boards) or relinquish control over their own currency (such as currency unions) while "soft pegs" are more flexible and floating exchange rate regimes. The collapse of "soft" pegs in Southeast Asia and Latin America in the late 1990s led to currency substitution to become a serious policy issue. A few cases of full currency substitution prior to 1999 had been the consequence of political and historical factors. In all long-standing currency substitution cases, historical and political reasons have been more influential than an evaluation of the economic effects of currency substitution. Adopted the US dollar as legal tender after independence as the result of a constitutional ruling. Ecuador and El Salvador became fully dollarized economies in 2000 and 2001 respectively with different influential factors[Brown, M.; Haas, R.D 2002]. Ecuador underwent the process of currency substitution to deal with a widespread political and financial crisis resulting from massive loss of credibility in its political and monetary institutions. By contrast, El Salvador's official currency substitution was a result of internal debates and in a context of stable macroeconomic fundamentals and long-standing unofficial currency substitution. The euro zone adopted the euro (€) as its common currency and sole legal tender in 1999, which might be considered a variety of full-commitment regime similar to full currency substitution despite some evident differences from other currency substitutions[De Nicolo, G.; Honohan, P.2012]. A common phenomenon in emerging markets is currency substitution and, consequently, foreign currency lending. Known as dollarization, the process refers to the use of a currency other than the country's own in place of or in addition to the local currency. The practice had been encouraged by governments in these economies for its positive impacts, and regulators had taken steps enabling citizens to open savings accounts, as well as borrowing in foreign currency. However, recently, we have observed that many emerging market economies have moved away from the practice: regulators in Hungary, Latvia and Poland have tightened eligibility requirements for borrowing in foreign currency and have encouraged banks to use moral suasion to deter retail level foreign currency (FC) borrowing. The authorities in these countries required banks to disclose the exchange rate risks of foreign currency loans to their clients. In countries like Croatia, Kazakhstan and Romania, stronger provisioning requirements were also imposed on foreign currency lending Brown and Haas [De Nicolo,2012]. Ukraine completely banned FC lending to households in late 2008. In 2011, the Korean government banned banks and other financial institutions from investing in foreign-currency denominated bonds ("Kimchi Bonds") that were used for conversion into local currency by Korean companies who needed foreign currency financing. Other countries that have taken measures to restrict the growth of foreign currency loans in 2011 include Angola, Belarus and Serbia. Nepal where households and business had been able to borrow in foreign currency for many years followed in the footsteps and banned all household borrowing in foreign currency in June, 2009, while enabling businesses to continue to keep their foreign currency lines of credit open. The Central Bank of the Nepal did not provide any justification as to why the practice was ended in its decision statement. [The Currency Substitution Theory links the erosion of money's function as a store of value to increased rates of saving and credit dollarization (for more on the Currency Substitution Hypothesis,see the surveys by Calvo and Vegh , Savastano , and Giovanni and Turtelboom . Most high inflation countries also had high rates of foreign currency saving and lending, which support the theory.The Minimum Variance Portfolio (MVP) Hypothesis developed by Levy-Yeyati and Ize and Levy-Yeyati focuses on the relative volatility of returns to financial assets in local and foreign currency. In this model, dollarization is driven by the volatility of inflation and real exchange rate depreciation, rather than the expected inflation and nominal depreciation. The domestic interstate is determined according to an interest parity condition that is not related to the

