The Economic Journal of Nepal, Vol.18, No.1, Issue 66, January March 1994©DOE TU

Full Convertibility in Nepal : Implications for Indo–Nepal Economic Relations

Vijaya Katti*

INTRODUCTION

With the changes in formal political. structure towards multiparty democratic system in Nepal the government could be seen in policies announcement then have towards the shift in emphasis from excessive regulatory controls to private sector-orientented strategy for industrial development with simplified and responsive administrative arrangements and easy access to factors of production.

Nepal has a unique relationship with India guided by social, cultural and religious affinity in addition to geographical proximity. Nepal has also a special regime of trade with India, which has an open border, free movment of capital, labour and payment arrangements. This regime delineates a unique policy framework within which Nepal has to operate. In itself, this opennes to a neighbouring economy would not make the case of Nepal special, because there are many countries in the world, which are in similar situaton and which have adopted a free trade policy, conditioning their economic structure to that of their larger neighbours. What makes Nepal's case intersting is that the common and open border make the movement of goods basically unimpeded giving rise to unscrupuluous and unrecorded trade.

Though there are no precise estimates in connection with unauthorised trade, it is believed in some quarters that during a number of years between 1978 and 1989, value of goods transacted through unrecorded trade channel between India and Nepal may be as high as eight to ten times of the officially recorded trade (Muni 1992). This growth has been facilitated by the complete freedom of currency movement between the two countries and availability of increasing number of transit outlets for Nepal through the Indian territory. Nepal's imports on a large scale outside the OGL, have been far in excess of Nepal's needs. It has been widely acknowledged that most of these imports find their way across the border into India. In 1991–92, pressures on the His Majesty Government to conserve foreign exchange led to a decrease in unathorised trade across the border into India. Nepal had been forced to convert around $120 million from its reserves to finance fupee imports from India under open general licence (OGL). Government of Nepal did not issue any licences for the import of goods from third countries.

---

* Dr. Katti is Associate Professor at Indian Institute of Foreign Trade, Mahrauli Institutional Area, New Delhi, India.

The unrecorded movement of goods to India normally funded almost exclusively in Indian rupees and this always leaves the country's businessmen in possession of large amounts of Indian money. This money, in turn, is used for unauthorised import in the Kingdom's requirements from India. (TOI 23 April, 1993). According to Intelligence Bureau Study, Nepal imports goods worth Rs. 300 crore a year from Hongkong, Singapore, Korea, and China. But the local consumption is hardly 10 percent of the imported goods the rest find their way to India. (Muni 1992)

ECONOMIC LINKAGE BETWEEN INDIA AND NEPAL

Nepal's economy is closely linked to the economy of India. Nepal's economic and commercial policies have been heavily influenced by its close relationship with India. The initiation of a policy reversal in India from licence and subsidy system to a more open and competitive environment was monitered carefully by the policy-makers in Nepal and efforts were made to synchronize Nepalese policy initiatives with those undertaken in India. Soon after India's announcements of economic and trade policy liberalisation in July 1991, Nepal announced liberalised industrial as well as trade policy along with foreign investment and one-window policy in 1992. The partial convertibility of foreign exchange with a system of 65:35 was also adopted. The industrial policy had been supplemented with trade and investment policies. Moreover, effective co-ordination of the implementation of such policies is being provided through the *Industrial Prommotion Board*. Along with current outward-looking industrial policy, government's receptive attitude towards foreign investment, productive workforce and attracitve incentives promise to give a further fillip to the pace of development in this small Himalayan Kingdom.

FULL CONVERTIBILITY

Nepal adopted one more step to integrate itself with the world economy be scrapping the partial convertibility system of 75:25 and making the Nepali rupee fully convertible on trade account on 12 February 1993. This was the time when India was still on partial convertibility regime and wide guesswork was on in India's trade and industry circle whether India would go fully convertible or not as the date of presentation of budget was approaching nearer. The announcement of Nepal's full convertibility took by some with surprise whereas cleared the doubts in the minds of others regarding India's stand on time issue of convertibility and confirmed their optimism that India would go for full convertibility.

