CENTER FOR INSTITUTIONAL REFORM AND THE INFORMAL SECTOR

University of Maryland at College Park

Center Office: IRIS Center, 2105 Morrill Hall, College Park, MD 20742
Telephone (301) 405-3110 • Fax (301) 405-3020

PARALLEL MARKET FOR FOREIGN CURRENCIES IN NEPAL

September, 1993

Development Research and Training Centre
Country Report No. 13

Authors: Zubaraj Khatiwada and Guru Prasad Neupane
Project Name: "Nepal Economic Liberalization"
Project No. 367-0161
Appropriation: 72-11110214
AID Project Office PRE/SMIE (Michael Farbmann)
AID Office funding the delivery order: USAID/Nepal

PARALLEL MARKET FOR FOREIGN CURRENCIES IN NEPAL

A Research Report

Submitted to

IRIS/University of Maryland, U.S.A.

By

Development Research and Training Centre

Kathmandu, Nepal

September, 1993

PREFACE

Existence of parallel market for foreign currencies is a common phenomenon in many developing countries which are characterized by restrictive trade practices, capital control and official fixation of the exchange rate at an overvalued level. The prevalence of parallel market for foreign currencies in Nepal is also viewed in the same paradigm. But the existence of parallel market even after liberalizing the economy needs some more explanations. Nepal has recently opted for outward oriented economic policies. Liberalization transcend8 to as far as industrial and financial sectors. Partial convertibility of the Nepalese rupee in the current account, with exchange rate determination left to the free play of the market forces, is a testament to that effect. With these policy changes parallel market for foreign exchange was expected to cease to exist altogether. Belying the expectation, the market continues to exist with black market transactions still commanding a premium in the range of 8 to 10 percent over the legal market. The focus of this study is therefore, to investigate the nature and underlying causes that perpetuate the sustenance of this market despite various liberalization measures already initiated so far. The specific objectives of this study are to articulate reasons for the continued presence of parallel market for convertible currencies, measure its size, identify the leading forces determining the parallel market rate, analyze changes brought about by full convertibility of the rupee in the current account and assess the presence of parallel market in the existing situation of capital control and other foreign exchange regulations.

In connection with this study, the study team made an intensive field visit/ survey in Kathmandu for gathering requisite informations. Beside Kathmandu, the study team also made a visit to some of the major towns like Biratnagar, Janakpur and Birgunj, and observed that the parallel market activities were nearly non-existent in these towns. As trade with Khasa (a small town in the Tibet Autonomous Region of China) is also considered to be a major factor influencing parallel market in Nepal, the research team made a visit to Khasa also. In course of the study, the research team had interactions with various businessmen and agencies involved in third country trade, persons engaged in tourism industry, officials of Federation of Nepal Chambers of Commerce and Industry, Nepal Overseas Trade Association, and officials of Nepal Rastra Bank and Ministry of Finance. The study team expresses its sincere gratitude to all the entities and persons that responded to the team's inquisitions.

This report tries to cover most of the issues mentioned in the research proposal. However, insurmountable problems were encountered while examining the extent of capital expatriation from Nepal and its implication in the parallel market and also in establishing quantativeiy, the relationship of the parallel market in Nepal with that in India. The task became difficult as the time series data of the parallel market rates for foreign currencies in India could not be available.

The study team comprised of Mr. K. Dahal as the research coordinator and Dr. Y.R. Khatiwada, Mr. G.P. Neupane, Mr. X.P. Acharya and Mr. K.B. Manandhar as research economists. The research associates involved in field survey were Mr. N.B. Thapa, Mr. S.P. Timilsina and Miss. S. Pandey. This institute would like to thank them all for their sincere work and devotion. Thanks are also due to Mr. Prithvi Raj Ligal, Hon'ble Member, National Planning Commission, Mr. S.P. Shrestha, Deputy Governor, Nepal Rastra Bank, and Mr. Praveen Dixit, Director, IRIS/Nepal Project for their enthusiastic support throughout the course of this study. Apart from the above, so many people provided services in the process of making this study that it is impossible to name them all here. The team expresses its heart-felt appreciation to each and every one of them.

This is the final report of the study which has incorporated most of the issues raised by the commentators in the earlier draft of this report, This Institute hopes that the findings of this study will prove useful to policy makers, academicians and enforcement agencies.

Development Research and Training Centre

Kathmandu, Nepal

TABLE OF CONTEXTS

LIST OF TABLES

EXECUTIVE SUMMARY

1. Parallel market in the foreign exchange is an outcome of regulations imposed on its transactions. The regulations Include liceneiny, quantitative controls, rationing and deliberate control over the price of forergn exchange. The inducement for the existence of parallel market also comes from official valuation of many items of merchandise exports as weil as imports. Such official valuations have been found to deviate, some times substiantially, from the actual valuation of transactions.

2. When there is rationing of foreign exchange, there is unmet demand for convertible curriencies which results in premium of such currencies Ln the parallel market. The importers and exporters can syphon foreign currencies away from the formal source into the parallel market by flouting official restrictions. Exporters generate supply of convertible currencies by under invoicing exports while the importers do so by overinvoicing their imports. Contraband and capital flows are also the major reasons for the existence of parallel markets in foreign exchange. Existence of parallel market in the past was mainly the outcome of such restrictions.

3. Earnest attempt at liberalization started in March 1992 when Nepal implemented partial convertibility of Nepaieae rupee in the current account. Bolder reform in the external account was introduced in February 1993 when Nepaiese rupee was made fully convertible in the current account and the number of items under import control was brought *down* to 12 and later to 6. Despite unification of offical exchange rate with the market rate, the black-market premium on trading of foreign currencies continues to exist.

4. The macroeconomic implications of parallel markets are many, some of which are loss in revenue from tariff and consequently other form of revenues, weakened effectiveness of official policy, resource misallocation and diversion of official resources for law enforcomcnt.

5. Participants in the parallel market consist of individuals who undertake this business as tne full-time profession. The instruments of trade includes cash, traveller's cheque, credit cards and Hundi, the latter being the major component *in* bulky transaction. The other participants are employeee of hotel, airlines, travel/trekking/rafting agencies, banks and of course, the tourists. In the process of undertaking trade in the parallel market even police, airline crews, and government officials are reportedly used.

6. A typical feature of operations in this market is that most of the trade is undertaken by members of extended family; as they can easily forge documents in favour of their own family members, making official enforcement redundant.

7. Higher floor price fixation and the requirement that exporters surrender the export receipt to the banking system generates demand for convertible currencies in the parallel market to the extent of carpet export in square metres times the minimum floor price less actual export price. In 1991/92 this demand amounted to U.S.$ 42.7 million.

8. The demand for foreign currencies in the parallel market to finance merchandise imports from third countries arises because of higher tariff rate and consumers' demand for theee goods, If the tariff rate exceeds the goods' price differential5 (market price less minimum floor price), the importers under-invoice import5 and finance the under-invoiced part of import by resorting to the parallel market. In fiscal *year* 1991/92, the demand met *from* the parallel market for such purposes is conservatively estimated at U.S.$ 13.5 million. Similar argumenta apply for trade under baggage rule. Assuming 15 thousand person5 availing of this benefit in 1990/91, d total of U.S.$ 9.4 million worth of demand is estimated to have been met from the parallel market. However, over the years, this is generating lesser and lesser demand pressure.

9. Other than for raw-wool imports, Nepali banks do not provide foreign exchange to finance trade from Tibet. Thie trade used to be settled mostly through commodity barter basis. Over the years Nepal is incurring deficits in its trade with Tibet which ultimately has to be financed in hard currencies. This generates demand for *foreign* exchange *in* the parallel market. In FY 1992/93 such demand was estimated at U.S.$ 64.25 million.

10. Gold has universal attraction. It is more intense in India and Nepal. A large part of gold coming to Nepal is destined for India to fetch a higher price. Until recent paet gold import was restricted in both the countries. Hence, such import was financed through recourse to parallel market. It is estimated that in 1992/93, illegal gold import required U.S.$ 6.3 million, which wae supplied by the parallel market.

11. It is indeed hard to estimate the amount of foreign exchange required to finance import of contraband. In a simple calculation based on police record of drug abusers, the annual consumption of such drugs amounts in the range of U.S.$ 3.7 million to U.S.$ 18.6 million.

12. The sources of supply of foreign currencies in the parallel market are identified as activitieis related to tourism, remittance, garment *exports,*

official travels abroad, passport facility and various tecnniques of flouting the regulations.

13. Tourism industry accumulates a sizable part of foreign exchange that would otherwise flow to the banking system. Of the total exchanges made by the tourists in Nepal, only 63 percent of sucn transaction was in fact effected through the authorized channels. The rest of the transaction takes place in the informal sector. Hence, thio industry is eerimated to have supplied nearly U.S. $ 36 million to the parallel market in FY1992/93.

14. Apart from traditionally popular Gorkha soldiers in the British Army, lately many "blue" as well ae "white" collar workers are increasingly going overseas in search of worke. In the absence of Nepali banks there and a higher premium available at the parallel market the repatriation takes place through parallel market. Such amount is presently estimated at U.S. $ 82.2 million.

15. Export of ready-made garments generates supply of foreign exchange to the parallel market by the official fixation of minimum floor price which is far below the actual export price. The exact amount of foreign exchange generated through this export under-invoicing, however, could not be worked out.

16. Official and business people returning on their visit from abroad do not surrender the remaining amount of foreign exchange to the banks. They sell this to the parallel market to obtain a rate higher than that offered by the banks. This also augments the supply capability of the parallel market.

17. The fact that export of images of deities, precious herbs, extracts of scarce animals is woll known. Wow much resources it generates in not known. This should definitely be sizable. A part of this is routed to parallel market in particular to support payment of Hundi in convertible currencies.

18. Whatever be the extent of economic freedom, some ethical and socio-political considerations will force the government to regulate international mobility of some "evil" goods: narcotic drugs, arms, and curio goods. The demand for these will continue to exist. Government will not only refuse but ban private trade over these items and parallel market will continue to operate. However, turnover of transactions in the parallel marker will decline, at least in terms of numbers of commodities financed through the parallel market.

19. If somehow, parallel markets persist to finance illegal transactions and if this results in the black market exchange rate of the rupee exceeding the market rate there will remain every incentive to obtain foreign currencies from the formal source and sell the same through the black market. This

reinforces the argument that black markets in foreign currencies will continue to survive.

20. Moat of the reasons for parallel market's existence are policy-induced, the clear examples being arbitrary setting of floor prices or valuation system with a view to impose tariff. Since these valuations differ from true market prices, distortions emerge in the form of under or over invoicing of transactions. Hence the mechanism of such valuation should be reviewed. It is suggested that the floor price fixation mechanism be continued with regular monitoring of international market prices.

21. The nature of economic as well as extraneous interdependence with India makes redundant the unilateral policy actions by Nepal. The problem is accentuated by the fixed exchange rate regime with Indian rupee. Hence, for enabling Nepal to take her independent policy actions, it is desirable to float the exchange rate of Nepalese rupee with Indian rupee. At the same time, the preferential tariff structure on trade with India also needs to be reviewed.

22. At the micro level, Nepali banking industry needs to be geared towards services orientation. This calls for improvement in the quality of services offered and efficiency. Viewed in the context of increasing number of Nepali national going abroad for employment, Nepali banks urgently need to have arrangements for properly channelising workers' remittances. Nepali banking net-work also needs to be extended to Tibet to take care of the growing bilateral trade. This requires to be supported by updating the existing bilateral trade agreements between China and Nepal.

23. The attraction of gold is apart from economic, is also a cultural and social phanomenon. There is no prospect of this slowing down upto the foreseeable future. Measures have to be undertaken to bring this trade within the legal network. It is recommended that let gold be sold in convertible currencies at a small margin over it8 international prices from Nepal's international airport premise.

24. Finally, Nepal needs a strong agency to constantly monitor parallel market activities both in Nepal and overseas such that corrective measures could be undertaken just in time.

CHAPTER I. NATURE OF THE PROBLEM

1.1 Introduction

1.1.1 Many developing countries are characterised by the existence of parallel markets in foreign currencies which are also known as black, informal., or curb markets. Parallel markets in any commodity develop in response to legal restrictions on its sale, ceiling on its price imposed by the authorities or both. When prices are officially administered, they do not reflect the true price that market forces would otherwise determine. The same principle applies to foreign exchange market also. When exchange rates are officially fixed, they refrain from becoming the market clearing rates. In Nepal, until the recent past, the Nepal Rastra Bank used to fix the exchange rate of Nepalese rupee and legally all the entities had to undertake transactions only at that rate. under such a situation, purchases of foreign currency were restricted to uses deemed by the authorities to be essential for the economy. However, the overvalued exchange rate of the rupee in the wake of strict foreign exchange control generated a heavy demand for foreign exchange, particularly for the import of third country goods which could be sold in the domestic market at higher profit margin. Since there was foreign exchange control, this demand could not be fully met from the official supply of foreign exchanges. The unmet demand for foreign exchange at uthe official rate used to spill-over into the informal market which *used* to be met by unauthorized supply of foreign exchange at a price above the official exchange rate. This caused the existence of parallel market of foreign currencies in the country. The premium on foreign exchange transaction in the parallel market used to depend upon a host of factors, particular the demand for third country imports and the grof itability on such imports, demand from the Indian side, and the effectiveness of enforcement. The premium fluctuated considerably over time and particularly in periods characterized by uncertainty about macroeconomic policies or unstable political and social conditions. This premium tended to react swiftly to expected future changes in economic fundamentals.

1.2 Causes and Magnitude

1.2.1 Parallel market in foreign exchange typically emerge out of restrictions on trade and capital flows. When foreign trade is heavily regulated and authorities maintain an overvalued exchange rate, there is obviously an excess demand for *foreign* exchange at the official rate. Maintenance of such disequilibrium exchange rate necessitates measures to allocate supply of foreign currency amongst competing demands through the import and industrial licensing system. As a consequence, parallel market emerges with premium for foreiqn currency that are often very high. This also encourages the rent seeking and directly unproductive profit seeking activities.

1.2.2 It is often argued that as the developing countries have limited foreign exchange resources, governments have to intervene in order to channelise them to priority areas and control luxury imports. Exchange controls and quantitative reetrictione are thus the natural outcomes. The restrictions are reflected in licensing procedures, acimrnistrative allocation of foreign exchanges, prohibitions, quotas, tariffs and many other regulations. The imposition of high tariff and quotas creates incentives for smuggling and fake invoices by generating excess demand for imported goods. The demand pressure gets in accounted by the fact that such imports are out of the tax bracket and hence, are available at the pre tax price. Illegal trade demands illegal foreign currencies which in turn leads to the establishment of a parallel foreign currency market. When quantitative controls and restrictions are imposed on the availability of foreign exchange and if the cental bank is unable or unwilling to meet all the demand for foreign exchange at its official exchange rate, those who are deprived of the access to official foreign exchange get prepared to offer a price above the official rata, as long as the risks and costs of evading the exchange control regulations are not prohibitive. When there are offers for higher exchange rate foreign currency earners will have an incentive to sell it in the black market rather than to the banks.

1.2.3 Once the parallel market in foreign currency come8 into existence, its size and the exchange rate premium over the official rate depend principally on the range of transactions subjected to exchange controls and the extent of legal enforcement by the authorities. If import demand rationing is not intense in the official foreign exchange market, the parallel currency market is likely to be thin. Further, if the country has a chronic balance of payments deficits and the cental bank lacks sufficient foreign exchange reserves to satisfy the demand for foreign exchange at the official rate, the black market would be well developed and organized, so that all the unmet demands for foreign currency could be supplied from this market at a substantially depreciated exchange rate. The supply of foreign exchange to such market comes from various sources such as: underinvoicing of exports, overinvoicing of imports, foreign tourists and the diversion of remittances from abroad through unofficial channels. Demand for foreign exchange emerges for illegal traders, portfolio diversification and capital flight, and residents' travel abroad. The uncertainties about the prevailing economic policies, higher inflation and lower rate of interest in the economy are often the most important determinant *of* demand for foreign exchange in parallel markets.

1.2.4 In the Nepalese context also, the cause of parallel market existence are not significantly different from those mentioned above. As Nepal followed a restrictive foreign exchange policy for a long time in the pretext of weak foreign exchange **reserves** of the country, trade, in particular the third country one, was highly regulated with the imposition of license requirement and other prohibitions. The lucky ones who could **get** the license used to sell their imports at a lucrative profit margin. Earlier, even import entitlement used ta fetch lurcative premium. Others deprived of the official supply of foreign exchange used to venture in the informal market where foreign currency wae available at a certain premium over the official exchange rate. Underinvoicing of the export earning was *the* major source of supply of foreign exchange in this market.

1.2.5 The other cause of the existence of the parallel market for foreign exchange is the restrictive policies adopted by India. India hae had a long history of inward looking policies in which imports are discouraged and import **substituting** industries are heavily protected. Monopoly or at most monopolistic **market** thus created generated shoddy products which could not satisfy the demand for quality goods, mostly demanded by middle class consumers. This put demand pressure on third country goods. And, as the government **was not** ready **to** finance such imports from the official source, the same had to be necessarily financed from the parallel market of foreign exchange. This used to create a heavy demand for foreign exchange in the parallel market and part of this used to be met through the **Nepalese side.**

1.2.6 One important commodity prohibited for imports but in heavy demand in' India was gold. As there was high profit margin on the sales of imported **gold** in the domestic market, Fmportere were often ready to pay high premium for foreign exchange in the parallel market to finance the gold imports. The tendency of capital flight from India and to some extent from Nepal toward the West is also supposed to have generated demand for foreign exchange in the parallel market, for, there were (and still are) strict legal **prohibitions** on capital flight abroad both from India and Nepal. Since there is an open border between Nepal and India with free and unlimited convertibility *of* Indian Rupee **(IRs)** into **Nepali** rupee **(NRs),** the demand for foreign exchange by the Indians for capital outflow could be met from Nepal side **as** well. It **is observed** that even at prsaent, the premium on foroign exchange in **tha** parallel market in Nepal is determined by the demand conditions prevailing in the Indian market. This is manifasted through the exchange rate at the Indian parallel market popularly known as the "Hawala" market in India.

1.2.7 The magnitude of parallel market is generally determined by several factors such as: (1) the extent of overvaluation of the domestic currency at the official exchange rate, (2) the extent of regulations on imports and exports, (3) legal provisione, law enforcement capacity of the government and the degree of penalty, and (4) the extent of control on services, transfers and capital flows. In the past, as the official exchange rate used to be highly overvalued followed by stringent controls *over* the external sector of the economy, export and imports used to be underinvoiced and overinvoiced in order to supply additional foreign exchange to the parallel market where it could be sold at a higher premium. However, even with the liberalization of trade and services, along with the market determined exchange rate, the parallel market for foreign exchange still continue to exist as evidenced by the rate of premium which exceeds formal market rates by around 8 percent. This reveals that existence of the parallel market is not completely determined by above factors alone.

1.3 Partial Convertibility and After

1.3.1 Effective March 1992, the Indian government announced partial convertibility of the Indian currency in the trade account. Accordingly, 60 percent of the foreign exchange earnings from exports could be exchanged into domestic currency at the market determined rate which was some 15 percent higher than the official rate. The other 40 percent had to be exchanged at the official rate. This gave additional incentives to exports from India. Nepal had no choice but to follow it due to the possibilities of trade deflection and diversion in the wake of open border with India and free convertibility *of* the Nepaleee rupee vie-a-vie the India currency.

1.3.2 Implement at ion of partial convertibility in the current account was announced by Nepalese government immediately after India did so. Accordingly, Nepalese exporters were entitled to exchange 65 percent of their foreign exchange earnings from the export Of goods and services at the free market rate and the remaining 35 percent had to be surrendered to the banking *system* at the official exchange rate. In July, 1992, the proportion of the free convertibility was raised to 75 percent and only 25 percent had to be sold at the official rate. The premium of free market rate over the official rate wae mote than 20 percent during the initial months *of* the adoption of partial convertibility which elided down to less than 17 percent subsequently. With the adoption of partial convertibility of the Nepalese rupee in the current account, trade became virtually open with only 43 commodities subjected to licensing requirement. This was further reduced to 12 when the proportion of convertibility was raised from 65 percent to 75 percent. This had given the impression that parallel market will cease to exist as the market rate of exchange was thought to have already included the premium of the free market rate over the official rate. However, the partial convertibility system not only created multiple exchange rates in the market but also encouraged informal market activities in the foreign exchange. Partial convertibility also resulted in dual exchange rate mechanism: one official rate, next market determined rate and still next several other rates implicitely emerging out of the auction of import licenses for commodities under quantitative control. It was observed that the official rate was far below the equilibrium rate determined by competitive market forces. Moreover, there was a tendency to bid up the auction for imports of controlled items which far exceeded the quantity of domestic consumption. The license for excess of imports volume over domestic consumption could easily be transferred to another importing parties at a much higher premium. This distorted the market value of the foreign exchange and caused the emergence of foreign curriencies at a rate which is much higher than the formal market rate.

1.3.3 Contrary to what was expected, the partial convertibility system did not eliminate parallel market in foreign exchange. How the system of partial convertibility encouraged parallel market activities is explained herein. The commercial banks had to surrender 35 percent (and latter 25 percent) of their foreign exchange earnings at the official rate fixed by the Nepal Rastra Bank (which was far below the market rate), the banks had to adjust for the gap arising out of the differences between the market rate and the official rate of exchange by quoting buying rates significantly below the marker: rate. The simple formulae for fixing the buying rate of foreign currienciee is outlined as:

$$BR = W.OR+(1-W)MR,$$

where

BR = Commercial Banks' buying rate of foreign exchange,
OR = Official rate fixed by the Nepal Rastra Bank,
MR = market exchange rate as settled by formal foreign exchange market, and
W = The proportion of foreign exchange earnings to be surrendered at the official exchange rate.