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degree of financial dollarization in the country. Thus, for a given variance of inflation, an increase in the variance of the rateof depreciation reduces dollarization by limiting the hedging benefits of dollar assets. One important.implication of this model is that it suggests that financial dollarization will persist as long as inflationvolatility remains high in relation to exchange rate volatility, even under low inflation. Among those who tested their theory, Basso et. al. demonstrated that in the case of 24 transition economies, interest rate differentials were the main drivers of the dollarization of both loans and deposits in the banking system. After the World War I, Nepali youths have continually migrated to foreign countries for livelihood. The growth of migration has rapidly accelerated in the last two decades after Nepal underwent policy changes conducive to open and liberal economy. In the beginning, the thrust of these economic policies was to either privatize or dismantle public enterprises. Policy failures have continued because of the inability of the private sector to operate such enterprises. Actions have not stopped in spite of the negative implications on the economy in the short as well as in the long run. It created chronic unemployment. Obviously, economic transformation did not produce significant positive changes but started to decline over time. In addition, since the late 1990s Nepal experienced a decade-long armed conflict. It has been estimated that the conflict cost the nation around 2.5 per cent of GDP growth per annum since 2000. A significant number of Nepali youths, over two million, work in different countries of the world. India, East Asia, Middle East are particularly popular destinations for employment. Over 1100 Nepalese leave the country every day in search of greener pastures [Papadogonas TA, 2009].. The outflow of people in search of opportunities in foreign countries has increased over the years. It seems that employment for potential Nepali workers depends on the need of the foreign countries. These youths send remittances to their families back home. The number of youths going abroad as migrant workers from Nepal and remittances they send back home have amazingly increased over the years, and it is believed that remittance plays a significant role in providing livelihood to the majority of people who live in rural areas. Nepal received around US $ 2.9 billion remittances in 2009 which jumped from US$ 0.8 billion in 2004, an increase of 262 per cent. Remittances contributed 18 per cent share to the total GNP of Nepal in 2006, the highest among the South Asian countries. In 2004, remittances covered 14.2 per cent of GDP which jumped to over 22 per cent in 2009. These data reveal that the dependence of Nepali economy on remittances has been increasing over the years and this trend looks to continue in the days to come.

The expenditure trend of the remittances received indicates that it may have significant role in reducing poverty. Out of the total remittances, 78.9 per cent is spent on daily consumption followed by repaying loans (7.1 per cent), household property (4.5 per cent) and education (3.5 per cent). This pattern of the use of remittances indicates that there is a big implication on the livelihood of the people as major portion of the remittances is spent on consumption. Merely 2.4 per cent of the remittances is spent on capital formation. Lack of employment generation due to the unproductive use of remittance will definitely hit the economy hard in the long run as the country is deep in the remittance trap. For many developing countries, the remittances that their citizens send from abroad constitute a large source of foreign exchange than international trade, aid, or foreign investment [**Kofi B. Afful, Kofi F. Asiedu, 2014]**. That seems true for Nepal also. The remittance total was four times greater than export earning, 81 times greater than FDI, 8 times greater than the earning from tourism and nine times greater than grants in 2009. Tourism is a promising sector in Nepal. Income from tourism seems to fluctuate, indicating fluctuation in the employment opportunities. Export and tourism earning as per cent of GDP were 11 per cent and 5 per cent respectively in 2009. This indicates that the progress of domestic sector that earn foreign exchange is not as encouraging as remittance. Many scholars have expressed their concerns over the non-sustainability of the economy if it depends only on remittance. In the context of weak economic performance, it would be unimaginable to absorb an increasing labor force in the domestic market. It would definitely put the country in trouble if there is a mass return of foreign workers. The mass return of youths is possible if the benefits from the services they are supposed to provide to the host country in terms of taxes are not greater than their earnings. As seen above, the bulk of remittances has been spent presently on consumption. Two actions are urgent to continue and sustain the economy. One, mobilization of the bulk of remittance inflow in the productive sector would help to create employment opportunities. Two, vocational education along with the skill-based training is urgent to boost the morale of Nepali labor in the international labor market. The former ensures sustainability of the economy even without remittance, and the latter helps to increase the bargaining power of migrants to get reasonable wages in the international labor market [Ozsoz, E.2013]

The Southeast Asian Central Banks (SEACEN) Research

Table 1

Financial Soundness Indicators

	Non-Performing Loans(% of Bank Loans)		Risk-Weighted Capital Adequacy Ratio (%)		Bank Return on Assets (%)	
	2007	2009	2007	2009	2007	2009
Cambodia	3.4	6.1 Sep	23.6	32.2 Sep	-	-
Fiji	6.0	3.2 Sep	13.2	16.2 Sep	-	-
Indonesia	4.82	3.9 Oct	19.2	17.5 Oct	2.6	2.7 Sep
Korea	0.64	1.2 Sep	12.0	14.2 Dec	1.1	0.5 Dec-09
Malaysia	6.4	4.6 Apr	13.2	14.1 Sep	1.5	1.5 Dec-09
Mongolia	3.2	16.5 Sep	14.2	7.5 Sep	-	-
Myanmar	2.38	2.6 Sep	43.4	37.3 Sep	-	-
Nepal	10.3	3.6 Sep	-1.71	4.3 Dec	-	-
Papua New Guinea	1.68	1.4 Jun	-	-	-	-
Philippines	4.45	3.3 Sep	15.0	15.5 Sep	1.3	0.8 Sep
Singapore	1.5	2.3 Sep	13.5	16.5 Sep	1.3	1.1 Dec-09
Sri Lanka	5.0	8.8 Sep	13.6	14.1 Sep	-	-
Taiwan	1.83	1.4 Sep	10.8	11.6 Sep	0.14 Dec	0.3 Dec
Thailand	7.28	5.3 Sep	15.4	16.4 Sep	-	1.6 Dec-09
Vietnam	1.5	2.2 Sep	-	-	-	-