Nepal's comfortable foreign exchange reserve worth nine months of imports was quoted to be an important reason for encouraging the government to take this *historic step* of going for full convertibility. The official exchange rate has been retained for imports of petroleum products, fertilizers and government expenses abroad. The official exchange rate for the US dollar has been declared 43.10 Nepalese rupees to one dollar (ET 15 February 1993). The exception to the open currency market is the Indian rupee which continues to be linked with Nepalese rupee on a permanent basis. The Indian rupee is an exception in view of the need to give assurance to those engaged in border trade that their activities would not be affected. The Nepalese rupee–Indian rupee exchange rate has been hiked by 3 per cent. Henceforth, the exchange rate shall correspond to Indian Rs. 100 equalling Nepalese Rs. 160 as against the earlier rate of Rs. 100 equalling Rs. 165. Imports from India can carried out in convertible currencies without restriction. So far, Nepal's imports from India in convertible currencies were governed by certain restrictions.

Nepal had adopted the partial convertibility system on 3 March, 1992, wherein 65 percent of the foreign exchange earnings through exports of services could be sold by individuals to commercial banks at rates determined by market forces for the currency concerned and the remaining 35 percent had to be sold to the Nepal Rastra Bank at the official rate. This 65:35 ratio was raised to 75:25 later in the year.

Nepal had adopted partial convertibility before India. Had the policy been adopted only after India or not adopted at all there would have been certain implications for Nepalese economy. Economists expressed apprehensions that Nepals's import competitiveness would slide which would further increase trade deficit. The opinion was fruther expressed that the goods imported from third contries would be cheap causing an adverse effect on the indigenous production, the possibility of soaring trade deviation and convertible foreign exchange reserves would decline steeply. India would become more attractive to tourists than Nepal and there could be greater encouragement for those coming to Nepal to bring Indian currency.

Nepal adopted partial convertibility policy with a view to maintaining the balance of trade by making import capacity consistent with export performance and helping the current account also. The policy aimed to maintain the exchange rate with Indian currency, hold the price line of Indian goods and avoid encouraging people to adopt the habit of holding Indian currency.

Provision of selling 65 percent currency in the market was expected to make the indigenous industries efficient, productive and competitive. The industries which were not able to use raw materials infull capacity under the passbook system got the privilege of raw materials being supplied to them from the market as per their necessities as the import substitution and industries capable of surviving on the basis of their own ability can manufactue and sell goods. This was expected to make the domestic market more dynamic and spontaneous.

EXPORT ORIENTED STRATEGY OF NEPAL

Given its small domestic market Nepal's interest would seem to lie in an export oriented outward looking srategy. To achieve that objective, manufacturers should be able to import capital goods and intermediate inputs at world prices and quality from the most competitive sources available. The problem is that once these goods are imported into Nepal they become liable to illegal re-export over the open borders to India where prices of these goods are typically higher than world prices because of Inda's very high protective barriers. Now with the opening up of Indian economy and lowering of the tariff structure, this condition should change in India and hence the deflection of third country goods to India, which is a serious concern to the autorities of both, should no longer remain a matter of concern. Deflection entails a loss of convertibale international reserves in exchange for non-convertible Indian rupees. Commodities sold to India were paid for with Indian rupees with full convertibility in both India and Nepal, these restrictions are no longer there so the possibility of deflection gets reduced to a certain extent. Nepal can eliminate the incentives for unscrupulous trade by aligning its tariffs on third country imports with those of India.

His Majesty Government has announced major customs, excise and sales tax concessions on commodities produced in the country, to neutralise the effects of the recent devaluation of the Nepalese currency and switching over to full convrtibility. The changes in the duty structure will now enable the goods produced in Nepal to compete favourably with those imported from India. Over 50 percent concessions have been accorded to silver, different kinds of machinery, wire coil upto 8 mm., iron scarp and material used for manufacturing bulbs. The import of gold and silver for use in domestically produced goods has been totally exempted from sales tax.

Given the full convertibility between the Nepalese and Indian rupees and the impossibility of avoiding scrupulous trade, prices in Nepal cannot differ from those in India by more than transport costs plus unauthorised risk premium. These costs may differ from one commodity to another, but by and large the law of one price holds firmly between India and Nepal.