Now suppose that W = 0.35 (i.e. if 35 per cent of the foreign exchange earning is to be surrendered at the official rate), OR = Rs 43 per U.S. Dollar and MR = Rs 50 per U.S. Dollar, then the buying rate (BR) of foreign exchange by the commercial banks would be Rs 47.55 per U.S. Dollar (i.e. BR = .35 x Rs 43 + .65 X Rs 50 = Rs 47.55). Allowing fur some Rs. 0.50 paise as the exchange commission, the buying rate of U.S. Dollar for the commercial banks would be around Rs 47 per U.S. Dollar. So the system implied a margin of 6 to 7 per cent (Re 3.0 as a difference between Rs 47.0 and Rs 50.0) between the buying and selling rates of U.S. Dollar by the banks. This enabled foreign exchange dealers in the curb market to fix their buying rates above and selling rate below the organized market rate and still make a profit margin. For instance, if the commercial banks used to purchase U.S. Dollar at Rs 47 per Dollar and sell at Rs 50 per Dollar making a profit of Rs. 0.55 per U.S. Dollar exchanged, a dealer in the parallel market could offer per Dollar price of over Rs 47 (say Rs 49) and make a profit of one rupee even if he sold the Dollars at the same rate of Rs SO per Dollar. Hence, as the parailel market dealers could afford a higher rate, there was incentive for the foreign exchange earners to exchange the currency in the parallel market. It was expected that with full convertibility, the buying rate could go up (say up to Rs 49.50) and still yield some (one percent) premium (margin) for the banks in foreign exchange transactions even if selling rate as determined hy the market forces (Re 50) is the same. Thue implementation of full convertibility was supposed to eiiminate the parailel market altogether.

1.4 Full Convertibility and After

1.4.1 In February 1993, Nepal effected the implementation of full convertibility of the Nepaleee rupee in the current account. Along with this, the number of commodity under quantitative control (requiring import license) were reduced from 12 to 6. Many liberai measures were taken subsequently. The includee among others: (i) the opening of bank accounts in foreign currency was liberalized (ii) foreign exchange facility for the Nepalese travelling abroad was increased; (iii) exporters were allowed to retain upto 50 percent of their export earnings in the form of foreign currency deposits at the domestic banks, and (iv) Import of gold and silver was liberalized through reduction on customs duties and sales tax on their imports. With the unification of the exchange rate and liberalization of the foreign exchange market, it was expected that the market exchange rate would reflect the true ecarcity value of convertible currencies and the parallel market will be eliminated. However, the black market continued to exist, although the premium in this market declined to 6-7 percent from as high as 25 percent earlier. However, the premium went up to 15 percent and still more around May-June 1993. This upsurge in premium can be linked with the Gold Bond Scheme introduced in India.

The Gold Bond Scheme generated heavy demand for gold and hence for foreign exchange in India which was to be met from the parallel market. It is believed that the demand for gold and hence for foreign currencies in the Indian market spills over into the Nepalese parallel market for foreign exchange resulting in a higher premium in the exchange rate in the parallel over the legal market. The epill-over effect can be rubntantiated by the market signal of declining parallel market rate along with the termination of

Gold Bond Scheme by India. So it is observed that liberalization of the foreign exchange market in Nepal alone can not eliminate the parallel market activities in foreign exchange in Nepal, as it is also governed by the foreign exchange activities in India. Further, as there are some items (such as narcotic drugs, defence equipments etc.) whose import can not be allowed in any sort of liberalized trade regime and as the capital account is still under control, the demand for foreign exchange for contrband imports and capital flow can not be avoided even if the current account is completely free. Along with these, the fixation of floor price of exports and customs' valuation of imports in its own way have also left prospects for the continuation of parallel market in foreign currencies.

1.5 Consequences of the Existence of Parallel Market

1.5.1 When all the foreign exchange earned by the country cannot be channelled toward the banking system, the central bank may find itself faced with continuing pressure on meeting demand for foreign exchange reserves and loss of firm control over the uses of foreign exchange it is supposed to allocate. Inadequate or even total absence of reserves at the disposal of authoritiee constrains the effective control of the central bank over the external sector. If the central bank continues opting for fixed exchange rate without resort to exchange controls, reserve losses through the balance of payments will act as a brake on excessive monetary expansion. But when exchange controls exists, the resultant balance of payments outcome will have monetary and hence inflationary effects.

In such a situation, if the prices of non-traded goods rise faster than the prevailing rate of inflation, the prices of traded goods will be held down by condititons in international markets and the official exchange rate. The relative decline in the price of traded goods in comparison to non-traded ones will encourage reallocation of resources away from the production of exportable6 and import substites and shift consumer's preference in favour of imports. Thus, the economy will have to face over- supply of those goods which do not generate or save foreign exchange and insufficient supply of those goods which generate or save the foreign exchange. Such a sub-optional pattern of production and consumption will involve a real cost to the economy and a loss of national income and welfare (see Michaele Nowak, 1985). If corrective policies are not taken, the distortions in relative price will continue to distort the structure of production and consumption in the economy.

1.5.2 The operation of parallel currency market has several adverse effects in the economy. Some of them are: (i) loss of tariff revenue because of smuggling and undeinvoicinq, (ii) loss of revenue from both income and sales taxes, (iii) the resultant lose of flow of foreign exchange to the cental bank which lowers the availability of the government to finance necessary imports,

(iv) emergence of rent seeking activities in the country'5 resource allocation, (v) increased cost of law enforcement, and (vi) weakened monetary control owing to the parallel market facilitation of intermediation in transmitting resources from domestic currency into foreign currency asset5 and other possible loss of seigfiorage revenue occuring to the government (see Agehor, 1993). Although parallel currency market may accommodate transactors whose demand far foreign currency is not met by the Official market and help expediting economic activities. there is little empirical evidence to support this aeeertion and the relative welfare effect5 are largely ambiguous. But what is obvious is that the high premium in parallel market generates incentives to divert export receipts from the official to the parallel market. As a result, instead of increasing resources at the disposal of the banking system for judicious uses, a substantial part of the foreign exchange will be diverted to the parallel market for illicit uses. It should, however, be said that existence of parallel market alone is not the sole cause of these distortions. In aome cases, parallel market emerge6 as a responce to them. The emphasis here is on the fact that parallel market constrains authorities in pursuing some kind of public policies. Even though quantitative estimate of revenue loss turn out to be formidable, some hints are presented in the third chapter (section 3.2).

1.5.3 Studies show that high premium in parallel market have considerably weakened the monerary grip over thebalance of payments of some countries and adversely affected the effective uses of capital control5 (see Agenor, 1993). In Nepal as the capital account is still under control, the availability of the foreign exchange in the parallel market facilitates the expatriation of capital by the Nepaleee who want to avoid income, property or wealth tax at home. On the whole, the existence of parallel market for foreign exchange in a larger extent is not only detrimental for the efficient allocation of resources and but also a hinderance to achieving desired objective5 of the macro economic policy measures.

CHAPTER 11. BEHAVIOUR OF FOREIGN EXCHANGE MARKET IN NEPAL

This chapter intends to explain the specific behavioural features of the participants operating in the paralle market for foreign currienciee in Nepal. The chapter begins with the evaluation of the real exchange rate of the Nepali rupee and its implication on the parallel market. In the second section the broken cross-rate in the exchange rate of Nepali rupee is diacuased. This section also analyzes how pegging of the Nepali rupee eimultaneouely with U.S. Dollar and Indian rupee created distortion in the official market for foreign exchange leaving scope for arbitrage in currency trading. The rest of the chapter deals with parallel market activities, mainly activities of the foreign exchange dealers, modus operandi of the Hundi market, premium in the parallel market. and linkage of the parallel market with illegal trade, capital flow and the Indian market.

2.1 Real Exchange Rate of Nepalese Rupee and the Parallel Market

2.1.1 For quite long, Nepal experienced with administered exchange-rate regime with attendant result of distortions in ite international trade and corresponding payments. The attempt at protecting nascent domestic induatriee via administrative, tariff and other (exchange rate) changes rooulted in diverting inveetment away from the tradeable sector. It was in June 1983 that Nepal pegged its currency to a select basket of currencies. Multiplicity of tariff structure, subsidies and auction of import licensee, however, resulted in multiplicity of real exchange rates. A real breakthrough in the exchange rate regime was initiated in March, 1992 when Nepaleee rupee was made partially convertible in the current account. There was noticeable improvement in Nepal's current account following this. Although improvement in the current account continued, the dual rate still allowed scope for maneuvering, manipulation and some extent of arbitrage persisted, the clear example being a tendency for underinvoicing of exporte. The official exchange rate still remained overvalued although imports at the official exchange rate were limited to POL products, chemical fertilizers, induatrial raw materials and capital goods. With a higher level of confidence of the authorities boosted by successive experiences with liberalization, full convertibility in current account was introduced in March, 1993. With this, the exchange rate has left to be determined by the market forces.

2.1.2 The real exchange rate of the rupee which remained overvalued during the period of administered foreign exchange regime is given in the following table (Table 2.1).

Table 2.1 Real Exchange Rate Indices of Nepaleae Rupee with Indian Rupee (RERI) and U.S. Dollar (RERD)

Year	RERI	RERD
1976	102.47	137.98
1977	99.32	128.42
1978	106.65	138.02
1979	104.61	131.96
1980	95.40	127.74
1981	92.64	129.83
1982	96.68	124.67
1983	105.73	130.34
1984	102.91	116.15
1985	100.00	100.00
1986	99.90	102.27
1987	102.11	107.26
1988	104.94	107.26
1989	105.54	96.81
1990	106.54	89.96
1991	105.10	85.58
1992	117.11	74.18

Source : International Financial Statistics and Estimates of the Research Team.

Note: Real Exchange Rate (RER) is defined here as:

$RER = TW\ XRI(CPI_N/CPI_{Row})$

where

TW = trade weights of home country in its international trade with specific country
XRI = Exchange Rate Index
CPI = Consumer Price index
N = Nepal
ROW = Rest of the World

2.1.3 In the above table, the index of RER>100 implies the appreciation of Nepali Rupee vie-a-vie foreign currencies. Likewise RER<100 implies depreciation. The table revels that Nepalese rupee had been substantially overvalued with U.S. Dollar during later 1970s and early 1980s. Even in the later 1980s, it remained overvalued till 1988. From 1989 onwards the real exchange rate has depreciated form the level of 1985. But it is observed that overvaluation of Nepalese rupee against Indian rupee has been severe in the recent years although it also exiated in early 1980s.

2.1.4 The table shows that Nepalese rupee has incurred a depreciation eucceseively for four years beginning 1989. This is however not accidental. It was tho year when Nepalese authorities initiated bold reforms in nominal exchange rate front. Further two discrete devaluations took place in 1991 resulting in a 21 percent of depreciation of the NRs with U.S. Dollar. At the same time one can notice accelerated pace in the U.S. inflation rate. That is why the extent of depreciation has been to the extent of more than 25 percent in 1992 from the level of 1985. Looking at the real exchange rate index, it can be said that the demand pressure for foreign exchange in the parallel market in the recent years is not on account of overvalued exchange rate of the rupee in the formal market.

2.1.5 If international value of home currency is overvalued, it creates anti-export bias by promoting imports and import substituting industries at the cost of export industries, generates rent seeking activities, and encourages parallel market for foreign exchange. In such a situation, the sustainability of financing international trade and capital flows will be at stake. Appreciation implies that there is a premium on sale of imported goods in the domestic market if the nominal exchange rate deviates from the ratio of relative price indices. This phenomenon diverts resources away from exportable productions. This is exactly what happened in Nepal in the past. All forma of incentives whether Exporter's Exchange Entitlement Scheme (1960s and early 70s), Dual Exchange Rate mechanism (1977) or Variety of tariff concessiona, all failed to generate a viable export sector. Thie is because nominal (official) exchange rate failed to correspond to changes in real effective exchange rate (RBER).

2.1.6 Looking at the movement in RER of NH6 in the recent years, there is apparently no demand pressure for foreign currency for financing the legal current account transactions and no need for recourse to parallel market in U.S. Dollar. On the contrary, there may be supply of U.S. Dollar to the parallel market. Hence, the demand for convertible foreign currency is for illegal transaction and other uses only.

2.2 Broken Cross Rate and the Parallel Market

2.2.1 Cross rate here is defined as the prevailing independent exchange rate between NRs and U.S. Dollar on the one hand and NRs and U.S. Dollar exchange rate in relation to IRs, on the other. Since there is full and free convertibility between NRs and IRs., any divergence in their respective exchange rates vis-a-vis U.S. Dollar leaves room for speculative activities in the foreign exchange market. In situation like Nepal's where its national currency is pegged to IRs and U.S. Dollar separately, the necessary condition for equilibrium nominal exchange rate in the foreign exchange market should be:

NRs/$ = IRs./$ * NRs/IRs.

Broken cross rate is sure to emerge when

IRs/$ * NRs/IRs = NRs/$

Denoting NRs/$ by a and IRs/$ * NRs/IRs by ß:

If a < α, thia means NRs depreciates faster than IRs as compared to the common currency U.S. Dollar. This implies that the foreign exchange transactors are to gain by exchanging U.S. Dollar in Nepal rather than in India. They can then easily convert NRs into IRs. Thue they end up with more IRs rather than by directly converting their Dollar into IRs. Exactly reverse scenario occurs when ß > a. In this case the Dollar holders gain by first converting it into IRs, and then ultimately purchasing NRs against IRs.

2.2.2 Broken cross rate is an outcome of fixed exchange rate regime. Furthermore, one can not expect broken cross rate to emerge even under fixed rate regime if domestic currency is pegged to only one intervening currency. This ie thus a distortion arising from official intervention in the foreign exchange market.

2.2.3 We now set to empirically evaluate the behaviour of exchange rate movements of respective currencies of Nepal and India against U.S. Dollar. Table 2.2 gives weekly average of the buying and selling rates of NRs and IRs against U.S. Dollar for one year'8 period (July 26 1992-July 25 1993).

2.2.4 In the table, both the rates are standardized in term of NRs. The differences in buying and selling rates is represented in the last two columns. The fact that there is a huge margin on selling rate is quite revealing. Selling rate for Dollar in India against the similar rate in Nepal goes up by as high ae NRs 5.81 per U.S. Dollar (Feb 14, 1993). Barring few cases selling rate lees buying rate differential has been consistently been higher in India than in Nepal.

2.2.5 This implies: either cost of intermediation in foreign exchange market of Indian commercial banks is much higher than corresponding costs in Nepal, or compared to Nepal Indian banks extract disproportionately larger share of profit arieing from foreign exchange dealings. Whatever may be the case this ceteris-paribus, makes Nepal more attractive for conducting foreign exchange business. Beginning early March '93, however, there is a complete turn-around. Since then, cost of intermediation in Nepal consistently exceeds such costs in India.

2.2.6 Reverting back to cross rate, a closer scrutiny of the table reveals that in almost all tho time during the review period Nepal has offered a higher rate over India on sale of Dollars. Hence, as convertible currency purchase is cheaper in Nepal, the dollar holding of Nepal may tend to flow

Table 2.2 Broken Cross Rate of the Nepalese Rupee

No.	Date	Buying rates		Selling Rates		Divergence(NCB-INCB)	
		NCBs*	InCBs**	NCBs*	InCBs**	Buying	Selling
1	26-Jul-92	47.57	46.88	49.62	49.76	0.69	(0.14)
2	02-Aug-92	47.13	46.84	49.04	49.70	0.29	(0.66)
3	09-Aug-92	46.53	46.78	48.23	49.60	(0.25)	(1.36)
4	16-Aug-92	46.50	46.77	48.26	49.59	(0.27)	(1.32)
5	23-Aug-92	46.50	46.80	48.30	49.63	(0.30)	(1.33)
6	30-Aug-92	46.54	47.02	48.34	50.02	(0.48)	(1.68)
7	06-Sep-92	46.55	46.90	48.35	49.80	(0.35)	(1.45)
8	13-Sep-92	46.55	46.77	48.35	49.59	(0.22)	(1.24)
9	20-Sep-92	46.54	46.79	48.35	49.62	(0.25)	(1.28)
10	27-Sep-92	46.52	46.78	48.32	49.60	(0.26)	(1.28)
11	04-Oct-92	46.52	46.76	48.32	49.56	(0.24)	(1.24)
12	11-Oct-92	46.52	46.75	48.32	49.53	(0.23)	(1.21)
13	18-Oct-92	46.52	46.76	48.32	49.56	(0.24)	(1.24)
14	25-Oct-92	46.52	46.77	48.32	49.58	(0.25)	(1.26)
15	01-Nov-92	46.52	46.81	48.32	49.65	(0.29)	(1.33)
16	08-Nov-92	46.52	46.82	48.32	49.66	(0.30)	(1.34)
17	15-Nov-92	46.52	46.84	48.32	49.69	(0.32)	(1.37)
18	22-Nov-92	46.52	46.83	48.32	49.68	(0.31)	(1.36)
19	29-Nov-92	46.52	46.81	48.32	49.65	(0.29)	(1.33)
20	06-Dec-92	46.52	47.20	48.32	50.14	(0.68)	(1.82)
21	13-Dec-92	46.65	47.70	48.33	50.84	(1.05)	(2.51)
22	20-Dec-92	46.65	47.67	48.33	50.74	(1.02)	(2.41)
23	27-Dec-92	46.65	47.68	48.33	50.76	(1.03)	(2.43)
24	03-Jan-93	46.65	47.75	48.33	50.87	(1.10)	(2.54)
25	10-Jan-93	46.65	47.72	48.33	50.82	(1.07)	(2.49)
26	17-Jan-93	46.65	47.69	48.33	50.77	(1.04)	(2.44)
27	24-Jan-93	46.65	47.76	48.33	50.88	(1.11)	(2.55)
28	31-Jan-93	46.65	48.17	48.33	51.57	(1.52)	(3.24)
29	07-Feb-93	46.65	49.03	48.33	53.07	(2.38)	(4.74)
30	14-Feb-93	47.06	49.76	48.58	54.39	(2.69)	(5.81)
31	21-Feb-93	49.81	48.19	50.31	52.55	1.61	(2.24)
32	28-Feb-93	49.89	48.37	50.39	52.81	1.52	(2.42)
33	07-Mar-93	49.94	51.18	50.44	51.24	(1.24)	(0.80)
34	14-Mar-93	49.93	50.53	50.43	50.57	(0.60)	(0.15)
35	21-Mar-93	49.91	50.31	50.40	50.36	(0.40)	0.05
36	28-Mar-93	49.89	50.27	50.38	50.33	(0.38)	0.05
37	04-Apr-93	49.54	50.05	50.03	50.09	(0.51)	(0.06)
38	11-Apr-93	49.30	49.94	49.80	49.98	(0.64)	(0.18)
39	18-Apr-93	49.23	50.16	49.72	50.20	(0.93)	(0.48)
40	25-Apr-93	49.23	50.11	49.72	50.13	(0.88)	(0.41)
41	02-May-93	49.23	50.07	49.72	50.12	(0.84)	(0.40)
42	09-May-93	49.22	50.08	49.71	50.13	(0.86)	(0.42)
43	16-May-93	49.22	50.09	49.71	50.13	(0.87)	(0.42)
44	23-May-93	49.07	50.11	49.56	50.13	(1.04)	(0.57)
45	30-May-93	49.03	50.19	49.51	50.22	(1.16)	(0.71)
46	06-Jun-93	49.01	50.15	49.49	50.40	(1.14)	(0.91)
47	13-Jun-93	49.01	50.31	49.49	50.35	(1.30)	(0.86)
48	20-Jun-93	49.01	50.30	49.49	50.33	(1.29)	(0.84)
49	27-Jun-93	49.01	50.17	49.49	50.20	(1.16)	(0.71)
50	04-Jul-93	49.00	50.17	49.48	50.20	(1.17)	(0.72)
51	11-Jul-93	49.00	50.19	49.48	50.20	(1.19)	(0.72)
52	18-Jul-93	49.00	50.18	49.48	50.20	(1.18)	(0.72)
53	25-Jul-93	49.00	50.18	49.48	50.20	(1.18)	(0.72)

Source: Nepal Rastra Bank

Note:

*** = Nepalese Commercial Banks**

**** = Indian Commercial Banks**

towards India. Before we move on tc analyzing the implication of broken cross rate on the operation of parallel market, WE conclude this section by saying:

(i) If selling rate (= buying rate for buyer) of Dollar in Nepal is leas than buying rate (= selling rate for seller) in India ß > a : the transactor will buy Dollar against IC in Nepal and sell that Dollar in India for IRs,

(ii) If a person holds U.S. Dollar, he will sell where the buying rate (= selling rate for seller) is higher.

2.2.7 All this assumes that there is no restriction on conversion. When there are reetrictione in force, the cost of speculation or arbitrage goes up and the transactors weigh gain from trade against costs including risks. When one considers the implication of broken cross rates on parallel market for Dollar, one has to compare the prevailing exchange rates in the official market against that in the informal market. Aseuming curb market rate much higher than official rate, there is a prospect for oniy an unidirectional flow. The broken cross rate is taken advantage of to supply Dollar in the informal market.

2.2.8 There are still restrictions on official provision uf convertible currencies. It is not provided for transactions that are considered illegal. One of the ways to finance such illegal transactions is to over invoice the imports of goods that are legally permissible. This means to say that the Lmporter of legal goods over state the Dollar price of such imports and supply the excess Dollar thus obtained from official source at the official rate to the parallel market at a premium. The prospect of channelising convertible currinecies from official sources to informal market depends on the combined effect of:

(i) the gap in exchange rates in the two markets,

(ii) the margin on sale of merchandise imports in the market as compared to speculative gain by trading in Dollar,

(iii) extra tariff on over-invoicing compared to the exchange rate diffenertials between the formal and informal market.

2.2.9 With so many complexities involved, it is guessed that cross rate is not any major component of parallel market, not only because amount involved is not sizable, also because the cross rate does not remain broken for long. Once the authorities detect it (which they do) they intervene in the market for restoring equilibrium rate.

2.3 Market Activities

2.3.1 Activities of Foreign Exchange Dealers

2.3.1.1 Nepal Rastra Bank (the central hank of the country) is providing foreign exchange facilities in different places through its own offices and exchange counters. All the commerciai banks are authorized to deal in foreign exchange transactions. Foreign exchange transaction facilities from banks are normally available from 10.0 a.m. to 3.0 p.m. while the exchange counters provide longer hours of services. The exchange rates of foreign currencies is quoted daily by the Nepal Raetra Bank on the basis of previous day's average rate. Commercial banks are free to fix their own buying and selling rates.