Sources: Replies to SEACEN Key Economic Indicators Survey 2010, SEACEN Member Bank Websites and IMF Global Financial Stability Report Oct. 2009.

Table 2

A Summary of Central Banks' Main Policy Responses to the Crisis

	Cambodia	Fiji	Indonesia	Korea	Malaysia	Mongolia	Philippines	Papua New Guinea	Singapore	Sri Lanka	Taiwan	Thailand	Vietnam
DOMESTIC FINANCIAL POLICIES													
Deposit Guarantee			•	•	•	•	•		•	•2/	•	•	•
Government Stake in Banks				•		•							
Regulatory Forbearance and Surveillance	•		•	•	•	•	•		•	•	•	•	•
MONETARY POLICY													
Policy Rate			•	•	•	•	•	•1/		•	•	•	•
Reserve Ratio	•	•	•		•	•	•			•	•		•
Liquidity Intervention	•		•	•	•	•	•		•	•	•	•	•
OTHERS													
Exchange Rate Management	•	•	•	•		•	•	•	•	•	•		•
International Swap Agreements 3/	•		•	•	•		•		•			•	•

Notes:
1/ New scheme to be introduced in 2010.
2/ Increase in policy rate due to inflationary concerns.
3/ ASEAN+3 (Japan, China and Korea) nations have officially signed an agreement to set up a US$120 billion currency swap fund under the Chiang Mai Initiative Multilateralization (CMIM). CMIM is to be launched on 24 March 2010 (Bank of Japan website).

Sources: ADB (2009), with modifications and updates from SEACEN member banks' replies to survey for EXCO/BOG background papers.

Table 3

Banks' Liquidity Management

	Min. holdings of liquid assets	Min. holdings of reserves	Liquidity ratio	Liquidity gap limit	Limits on concentration of funding	Cash flow projection	Max cash outflow	Stress testing
Cambodia		√	√	√		√		√
Korea	√	√	√	√	√	√	√	√
Malaysia	√	√	√	√	√	√	√	√
Mongolia								
Myanmar	√	√	√					
Nepal	√	√			√		√	
Philippines	√	√	√					√
Sri Lanka	√	√	√	√		√		
Taiwan	√	√	√	√	√	√	√	√
Thailand	√	√	√	√	√	√	√	√
Indonesia	√	√	√	√	√	√		√
Vietnam		√	√			√		

Source: SEACEN Member Banks Replies to Survey for Research Project on "Liquidity Measurement and Management", June 2009.

Table 4

Selected Central Banks' Liquidity Management Policies

	Min holdings of liquid reserves	Monitoring via data submission	Monitoring via onsite/offsite examination	Encourage contingency panning
Cambodia	√	√	√	√
Korea	√	√	√	
Malaysia	√	√	√	√
Mongolia				
Myanmar	√	√	√	√
Nepal	√	√	√	√
Philippines	√	√	√	
Sri Lanka	√	√	√	√
Taiwan	√	√	√	√
Thailand	√	√	√	√
Indonesia	√	√	√	√
Vietnam	√	√	√	√

Source: SEACEN Member Banks Replies to Survey for Research Project on "Liquidity Measurement and Management", June 2009.