2.3.1.2 Beside banks; hotels, travel agencies, trekking agencies, super markets etc. are authorized license holders to deal in foreign exchange. NRB undertakes periodic inspection and supervision of commercial banks and license holders. All the banks and license holders have to provide "foreign currency encashment receipt" to the transactors when Porergn exchange transactions take place. Total foreign exchange earnings from the authorized foreign exchange dealers, other than commercial banks, are to b e deposited in the form of foreign curriencies in the commerciai banks in a special convertible account and obtain the equivalent local currency. This will bring the foreign exchange into the banking system.

2.3.1.3 However, such foreign exchange dealers are not allowed to sell the foreign currencies. This is mainly because the capital account in the balance of payments is still under control. Sales of foreign currencies, for the purpose other than merchandise imports, and specified service items need to obtain permission from NRB and sales of foreign currencies can take place only in the banks.

2.3.1.4 Regarding informal market activities, there are some peopie engaged in dealing with foreign exchange transaction in the Kathmandu market. Total number of such dealers is not known. They operate from a room (guest house, bueinees office, individual house, etc.) which is quite secret and unknown to the authorities but still maintain direct or indirect contact with the foreign exchange transactors. Most of the foreign exchange dealers are either Indian or Nepaleee.

2.3.1.5 A survey was conducted to trace the prevailing exchange rat8 of foreign currencies, mechanism of remittance and volume of transaction in this market. Since gathering information from this sector was formidable, one research assistant was deputed for a period of eight weeks to observe parallel market behaviour and to collect all relevant informationa indirectly.

2.3.1.6 It is found from the survey that the parallel market mainly deals with US Dollar denominated cash, traveilers' cheques and Hundi. Other currencies that are transacted apart from US Dollar included Pound Steriing, Singapore Dollarsand Hong-Kong Dollars. However, the US Dollar was found to be dominating both the volume and value of transactions.

2.3.1.7 Exchange rate of foreign currencies in the parallel market fluctuated daily or weekly depending upon the rate prevailing in Indian markets. Every morning and afternoon the foreign exchange dealers contact their counterparts in India, Hong Kong and/or Singapore to obtain the prevailing rates. Exchange rate in Kathmandu market is determined mainly by Indian market. While doing so they tell us that the price of foreign exchange (buying rate) in Nepali market remains slightly lower than the Indian parallel market. It is mainly because of the additional risk incurred in transferring money between Nepal and India.

2.3.1.8 Host of the remittances of foreign currencies is made through Hundi. Hundi is a payments order (IOU) given by the foreign exchange transactors in respective countries. It facilitates the transactions because they need not carry foreign exchange with them. The exchange rate for Hundi is found to be 2 to 5 percent higher than cash transaction. More than 50 percent of the foreign exchange transaction is settled through Hundi.

2.3.1.9 When the supply of foreign currencies exceeds local demand, the supply is channeiised either to Hong Kong or to Singapore. According to the regulation of Nepal, people can not take out foreign exchange from the country without the prior approval of The Nepal Rastra Bank. Therefore, people dealing in foreign exchange reportedly employ the crew members of the airlines (piiots and air hostesses) to carry the Dollar. If this seems to be inadequate, they use the cargo loaders and even the security Officers on duty to carry the excess Dollars until they cross the security check points and hand over to the beneficiary already on board. The fee for doing such services is likely to be one percent. If the security system is tight and unfavourable to the transactors they redirect the surplus amount to India.

2.3.2 Modus Operandi of tbe Hundi Market

2.3.2.1 Hundi ia an un-official or an informal banking transaction. This kind of transaction is effected mostly in the case of transfer of foreign curriencies in other countries. For example, if person of a less developed country which is short of hard currency wants to transfer the equivalent of $ 100 to a developed country, he approaches a Hawala (Hundi) banker and deposits with him an agreed amount in local currency and the sum of $ 100 will be made available to him at his destination. The premises of the Hundi banker may be a gold jewellery shop, a real estate agency or the office of a general merchant or overseas trader. The remitting person has to pay a sufficiently attractive commission to the Hundi banker-the premium over the official rate at which the hard currency can be purchased in the home country. In return for his deposit, the person will receive a document not the type of the usual bank receipt or token but an entirely different kind of token that is recognized only between the clients, the Hundi banker at home and the correspondent banker in the final destination of transfer. By telephone, telex or fax, the Hundi banker at home will send message to his correspondent banker in the destination about the amount to be paid, the currency *in* which the amount has to be paid and the identification of the special token. Trust is the most essential element of such transactions. In a simple model like this, the Hundi banker in home country will use the local currency to buy locally produced or otherwise available goods like gold, drugs, other contraband items and smuggle them out of the *country* with an intent to sell it for hard currencies and pay off to the correspondent banker in the destination the sum of $100. If there is a continuous two way financial traffic between the two bankers, they will make periodic reconciliation and adjust the debits and credits in their respective accounts and arrange for transfer of the net amount due.

2.3.2.2 In fact, there are various complex mechanisms of transferring funds. Let us suppose the Hundi banker in the home country has accumulated a large amount of local currency due to deposits from customers. In the developed country, where he wants to transfer the capital he has a trading company managed by his relatives. The relative's company in the developed country exports a consignment of goods to the relative's company in the homeland. The price quoted is highly inflated. The over-invoiced amount is remitted by the latter company to the former for the approval of the customs authorities and the central bank. This can be eaeily done. The importer does not disclose to the authorities the special relationship underlying the transaction and insists on the acceptance of the transaction as reported in the invoice. Large sums of hard currency can be remitted from developing country to developed ones in this manner or sometimes by miedeclaring the cargo (thereby automatically misdeclaring the price) or by importing junk. The company in developing country can under-rnvoice a consignment eay of readymade garments exported to developed country. The difference between the actual price and that shown in the invoice can be retained abroad *in* a separate account. The launderers can thus take advantage of the formal banking sector as well as the Hundi banking channel in transferring large sums of money. If, however, there are laws against money laundering with connected laws requiring reporting of transactions, *the launderer* will not take *help of* the formal banking sector but work in conjunction with various correspondent Hawala bankers spread over a large number of countries. Quite often, the Hundi bankers in various countries have *strong* bonds either by blood or by marriage. Money laundering legislation can hardly reach Hundi bankers and they will obviously not comply with reporting requirements, because in that case they will be in the tax net.

2.3.2.3 For Nepal, the major corresponding Hundi centres are Hong Kong, Sinqapore, Banqkok and Delhi. The Hundi dealers acquire their hard. currency through the Nepalese labour force employed abroad, who want to send money to their relations in Nepal. The money is distributed by the Nepal-based agents of the Hawala dealers to the relations in Nepal after the Dollars have been collected abroad.

2.3.2.4 In principle with the liberalisation in the exchange control regulations, ths market rate and the Hawala rate of hard currencies should tend to converge. But with increasing adoption of money-laundering legislation and reporting requirements of suspect transactions in more and more countries, the Hawala banking system with the concomitant support provided by practices of under-invoicing and over-invoicinq continues to have its attraction to those who live by crime-commercials or otherwise.

3.3.3 A Cobweb of Illegal Trade, Capital Flows and the Parallel Market.

2.3.3.1 In this section an attempt is made on exploring variety of interconnections among the trade of contraband, gold smuggling and capital flows baaed mainly on news reports. To the best poeeible extent their modus operandi will also be identified.

2.3.3.2 Before proceeding to the mechanism, a few words on parallel market or smuggling will be in order. Generally, smuggling activities is attached with stigma making this trade something Like immoral, unjust, unsocial or even inhumane. This precludes the possibility of A clear appreciation or scrutiny of this kind of economic activity. This trade even though illegal, with persons engaged *in* smuggling subject to various legal penalties, is still *a* part of a country's international trade in goods and services and frequently is effected through official permissiveness or active connivance of law enforcement agencies. In economic sense, smuggling is resorted to, to avoid taxes or to laundering money derived from other illegal sources.

2.3.3.3 Penalties relating to smuggling can be considered a part of the cost of smuggling, which may be defined a6 the cost of effecting trade beyond what would be required if trade were undertaken formally. The Costs would include abnormal handling costs because of unuaual route of transportation, uneconomic packaging to evade detection, bribes paid to customs officials, excessive price of Dollars in the black market and expected value of penalties and forfeitures. The benefits are obvious.

2.3.3.4 Capital movement could both be a source or an use in the parallel market. It is a common fact that bigger construction projects like hydroelectricity, airports and highways involving millions of rupee ends up in nomenclatures like commission, kick-back, favour, bribe or corrupt ion. Similar is the case with official procurement involving huge sums of money. These commissions are effected in convertible currencies. Even though such kind of commissions are deposited directly into the foreign bank account of the recipient by the grantor of the commission, these are likely to be used in the settlement of financial transactions involving Nepales rupee in the longer-run, if the blacj market premium on such transactions exceeds the interest income or security considerations. Amount thus received by powerful political/bureaucratic personnel8 may be used in following ways. Firstly, if the premium in the Nepaleee parallel market is high and if the recipitent does not want to and afford to keep the foreign exchange overseas, it will have subaeguentily to enter the parallel market from the supply side. Secondly, this money can be squandered in conspicuous consumption which will increase imports. Thirdly, there could be a capital outflow, not necessarily to take advantage of exchange rate, interest rate or other yield differentials, but as a security measure in anticipation of future reprisals in Nepal. Since this is only conjecture, one can not be very definitive.

2.3.3.5 Another link between Dollar black market and capital movement could be as follows: If a foreign national with enough illegal rupee resources wants to stock his asset overseas, the authorities would refuse exchange permission for he can not submit legal income document. In such case, he may resort to the parallel market so that he could syphon capital away from Nepal. Capital account is still under strict control. Nepali national if they want to transfer capital abroad, will have to resort to the parallel market. It is often said that property tax paves way for capital outflow. There have been efforts to levy property tax, the net effect of this will depend upon the relative tax rate between sending and recipient country. Moreover, legal provision of capital tax alone does not matter. What matters most is the enforcement. In this context, Nepali tax administration is relatively weak.

2.3.3.6 Some innovation8 have been observed in the parallel market of foreign exchange in the context of liberalized foreign exchange market. The global wave of economic liberlization has also gripped south-Asia. Liberalization of current account has been intense since mid 1992 both in Nepal and India. official liberalization had the effect of squeezing the size of transaction in the black market. The heavy terrorist bombing of Bombay and Calcutta in March 1993 was and still is considered to be a reprisal by Hawala trader to regain their trade. The Indian authorities continued with further liberalization undaunted. The consequence was the narrowing down of the operating margin per Dollar between Indian banks and Hawala market.

2.3.3.7 This competition forced Hawala market to compete in terms of quality of services offered. When remittinq funds of Indians working in the Gulf, the Hawala market faxes its agent in India, the fax includes the photograph of the remitter. The agent residing in India goes to the recipient household and submits the amount. A photograph of this receipt is immediately faxed back to the Gulf party which in turn delivers it to the sender. The conversation between recipient and the agent is cassette-taped and sent back to the Gulf at the earliest convenience. This gives faith to the Hawala transaction. Even though cost of transaction remains the same, the intimacy and tendernees of care is more apparent in Hawala market. We still do not have informations on such innovations in the Nepali parallel market, but if it is to survive the official business competition, it should definitely have propelled attractions either through price or through quantity or by an optimal mix of the two.

2.4 Premium in the Parallel Market

2.4.1 In order to obtain the exchange rate in the parallel market the research assistant visited the Hundi market and gathered data on exchange rate on every Wednesday from April 13 to June 16, 1993 (eight weeks) regularly. The team collected the exchange rate for cash Dollar, travellere cheque and Hundi. Next, the average exchange rate of commercial banks was also collected from NRB. The exchange rate prevailing in the formal and informal market in Nepal is presented in Table 2.3.

2.4.2 The premia estimated in the table are based on the selling rates of U.S. Dollar. The table shows that the parallel market rate has remained always higher than the commercial bank rate. The parallel market rate is found to be higheet for Hundi, because of the transferring risk followed by cash Dollar. The selling rate of Hundi and cash Dollar is found to be Rs. 1.20 and Rs. 0.60 higher than the TC. From the table it is observed that the parallel market rate is 6.75 to 13.64 percent higher than the commercial banks rate in case of cash Dollar and 7.95 to 14.68 percent in case of Hundi. The time profile of the premia in the parallel market is exhibited in the graph (G:2.1). The yraph reveals that the premium after recording an upward movement upto the end of April, 1993 has gradually declined over the recent months. The peak in the premium in the parallel market can be linked with the higher gold price in India and also in Nepal on account of the introduction of Gold Bond schue in India. As the scheme exerted higher demand for gold, the demand for foreign exchange for financing gold imports also shot up. This resulted in a higher premium for U.S. Dollar in the parallel market.

2.5 Linkages with the Indian Market

2.5.1 Nepal has unique trade relations with India. There is free human and merchandise flows between the two countries. In this context it is hard to

Table 2.3 Parallel Market Premium of Foreign Exchange in Kathmandu Market

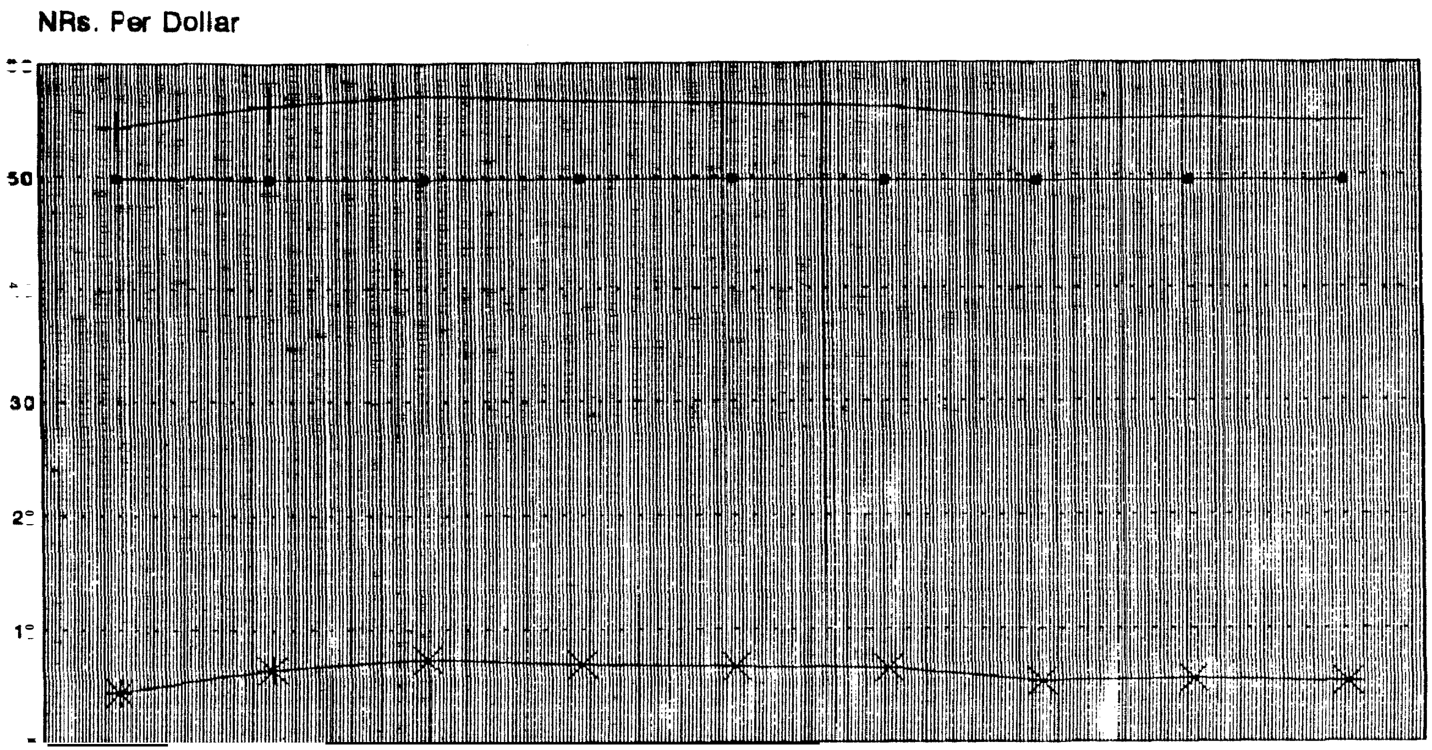
(In Rupees)

Items	April 13	April 23	May 1	May 8	May 15
Commercial Bank Rate (Average)	40.70	40.72	49.72	49.711	49.71
Parallel Market Rate (Cash)	53.65	56.50	56.50	56.00	55.80
Parallel Market Rate (TC)	53.50	55.50	55.90	55.40	55.20
Parallel Market Rate (Hundi)	54.25	56.25	57.101	56.60	56.40
Parallel Market Premium (Rs.)					
Travellers Cheque	3.71	6.27	6.67	6.17	5.97
Cash Dollar	3.66	6.76	6.78	6.29	6.09
Hundi	4.46	6.53	7.36	6.89	6.60
Parallel Market Premium (%)					
Cash Dollar	7.75	13.64	13.48	12.47	12.07
Travellers Cheque	7.45	11.47	12.27	11.27	10.87
Hundi	8.96	12.97	14.68	13.66	13.28

Items	May 22	June 2	June 9	June 16
Commercial Bank Rate (Average)	49.56	49.40	49.49	49.48
Parallel Market Rate (Cash)	55.50	54.25	54.45)	54.15
Parallel Market Rate (TC)	54.90	s3.65	53.85	53.55
Parallel Market Rate (Hundi)	58.10	54.85	55.05	54.7s
Parallel Market Premium (Rs.)				
Travellers Cheque	5.67	4.42	4.62	4.32
Cash Dollar	5.94	4.76	4.98	4.67
Hundi	6.541	5.36	5.56	5.27
Parallel Market Premium (%)				
Cash Dollar	11.47	8.96	9.38	8.76
Travellers Cheque	10.26	7.75	8.15	7.55
Hundi	12.67	10.16	10.561	9.96

Source: Field Survey

G 2.1 Premium for U.S. Dollar in the
Parallel Market



Bank Rate	49.79	49.72	49.72	49.71	49.71	49.56	49.49	49.49	49.48
Parallel	54.25	56.25	57.1	56.6	56.4	56.1	54.85	55.05	54.75
Premium	4.45	6.53	7.38	6.89	6.69	6.54	5.36	5.56	5.27

Weekly Trend

Source: Field Survey

control smuggling activitirs in Nepal. The demand for which generates in India, whereas such activities in case of other countries can be controlled more easily. Further, one of the foundation stone of the economic relation between Nepal and India has been the system of free and unlimited convertibility of Indian rupee in Nepal. Technically, restrictions exist on capital account nature of transactions. But in practice restrictions are not very effective. So in practice it is virtually a free and unlimited convertibility. What this means to say is that if demand for convertible currencies emanates through Indian currency, there is in effect no means to control it; as the demand for Indian currency is either easily accommodated into the system or the system easily succumbs to ouch demand pressure from the public.

2.5.2 Because of this factor, the foreign exchange policies being pursued in either country normally affects the other. The degree of this effect is naturally dictated by the size of the economy. Indian policy decisions can shake the Nepalese economy, whereas Nepalese policy measures can have only a token effect on the Indian economy.

2.5.3 Conceptually the link between the Nepalese and Indian foreign exchange market runs like this. Due to lack of exchange control in Indian rupee, if the rate in Nepal falls below the prevailing rate in India, it will encourage imports ultimately destined for India. The final impact of this on Nepalese economy will be depletion of convertible currency resources and increase in Indian rupee balance. On the other hand if the rate in Nepal goes above the Indian rate this will result in some of the goods of Indian origin being exported through Nepal. The impact of this will be pressure on the Indian rupee balance.

2.5.4 Theoretically, this should not be a problem. The authorities will always have the option of buying Indian rupee through payments of convertible currencies. Thus the problem does not look a serious one. But once we take into account the exchange rates being applied, then we can see the dimension of the problem. As mentioned carlicr, thio particular problem will arise only when the Nepalese market rate of US Dollar is higher vis-a-vis Indian market rate. This necessarily implies a net loss to Nepaleee banking sector as it will have to buy Dollar at higher rate and sell it to the Bombay market (for purchasing Indian rupee) at lower rate.

2.5.5 Because of this built-in constraint it has always been the policy of Nepalese authorities to shadow the Indian market rate of U.S. Dollar. But the Nepalese experience, especially after the adoption of partial convertibility, the deflection of Nepal's international trade is influenced more by issues like tariff, customs valuation, degree of import liberalization etc. rather than by discrepancies in the exchange rate. This can further be substantiated by the following couple of points.

2.5.6 After the adoption of partial convertibility the authorities in Nepal significantly liberalized the trade sector by widening the list of Open General License (OGL). One of the items which wae taken out from the auction list and placed under OGL was palm oil. Immediately after this measure, a lot of import LCs were opened in Nepalese banks for importing this item. But subsequently when the traders realized that palm oil import is being liberalized in India also, all these LCs were cancelled. Not a single item from these LCs was actually imported.

2.5.7 The same type of thing has happened after the presentation of the budget for FY 1993/94. Clove was being imported by paying premium as it was under Auction list. As the Auction list was completely done away with, naturally these items should have been much in demand. Though tariff for these items has been substantially hiked, it has affected only clove import, the reasons simply being the freeing of imports by India itself.

2.5.8 One noteworthy feature of the exchange rate policy in Nepal after the partial convertibility is the more or lees abandonment of perfect matching of U.S. Dollar rate in Nepal vis-a-via Indian rate. This has resulted in cheaper Dollar in Nepal compared to India. Logically this should have led to a surge in the demand for goods ultimatelly destined for India. But the experience in this phase is an actual fall in such imports. This is mainly a result of opening of Indian economy. A lot of import is now allowed to take place either through OGL or through baggage rule.

2.5.9 Similarly, based on the informal discussion with the traders it is known that a significant degree of re-export of computer and related goods is taking place from Nepal even though these goods can be easily imported by Indian traders themselves. Tariff in Nepal is only marginally lower as compared to the Indian tariff. In such a scenario logically there is no reason why such re-exporting should take place. The main factor suetaininq this business is the significantly lower custom valuation level prevalent in Nepal.

2.5.10 Thus it can be safely concluded that the foreign exchange market in Nepal has strong linkage with the Indian market. But the degree of this relationship is affected not only by the presence or absence of broken cross rate but also by a host of other factors such as level of liberalization, tariff rate, custom valuation, baggage rule etc.

CHAPTER III. DEMAND FOR FOREIGN EXCHANGE IN TEE PARALLEL MARKET

In this chapter we make an attempt at assessing the magnitude of demand for foreign currencies that appears in the parallel market. Obviously the demand for foreign currencies originates to finance imports of goods, services and to some extent even capital. In other word demand for currencies is in fact a derived demand, the primary demand being demand for various goods and services. In our scheme we therefore identify the source of these primary demands and wherever possible even quantify the amount demanded. In doing so we come across carpet and garment industries, merchandise imports, trade with Tibet, baggage trade and contraband imports (gold, drugs...). This definitely is not an exhaustive list and there is no mechanism of doing so, mainly because we are dealinq with the informal market where the volume and value of transaction is not available for scrutiny.

3.1 Carpet Industry

3.1.1 Carpet is the largest exporting item of Nepal. Carpets constituted 60 percent of the third country exports and more than 50 percent of the total exports of Nepal in FY 1991/92. This is one of the industries giving employment opportunities to a large section of labourers. In Kathmandu valley there are 750 regietered firma producing carpet and giving employment to more than 110 thousand people (as of FY 1991/92). The number of unregistered firms and employment generated by these firms is estimated to be at least 50 percent of the registered ones. The destination of Nepalese carpet is mainly Germany which has a share of more than 80 percent in Nepal's export of the carpets. The sources of its raw material (raw wool) are New Zealand and Tibet of China, the former being the major source. Estimate of the input-output coefficient for this industry indicates that with one rupee worth of raw wool, two rupees worth of carpet can be produced. So this is one of the industries based on imported raw materials which can generate nigher level of value added in the course of manufacturing. The following table gives the export of carpet in quantity and value for the last five years.

Table 3.1 Export of Carpets from Nepal

Fiscal Year	Ouantity Exported (in Sq. Meter)	Export Earning (Rs. in Million)
1987/88	802,100	1211.78
1988/89	913,582	1589.19
1989/90	1,152,265	2294.69
1990/91	1,628,318	3701.99
1991/92	2,371,451	7130.93

ource: Trade Promotion Centre, Pulchowk, Nepal.

3.1.2 The government has fixed the floor price of carpets with a view to control their quality and to minimize the problem of underinvoicing of export receipts. Accordingly, the minimum price for unwashed carpets is fixed at 60 U.S. Dollars per square meter and that for washed ones is 65 U.S. Dollars. Although the fixation of minimum price has taken care of the possibility of underinvoicing of export value and thus the generation of parallel market of foreign currency from the supply side, the same is observed to have created the parallel market from the demand side. As the market price of carpet exports is found to be lower than the floor price fixed by the government, carpet exporters exporting their product at less than the official price have to go to the informal market to buy foreign currency to make up for the difference between market price and official floor price of the carpets. This however does not imply that all the carpets are exported at higher declared price than it's actual market price. There are many carpets, which fetches significantly higher prices because of its quality-in terms of materiala used ae well as the design. So there also exists a possibility that the demand for foreign exchange generated by the lower export price in comparison to the floor price may be financed from the same industry where surplus of foreign exchange is generated through sales of quality carpets at a price higher than the floor price.

3.1.3 To examine the extent of parallel market in foreign exchange generated by carpet industry, a sample survey of the production and salee prices of carpet of different firms was conducted in Kathmandu. For conducting the survey, total number of carpet producing firms in Kathmandu along with the capital invested and number of employees of each firm was obtained from the Department of Industry. Then, in order to adopt a stratified sampling technique, the carpet producing firms were classified into small, medium and large firms based on the capital invested in the industry. Firms having capital investment of up to one million rupees were considered as small firms, with investment between one to 5 million rupees as medium, and firms with investment exceeding 5 million rupees as large ones. Then a random sample of 20 firms from the small group, 10 from the medium group and 5 from the large group of firms was taken in order to conduct the survey. A questionnaire was developed to gather information regarding the types of carpet produced, the sources of raw materials, the cost of production and the salee price. Of the sample chosen, the survey team however, could get the response from only 12 small, 8 medium and 5 larger firms producing carpets.

3.1.4 The survey exhibited that most of the carpets woven were of 60 knote followed by a few of 80 knots. Of the firms surveyed, 85 percent used to weave 60 knots carpets, 10 percent used to weave both 60 and 80 knot carpets and Only 5 percent used to weave carpets of more tnan 80 knots. Regarding the raw materials used, ae many as 45 percent of the producers were found to use 80 percent New Zealand wool and 20 percent Tibetan wool whereas 30 percent of the producers were found to use 75 percent New Zealand and 25 percent Tibetan wool. However, 15 percent of the firms were found to use New Zealand wool at less than or equal to 70 percent and Tibetan wool at more than or equal to 30 percent. Only 10 percent firms used New Zealand wool at more'than 80 percent of the requirement. This indicates that the major source of raw wool is. New Zealand with Tibet supplying about 20 percent of the raw wool consumed in the process of carpet production.

3.1.5 The survey indicate that the average cost of production of 60 knot carpets is Rs 1,825 per *square* meters (for unwashed ones). Adding washing cost of an average Rs 125 per square meter, the total cost of production for washed carpet comes at Rs 1950 per square meter. The average sales price per square meter as observed in the survey is Rs 2060 or 42 U.S. Dollar (at the exchange rate of 1 U.S. Dollar = Rs 49 as of June 30, 1993). As the export of carpet in 1991/92 stood at 2'371,451 square meter, the value of export in U.S. Dollars come at 99.6 million. However, the value at the official (floor) price would be worth 142.3 million U.S. Dollar.' So there appears to be a shortfall of 42.7 million U.S. Dollar on the part of the exporters that has to be surrendered to the Nepali banking system. The exporters thus go to the parallel market for meeting their demand of the U.S. Dollar. Hence, it is estimated that due to the minimum prices set by the government on carpet exports, demand for foreign currency in the parallel market is generated worth 42.7 million U.S. Dollar.

3.1.6 From the survey it was, however, observed that of the total number of carpet producing firms covered in the sample, most were not exporters. In a situation when producers are not exporters actual export prices may be significantly different from the producers price. It is observed that although there are hundreds of producing firms, the noted carpet exporting firms are around 25 to 30 only. The latter are observed to have monopolised the export market and exploited the producers by offering a price far below the price they get for exports. In such a situation the sales price of the producers is expected to be much lower than the sales price of the exporters and our estimate of the sales price in the earlier section might have been under estimated. Hence, a separate survey of the exclusively carpet exports firms was conducted in the second stage. In this context, the export prices of 15 carpet exporting firms were collected. The survey showed the export price ranging between 42 to 65 Dollar per square meter with the mean (average) price of 49 Dollar per sq. meter and the standard deviation of 6.85 Dollars.

'Although the system of minimum floor price to be fixed by the government has bttn abolished, it has bean replaced by a system wherein the concerned association of the businessmen themselves will advice the government on the prevailing price as a reference price below which export will not be allowed. However, the post-floorprice abolition period shows the reference prices not much significantly different from the earlier one.

It was also observed that moot of the carpets exported were washed ones which have the minimum (floor) price of 65 Dollar per square meter. The survey thus indicates that there is a deficit of foreign exchange equal to 16 Dollar per sq. meter of carpet exported. As 2,371 thousand sq. meter of carpet was exported in 1991/92, given the floor price of 65 Dollar per sq. meter, some 37.9 million US Dollar worth of foreign exchange was short for the exporters to surrender to the banking system. This implies that the demand for foreign exchange equivalent to Rs 1857 million (US Dollar 37.9 million) was placed in the parallel market to meet the foreign currency need of the carpet exporters. Thus, it is observed that minimum export price of carpet has been a major contributory factor for the emergence of parallel foreign currency market.

3.1.7 Although the government has abolished fixation of minimum floor price for carpets, the Federation of Nepalese Chambers of Commerce and Industries has been opting for the prices as the indicative floor prices and export valuation is done in the same basis. Therefore, there is still the existence of parallel market due to administered export prices of carpets.

3.2 Merchandise Imports from Third Countries

3.2.1 In an attempt to diversify foreign trade and reduce dependence on India for exports as well as imports of the necessary items, Nepal adopted various policies in the areas of trade and exchange rate regimes since early 1960's. As a result, Nepal's third country trade increased from 18 percent of total trade in 1974/75 to more than 50 percent in 1979/80, and more than 75 percent in 1989/90. As of 1991/92, the share of third country trade on Nepal's total imports stood at 59 percent. The payments of this import has to be made in convertible currencies and bulk of the transactions is in U.S. Dollar.

3.2.2 Imports duty and sales tax levied on third country imports are the principal sources of revenue of the government. Sales tax is collected on the source at the customs point. Besides, income tax is also collected from the imports on the basis of the total amount of imports. The customs duty on third country imports hao always remained very high (ranging from 5 to 110 percent in July 1993). Because of the high tariff, there is always an incentive to the importers to underinvoice the imports and evade customs duty as well as sales tax.

3.2.3 In a situation of high customs duty and sales tax on the one hand and the existence of the parallel market on the other, the importers have a choice to finance their imports either from the formal market or from the parallel market. While making the choice, they compare the cost and benefit between the government taxes and the premium rate of foreign exchange in the parallel market. If the premium of foreign exchange is lower than the tax, there is an incentive to the traders to under-invoice his imports and finance the foreign exchange requirement arising out of underinvoiced trade from the parallel market and make a profit.

3.2.4 In the past, there was a tendency to over-invoice imports and sell foreign exchange in the parallel market. This still applies to the items with low customs duty such as industrial raw materials, machinery and other capital goods. On the other hand as there was a subsidy on specific exports ranging from 5 to 20 percent in the early 1980's, exports also used to be overinvoiced to get large amount of subsidy. For surrendering foreign exchange to the banking system to the export of overinvoiced amount, the exporters used to resort to the parallel market. Now the situation has changed. With the devaluation of Nepalese rupee by 14.7 percent in November 1985 subsidies on third country exports was withdrawn. Minimum impart duty rate has been increased from 1 percent to 5 percent. and the customs office has its own valuation of the imported goods. Hence, there is no incentive for overinvoicing of exporte. For imports overinvoicing, whatever it exists, is up to the level of minimum valuation of the customs.

3.2.5 In order to examine whether third country imports are being underinvoiced or not and financed frnm the parallel market or not, the research team made an observation and held informal discussion with many traders, customs officials and related governmental officials. It was learnt that praotioo of underinvoicing imparts is quite rampant and this is being financed through the foreign exchange generated in parallel market. It was also learnt that agents or traders in Hong Kong or Singapore quite easily help in manipulating the import documents for the Nepali importers.

3.2.6 In order to examine the process and magnitude of underinvoicing of imports, the research team obtained a list of some 50 items for which the effective tariff rate (basic duty, additional duty, countervailing duty and sales tax) is higher than 50 percent. It is mainly because items with higher tariff rate are naturally more susceptible to underinvoicing . Secondly, the research team collected the customs valuation of these selected fifty items from the Customs Valuation Book 1992/93. The official valuation price and the total tax on these items were added together and thus derived the landed price of the imported items. Then the research team collected the prevailing wholesale price of these selected items in the Kathmandu market.

3.2.7 With these information at hand, an attempt was made to identify whether the Customs Department's valuation for these items were under/over valued. As under the present OGL (Open General License) system , any importer is free to import such goods which he finds to be profitable, the traders involved in such business state that the rate of profit worke out around 2.5 per cent. If there exists abnormal profit in excess of this, new firma can always enter into this business thus driving it lower. Therefore, if this difference exceeds 25 percent, it waa aasumed that the item is undervalued and subsequently the underinvoiced part of the foreign exchange is financed from the parallel market. In fact, this 25 per cent is not a strict rule. Even though the entries by new agents are free which would theoretically drive down the profit margin below this magnitude, the return on alternative investments with lesser risks exceed 13 per cent, the benchmark on term deposits at commercial banks. It is in this context(in terms of higher risks) that: 25 per cent has been considered as normal profit in this line of business.[2] The compiled data of selected 50 items of which the landed cost and wholesale price in the local. market are estimated in this study are presented in Table 3.2.

3.2.8 The Table 3.2 givee the list of the selected items, their market price, custom valuation, effective tariff ,the landed price of the imported items and the market price. It is obvious from the table that the landed price of these selected high tariff items has always remained lower than the market price. The difference between the two prices ranges from 28.7 percent (video cassette recorder) to 893.6 percent (camera). This may be because of higher demand of many of these goods in India as some of these items are still restricted in India and the demand being met through imports from Nepal. Thirty-one out of the fifty items in the sample show market price higher by more than 100 percent compared with the landed price baaed on the custom valuation. Thus on the basis of theoe findings it is observed that imports from overseas countries are undervalued by the customs authorities. Thus importers are obtaining foreign currencies from the parallel market in order to finance such underinvoiced imports.

3.2.9 In order to assess the magnitude of demand for foreign exchange from the parallel market for such under-valued imports a list of imported items from overseas countries was obtained from the Department of Custom6 HMG, for FY 1991/92. We collect the quantity and price of items selected in our study. Next, we obtained the percent under/overinvoicing (after allowed 25 percent as a normal business profit). Then we calculate the amount of foreign exchange needed for importing theee items from the parallel market (see Table 3.3). Cosmetic goods, dry sell battery, electric goods (such as refrigerator, emergency light), photographic films and papers, bearing, calculator, poleyeeter textile, shoes were the important items demanding higher amount of foreign exchange from the parallel market. The estimation shows that about

[2] In fact, this 25 per cent is not a strict rule. Even though the entries by new agents are free which would theoretically drive down the profit margin below this magnitude, the return on alternative investments with lesser risks exceed 13 per cent, the benchmark on term deposits at commercial banks. It is in this context(in terms of higher risks) that 25 per cent has been considered as normal profit in this line of business.

Table 3.2 Government Valuation and Market Price of Selected Imported Goods in Nepal.

(In Rupee)

No.	Items	Specification	Market price	Custom Department Valuation	Effective Tariff (in Percentage)	Official Valuation	Over/Under Invoice (in Percentage)
1	Air Conditioner	1.5 tons	90000.0	20043.5	154.4	50990.7	76.5
2	Audio Cassettes	Per Piece	55.0	11.4	71.6	19.5	181.6
3	Bag and boxes	16" Lenght	1280.0	121.5	65.6	200.8	537.5
4	Bearing	No. 360	65.0	14.8	65.6	24.6	164.4
5	Ball Pen with watch	Per Dozen	420.0	107.2	50.7	161.5	160.0
6	Beer	per Cans	65.0	14.9	203.6	45.1	44.2
7	Calculator	Citizen 10 Digits	595.0	61.9	69.7	105.0	466.9
8	Camera	Yashica with Flash	2850.0	173.2	65.6	286.8	893.6
9	Cassette Player	National	9000.0	1237.3	103.6	2518.4	257.4
10	Cigarettes	555 per 200 stick	390.0	148.5	103.7	302.4	29.0
11	Cutlery Set	Thailand Made	295.0	34.1	59.6	54.4	442.7
12	Dry Battery	Dozen	180.0	28.2	53.5	43.3	315.6
13	Emergency Light	Rambo	910.0	160.8	59.6	256.7	254.5
14	Fan	Table Fan 16"	1450.0	655.7	57.3	1031.5	40.6
15	Fax	Canon	89000.0	15836.8	76.6	27967.8	218.2
16	Gogals	Taiwan Made	300.0	42.8	65.6	70.9	323.2
17	Hair Dryer	(LS 828)	550.0	155.9	58.7	247.4	122.3
18	Lighter	Per Dozn	120.0	28.8	65.6	47.7	151.5
19	Mini bus (over 35 seats)	Japanese	600000.0	223678.0	53.5	343569.3	74.6
20	Mixer/Juicer/Grinder	Super Blender	1800.0	196.9	112.4	418.3	330.3
21	Car	Toyota Car	800000.0	236521.0	154.4	601709.4	33.0
22	Motor Cycle	CG 125 Honda	192000.0	74411.4	58.7	118090.9	62.6
23	Photographic Films	Kodak (Dozen)	1920.0	450.4	59.6	718.8	167.1
24	Photographic Papers	Konika (Roll)	4300.0	1237.3	59.6	1974.7	117.8
25	Playing Cards	Dozen	744.0	90.7	94.4	176.4	321.8
26	Polyster Textiles	Roll of 20 meters	9128.0	989.8	77.8	1757.9	419.3
27	Radio Transistor	National	1200.0	~~229.6~~	~~72.5~~	~~396.1~~	~~202.9~~
28	Refrigerator	125 Liter, National	26500.0	4746.1	65.6	7859.5	237.2
29	Rice/Pressure Cooker	6 liter National	2150.0	742.4	58.7	1178.1	82.5
30	Scotch Whisky	Red Label One Ltr.	885.0	333.1	58.7	528.6	67.4
31	Shoes others	Trekking (Per Dozen	10800.0	2960.4	69.2	5024.2	115.0
32	Leather Shoes	Per Piece	450.0	150.0	72.9	259.4	73.5
33	Sleeping Bags	Per piece	2400.0	1187.8	65.6	1967.0	22.0
34	Stapler Machine.	HD-10 Per Dozen	660.0	185.6	59.6	296.2	122.8
36	Table/Deco/Room Lamp	Singapore Made	250.0	51.7	60.6	85.7	191.9
37	Baby Powder	Singapore Made	100.0	12.9	65.6	21.4	366.7
38	Television Color	20" SONY	47000.0	16084.3	103.6	32739.5	43.6
39	Toaster	NT-131 (National)	1525.0	418.2	58.7	663.7	129.8
40	Toilet Soap	Lux Per K.G.	225.0	85.6	59.6	136.6	64.7
41	Toys (other)	Dozen	600.0	133.4	65.6	220.8	171.7
42	Typewriter Ribbon	Japanese	250.0	99.0	59.6	158.0	58.3
43	Vacuum cleaner	Per Piece	5600.0	1237.5	94.4	2405.2	132.8
44	Video Cassettes Recorder	National, Japan	35000.0	13362.3	103.6	27190.0	28.7
45	Video Cassettes Tape	120 minutes	245.0	44.5	71.6	76.4	220.5
46	Video Games	9 games per set	2200.0	215.3	65.6	356.5	517.1
47	Washing Machine	National N.A.	16000.0	4503.6	94.4	8755.0	82.8
48	Watch all Kind	Seiko Quartz	3350.0	517.2	77.6	918.5	264.7
49	Woolen Textile	Per meter 58"-62"	562.5	225.2	59.6	359.4	56.5
50	Zip Fasteners	Per Gross	720.0	222.7	112.4	473.0	52.2

Source: Customs Tariff, Complied by Nepal Overseas Trade Association. Retail price was collected on 15-17th June 1993, in Kathmandu Market.
Exchange Rate 1 \$ = 49.49 (Selling Rate of Nepal Rastra Bank)

Table 3.3 Estimated Demand for foreign Currency in the Parallel Market for Imports Finance

No.	Items	Unit	Quantity of Imports	Official Valuation (Rs. Million)	Under invoicing (In Percentage)	Foreign Currency Demand in the Parallel Market (Rs. Million)
1	Air Conditioner	Piece	345	2.367	76.50	1.22
2	Audio Cassettes	Dozen	26042	4.05	181.58	6.34
3	Bag and Boxes		NA	NA	537.48	0.00
4	Bearing	Dozen	94799	27.387	164.37	38.17
5	Ball Pen with watch		NA	NA	160.00	0.00
6	Beer/Liquor	Cans	4321	0.546	44.17	0.10
7	Calculator	Dozen	13753	6.86	466.87	39.15
8	Camera	Piece	13	0.611	693.57	5.31
9	Cassette Player	Piece	405	0.093	257.37	0.22
10	Cigarettes		NA	NA	28.97	0.00
11	Cutlery Set	Dozen	6074	2.483	442.68	10.37
12	Dry Battery	Dozen	1019030	28.765	315.48	83.56
13	Emergency Light	Dozen	6525	12.334	254.49	28.31
14	Electric Fan	Piece	12505	6.491	40.57	1.01
15	Fax	Piece	146	4.638	218.22	8.96
16	Goggles	Dozen	4091	2.102	323.17	6.27
17	Hair Drier	Piece	41530	2.946	122.31	2.87
18	Lighter	Groce	4509	1.559	151.52	1.97
19	Mini bus (over 35 seats)	Piece	59	13.197	74.64	6.55
20	Mixer/Juicer/Grinder	Piece	7490	1.475	330.33	4.80
21	Car	Piece	401	94.845	32.95	7.54
22	Motor Cycle	Piece	158	11.757	62.59	4.42
23	Photographic Films	Dozen	70253	23.443	167.12	33.32
24	Photographic Papers	Roll	24746	22.868	117.78	21.21
25	Playing Cards	Dozen	17943	2.296	321.61	6.81
26	Poleystar Textiles	Meter	172776	6.65	419.26	26.22
27	Radio Transistor	Piece	405	0.093	202.94	0.17
28	Refrigerator	Piece	4737	16.039	237.17	38.27
29	Rice/Pressure Cooker	Piece	7280	4.125	82.50	2.37
30	Scotch Whisky		NA	NA	67.43	0.00
31	Shoes others	Pairs	350680	17.986	114.96	16.18
32	Leather Shoes	Pairs	21726	3.266	73.51	1.58
33	Sleeping Bags	Dozen	9076	4.806	22.01	-0.14
34	Stapler Machine	Dozen	5734	0.42	122.82	0.41
35	Synthetic Carpet	Sq.meter	52314	7.35	90.69	4.83
36	Table/Deco/Room Lamp	Piece	17720	0.951	191.66	1.59
37	Baby Powder	Doze	207365	32.202	366.67	110.02
38	Television Color	Piece	3983	40.01	43.56	7.42
39	Toaster		NA	NA	129.78	0.00
40	Toilet Soap	Groce	12121	11.58	64.66	4.59
41	Toys (other)	Dozen	76662	10.624	171.68	15.58
42	Typewriter Ribbon	Dozen	616	0.129	58.26	0.04
43	Vacuum cleaner	Piece	770	0.76	132.83	0.82
44	Video Cassettee Recorder	Piece	960	11.749	26.66	0.43
45	Video Cassettee Tape	Dozen	6496	4.021	220.54	7.66
46	Video Games	Piece	8964	1.727	517.10	8.50
47	Washing Machine	Piece	674	2.22	62.75	1.28
48	Watch all Kind	Piece	19243	3.102	264.73	7.44
49	Woolen Textile	Yards	27148	2.641	56.52	0.83
50	Zip Fasteners	Groce	4019	1.043	52.21	0.28
	Foreign Exchange Demand from Parallel Market					574.6

Source: Compiled tom Customs Trade Statistics, Imports from Over Seas Countries
Department of Customs, Ministry or Finance

Note: Official Valuation in this Table refers to the total value of imports as recorded by the Customs Department whereas official valuation in Table 3.2 refers to unit price.