Figure 1. Macroeconomic and Social Indicators

Nepal GDP Annual Growth Rate

The Gross Domestic Product (GDP) in Nepal expanded 3.65 percent in 2013 from the previous year. GDP Annual Growth Rate in Nepal is reported by the Central Bureau of Statistics, Nepal. GDP Annual Growth Rate in Nepal averaged 4.38 Percent from 1994 until 2013, reaching an all time high of 8.60 Percent in 1994 and a record low of 0.10 Percent in 2002. Nepal is one of the least developed countries in the world and relies extensively on foreign aid. The main sector of the economy is agriculture, which employs over 70 percent of the population and accounts for 33 percent of GDP. As Nepal is home to the highest mountains in the world, tourism has been steadily growing in importance and is an important source of revenue. Also, the country has been working on exploiting hydroelectric power. Although Nepalese economy has been steadily growing in recent years, lack of governmental institutions, growing population and remnants of social instability are sources of concern. This page contains - Nepal GDP Annual Growth Rate - actual values, historical data, forecast, chart, statistics, economic calendar and news. 2014-01-18

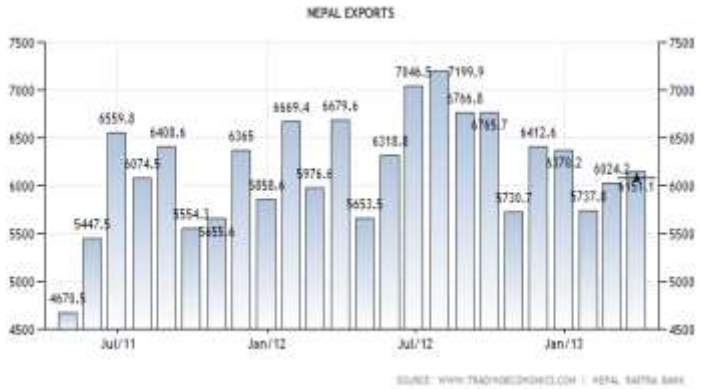
Actual	Previous	Highest	Lowest	Forecast	Dates	Unit	Frequency
3.65	4.85	8.60	0.10	3.65 | 2013/12	1994 - 2013	Percent	Yearly

Nepal Economic Indicators

Nepal Exports

Exports in Nepal increased to 6151.10 Million NPR in March of 2013 from 6024.20 Million NPR in February of 2013. Exports in Nepal are reported by the Nepal Rastra Bank. From 2001 until 2013, Nepal Exports averaged 5072.2 Million NPR reaching an all time high of 7550.9 Million NPR in August of 2008 and a record low of 2831.6 Million NPR in July of 2002. Nepal mainly exports iron and steel, knotted carpets, textiles, plastics, hollow tubes, beverages and vegetables. Nepal's main trading partner is India (accounting for 66 percent of all exports). Others include Bangladesh, Germany, France, Canada, China and Japan. . According to Nepal Exports - actual values, historical data, forecast, chart, statistics, economic calendar and news. 2014-01-18

Actual	Previous	Highest	Lowest	Forecast	Dates	Unit	Frequency
6151.10	6024.20	7550.90	2831.60	6350.68 | 2013/04	2001 - 2013	Million NPR	Monthly



Exports Notes

Exports measure the amount of goods or services that domestic producers provide to foreign consumers by. It is a good that is sent to another country for sale. In the past, export of commercial quantities of goods normally required involvement of the customs authorities in both the country of export and the country of import.

Markets	Last	Previous	Average	Trend	Unit	Reference	Frequency
CURRENCY	98.46	98.89	80.66			2014-01-6	Daily
GDP	Last	Previous	Average	Trend	Unit	Reference	Frequency
GDP	19.42	18.98	4.29		USD Billion	2012-12-1	Yearly
GDPANNUAL GROWTH RATE	3.65	4.85	4.38		Percent	2013-06-30	Yearly
GDP PER CAPITA	399.70	386.47	240.59		USD	2012-12-31	Yearly
GDP PER CAPITA PPP	1279.28	1236.95	878.29		USD	2012-12-31	Yearly
Labour	Last	Previous	Average	Trend	Unit	Reference	Frequency
POPULATION	27.47	27.16	17.48		Million	2012-12-31	Yearly
UNEMPLOYMENT RATE	3.00	8.80	4.52		Percent	2008-12-31	Yearly
Prices	Last	Previous	Average	Trend	Unit	Reference	Frequency
INFLATION RATE	4.98	8.11	8.36		Percent	2013-07-15	Monthly
Money	Last	Previous	Average	Trend	Unit	Reference	Frequency
INTEREST RATE	8.00	8.00	6.53		Percent	2013-12-31	Monthly
Trade	Last	Previous	Average	Trend	Unit	Reference	Frequency
BALANCE OF TRADE	-42116.30	-38333.30	-16463.57		Million NPR	2013-03-31	Monthly
CURRENT ACCOUNT	-179.00	-377.45	-23.20		USD Million	2011-12-31	Yearly
CURRENT ACCOUNT TO GDP	-0.90	-2.40	2.50		Percent	2011-06-30	Yearly
EXPORTS	6151.10	6024.20	5072.22		Million NPR	2013-03-31	Monthly
IMPORTS	48267.40	44357.50	21535.79		Million NPR	2013-03-31	Monthly
Government	Last	Previous	Average	Trend	Unit	Reference	Frequency
GOVERNMENT DEBT TO GDP	32.50	34.10	52.75		Percent	2011-06-30	Yearly
GOVERNMENT BUDGET	-3.80	-3.50	-3.55		Percent of GDP	2011-06-30	Yearly
CREDIT RATING	15.00						