Rs 574.77 million wae demanded from the parallel market to import the selected 50 items in FY 1991/92.

3.2.10 Of the total 284 commodities listed in the Customs' Book of Tariffs, there are altogether 80 commodities liable to an effective tariff of 50 percent or more. As our sample covers only 50 items, the demand for foreign exchange in the parallel market for financing the undarinvoiced portion of the imports is only a certain portion of the demand. Further there are some 195 commodities which are liable to an effective tariff of more than 25 percent. There is every possibility to underinvoice the import price of these items given the premium of Dollar in the parallel market at less than 25 percent. There are only 90 commodities for which the effective tariff is less than 25 percent. Only 12 commodities enjoy effective tariff at less than 10 percent. Since the present parallel market premium is also around 8-10 percent, these are the only commodities for which underinvoicing will not be beneficial for the importer. For rest of the commodities there is ever possibility of underinvoicing if the customs valuation is lower than the imported price. Thus the demand for convertible currency in the parallel market may be substantially higher than that mentioned above.

3.2.11 It is also a common practice in Nepal to overinvoice imports of items with low tariff rate (mainly industrial machinery and industrial raw materials) which might have been helping finance a part of demand created from the underinvoicing of imports. Customs valuation does not safeguard this type of overinvoicing because the list does not cover these goods and also the valuation is only the minimum price.

3.3 Imports from Tibet

3.3.1 Trade flows between Nepal and Tibet, an Autonomous Region of China, takes place under the provision of Nepal-China Trade and Payments Agreement of May, 1974. Under this agreement there is no provision for providing foreign exchange for imports from Tibet. So the trade between Nepal and Tibet has to be necessarily conducted *on barter* basis.

3.3.2 Nepal borders with Tibet of the People's Republic of China in its north. The two countries are connected by Kathmandu Kodari highway constructed under the Chinese aid. This highway connects Kathmandu with Khasha which is a small town in the Tibetan Autonomous Region of China. There is a free movement of people of hoth the countries living within a distance of 15 kilometres from the border. Barter trade exists between the two countries mainly because the Chineee currency (Yuan) and Nepali rupee are not convertible currencies. Looking at the nature and size of the trade it is obvious that not all trade takes place on barter basis. Hence, the possibility of parallel market's foreign exchange involvement in this trade.

3.3.3 In order to gather necessary information in this regard, the research team viaited the Trans-Himalayan Trade Association in Kathmandu. In an informal discussion, it was explored that the amount of imports from Khasa is many times higher than the exports, and the trade deficit is mainly settled in Nepalese rupee. It was curious to know how the Nepali rupee on the Khasha market could be converted into Chinese Yuan and other convertible foreign currencies. Hence, a team of two research economists made a visit to the Khasha market for the survey.

3.3.4 While visiting the Khaeha market the research team met with the Nepalese customs authorities in the Taropani Customs Office and gathered necessary information regarding the trade. From the discussion it was found that rice, wheat flour, dried chilly, vegetable ghee, spices, noodles, garlic, green vegetables etc. were the principal exports of Nepal to Tibet. But recently exports to Tibet has gone down. Similarly, Chinese products such as raw wool, cotton textile, canvas shoes, synthetic textile, kitchen equipments, torch Light. umbrella, liquor, cigarette, toilet soaps, shampoo etc. were the principal items imported into Nepal. It was also observed that a significant part of the imports from khaeha market entered Nepal through the jungle to Dolakha and Sindhupalchowk districts before reaching Kathmandu to avoid the customs duty. The team also felt that some under invoicing of the imports was evident.[3] On an average, the total volume of imports other than raw wool from Khasha is estimated to be between Rs 1.0 to 1.2 million (average Rs 1.1 million) per day. The shops in the Khasa market are closed on Sundays and other republic holidays, thus they work for around 300 days a year. Hence, the total volume of imports from Khasha works out at Rs 330 million (66 million US Dollar) per annum. On the export front, total export from Nepal is estimated to be around Rs 30 to 40 million (1.75 million U.S. Dollar per annum). Thus there remains a trade deficit of 64.25 million U.S. Dollars which need to be financed from the parallel market.

3.3.5 Of the total imports, raw wool accounted for about U.S. Dollar 44 million in FY 1991/92 which constituted for 40 percent of the total value of imports from Khaeha.[4] There is no customs duty on raw wool because this is an industrial raw material. Commercial banks in Nepal provide foreign exchange in the form of bank draft for the payment of raw wool. Since, there is no

---

[3] As the goods exported to Khasa market from Nepal does not come under the perview of minimum floor price and also because the trade with Tibet takes place officially under the barter system, thus possibility of undervalution of export from Nepal does not arise.

[4] Even though officially trade with Tibet has to take place under barter system, because of its special nature the required amount of foreign exchange for procuring raw wool is provided by the banking sector. Thus this effectively means 40% of the Tibet trade is of the parallel market.

provision of foreign exchange for the payments of remaining items, there is a need for alternative source of financing the trade deficit

3.3.6 While visiting the Khaeha market, the research team found that the traders in the market used to quote the price in Nepali rupee and they accept Nepalese currency as an usual mean8 of payments. In reepcnse to the enquiry of the research team, themerchants told that they submit the Nepaleee rupees to the wholesalers who either supply them with goods or they exchange the Nepaleee rupee for Chineee Yuan with the wholesalers. The exchange rate of Nepaiese rupee with the Chinese Yuan was Rs 6.0 for one Yuan on June 5, 1993 (the time of the field visit).

3.3.7 Discussion with the bigger traders or wholesalers revealed that they exchanged the Nepalese rupee thus collected in Khasha for U.S. Dollar with the Nepalese foreign exchange dealers operating in the parallel foreign exchange market in Kathmandu. It wae also discovered that there are some people exclusively specializing in trading and transferring Nepaii rupee and Dollar between Kathmandu and Xhasha market. Quite against the general impression, some Tibetan traders were also reported to spend a part of their holding of Nepaleee rupee in purchasing gold bar or gold jewellery from the kathmandu market. The size of such transactions, however, in unknown. Some of the Nepali traders make payments to the Tibetan traders in Hong Kong and at other parts of China through Hundi (denominated mainly in U.S. Dollar) rather than physical movement of convertible currency itself.

3.3.8 Beside Khasa, Olangchung Gola in Taplejung district and Tinker in Darchula dietricta are other two trading passes between Tibet and Nepal but the volume of trade from these points is very limited due to lack of road transportation facility.

3.3.9 Taking into consideration the growing trade between Xathmandu *and* Khasa, it is conservatively ootimatad that about U.S. Dollar 60 million per annum in demanded from the parallel market to finance the imports from Tibet of the People's Republic of China. From section 3.3.4 total imports value(except raw wool) io estimated at U.S. Dollar 66 million and export0 valuo at U. S. Dollar 1.75 million leaving a trade imbalance Of U. S. Dollar 64.75 million. Accounting for Nepal's export to Khasa in Nepalese rupees including gold (section 3.3.7), a net payment deficit of U. S. Dollar has been estimated.

3.4 Gold Import

3.4.1 Traditionally, gold has been playing a dual role in the area of parallel foreign change market. On the one hand it is a perennial source of demand for foreign exchange and on the other it is a yardstick for fixing the premium of foreign exchange vis-a-vis the official bank rate.

3.4.2 Demand for gold: Gold is normally demanded in Nepal for meeting: (a) social requirement such as marriage, festival etc. (b) as an alternative instrument of saving as a hedge against inflation and exchange rate, (c) for meeting emergency requirements (a precautionary motive) and more importantly, (d) for re-exporting to India.

3.4.3 Out of these various sources of demand for gold, the volume of social requirement demand and precautionary motive demand of gold depends on the activities within the country. The quantity of gold demanded for making it as an alternate instrument of investment depends on the price movement of gold in Nepal. Till recently the price movement of gold has consistently been beating the general inflation rate. The volume of demand for gold in Nepal for re-exporting is governed by (a) the price differential of gold between Nepal and India (b) demand for gold in India. Regarding the price differential, it has consistently been lower in Nepal compared to that of India. It is because import of gold was more restrictive in India compare to Nepal. Also in terms of volume of gold, the demand in India exceeds that in Nepal by many folds.

3.4.4 Supply of Gold : The sources of gold supply in Nepal are: (a) import by staff and/or dependents of British Army working mainly in Hongkong, (b) imports under the baggage rule and (c) smuggling. All the smuggled gold can be safely presumed to be destined for India. Gold brought under baggage rule is normally catered for the internal demand. Regarding gold imported by British Gorkha soldiers, certain portion of it is consumed within the country while the remaining portion is smuggled into India through the traders.

3.4.5 Demand of gold in India: If it is only for meeting the internal requirement, not much foreign exchange would have been demancted from parallel foreign exchange market in Nepal. Gold being imported by British Army (Gorkha) people and the gold being brought under baggage rule can be safely assumed to be adequate for Nepal's internal requirement. It is because of insatiable demand for gold in India that foreign exchange is demanded from parallel market in Nepal. The incentives for re-smuggling of gold from Nepal into India are as follow: (a) price of gold is substantially higher in India as compared to international prices (b) gold price in Kathmandu is marginally lower vie-a-via the price in the Indian market, and (c) there is tremendous demand for gold in India. On top of all these factors, there is open border between the two countries and Indian rupee is freely convertible into Nepalese rupee. So all these factors make gold smuggling into India an attractive informal business.

3.4.6 World Gold Council has estimated the annual demand far gold at 2800 Metric tone. As compared to this the Indian demand has been calculated a6 230 Metric tone (The Economist, April 10, 1993). This shows the appetite for gold in India. This fact has been more or less corroborated by one study done in India. As per the finding of that study the average annual volume of smuggled gold into India is around 150 metric tons (Economic Times 27 Feb., 1993).

3.4.7 Premium Fixation: Because of the overwhelming volume of foreign exchange demand from the parallel market for meeting the requirement of gold, it plays a crucial role in fixation of the premium on foreign exchange. Before we go into the detail mechanism of premium fixing, one thing should be clearly understood that even though parallel market operate separately in India and Nepal, the premium in Nepalese market is a perfect reflection of the premium being carried in India at a particular time. This is quit2 understandable in the context of absence of any exchange control between Nepali rupee and Indian rupee. Otherwise any discrepancy in the premium will automatically generate arbitrage in any of the two markets.

3.4.8 Based on the informal. discussions with persons directly or indirectly involved in the business of parallel foreign exchange market the modus operandi of this *business* runs like this: (i) gold price in India and (ii) Gold price (international) are taken as the exogenous factors. The difference in the prices of these factors normally creates premium in the local gold market. This premium is generally reflected in the parallel foreign exchange market. For example; present international price of gold is around U.S. Dollar ***395*** per oz. This is equivalent to U.S. Dollar ***146 per*** tola ***(21.66*** gramme). The local price per tola is Rs. 8300. From this scenario the cross rate of Rs 56 per U.S. ***Dollar emerges.*** Out of tnis some amount (normally between Rs 1 to 2, baaed on the demand and supply) has to be deducted for transaction costs, profit margin and interest coat etc. This will lead us to the Hundi rate of Rs 54-55 per Dollar-which is the rate right ***now*** prevailing in the market.

3.4.9 In the first seven months of FY 1992/93, Nepali customs confiscated 113 kgs of gold. Assuming only 25 percent of the illegal import being confiscated, total imports during the periood totals 452 kgs. Considering international price of gold at U.S. $395/oz., a total of 15910.4 oz (=452 kg) of gold import required U.S. 63 million, which was supplied by the parallel market. Annualizing this, the ***amount*** of hard currency demanded in the parallel market for financing gold import during 1992/93 works out to be 10.6 million U.S. Dollars. However, to assume that 25 percent of the gold smuggled is confiscated is a very optimistic estimation. As confiscations occur only as an error in the smuggling mechanism (such as sudden transfer of the customs officials, revenue intelligent officials, other law enforcement officials from the duty in International Airport, and informations provided by Interpol regarding the gold smuggling), it can be said that not ***even 10 percent of the*** smuggled gold is confiscated. In this situation the illegal import of gold and hence the demand for foreign currency in the parallel market should be substantially higher than that estimated above.

3.5 Baggage Rule

3.5.1 The introduction of baggage rule in Nepal has a politico-economic connotation. After Tibet became an autonomous region Of the People's Republic of China in mid-1950s, some of the Tibetans found their way into Nepal as refugeee. The level of economic activities in the Nepali Himalayan region bordering Tibet region of China wae very thin. This thinness was more severe as one climbed up the high mountains. Trade waa the mainstay of life there. If nothing was done to improve the economic well being of the people in thooe high hills, they could collaborate with the Tibetan refugees in an insurgency against Chinese governance in Tibet. The Nepali government did nnt like that to happen. To preempt this outcome late king Mahendra not only allowed but also encouraged once a year business visit by mountain people of Nepali origin to overseas countries. On their way bock, they brought consumer goods for sale and made some profit. Another motive for officially (but informally) encouraging such practice was driven by a desire to maintain a balance between northern Himalayan region bordering Tibet (with thin, seasonal and sparse economic activities) and people in the south bordering India (with a much denser and higher level of economic activities). The long, and easily accessible border accompanied by much higher level of protection than prevailing in India encouraged deflection of the import under baggage rule to the Indian market at a much higher level of premium over comparable alternative investments.

3.5.2 In due course of time, this premium attracted people beyond initially designated community. There is as yet no estimate of the relative size of the imports from overeeas under baggage rule vie-a-vie imports from the same sources via official channels. Before initiation of imports liberalization this wae sizable. This increased further with extension of Nepalese Airlines Services to international destinations and access to Kathmandu by international flights.

3.5.3 This is interesting to ask: what are the factors that encouraged thie mode of imports. Three such factors have already been outlined. They are: (F) deliberate official inducement, (ii) high level and rate of protection in India and (iii) increased international air-traffic density in Nepal. Still more attractions can be identified. One of them is the over-valuation of official exchange rate of Nepali Rupee vie-a-vie all international currencies. This increased demand for overseas merchandise imports both in Nepal as well as in India. Finally lax and corrupt tariff administration in both countries also facilitated the perpetuation of this type of transaction. What follows is an attempt to assess the magnitude of transaction in the parallel market.

3.5.4 After keeping the permissible foreign exchange facility fixed at equivalent to U.S. Dollar 100 per passport per year for many years, it was raised to U.S. Dollar 150 in fiscal year 1989/90. In succeeding years it has been raised to U.S. Dollar 300 and then to U.S. Dollar 1000. In fiscal year 1992/93 it has been raised further to U.S. Dollar 1500. The proposed budget does not alter this amount, but makes some adjustment in tax rates.

3.5.5 We now set to evaluate the magnitude of transaction in the parallel market emanating from the baggage rule. There are two component5 to be evaluated. One is the list of permissible items and quantity of import5 under- baggage rule and another is the amount of U.S. Dollar provided through the official channel to overseas traveller. The major items allowed under baggage *rule* are given below:

> Watch (one), Camera *(one),* Liquor (1 litre), Gold (3 tola), Silver (50 tolas), Cigarettes (200 sticks), Cosmetics, Shoe5 (3 pairs), Saree (3 pieces), Track suit (1 palr), shirts (3 pieces), Trousers (3 piecao), Jean Pant (1 piece), Jean Jacket (3 pieces), T-shirts, Calculator (1 piece), Electric Iron (I set), Video game (1 set), Hair Drier (1), and Others: (bra, panties, briefs, hankies, toiletries, bed-sheets, pull-overs, toys, shaving sets, sweat5 etc.)

3.5.6 In order to collect information on the volume and value of (informal) trade arising form the provision of baggaqe rule the research team made personal visits to various trading points in Kathmandu such as Bishal Bazar, Indrachowk, Jhonche, Thamel and New road. The team however could not ascertain the time series of prices of individual items. What the team could obtain was the present prices. The prices of some of the commodities put under Baggage Rule is moving downwards. However, price5 of items like textile, shoes, cosmetics and ladies wear is observing an upward trend. As such for baggage as a whole the Dollar prices (particularly in Hong Kong and Bangkok and to some extent in Singapore and Dhaka) is assumed to remain stable over a period of four years that this study takes into consideration. To arrive at the import value in domestic currency, the team multiplied the Dollar value of imports (assumed to be constant for the last few years) by fiscal year-end (mid-July) exchange rates of Nepalese rupee vis-a-vis U.S. Dollar and made a deduction of 25 percent as the profit margin of the couriers in order to get the import price at customs point. It is assumed that the maximum margin between purchase price of courier in South-east Asia and his sale price to wholesaler in Kathmandu may be up to 25 percent only because the time involved is short and secondly, it is wholesaler who finances the courier'5 travel for business. This imposes an upper limit on the courer's margin of profit.

Table 3.4 Demand for foreign Exchange in the Parallel Market to Finance Imports under Baggage Rule

Details/FY	1989/90	1990/91	1991/92	1992/93
I. NRs/U.S. Dollar Rate	29.0	43.0	43.0	50.0
II. (a) Valuation of Imports at market Price (in Rs.)	30,000	50,000	50,000	60,000
(b) Value of Imports at International Price (Rs.)	24,000	40,000	40,000	48,000
III. Official Exchange Facility				
(a) in U.S.Dollar	150.0	300.0	1,000.0	1,500.0
(b) in Nepali Rupee	4,350.0	12,900.0	43,000.0	75,000.0
IV. Demand in the Parallel Market per courier (in Rs.) (IIb-IIIb)	19,650.0	27,100.0	-3,000.0	-27,000.0
V. Other Expenses (travel and accomodation (in Rs.)	7,250.0	10.750 0	10,750.0	12,500.0
VI. Demand for U.S. Dollar After Adjusting Other Expenses (in $)	928.0	880.0	180.0	-290.0

Source: Field Survey, Nepal Rastra Bank.

3.5.7 Surveys and interviews with the business people involved in trade with courier (people who import these goods) revealed following information. Table 3.4 indicates the market value as well as value at international price of the commodities imported under baggage rule and the magnitude of demand for foreign currency from the parallel market to finance the imports not covered by the official foreign exchange facility under baggage rule.

3.5.8 In the above Table, the value of imports under baggage rule at the market price of Kathmandu, value of these imports at international price, official foreign exchange for financing the imports are estimated. The difference between the value of imports at international price and the amount of foreign exchange made available for this purpose is taken as the magnitude of demand fur foreign currency *in the parallel market.* The Table shows that each courier doing import business through baggage rule used to demand Rs 19.6 thousand (U.S. Dollar 678) per trip of travel abroad in FY 1989/90 and Rs 27.1 thousand (U.S. Dollar 630) in FY 1990/91. Adding other expediture like fooding, lodging and other miscellaneous expenses which is at least 250 Dollars the demand for foreign exchange in the parallel market per trip of travel is worked out at U.S. Dollar 928 for FY 1989/90 and U.S. Dollar 880 for FY 1991/92. Tn the subsequent years with increases in facility by a substantial amount, the scenario has changed. As the Table revels in FY 1991/92 there was a foreign exchange surplus of Rs 3 thousands per courier and the surplus reached to Rs 27 thousands in FY 1992/93 due to further upward revision on the foreign exchange facility under the baggage rule. After taking into account, other expenses the net demand for foreign exchange in the

Page 36 is missing, Sorry for the inconvenience.

3.6 Demand Prom India

3.6.1 Traditionally the parallel market for foreign exchange in Nepal has been operating in tandem wrth the Indian market. This strong nexus between the two market is mainly due to the following reasons:

(a) lack of any exchange control between the two countries
(b) more or leas the same degree of regulation in the area of foreign trade regime
(c) strong level of control on capital account type of transactiona
(d) until recently almost a total restrictions on luxury goods import

3.6.2 In this environment it is but natural that operators in both the countries conduct their transactions in close nexus. The ultimate result of this strong nexus used to bit the spillover effect of one market on the other i.e., any demand for foreign currency which could not be met from one market, will normally be met from another market. Similarly any shortage will naturally be supplied from the other market.

3.6.3 Based on the underlying demand for foreign currency from the parallel market it might juat be that money thus collected far exceeds the supply from this source. But for Hundi operator this is not even a minor problem. Any fund generated by Nepalese operator can very easily be digested, by Indian Hawala operator-the size of the Nepalese market being tiny as compared to Indian market. This operation is made both smooth and trouble free because of free and unlimited convertibility between NER and INR. In fact this LB one of the factors contributing towards significant inflows in Indian Rs. in Nepalese banking sector being observed in recent times. Presently a significant number of people are working in different parts of Asia (details in section 4.2). Partly due to the premium in foreign exchange and partly due to the practical difficulty in remitting the money from such working place to Nepal, all these worker's earning8 are being tapped by the Hundi operators.

3.6.4 Such funds normally will be disposed towards meeting the demand created within the parallel market. If somehow not enougn demand is there, then naturally it will have to be spilled into Indian market. During recent times, and specially after the liberalised foreign exchange regime, the legal import of gold has been made easier. This seems to have significantly reduced the demand for foreign exchange in the parallel market. In such a scenario, it is but natural that these surplus will be disposed in the easily available Indian market and reimbursed in Indian Rs. This is reported to be one of the factors responsible for inflows in the IRs. being seen in Nepal.

3.7 Others (Narcotic Drugs, Service Payments, and Capital Outflow)

3.7.1 *Narcotic Drugs*

3.7.1.1 The problem of drug-abuee in Nepal started after opening of Nepal to the outside world beginning 1950s. Although use of cannabis by hermits and saints dates back to time immemorial, it has never created any social problem whatsoever. In fact in some parts of Nepal, use of Bhang is still a part of feetivitiee. It is not used thereafter until the next festival session. since it Fe a wild product it does not need any financing.

3.7.1.2 Abuse of drugs an a problem etarted since the 1960's. Upto 1960a a total of 50 persons were estimated as compulsive abusers. By mid 1970s this number reached 1,000. In mid 1980s this number was estimated at 25,000. At present this *number* is estimated to range between 30,000-40,000 with Kathmandu valley alone accounting for 50 to 60 percent of the total national abuaere.

3.7.1.3 The extent of drug-abuse in Nepal is increasing in direct proportion to the number of tourist arrivals, particular-y those from the western hemisphere. In fact, between mid 1960s and mid 1970s Nepal waa considered a paradise by HIPPIES. it was hippy arrival that introduced modern kind of chemically proceesed drugs (such as LSD) in Nepal.

3.7.1.4 One of the indicators of menace is the numbers of arrests made by enforcement authorities. The following table qivee the number of drug related arrests in the recent years.

Table No. 3.5 Total Number of Drug Related Arrests in Nepal

Year	Number of Drug Related Arrests
1989	312
1990	520
1991	529

Source: The Rising Nepal, Various Issues.

3.7.1.5 In a period of 5 years beginning 1988, a total of 2,238 persona have been brought into custody. Of this 87.6 percent (1961) were Nepaleee nationals and the reet were foreigners. From *these* arrests 10,217 kqa of cannabis, 1,700 Kge. of *opium, 247* Kgs. of hashish and 42 kgs of heroin was confiscated. Of this only a small fraction may have originated in Nepal.

3.7.1.6 It is gradually being realized the Nepal is developing into a transit point between golden triangle (Burma, Laos and Thailand) and golden crescent (Pakiatan, Afgiatan and Iran) (both are the major producers) and other part of Asia, Europe and U.S.A. The international nexua operating in drug trade in Nepal has been so wide and diverse that some arrests and raids have involved even Liberian, Nigerian, Kenyan, Thai, Ethiopian, Pakistani, Bangladeshis, Burmese, Chinese and Indians. It is also observed that flow of narcotics and contraband gold from Tibet to Nepal is on the rise. Even some embassies such as North Korean, Burmese, British, German, and Soviet were alleged to be involved in trafficking in illegal business.

3.7.1.7 So far, there is no precise estimate of number of drug user8 and amount of their consumption. Various sources estimate the number between 25.000 to 40,000. Similarly, their daily consumption amounts anywhere between Rs. 500,000 to Rs 2,500,000. On an annual basis this works out in the range of Rs 182.5 million to Rs 912.5 million. As most of the supply source originated either in golden triangle or golden crescent or partly also in India, this consumption generates a demand mostly for convertible currency which invariably is met through parallel market.

3.7.1.8 The question now arises, how is this met. As was outlined above, Nepal is growing into a transit point between golden-triangle and golden crescent on the one hand and western Europe and U.S.A. on the other. This intermediation between producers and consumer6 involves participation of Nepalese drug traffickers as well. Of course, the commission thus made should be in convertible currencies. Whether this source of financing is sufficient, deficient or surplus is an issue for a separate and independent enquiry.

3.7.1.9 Taking advantage of autarkic trade regime pursued by Indian authorities so far, the illegal Dollars thus earned is recycled in buying gold, electronic and other goods and reexported to India through Nepal. With the pace of economic reforms taking place in India, this arbitrage can not be expected to last long.

3.7.2 **service Payments**

3.7.2.1 Other likely factors causing demand for foreign exchange are financing of education and medical treatment overseas. In the past some portion of the foreign exchange required for these services were reported to be financed from the parallel market, mainly on account of the bureaucratic red-tapism it has to go through. With recent liberalizations, however, this demand is being accommodated by the authorities through simplified procedures for the sanction of foreign exchange for these services payments. If one gets admission in schools abroad, the document of the admitted school is to be submitted to the HMG/N Ministry of Education and the endorsement by the latter makes him eligible for the foreign currency facility.

3.7.2.2 In the case of medical treatment too, if the board of doctors constituted by the government attests that the treatment can not be undertaken in Nepal, Nepai Rastra Bank has been providing the foreign currency to the required extent. Hence, it is observed that the demand for foreign exchange for these service payments is almost fully met by the institutional sources itself. So, if it is having any effect in the parallel market,presumably it Fe working through the supply aide.

3.7.2.3 The existing regulation regarding the foreign exchange facility provided for medical expenses requires the concerned person to submit documentary evidence covering at least 65 percent of the amount made available. Any amount not covered by this document requires to be returned in foreign currency itself. But in practice this regulation is hardly enforced-The role of Rastra Bank in this connection has been limited only in not providing foreign currency facility for such persons for subsequent medical treatments. Any follow-up measures to actually force the concerned persons to surrender the unspent amount has not been undertaken so far.

3.7.2.4 As there is no mechanism to follow up the cost incurred in such services abroad, and other miscellaneous expenses any amount left on return to Nepal is likely to be directed to the parallel market as it still attracts a premium over the market rate.

3.7.3 Capital Flight

3.7.3.1 Demand for torergn exchange for capital flight takes place either to aviod income and property tax, to prevent capital loss from exchange rate changes, to earn higher return through interest rate differentials, to safeguard the illegally earned property or to transfer family assets for political or social reasons (such as the anticipation of future reprisals). As there is capital control in Nepal, demand for foreign exchange for these purposes is to be met from the parallel market. As discussed in the second chapter, there are various ways to earn illegal property and the fear of confiscation of such property lures one for capital flight. Furthermore, even the foreign nationals who have illegally earned property in Nepal and want to repatriate it, will have to resort to the parallel market; as they cannot show the source of their income and hence the authorities would refuse to grant exchange permission through the banks.

3.7.3.2 Nepal has recently introduced property tax which is supposed to encourage capital flight. But the foreign currency needed for this purpose is not necessarily the convertible currency, the non-convertible (Indian) currency has been serving this purpose to a large extent. As there is no restriction for the Nepalese to accumulate property or deposit money in the bank account in India and as there is free and unlimrted facility to convert NRs into IRs; the expatriation of property is highly facilitated. So the pressure of demand for foreign currency for capital flight is more likely to fall on Indian currency and hence little impact on the parallel market for convertible currencies (a more detailed analysis has been made in chapter five).

CHAPTER IV. SUPPLY OF FOREIGN EXCHANGE IN THE PARALLEL MARKET

To examine the supply of foreign exchange in the parallel market is really a tough task as no secondary data is available. The transaction in the parallel market, particularly the supply side is conducted in utmost secrecy, for this is not only illegal, the transactor or suppliers fear even ostracization. However we make the earnest attempt to gauge the amount of eupply through categorized sources. While doing so, we have concentrated broadly on two sources: firstly supply leaking to the market through policy inconsistencies or loopholes or even with connivance of the enforcement authorities and secondly through arbitrage or discrepancies in economic fundamentals in Nepal on tho one hand and that in India and rest of the world on the other. We thus end up with the following sources of supply: workers remittancee, tourism, export of ready-made garments and various others.

4.1 Tourism Industry

4.1.1 Tourism is the most important source of foreign exchange earnings in Nepal. In FY 1991/92 Nepal earned a sum of Re. 5016.9 million equivalent of foreign exchange from this sector which was 20.0 percent of the total foreign exchange earnings of the country. A large number of tourists arrive from overseas countries for the purpoee of sightseeing, mountaineering, trekking, etc.

4.1.2 According to the Foreign Exchange Regulations in Nepal, tourists are required to settle their expenses in foreign currencies and receive the foreign currency exchange encashment receipt from the banks or authorized money changers, so that the foreign exchange will go to the banking system. If the tourist wants to extend visa he should present the evidence that he had exchanged at least 12 Dollars per night. On the basis of the foreign currencies exchange receipt, tourists are entitled to reexchange up to 15 percent of their total exchange made inside Nepal. This facility will be made available only at the time of their departure.

4.1.3 Both the luxury and budget tourists come to Nepal. The budget tourists stay in small hotels and lodges and settle their bill in Nepali or Indian currencies which they get changed in the parallel market. The tendency becomes high if such tourists have come to Nepal through India where they have already observed the premium of the foreign currency in the parallel market. Even if the tourist pay the bill in foreign currency, not all the small hotels and restaurants provide the foreign currency encashment receipt either because they are not authorized for foreign exchange transaction or because they want to do foreign exchange buaineae in disguise.

4.1.4 It is observed that a large number of the tourists visiting Nepal use to exchange their foreign exchange in rhe informal market because (i) they qet higher price for their currency in the informal market than commercial banks can offer and (ii) exchange facilities in the banking system are not available all *the time.* Hotels, restaurants, travel agencies, trekking agencies, handicraft shops are the principal places where they exchange or settle down their payments in foreign currencies. Although most of the tourist related service industriea are authorized to exchange money at the official rate, they often avoid giving the encaehment receipt. Such transaction5 then do not come within the pm-view of *the Nepal Rastra* Bank and the foreign currency goes to the parallel market. Therefore, tourism is supposed to be a major industry supplying foreign exchange in the parallel market.

4.1.5 In order to know what percentage of the total expenditure of the tourists goes to *the* informal market, the research team conducted a survey in the Tribhuvan International Airport *in the second* and third week of June. Altogether 60 out-going tourists were interviewed within a *period of* four days. Of the total 60 queationnaise, 50 were returned with complete responses. Questions were *asked about* the tourists' duration of stay, total expenditure, agencies where money was exchanged and the receipt of foreign currency.

4.1.6 The survey exhibited that the average stay of tourist in Nepal was 32 days, and the average expenses at $16 per day which is nearly similar to *the national* average. The expenses ranged from 5 to 300 Dollars per day. The survey revealed that around 43 percent of the tourists exchange their currency in the bank, 90 percent in the hotel and 37 percent in the informal market. It is also obeerved that *most of* the *luxury* tourists (incurring higher level of expenses) resort to the banks for exchanging their currency where as the budget tourist sneak to the parallel market for the same. The survey finding thus *shows* that more than one third of the foreign currencies is exchanged in the informal sector.

4.1.7 In hotels, tourists other than Indian need to settle down their payments in foreign currencies. Once they pay foreign currencies to the hotel cashier, they need to obtain foreign exchange encaehment receipt. This is the evidence to recognise that they have exchanged their currency in the bank or they have settled down their payments in foreign currencies. Nepal Rastra Bank regulates the receipts of foreign exchange on the basis of their encaehment receipt only.

4.1.8 If the tourist pays his bill in foreign currencies, but does not obtain the foreign currency encashment receipt, the cash counter employees of the hotel, travel agency or the trekking agency can sell that portion of the foreign currency which was exchanged without giving any receipt in the parallel market to gain the premium rather than submitting it to the bank. Foreign exchange earnings of the travel agencies from sight-seeing and other tourist related services can be easily diverted from bring submitted to Nepal Rastra Bank and hence, such income may not go to the banking system. The same procedure applies in the case of casino, handicraft stores, and other shopping arcade8 which are legal or illegal exchange dealers of foreign exchange. Unless thoy voluntarily surrender the foreign exchange from their services, the regulatory device is ineffective to bring the foreign exchange so earned to flow into the banking system.

4.1.9 In the case of managed group tour, the payment is settled down between Nepali and foreign travel agencies. If the Nepali travel agency intends to dfvort foreign exohanga from this type of source, they can do it easily by simply requesting its counterparts to deposit the payment in bank account abroad. If they need foreign exchange to settle down the minimum necessary payments in Nepal, they can buy foreign exchange from the parallel market. This is a good practice of remitting foreign exchange abroad by third parties as well providing foreign exchange to the travel agencies, if they need it. Therefore the research team has found that the group travelling in another suitable means of diverting foreign exchange from the country. There ha8 been an intimate relationship between the foreign exchange dealers and travel agencies which helps not only for remitting abroad the foreign exchange earned but also facilitates capital flight.

4.1.10 The foreign exchange regulation enforce that all the hotel bills of the touriet should be settled in foreign currencies or on the basia of foreign exchange encashment receipt of the tourist. But the regulations are often made defunct by several manipulations. Some of them are mentioned here. First, the hotel8 (mainly catering to *the* budget tourists) sometimes, particularly in off season, are ready to accept Nepalese rupee payments from the tourist which they might have exchanged in the parallel market at high premium. while doing so, the hotel registers not the name of the tourist but of the person (usually a tourist guide, taxi driver or any other ***broker or agent)*** who ***escorts*** the tourist to the hotel as the guest of the hotel. Then the tourist can easily make payments for hotel accommodation in Nepalese rupee by the name of the Nepalese (or also the Indian). The agent involved in this business gets some commission for his service, the hotel gets its customers, the tourist manages his accommodation at a cheaper price; so everybody is benefited except the banking system which is deprived of the foreign exchange receipts. Second, besides room expense in the hotel, either the tourist can make their payments for food, and other service8 (like telephone, laundry, sightseeing etc.) in

Nepalese rupee with an understanding with the hotel management or the hotel does not show the foreign exchange earning from these sources to the foreign exchange regulatory authorities. In either case, the foreign exchange is diverted to the parallel market. And third, if the tourists does not insist on the encashment receipt either because he sees no use of it or because he is in a time constraint, the cashier in the hotel will avoid giving him the encashment receipt and divert the foreign exchange to the parallel market. It is common for the cashiers working in tourist industry to maintain a personal petty cash balance to make the deal.

4.1.11 Beside food and accommodations, tourist spend a part of their income in buying souvenir and other Nepali goods (such as carpet). In such case they pay the bill in US Dollar and ask for higher exchange rate. It is observed that many shops in kathmandu use to quote the prices in US Dollar and offer a higher rate for the Dollar but of course much lower than the parallel market rate. Once goods are sold in foreign currencies, rhey use to sell it in the parallel market.

4.1.12 As the survey has found that, of the total amount spent in Nepal around 63 percent has been exchanged in the formal source and the rest 37 percent in the informal sector, the tourism income as recorded in the official publications is underestimated. Further it is observed that about 37 percent of the tourists do not get any encashment receipts, 7 percent get the receipt for only less than 50 percent of their exchange and 13 percent less than 75 percent of the exchange. Only 43 percent of the tourists get cent percent encashment receipts. Considering the tourism income of Rs. 5016.9 million for FY 1991/92 as the tourist expenditure during that year, it can be said that some NRs 1.85 billion equivalent of foreign exchange goes to the parallel market from the tourism industry. But as mainly the budget tourists resort to the parallel market for exchanging their currencies and as their contribution Fe only a small portion of the total tourist income, the estimate made above might have been upward biased. This is because the survey gives equal weightage to all the tourists regardless of their level of foreign currency spending in Nepal.

4.2 Workers' Remittance

4.2.1 Movement of Nepalese work force (other than military services) to countries other than India is a recent phenomenon. Due to the lack of gainful employment opportunities in the country, many Nepali workers have been going outside for employment. Gorkha soldiers, farm labour, blue collar workers, household help, etc. are the principal employment opportunities traditionally available for the Nepali workers. Most of the Gorkha soldiers work in Hong Kong, United Kingdom, Singapore and Brunei while other labourers are increasingly moving in the Middle East (Saudi Arabia, Kuwait, Bahrain, Quatar etc.), South Korea, Japan, etc. Workers working in the Middle East obtain official work permit. But workers in Japan and South Korea are understood to have entered there through tourist visa and extended their stay illegally.

4.2.2 The official data on the actual number of workers working in different countries is not available. But unofficial sources say that there are about 5,000 workers in South Korea, 2,500 in Japan, and more than 10,000 workers in the Middle East countries. Nepalese workers going to Middle Eastern countries travel either by Saudiair, Biman Bangladesh, PIA or Air India. Details of the persons travelling by airlines other than Saudiair is not available. The study team took the details of the persons travelling on that airlines for the last 12 months.It was found that during that period (July 1992-June 1993) altogether 3348 persons had flown by that airlines to Saudi Arabia only. A8 normally Nepaleee workers go on a three year contract, it can be safely assumed that at least 10,000 workers are working in the Middle East at any point of time.

4.2.3 The minimum average wage for theee Nepali workers (excluding food and accommodations) is US $ 150 in the Middle East countries, $ 350 in Malaysia, $ 500 in South Korea, and $ 1,000 in Japan. Of the total earnings it is estimated that they save and repatriate almost 100 percent of their wages or salaries. Thus, the Nepali workers abroad make a total savings of around U.S. $ 80 million per year. This money is supposed to come into the country. Out of this even if they remit only 75 percent it can be conservatively estimated that some $ 60 million should have been remitted. Banking sources report that none of it is coming into the country from the official channel. These workers remit their savings to their homes in Nepal via parallel market. They send their savings to Hong Kong or Singapore where the agents of such foreign exchange transactions reside. They buy the foreign exchange from these workers and order their counterpart in Kathmandu via fax meeeage to pay the beneficiaries or their family members in local currency. The rate of such remittance is found to be higher than the bank rate and lower than the rate existing in the parallel market.

4.2.4 The foreign exchange operators in Hong Kong and Singapore deal not only with the Nepali workers but also with workers from India, Pakistan, Bangladesh etc. The foreign exchange thus, accumulated, is sold to the importers or other traders who need it. There is no official arrangement between the banks of south Korea, Middle East and other countries to send the remittance via banking system in Nepal. Therefore, the workers are bound to use the illegal way. The difference in the exchange rate between banks and parallel market provides incentive to the workers to sell their foreign exchange in the parallel market. Similarly, importers who intend to under-invoice imports can get foreign exchange in the parallel market at a premium which is still lower compared with the exorbitant tariff and sales tax on imports if one is to trade through legal channel. Thus, both the workers who supply and importers who demand foreign *exchange* gain from such distortions.

4.3 Ready-made Garments

4.3.1 Ready-made garment6 are the second principal exporting item of Nepal after carpets. Total export of ready-made garments has reached to Rs. 3205.2 million in FY 1991/92 accounting for 25.9 percent of total exports to third countries. USA is the principal importer of Nepalese garments. Men's cotton shirts, rayon ehirts, trousers, ladies blouse, underwear etc. are the principal exporting items. The practice of fixing minimum floor price on exports of various items of ready-made garments has not prevented emergence of parallel market in foreign currencies. This practice however has been replaced by the system of concerned association providing the reference price to the Customs Department. Therefore, in thia section an attempt is made to examine the existence of parallel market of foreign exchange through the ready-made garments exporting sector.

4.3.2 Since secondary source of information was not available regarding the parallel market in garments exporting sector, the research team conducted a market survey to obtain the necessary information in the following way. First, a list of the garment exporters was obtained from the Garment Exporters Aesociat *ion* of Nepal. It was found that there were altogether 443 ready-made garments exporting firms regietered with the Association by the end of July 1992. Then a selection of 5 percent sample from the total garment exporters was made on a random sampling basis. Thus altogether 22 garment exporters were selected for the interview. The selected firms were provided with a eet of questionnaire. Informal discussion were also held with the executive members of the Association *to* verify the answer0 and/or collect additional information. The survey was confined to Kathmandu valley mainly because almost all the garment exporting firms are located here.

4.3.3 Garment industry has boomed in Nepal since FY 1984/1985. The impetus for garment boom in Nepal arose due to the imposition of quota by the United States for the export of garments from India. Due to this quota problem, Indian exporters shifted their operations to Nepal or Bangladesh where they did not have the quota or the given quota was not covered. Thus, the credit for ready-made garments export from Nepal goes to the Indian exporters. Most of the export buainess of Nepalese ready-made garments ie still under the control of Indian exporters.

4.3.4 The modus-operandi of garment exporters as revealed by our survey in outlined below, It is observed that the Indian exporters operate through their agents or representatives in Nepal. These agents or representatives allocate orders to the respective firms as per the direction of Indian exporters living either in New Delhi or in New York. Also it is observed from informal discussion with the garment exporters that most of the importers of Nepalese garments in the USA are migrated Indians. The agents obtain instructions on what to produce at what quantity, quality and design etc. mainly from New York. The quality of fabrics, style of garments, date of shipments etc. are also controlled by them. These agents receive order and samples from their counterpart in USA and allocate orders to the Nepalese garment firms on the basis of their capacity and past performance of these firms. Since, adequate fabric is not produced locally, garment industries need to obtain fabrics and other raw materials from India. Most of the garment industries obtain fabric on a short-term credit basis on the recommendation of the agents. It is also found that moet of the workers involved in these industries are Indians and they work on a piece contract basis. The survey indicates that about 60 percent of the total workers in the garment industry are Indian nationala.

4.3.5 In order to ensure the inflow of foreign exchange generated from export of garments, Department of Commerce, His Majesty's Government ueed to fix the minimum floor price of different category of ready-made garments until March 1993. The official floor price of these garments used to change very frequently. The latest official minimum floor price of the popular exporting garments according to their category number is presented in the following table:

Table 4.1 Floor Price of the Ready-made Garments

(US Dollar per unit)

Category Number/Name	1992
340 Men's Shirt	2.94
640 Men's Shirt	2.56
347/348 Men's Shorts	2.56
641 Ladies Shirt	2.56
636 Ladies Dress	4.08

Source: Garment Exporters' Association, Nepal.

4.3.6 Nepalese garment exporters need to obtain either irrevocable letter of credit or advance payment from the importers co export the garments- Exporters can negotiate with local commercial banks for the payments in Nepalicurrency. Pre-shipment credit is also available to the exporters from the commercial banks. After examining the important documents negotiatod with the commercial banks, it was found that most of the transactions were conducted at the floor price fixed by the government. There is a strong possibility of actual export price exceeding the floor price end hence possibility of under-invoicing of export and supply of surplus foreign exchange to the parallel market.