Trade	Last		Previous	Highest	Lowest	Forecast		Unit
BALANCEOF TRADE	-2116.30	2013-03-31	-38333.30	-3913.30	-42116.30	-41662.87	2013-4-30	Million NPR
CURRENT ACCOUNT	-179.00	2011-12-31	-377.45	538.99	-390.10	-223.77	2012-12-31	USD Million
CURRENT ACCOUNT TO GDP	-0.90	2011-06-30	-2.40	5.50	-2.40	-1.20	2011-12-31	Percent
EXPORTS	6151.10	2013-03-31	6024.20	7550.90	2831.60	6350.68	2013-04-30	Million NPR
IMPORTS	48267.40	2013-03-31	44357.50	48267.40	8000.30	48859.61	2013-04-30	Million NPR

More recently, with the advent of small trades over the internet such as through Amazon and e-Bay, exports have largely bypassed the involvement of Customs in many countries due to the low individual values of these trades. Nonetheless, these small exports are still subject to legal restrictions applied by the country of export.

Conclusions

Dollarization is heavily related to inflation, as argued by the currency substitution view. This theory argues that as inflation goes up, so does the degree of deposit and loan dollarization in an economy. Another implication of the view is when inflation falls, households and businesses should switch back to local currency for their savings and borrowing needs. The currency substitution view partially explains the fall in the overall degree of dollarization in Turkey following the adoption of the inflation targeting regime and the subsequent fall in the annual inflation rate. Other factors may also contribute to dollarization. As suggested by the institutional view and the Minimum Variance Portfolio Theory, the institutional credibility or the relative volatility of inflation and the real exchange rate depreciation are also known to be other drivers of the dollarization process. Thus, stabilization of the inflation rate may or may not necessarily lead to de-dollarization of a banking system. In the case of Nepal , during our analysis period, we see that there is a high correlation between inflation and the ratio of foreign currency loans to local currency loans. The Turkish banking system simply converts foreign currency deposits into foreign currency loans, as we find out. The absence of hedging as a result of such practice makes the Turkish banking system vulnerable to sudden and drastic exchange rate fluctuations. We know from history that global economic crises lead to the outflow of capital from emerging market economies like Turkey and can result in large and sudden depreciation of local currency. Considering the fact that by 2009, more than a quarter of all loans in the Turkish banking system were in the form of foreign currency and for every 10 TL worth of foreign currency deposit in the system, there is 7 TL worth of FC loans, we can understand the severity of the risk posed. The timing of the 2009 decision is appropriate given the increase in the foreign currency loans vis--vis foreign currency deposits in the banking system. We believe the regulators in Turkey made the policy changes a preventive measure against possible future financial distress, which might have undesirable social implications. By only concentrating on household loans as opposed to business loans, the regulators also aimed at protecting the group of borrowers who are more prone to financial losses. In the aftermath of the regulatory change, Turkish banks continued to lend in foreign currency to mainly export-oriented industries. In a report released by the S&Pin 2012, it is mentioned that about one-third of commercial loans at that time are denominated in foreign currencies, and because the banking system is prohibited from lending to households in foreign currencies, its exchange rate riskis not significant .In October, 2013, the Turkish Central Bank issued another decision regarding foreign currency deposit accounts. All existing foreign currency accounts were to be ceased or converted to Nepalese rupees accounts by 2015. This new development shows the willingness on the part of Turkish regulatory authorities to restrict foreign currency exposure in the banking system even further .We believe our conclusions here can be generalized to other heavily dollarized economies. Regulatory changes regarding loan dollarization, as in the developing countries are moving towards the mitigation of the risks explained above. Thus, our findings in the case of Nepal can be applicable to other such economies in the world.

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