4.3.7 It is also found from the survey that the actual market price of garments is almost always higher than that of the floor price fixed by the government. Thus, there emerges additional supply of foreign exchange in the parallel market from the exports of ready-made garments. The excess Dollars due to under invoicing of the garments exports are reportedly received by the importer8 in New York. Nepali garment exporters get the minimum price which is fixed by the agente on the directives of the Indian exporters which is not necessarily equal to the actual export price. There is a kind of monopsony of the Indian exporter5 in the ready-made garments exports. Therefore, the excess supply of foreign exchange due to the under-valuation of the ready-made garmente goes to the Indian parties. If the amount generated by such under-invoicing is payable to the Nepali exporters, it is settled in Indian currencies. This scenario occurs mostly in procurement of fabric which is usually bought on credit. Hence, it is observed that the excess supply of Dollar due to under-invoicing of ready-made garments export ultimately results in the transaction of Indian rupee rather than U.S.$.

4.3.8 From the 4th of March 1993 the Ministry of Commerce, HMG has abolished the floor price of ready-made garments. This follow5 the adherence of government to market-based economic rules. However, this policy shift still results in some anomalies as outlined below.

(a) Other things remaining the same, under-invoicing of exports will reoccur and the foreign exchange earning to he surrendered to the banking system of the country will be lower than now. It ie mainly because there is still an unmet demand for foreign exchange in the parallel market and U.S. Dollar still fetches a premium over the official rate.

(b) Capital outflow will occur from the country. Thie originates mainly from exchange rate risk as well as higher rate of inflation in Nepal vie-a-via its trading partnere. Furthermore, Nepal is only a traneit point in thie business between Indian and the U.S. The centre of economic interest of Indian garment investors is India rather than Nepal. All these factors either in isolation or in combination with each other reinforce the arguments *for* capital flight from Nepal.

(c) Th8 Nepali bueineee people have less clout over garment industries operating in Nepal, one of the reaeons being lack of experience and also information. As such all the benefits accrue to the Indian business. In order to increase the stake of Nepali entrepreneurs and thereby a higher extent of retention of profit within Nepal itself the Garment Association has been advising the Customs Department to review and continue with the *reference* price of those exportable items.

4.4 Official and Business Travel

4.4.1 Beginning 1960s Nepal made conscious and deliberate efforts to diversity its international trade. Up to this period the country's international trade implied trade with India alone. In this context, diversification in essence meant lessening of trade dependence with India in favour of trade with "other" countries. Apart from market coneiderationa this called for variety of policy interventions. Briefly these intervention8 can be categorized under following headings. Firstly, it worked through nominal exchange rate. This means to say that exchange rate of NRs vis-a-vie convertible currencies, in particular the U.S.Dollar, was deliberately maintained overvalued. This was in turn supported by the gradual exposure of the economy to the rest of the world. This resulted in growing aid-inflows that helped to sustain financing of imports from overseas. Secondly, fiscal *intervention in* the form of export subsidy and so-called Exporters' *Exchange* Entitlement (EEE) scheme further induced growing trade flows, particularly, imports from the rest of the world. In brief, under EEE exporters to third countries were entitled to retain part of the export proceeds to import priority goods from overseas, priority goods being specified by the Government. This amount of retention varied depending on the nature of exports: exporters of priority and higher degree of Nepali value-added goods got higher retention limit and the export goods that were considered to include leas value-added got lower retention limits. The third policy intervention to diversify Nepal's trade away from India was import license transfer mechanism. This is what we are concerned with in this section of our report.

4.4.2 Under this mechanism Nepali nationals earning their income abroad were allowed to import certain goods within the range of certain fraction of their grose income earned abroad. Typically, 40 percent of the certified income earned abroad and certified by the foreign payer (employer) could be used in importing goods from third countries. The goods permissible for import license ranged from simple personal effects to durable consumer goods like motor cars, mobike, T.V., Video cassette player and recorder, air conditioners, music sets and so on. One intereating feature of thie mechanism was that the license was clandestinely transferable, meaning the earner himself could on presentation of valid earning source endorse his import entitlement in favour of others. If person made a valid income overseas amounting to U.S.$ 1,000, the earner was eligible to import good8 worth U.S.$ 400, the import of which he could endorse in favour of other business people. what is interesting here is that the person travelling abroad even if supported by national treasury in the form of per diem, travel and hotel expenses was eligible to allot 40 percent of his receipt for valid import. However, recycling *of* this kind of national fund comprised a small proportion of the total turnover in this kind of business. The major source of financing such imports was earnings of British Army soldiers, Nepali professionals working abroad and even students who go abroad for scholarships under various personal, bilateral and multilateral sponsorships. In fact *such* income forms a part of the official capital inflows. There is no mechanism to ascertain what proportion of the Dollar supply in the black market flowed through this source. However, what is for sure is that this constituted an element of supply.

4.4.3 People of Nepali origin going abroad either on domestic or foreign donors' financing were allowed to import foreign goods within certain fraction of their foreign exchange income made abroad. This kind of income earned abroad invariably flowed to the parallel market at the cost of official market for the simple reason that black market rate remained much more favourable over the official rate. Furthermore, it was not even necessary for actual transfer of foreign exchange to take place. Even simple permission to part with importing entitlement fctchod reward, the reward/premium depending on conditions prevailing in Indian and Nepali market. In this way even if the cash transfer did not take place (in other words if Nepaii returning by making income abroad simply parted with income certificate without any foreign exchange transfer taking place) this would generate demand for (rather than supply of) foreign exchange in the parallel market. Thus the scheme of import license contingent on income earned abroad generated both the demand and aupply pressure, with heavy tilt leaninq towards the latter.

4.4.4 With the liberalization in international trade and exchange control, this kind of clandestine transfer of import entitlement does not fetch any reward. Even then, with still higher rate available in the parallel market, parsons returning from earning money abroad still sell their foreign exchange in the 'black' rather than the formal market. Thus foreign travel by Nepali nationals still constitutes a source of supply of Dollars to the parallel market.

4.5 Passport Facility

4.5.1 Nepalese nationals visiting third countries are provided certain amount of convertible currencies for meeting the requirements of the visit during their stay abroad. This facility is popularly known as Passport facility.The amount of this facility is presently set at US $ 1500.00 (per person during one fiscal year).This amount during the past has been provided as follows:

Table 4.2 Foreign Exchange Facility Rgainrt **Passport**

Effective From	Amount (in U.S. Dollars)
April, 1993	1,500
March, 1992	1,000
July, 1991	Between 300 to 600 (Depending on countries)
Prior to July 1991	150

Source: Nepal Rastra Bank.

4.5.2 This facility is available to any person who is going abroad, irrespective of the purpose of his visit. So this facility is enjoyed even by such persons whose visits are financed partly or fully by host agencies.

4.5.3 Out of the total number of people visiting abroad, the proportion of those visitors being financed by the foreign agencies, is very significant. so when such people utilize this facility these foreign currencies are bound to enhance eupply in the parallel market. The supply of foreign currency through this category has been found to correspond to the magnitude of premium in the market. This is corroborated by the time series data in use of paeeport facility. The following Table (4.3) clearly shows that as the premium in the parallel market goee up, the average withdrawal under this facility also goes up.

4.5.4 On an average each month 300 to 500 people go to the Middle East for employment. The available information suggests that each and every worker exercise this facility to the fullest extent (U.S. $ 1,500). When they reach the deetination, none have been found to hold this amount.

4.5.5 This is because all such workers go for working a8 per the arrangement made by various manpower exporting companies operating in Nepal. So all the foreign currencies exchanged by workers are retained by these companies (the required local currency for this exchange is provided by these companies). The apparent reason for this is that once they reach the deetination there is no need to have any foreign currency with them.

4.5.6 This fact has been proved from the letters received from the Nepaleee Embassy in Saudi Arabia stating that almost all the workers arrived in Saudi Arabia without any currency with them, even though they have their paeeport showing U.S. $ 1,500 exchanged in Nepal.

4.5.7 While interpreting the table A note of caveat ehould be borne in mind. The table reflects gross disbursement of exchange facility. By this we mean that all the pereone that appear in the table are not neceeearily couriers or merchants. The table also includes persona who are going abroad also as official, semi-official, business, academic, scientific or cultural participants and are partly or fully financed by the host agencies. In this case they do not neceeearily exchange all the Dollar facilities either they lack the rupee resources or they do not need to do so since they are either paid for their services abroad or are taken all the care by the host agencies. We don not have any clear mechanism to aegregate the outbound travellers between couriers and others simply on the basis of numbers of persons using paeeport facility. What we are trying to drive here is: if there were some mechanism to ascertain the true number of couriers, then the average use of facility by them would hover around 100 percent unlike 87.9 percent that appears in this table.

Table 4.3 **Use of Official Dollar Under Baggage Ruls**

(First I I months of the Fiscal Year 1992/93)

Months Ending	Amount Drawn (US $)	No. Of Persons	Average Drawl Per Person	Drawl as percent of Permissable limit
Mid August, 1992	1,604,562	1,982	810	81.0
Mid September, 1992	3,034,311	3,295	921	97.1
Mid October, 1992	2,174,334	2.414	901	90.1
Mid November, 1992	2,181,919	2.616	834	83.4
Mid December, 1992	2,016,298	2,087	966	96.6
Mid January, 1993	1,760,789	1,979	890	89.0
Mid February, 1993	2,045,232	2,482	1.002	100.0
Mid March. f993	1,569,898	1,743	901	60.1
Mid April, 1993	1,760,872	1,261	1.396	93.1
Mid May, 1993	3,251,478	2,170	I.498	100.0
Mid June, 1993	3,774,180	3,077	[illegible]	81.8
Total	25,173,873	25,466	11.346	967.2
Monthly Average	25.173.873	2,315	1.031	87.9

1. Covers transactions of 12 branches of 6 commercial banks in the Kathmandu valley
2. Figures rounded to the nearest Dollar

Source: Nepal Rastra Bank

4.5.8 Now we go on to analyze in brief the factors that explain the slow down in demand for Dollars under the baggage rule. The exogenous factors already outlined above is shortfall in derived demand of Indian customers for third country goods arriving in Nepal. This follows a shift in Indian Economic policy stance toward a more liberal and outward orientation manifested through (i) putting imports of many consumable under OGL (ii) restructuring and rationalisation of tariff such that rate of effective protection scaled down, and (iii) the competition thus enforced on domestic producers to some extent improved the quality of Indian goods itself which switched demand for domeetfc production. This expenditure switching effect was further reinforced by the heavy dose of devaluation administered on Indian rupee against all convertible currencies. Endogenous factors, defined here as policy measures induced by the domestic authorities, that affected the baggage trade are: (i) heavy devaluation of Nepali rupees against U.S. Dollar (20.9 percent) and simultaneous revaluation of Nepali rupees against Indian rupee (1.8 percent} in July 1 and 3 1991. Thie had the effect of substitution (virtual replacement) of third country goods by Indian goods in the Nepali markets, (ii) the tariff structure of Nepal discourages third country imports deliberately, by imposing a higher rate of tariff compared to similar imports from India.

4.6 Others

4.6.1 Illegal Exports

4.6.1.1 Upto early 1970s Nepal was considered a paradise by drug users. Such drugs comprised mainly Cannabis, Marijuana and their extracts popularly known as hashish. The consumers consisted mostly West Europeans and North Americans. Following strict enforcement by Federal Drug Admininstration of U.S.A. in the wake of Vietnam War, Nepal had to follow suit and imposed strict penalty on use of such drugs. As such, Nepal has now turned nut to be net importer.

4.6.1.2 At the present, major illegal exports from Nepal is reported to include precious medicinal herbs, extracts from tiger, rhinoceros and musk deer, and historic as well as pre-historic relics including archaeological artifacts. There is however, no way for assessing the exact turnover of this kind of trade both in value as well as volume terms. As these are light but highly valued goods the value of such trade should definitely be quite high. It is unofficially understood that the amount of foreign currencies thus generated is partly used for financing drugs import as well as luxury goods, partly it is used to support Hundi payments abroad originating in Nepal and the rest remains in foreign banks.

4.6.2 Under-invoicing of Exports

4.6.2.1 Besides, woollen carpets and ready-made garments there are very few items which are exported to third countries. As the analysis of overvaluation (undervaluation of carpets and garments) and subsequent demand/supply of the foreign exchange in the parallel market has already been discussed, this section reviews the possibilities of under-invoicing of exports other than carpets and garments.

4.6.2.2 The major items being exporred to third countries after carpets and garments (which together account for about 85 percent of the third country exports) are pulses, hides and skins and handicrafts. These three items constituted about 12 percent of the total third country exports in 1991/92 and 9 percent in the first 9 months of FY 1992/93.

4.6.2.3 It is common for the exporters of these items to under-invoice their export values, as in many cases the importers of these items abroad are in close connection with the traders in Nepal and can manage such trade in their favour. However, as the total volume of exports of these commodities is not very large (about Rs. 1.5 billion in FY 1991/92), the generation of foreign exchange by under-invoicing the exports is apparently not very large. The exact quantification however is not possible.

4.6.3 Over-invoicing of Imports

4.6.3.1 As the valuation of imports by the Customs Department is only a minimum valuation, the Customs Office has no objection if the imports are over-invoiced. As over-invoicing generates additional revenue to the government, the customs officials are not concerned about its repercussions in the foreign exchange market. The necessary condition for over-invoicing of imports is that the effective rate of tariff on imports should be less than the premium on foreign exchange in the parallel market. For instance, if a commodity is liable to a basic customs duty rate of 5 percent and a sales tax rate of 5 percent, the effective tariff would equal 10.25 percent. In such a situation by over-invoicing imports, the importer will have to pay a duty of 10.25 percent for over-invoiced portion of imports. However, if the importer can dispose-off the foreign currency equivalent to the over-invoiced amount in the black market at a premium of over 10.25 percent as compared to the formal market rate, then *he* can make a profit by over-invoicing imports. If the premium is less than this, he will no more be encouraged to over-invoice imports. Thus both the customs duty rate structure and premium on foreign exchange in the parallel market should be taken into account while analyzing the possibility of supply of foreign exchange in the parallel market through over-invoicing of imports.

4.6.3.2 The tariff etructurc as well as marked differential in the officially fixed exchange rate and the black market exchange rate of foreign currencies used to induce over-invoicing of imports in the past. As warranted by the policy of imports substitution, industrial raw materials and capital goods used to enjoy one percent customs duty with no additional duties or sales tax for quite a long time in the past. Foreign exchange facility also used to be provided for such imports on a priority basis. As the exchange rate was highly overvalued, the imports at the official exchange rate were highly subsidized. Even with the implementation of partial convertibility of the rupee at the current account, imports of machinery, industrial raw materials, and life-saving drugs was allowed at the official rate which was some 14 percent lower than the free market rate. In such a situation, two types of distortions used to exist: (i) over-invoicing of imports and sale of the surplus foreign exchange in the parallel market, (ii) direct diversion of foreign exchange to the parallel market and virtually no imports of the goods. As India had a relatively more restricted trade regime, there was a great demand for industrial raw materials and capital goods. Observing the lax in border surveillance, third country trade administration, and foreign exchange regulations, the importers used to either import raw material and capital goods to re-export them to India or sell the foreign exchange itself in the parallel market. With trade liberalization both in India and Nepal, the scope of trade deflection and diversion has significantly dwindled. However, until full convertibility of the rupee at current account was introduced, the tendency to over-invoice import8 of the industrial raw materials, machinery and life-saving drugs used to continue as the official rate of exchange at which these imports could take place was significantly lower than the parallel market rate (some times, the differential between the official and the parallel market rate was as high as 25 percent). With the implementation of full convertibility in the current account and unification of the exchange rates, all imports take place at a single market exchange rate. Hence, the emergence of parallel market due to wids margin between *the* official and the open market rates ceased to exist.

4.6.3.3 To examine the possibility of over-invoicing of imports for obtaining the premium (parallel market rate *of* exchange is less than the open market exchange rate) it is *necessary to review* the existing tariff rate structure. As the premium in the parallel market as of now is not more than 10 percent, over-invoicing of any imports will take place only if the effective tariff rate is not more than 10 percent. An examination of the tariff rate structure for FY 1992/93 reveals that out of 284 commodities listed in the Tariff Book, only 12 commodities enjoy an effective tariff of less than 10 percent. In the tariff rate structure proposed for FY 1993/94 such commodities subject to less than 10 percent effective tariff rate are only 10. They include mainly agricultural tools, advertisement materials, posters, gold and silver. Besides gold and silver other commodities bear insignificant share in total imports. The possibility of over invoicing of gold and silver is evaporated hy the updated information on bullion prices in the international market. On the whole, the existing tariff rate structure has left 1ittle room for over-invoicing but a wide room for under-invoicing of imports from third countrice.

CHAPTER V. EXPECTED SCENARIO IN THE EXISTING SITUATION OF FOREIGN EXCHANGE REGULATIONS

5.1 Contraband

5.1.1 Ae per news reports and general observations Nepal is rich in variety of rare herbs available in the Himalayan mountains. Extract of wild life like muek-deer is also prevalent in Nepal. Of late, the insatiable Chinese demand for tiger extracts has resulted in poaching of Nepali tigere. Same is the case with rhinoceros horns. Nepal rightly boasts its pride on ancient civilization with plenty of exotic images, statues and temples. These items are reported to fetch astronomical prices in the western world. In the last few months export of human skull made headlines in Nepali press. Nepal is considered to be exporter of these items, even though trading in these goods is illegal.

5.1.2 On the imports side, use of narcotic drugs is a recent development in Nepal. Nepal as yet does not possess the capability of processing these drugs. Another important contraband impart is gold, and to some extent silver although such imports have recently been legalized. Although Nepal has its own domestic market for these goods, it is quite small compared to the volume of imports. The transit trade of these goods is considered to far exceed the domestic consumption. It is generally believed that drugs arriving in Nepal originates in "Golden crescent" and "Golden Triangle" and is destined to western Europe and North America. Similarly the gold arriving in Nepal is deetined for India.

5.1.3 The black market for foreign currencies exists primarily to facilitate these trade flows. The black market demand for Dollar is inrended to finance drug, and gold & silver imports. This parallel foreign exchange market receives Dollar supply through export of Contraband herbs, extract from musk-deer, tiger and rhinoceros, precious stones and archaeological artifacts. The net position of this market is hard to determine.

5.1.4 The Nepali market for Dollar is not an insulated one. It is closely interlinked with Indian black market called Havala. There are news reports that Nepali Dollar black market and the Havala are also involved in financing arms trade. Regional terrorist organizations like LTTE, Mujahiddin, Khalistani, Pakistani, Kaehmiri and even Tibetan insurgents are reported to resort to Nepali and Indian black market seeking foreign exchange. There is thus an intricate nexus between parallel markets for Dollar, narcotics, gold, curios, and arms, extending from Afghanistan and Pakistan in the east to North American continent in the west.

5.1.5 We conclude this section by saying that even in a completely liberal trade regime, the items just outlined above (e.g. arms, narcotic drugs, historical relics) will continue to be protected. Hence, demand for foreign exchange in the parallel market for these items will continue to exist.

5.2 The Regulatory Aspect of Foreign Exchange Market

5.2.1 Existing Foreign Exchange Regulations

5.2.1.1 Nepal has been exercising a system of foreign exchange regulation from the very beginning of its international exposition. This regulatory system is very comprehensive and exhaustive in its nature. The main objective of the regulation is to bring into formal channel all the transactions in foreign currency which take place in the country, This system is broadly summarised as below.

5.2.1.2 Export: Any company exporting goods from Nepal into third countries has to furnish the evidence of either advance payment receipt or irrevocable letter nf credit. Both these instruments are more or less a guarantee that export payment will be realised. To take care for the possibility of any under-invoicing the system of minimum floor price has also been introduced.

5.2.1.3 Import: Any importer who wants to import goods in excess of U.S. Dollar one thousand from third countries can do this only by opening a letter of credit in favour of the foreign supplier. In the case of import of less than U.S. Dollar one thousand also; import through payment in bank draft or telegraphic transfer is not automatically granted. Special permission ii3 necessary. These provisions have been made to ensure that foreign exchange outflow takes place only for genuine purposes.

5.2.1.4 Tourism: In the area of tourism the prevailing system is: any entity (hotel, travel agent etc) willing to undertake foreign currency transactions has to take an authorization from the Nepal Rastra Bank {Bank hereafter). Without this authorization if anybody is found to be undertaking such businesses he will be subjected to legal punishment. These authorised agents are required to submit regular returns to the Bank providing the details of their incomes and expenditures. All their incomes in foreign currency has to be deposited in the banks. Any expeneea or expenditure incurred in foreign currency has to be undertaken only with the permissible regulations.

5.2.1.5 Invisible: Before the liberalization measures undertaken under the partial and full convertibility policy, all the expenses coming under the category of medical treatment, higher education, business travel, personal travelling and participation in seminar, training etc. had to be sanctioned by the Bank. Presently except for expenses involving medical treatment and higher education all other transactions requiring foreign currency can be obtained from any commercial banks. While providing foreign currency the commercial banks normally are required to collect some form of documentary evidence. Similarly, every Nepali national is authorised to avail of U.S. Dollar 1,500 in one fiscal year if they travel to any of the third countries. In order to minimise the possibility of misuse of this facility the concerned person will have to produce his valid passport and confirmed air ticket.

5.2.2 Shortcomings in the Present System

The foreign exchange regulation system outlined above, looks quite exhaustive indeed. In reality, however, within the periphery of the present system itself, leakages of the foreign currency seems to he widely taking place. The main areas of loopholes are as summarised below.

5.2.2.1 Tourism: The tourism sector is one or the main areas or Leakage or foreign currency. Earnings from tourism can be broadly categorised under: ticketing, sight seeing, trekking etc. out of these only the foreign currencies earned out of ticketing is captured within the system. The main reason for it being the system of repatriation. All the Airlines (including RNAC) demand foreign currency from the concerned travel agents towards the payment of ticket sold by them. As Bank does not provide foreign currency for the ticket sold to the foreigner, naturally all the receipt will have to come to the formal banking sector.

5.2.2.2 This does not apply in the case of sightseeing and trekking services provided to the tourists. All the expenses incurred by tourists for this purpose is retained within the country itself. Because of thio fact, the possibility of leakage taking place exist. The regulatory set up for controlling this type of money is the compulsion made for each authorised agent to credit all the proceeds into the banking sector. The only instrument which is available with the authorities for enforcing this is the spot checking on the sight. Such spot checking of all the agents is physically impossible. Furthermore, the method employed by the agent make the work of detecting these malpractices almost impossible. What the concerned travel agents are reported to be doing is asking the foreign agents (through which they are receiving the tourists) to channelise certain portion of the foreign currency to be paid directly into the specified account of the beneficiary outside of Nepal. As far as the foreign agent is concerned this is not going to make any difference to him so long as his group is getting the required services in Nepal. Right now there is no mechanism to establish a correlation between the amount of foreign currency remitted by any particular company and the number of tourist for whom it has provided hospitality services of either sightseeing or trekking.

5.2.2.3 Similarly, as per existing regulations whenever any tourist sells foreign currency he is to be provided with FEER (Foreign Exchange Encashment Receipt) by the authorised agent, whether it is a bank or a travel agent or a hotel. At the time of his departure from the country, if he has surplus rupees remaining with him, he is entitled to sell Nepali rupee and buy U.S. Dollar, not exceeding the amount of 15 per cent of what he has already encashed. For this purpose he has to surrender the original FEER receipt. The experience in this field suggests that quite a few tourist use this facility. But informally what has been learnt is that people related to the tourism sector collect these receipts from the tourist8 and then encash it by themselves. As part of rule the tourist himself has to request for the re-purchase. But because of the nexus between officials of the bank at the airport and the tourism industry related people, this regulation is generally violated impuniry.

5.2.2.4 starting from the fiscal year 1992/93 exporrers have been allowed to remit certain portion of their export earnings as a commission to the foreign buyer/agents. For the purpose, they have to submit documents showing that such payments is due to them. In most of the international trade these types of payments are definitely a part of the business expenses. Rut two things can lead us to suspect some leakages taking place from this window. These are:

(a) Prior to the authorization to pay from this channel, there was not much demand from the exportere to make for these purchases. Exporters have been found to be making payments under this facility only after this has been legalised.

(b) In some of the cases it has been found that exporter has exported the goods to Germany, whereas they had requested the money to be remitted to some agents in Hongkong.

5.3 Regulation on Capital Account and Parallel Market

5.3.1 Nepal has travelled a long way in regard of foreign exchange regulations. Beginning from tne establishment of Nepal Rastra Bank in 1956 to 1980s, the authorities assumed all control over the private (or non-official) use of foreign exchange. This involved both the debit and credit side of the operations. It was the authorities which determined where, how, when and on what to use the receipt of foreign exchange. Similarly. the authorities assumed full (or monopoly) control over the allocation of foreign exchange. The authorities also arbitrarily fixed prices of foreign exchange within a certain band of Bretten-woods parity. Things have changed now. Current account transactions have been liberalized to a considerable extent. So called "priority items" that were eligible for preferential treatment in term of tariffs has been done away with. The market rate of exchange can now legally deviate from indicative rates applicable to Nepal Rastri Bank. Control over international trade through non-tariff barriers (quota, license) Fe almost non-existent. Economic agents with valid sources of foreign exchange earning8 are free to maintain foreign currency accounts in Nepali banks.

5.3.2 capital account traneactiona are still under control, but still these control8 are leas atringent than before. When we aay foreign capital the focus is mostly on direct foreign investment (DFI). Almost non-existence of secondary-market and thinness of even primary security market precludes the immediately encouraging scenario for portfolio investment. In what follows we deal with major aspects of Foreign Investment and One-Window Policy 1992 that involve international capital flows. Except for industries related to defence, public health, environment, and cottage all othere are open for foreign investment with equity participation ranging upto 100 percent. Defence includes security printing and currency minting. Public health and environment related industries include all tobacco and alcoholic beverages, chemicals, mining, water resources, petroleum and so on. Cottage industries include all those enterprises whose total investment does not exceed Rs 20 million. However, even within cottage industries, foreign technology transfers are permissible.

5.3.3 In this definition foreign investment includes foreign currency, capital assets, equity participation, reinvestment, loans, patent rights, formulas, use of trade-mark and good-wills, and technological, advisorial, managerial as well as marketing services. The policy document enshrines following on repatriation from Nepal.

- a part or whole of the amount derived from sale of equity
- amount received as dividends
- amount due for amortization on forergn loans
- amount due on a account of transfer of technology
- amount due a5 compensation on account of aeizure of property
- upto a maximum of 75 percent of the allowances of foreign nationals working in enterpriaes in Nepal and receiving their allowances in foreign currencies.

5.3.4 Apart from these, the policy offers following fiscal incentives to foreign investors:

- a 15 percent rate of tax will be applicable on: (i) interest income on foreign loans, (ii) royalty, technical and management fee,
- income from export ie exempt from income tax.

5.3.5 Apart from above, there are following legal provisions involving foreign exchange transactions. Currency exchange business has been made liberal.

Nepal Rastra Bank on evaluation of the application to deal in money changing will award such license, the amount of fee on such license will not exceed Rs 100 a year. There is still strict control over transfer of securities (equities) outside Nepal. Securities cannot be exported, transferred or gifted in favour of persons residing abroad. Similarly, Nepali authorities control opening of bank account by individuals or companies in banks abroad. This can be done only with prior approval of Nepal Rastra Bank.

5.3.6 Our interest now is to analyze how do these controls on capital account affect the parallel market. At the outset we make it clear that the thrust of the policy outlined so far is more towards providing stimulus to foreign investors in Nepal rather than to check the capital outflows. In case of Nepal, it has historically been observed that FDI is not a function of policy incentives alone. Apart from Policies, Acts and Regulations there are multitude of factors, mostly structural, that determrne the flows of foreign capital either way. To cite for example, standard of infrastructural services (transport and communication, power), bureaucratic inefficiency, size of the market, availability of skilled manpower, and importantly degree of political stability in the context of abrupt and discontinuous shifts in policies and priorities of the authorities.

5.3.7 The prospect of capital transaction (involving foreign exchange) spilling over into the parallel market is hard to quantify. It depends on so many factors some of which are as enumerated here in:

(i) returns in parallel market in Nepa 1 relative to capital outflows abroad through legal means,

(ii) returns in parallel market in Nepal vis-a-vis parallel markets abroad, if there exists any such market there,

(iii) returns on ploughing back (reinvestment) in Nepal compared to taking back to home country,

(iv) cost of flouting official rule in Nepal compared to doing so abroad,

(v) returns in parallel market in Nepal vie-a-vie returns on capital employed legally in Nepal.

5.3.8 Reflecting on some of these poseibilitiee, we can only conjecture that investment in parallel market in Nepal is a favourable proposition viewed in terms of higher rate of return in informal over formal marker and lesser effective cost of violation of rules in Nepal over similar costs overseas.

5.3.9 In this context, let us see what components of capital account may spill over to the parallel market. First of all, the incentive on foreign investment in Nepal stipulates that foreign nationals working in bueineee concerns in Nepal and receiving emoluments in foreign currencies are eligible to repatriate 75 percent of their earnings made in Nepal to wherever they opt. If there is some use of Nepali currency for such personnel there ie every incentive to exchange such foreign currency in parallel market rather than in the formal market. If such incentive does exist there is every possibility that the employer may overstate his own and his employees' take advantage of emoluments simply to this rule. This assumes more importance as the policy is silent about the extent of emolument offered to such employees. If there is no control on cost structure there is every likelihood of overstating cost. Still another prospect of foreign capital flowing to the parallel market is the provision of repatriation of dividend, royalties etc. If equity holders are overwhelmingly foreigners and the returns to foreign exchange in parallel market is higher the owners may collude to understate profit so that they can syphon dividend to the black market. One word of caution here is that, if the return on parallel market is so high. this would definitely discourage investment in the formal sector. Furthermore, if the earnings in Nepal is made in rupees, and which is the case in practice, there is no incentive for repatriator to resort to parallel market as the rupee there will trade for a discount rather than the premium. Nevertheless, so long as the foreign investors have access to official exchange facilities and if they can easily place this amount to the parallel market, there is all the reward for indulging in this business.

5.3.10 In case of foreign capital, transfer pricing is one of the most talked and easiest way of taking capital away from the country of investment. This mechanism assumes that investor has companies operating in many countries. The company here procures inputs from its own company abroad at an inflated price, processes these inputs here and markete the final products through its own company located elsewhere at a deflated price. Thus the value added and taxable income gets squeezed. The detection of such kind of transaction requires efficient and strong supervisory body which can trace in the mis-invoicing of inputs and outputs. In the present context Nepal does not possess any mechanism to detect capital flows through such transfer pricing.

5.3.11 The generalization so far has been sweeping. In the Nepalese context foreign exchange has two components: convertible and inconvertible, the latter being the Indian rupee. Horeover, there is an asymmetry of official treatment between the two components. There is an unlimited and free convertibility available for Indian currency. At the same time, there are still variety of restrictions on convertible currencies. There is an open border with India with free flows of factors including labour and capital. In this context it is quite plausible that capital flows occurs mostly between India and Nepal rather than with third countries. The flows of capital between the two economies was attested during the trade-impasse between Nepal and India during 1989-1990 when India threatened with making public the list of Nepali capital holders in India if she does not succumb to the Indian interest.

5.3.12 Before concluding this section warrants one clarification: that is the latter part of argument does nor entirely preclude the poeeibilitiee of capital outflows to third *countries.* We conclude this section by saying that at least in terms of number of occurrences capital flows is more likely and recurrent with India rather than with third countries.

CHAPTER VI. CONCLUSION AND RECOMMENDATIONS

6.1 Generally the existence of any form of parallel market in foreign currency is a reflection of government control in the foreign exchange market and the exchange rate. However, the situation in Nepal is something different from this. The nature of the parallel market suggests that such market exists not because of controls over foreign exchange peree but due to distortions in other areas of economic policies. Some examples of this are valuation system adopted by the Customs Department (for both exports and imports), baggage rule provisions, trade with Tibet Autonomoue xegion of China, gold prices, and demand for foreign exchange from the Indian side. Thus inadequate supply of foreign exchange alone does *not* explain the parallel market's existence. Hence, Other issues related to foreign exchange should be taken into consideration, if the objective is to dampen the size of activities transacted through the parallel market.

6.2 Continuation of a relatively controlled external sector and foreign exchange regime in India necessarily implies that any policy measures to be adopted in isolation by Nepal for controlling the parallel market activities *can* not be very much effective. This is because the Indian and Nepalese economies are so closely linked that demand for convertible currencies in either country can be met through the supply from the other. Normally, the existence of any parallel market in foreign exchange will call for either demand suppressing or supply-augmenting measures. In the context of close linkage between tho foreign exchange markets in India and Nepal, these measures alone are not likely to be fully effective. However rigorously Nepal implements demand suppressing measures it might just create a situation of eyphoning of foreign currency into the Indian market. Similarly any choking of supply routes will result in such demand being met from Indian sources. so any measure for combating this problem effectively has necessarily to be taken in both the countries. It is *a* signal *to* the Nepalese authoritiee that any economic liberalization or for that matter, foreign exchange liberalization measure taken in isolation has every prospect of distorting economic activities, Thus even if Nepal proceeds with capital account liberalization, if India does not do so the expected outcomes are doomed to fail.

6.3 A system of floor price for exports and customs valuation of imports has its own benefit in an emerging economy with various degrees of exchange control still prevalent. Not only this, fixation floor price of exportable items, especially in the case of carpets, helps in maintaining their quality and prevents under-invoicing. The only thing that can and should have been done is the regular updating of such prices inconsistent with the fluctuation in international market prices. Although the system of officially fixed floor price has been discontinued in both the carpet and garments, a system of concerned association providing a reference price for both the items is prevailing. In this context, it is recommended that the system of floor price either by the government or by the association should continue. at the moment, however, such floor price should not be set at more than 50 U.S. Dollar per square meter in the case of carpet. It should be clear that it is the unrealistic from price fixation rather then the system of fixing floor price itself which has generated parallel market. If the floor price could be adjusted regularly, it will not only control under-invoicing of exports and subsequently capital flight but also check price cuts by deteriorating the quality of products.

6.4 Without employing internationally reputed surveyors for the purpose of customs valuation, under-invoicing and over-invoicing will be very difficult to prevent. Nevertheless, based on the available information, it can always be updated from time to time. on the issue of import valuation, however, one thing will have to be carefully considered. Most recurrent problem in the area of import valuation is undervaluation i.e., government valuation of most of the commodities is lower compared to the actual cost of procurement. This necessarily calls for an upward revision in their valuation. Since Nepal's tariff structure is mainly advalorem, this will result in a higher level of revenue. As the import bueineee is somewhat based on the duty structure prevailing at any point of time, a sudden hike in the custom8 valuation might however, have an adverse effect in the import8 business. This problem can be tackled through a review of the valuation as well as the duty structure in such a way that on the one hand the valuation reflects its actual procurement cost and on the other make it sure that the duty to be levied also remains more or less the same. This type of policy readjustment will not affect either the government or the importer. In fact as the importer will have no more to reaort to the parallel market for funding the under-invoiced portion of imports, it will reduce importers cost to that extent. The demand for foreign exchange in the parallel market will be substantially reduced by such a measure.

6.5 Nepaleee workers working abroad (mainly in Japan, Korea, and Middle Eaet) are remitting their savings mainly through the Hundi channel. The prime reason for this obviously is the premium being made available by Hundi operators. Still more important reason for doing so is the difficulty they face in romitting their oarninge through the official banking channel. Nepaleee banking sector is geared towards meeting the foreign exchange requirements of visible trade only. So its service network is New york, Hongkong and Singapore oriented. Nepalese banks do not have any significant relationship with banks in Korea, Japan and no presence at all in the Middle East. This is one of the reasons why people working there are not able to remit their earnings through the banking channel whenever they may like it. Thus, it is recommended that the banking service by the Nepalese commercial banks be extended to those countries where plenty of Nepaleee workers are employed.

6.6 One another factor to be considered is the relative efficiency of the Hundi operator <u>via-a-via</u> the banking sector. Any remittance received under *the banking* **channel** normally goes through several formalities before actual **payment** is made to the beneficiary. People **generally** tend to take all theee formalities as hassles. These hassles have increased intensity if the beneficiary happens to reside outside Kathmandu. On the contrary, the efficiency of Hundi operator is almost classic. Fund are delivered to the ultimate beneficiaries within 24 hours (no need to give official evidence of one's official identity, no need to ask any one as your guarantor, no need to have account in the bank, etc.). The wide spread use of facsimile has made the job of Hundi operator very easy. However, whatsoever easy the banking procedure is made, there are limits on that. **Banks** can never be expected to **deliver** the fund simply on the strength of a fax message. Even then there **are** certainly scopes for much improvement in the banks' operation in terms of their **coverage** to include Middle East (especially Saudi Arabia) and in terms of increasing the efficiency.

6.7 The scope for bringing the workers remittance into the banking sector is corroborated by the frequent request letters received from the Nepalese missions in the Middle East and also from some foreign exchange brokers requesting the Nepalese banks to establish the necessary mechanism for receiving such funds. So far, except for some arrangement made by one bank to streamline the remittance originating from Singapore and Brunei, no other arrangements have been made. This needs to be seriously looked into by the banks in Nepal.

6.8 Imports from Tibet Autonomous Region **of** China is increasing day by day. At the beginning it used to be mainly raw wool meant for making carpets. But, now it encompasses a wide variety of consumer goods. One of the **reasons** helping in this business is the sharp depreciation being witnessed in the exchange rate *of* the Chinese Yuan. This has resulted in the availability of Chinese goods comparatively at a cheaper rate. As the bilateral trade agreement between the two countries does not give any scope for channelling this business through banking sector, it has to be necessarily conducted either on barter basis or on the basis of convertible *currencies* financed from the parallel market. Since *not* much is being presently exported to Tibet from Nepal, most of *the* trade is being conducted through parallel market. This needs to **be** rectified immediately by (a) making suitable changes in the bilateral trade agreement and (b) by establishing banking relationship between the banks in Nepal and China. For this purpose, visits between the Nepalese and *Chinese* baking delegations has taken place a couple of times. But not much significant progress has been achieved. This matter needs to be seriously looked into by the authorities. Even if this requires giving new dimension to Nepal-Tibet trade through major changes in the Nepal-China trade treaty the authorities should be prepared for that.

6.9 Gold has been playing a very significant role in the existence as well. **as** in the premium fixation of the convertible currencies' **parallel** market.

Gold has been able to play this role simply because of the huge appetite for gold among the people and the wide difference in the local market price and the international price. So long as this wide margin ie not brought down, no significant progress can be achieved in this front. This can only be done through a deliberate policy of eaey gold import. In fact the gradual reduction in the premium of foreign currency in the parallel market during the recent period is mainly due to the policy of easy import of gold (for those who have sources of income in foreign currency). Because of our preoccupation with eocio-economic conditions, the authoritiee can not think about allowing the gold import through the formal banking sector. So the existing policy of gold import being allowed only for those *who* have ❑ oufce of income in foreign currency is viewed as the appropriate policy for the present. The only change which neede to be made is the methodology of calculating the source of income. At present any Nepali citizen going abroad can avail of US dollar 1500 (in one fiscal year) as paesport facility. While exchanging this facility, it will be endorsed in the passport by the bank, thue certifying that he has exchanged that much of foreign currency. But right now Cuetoms Department does not count this as a source of foreign currency income as far as the gold import is concerned. Apparently there is no reason why thia should not be considered ae a source of foreign currency income.

6.10 While adopting any policy regarding gold import one thing however, has to be considered very carefully. Our policy cannot be significantly different from the policy being adopted in India. As mentioned earlier, due to free convertibility of the Nepalese rupee <u>via-a-vie</u> the Indian rupee to an unlimited extent and also due to open border along with free mobility of people between the two countries, any significant divergence from the policy adopted in India could either make it redundant or might become a serious source of leakage or distortion.

6.11 Remaining within the above mentioned built-in constraints also, *one* thing can be done. Gold ie freely available in Hong *Kong,* Singapore, Dubai etc., at international market price. But depending on the quantity purchased, some premium is charged. For example, if someone buys one ounce of gold, he will normally have to pay a premium of around US dollar 20-25 over and above ruling price. This magnitude of premium significantly goes down as the volume of purchase goea up. The Nepalese experience on the parallel market (especially after the adoption of the partial convertibility) has been that as the procedure for gold import is made more easy, convenient and cheaper, it strongly leads to a reduction in the premium over official/formal rate via reduction in the gold price through increased supply of gold. So if the procurement of gold is made more convenient, eaey and to some extent cost efficient also through Arrival hall in the Airport, it should defenetly have adveree effect on the premium of parallel market. So arrangement should whereby some agency will purchase gold in large quantities in international market and sell it in the <u>Arrival Hall</u> of the airport through payment in foreign currency. This measure also might help to some extent in reducing the margin between the local market price and international price of the gold and hence reduce demand pressure for convertible currency in the parallel market.

6.12 Regarding the leakage taking place through the tourism sector it is basically a reflection of the availability of premium and the operation in this sector takes place in such a wide area that it is practically impossible for the authorities to closely follow up and monitor the activities. So it is mainly by suppressing demand for foreign currencies in the parallel market that the leakage of foreign exchange to the parallel market through the tourism sector can be discouraged. The monitoring by the Nepal Raetra Bank could also be improvised to minimize the *intensity of the* problem.

6.13 In order to have a view of changing size and shape of parallel market for foreign exchange, it is imperative that some agencies either in the government or in the central bank should monitor the prevailing parallel market rates in India and Nepal on a regular basis. *This system is lacking* in Nepal. so the discussion among the policy makers can take place only on rumours or news paper reports. This cannot be regarded as an appropriate set up.

6.14 It is understood that the Ministry of Finance in India continuously monitors the parallel market with the help of paid informers. Department of Revenue Intelligence (DRI) always manage to got in constant and close touch with the changing situation in the parallel market which subsequently helps them in taking corrective measurea. There cannot be two opinions on the need and usefulness of such a sat up in Nepal also.

6.15 To conclude, the practical way to containing parallel market for foreign exchange is to prune demand for foreign currency that can not be met by the banking channel. However, this is possible only if the demand is domestically originated. The spill-over effect of the demand for foreign exchange in India can in no way be controlled so long as Nepaleee rupee is fully convertible with Indian rupee. Hence, there is no way out except for waiting India's move towards further liberalization of the foreign exchange regime. Suppression of domestic demand will only minimize the intensity of parallel market activities. Complete control will be possible once both Nepal and India take a move to decontrol capital account along with easing other foreign exchange regulations.

REFERENCES

Agenor, Pierre-Richard (1993), Parallel ***Currency Harkets in Developing*** Countries : *Theory,* **Evidence and** *Policy Implications,* Princeton **University,** Princeton, New Jersey.

A Quarterly Newsletter of Nepal Journalist Forum Against Drug **Abuse,** *Challenge,* Oct-Dec 1992.

Economic Service *Centre, Study on Garment Industries,* **Balaju, Kathmandu,** April, 1993.

The Economic Times, Bombay, Feb. 27, 1993.

The Economist, London, April 10, 1993.

International Monetary Fund, International *Financial Statistics,* various **issues.**

Mathema, Puehkar: Drug Abueion: **Need for Efforts to Break the Deadly Circle,** ***Gorkhapatra,*** June 25, 1993.

Ministry *Of* Finance, **HMG/N,** *Economic Survey,* **1992/93, Kathmandu Nepal.**

Ministry of Industry, **HMG,** Nepal, *Industrial Enterprises Act,* 1992.

Ministry of Law and Justice, **HMG,** Nepal, *Foreign Exchange* Regulation Act, (with revision), 1966.

Nepal **Raetra Bank,** *Income and Employment Generation from Tourism in Nepal, 1989.*

Nowak , Michael **(1984),** "Quantitative Control and Unofficial **Markets in** Foreign Exchange: A Theoretical Framework," ***IMF*** *Staff* Papers **Vol 31(2), pp.404-31.**

Wagle, Kul Chandra: Fifteen Thousand Drug Abusrs within **Kathmandu Valley,** Gorkhapatra, June 25, 1993 page. 7.