After the announcement of full convertibility, increase in prices of petroleum products and urea, from NRs 9.25 to NRs 9.75 per kg. diesel and petrol from. NRs. 11.25 to NRs. 11.50 and NRs. 29 to NRs 30 per litre have also been announced (ET 13 February, 1993). Prices of above mentioned products have not increased in India and there is a wide disparity in prices of these goods prevailing in India and Nepal. Hence the posssibility of deflection specially in case of these commodities cannot be denied.

The high incidence of unscrupulous trade of third country goods destined for Nepal into India had been motivated by the high levels of protection in India which increases the domestic price of a commodity by a factor of nine times of its c. i. f. price. The intensity of import restrictions, however, has always been relating less severe in Nepal an there has consequently been a tendency for traders to take advantage of the resulting differences in the price of third country goods bretween the two countries. Foreign articles imported at minimal or zeo tariff rates into Nepal are therefore, often got illegal way out of the country to India where high tariff was provided them a sheltered market.

Since the import of inputs and capital goods at world prices from third countries could result in their illegal re-export or enter into unrecorded trade of the final commodities to India, it would be necessary to ensure that these goods are actually used for production and also that the final product is not exported illegally. To achieve this Nepal needs to replace quantitative restrictions on the import of raw materials, intermediate inputs and capital goods from third countries with high tariffs that would prevent re-exports to India. The Government of Nepal can think of setting import taxes in such a manner which would maximise revenue to the government.

Both India and Nepal have an advantage of low labour cost but Nepal has an additional advantage as it does not have too many domestic industries producing intermediate or capital goods which it has to protect. This implies that Nepal could, without worrying too much about protecting these industries, import high-quality inputs and capital goods at world prices and thus reduce its cost of production of final commodities well below those of India. This gives an edge to the Nepalese producers which has been exploited in order to promote exports to third countries. Trade statistics reveal that Nepal's exports to third countries are increasing at a higher rate than that to India.

As with Jonathan Swift's Gulliver, the relevant concept of the size of an economy is affected by its surrounding environment; a country could be small in the world economy and yet become a gaint in its own region imposing on its smaller neighbours is relative price structure and the consequences of its trade policies (Blejer 1992). This is very well proved in the case of India and Nepal.

IMPACT OF INDIA'S LIBERALISATIOM POLICY ON NEPAL

The initiation of a policy reversal in India from licence, permit and subsidy system to a more open and competitive environment can not but have salutary effects on Nepal's prospects on liberalisation. A close monitoring of the developments in the Indian economy may be needed to synchronize Nepalese policy initiatives with those undertaken in India.

Political change notwithstanding, Nepal's relations with India and the direction of the Indian economy are likely to be the major factors guiding the effectiveness of measures undertaken by Nepal. The radical changes in macro-economic policies and, more specifically, the major structural cnanges which have been announced in quick succession in India is likely to need som time to be fully assimilated. However, their implications on the Nepalese economy need not be undermined. For all practical purpose, Nepal interacts economically with and through India which is likely to be the pattern for the foreseeable future. Nepalese investors who have been accustomed to take undue advantage of the inward looking policies in India may have to switch their investments from trade to more productive sectors. The government will also be forced to take some bold and concrete steps to make the Nepalese economy more competitive and self-sustaining.

CONCLUSION

Prime Minister of India Mr. P. V. Narasimha Rao during his official visit to Nepal from October 19-21, 1992, announced a number of decisions to further strengthen and expand bilateral cooperation. In the trade sector, in particular, substantial improvements have been made in the access regime for Nepalese exports to India. The proforma clearance system has been replaced by a system of *Certificate of Origin* to be issued by HMG/N. The requirement of Nepalese raw material content for duty free access to Indian market has been reduced from 55 to 50 percent. An additional dimension of Nepalese labour content has been included in determining the eligibility of a Nepalese product for access to the Indian market free of customs duties and quantitative restrictions. Movement of Nepalese private commercial vehicles from the Nepalese border to Calcutta, Haldia and back is allowed after endorsement by the Nepal Transit and Warehousing Co. Ltd., Nepal Transport Corporation, HMG/N and the necessary undertaking by them to the indian customs authorities. Nepal to Nepal movement of Nepalese vehicles and goods through India is now allowed without cash deposit or bond system upon the necessary undertaking given by the Nepalese customs authorities. In addition to the existing system of payment in Indian rupees, Nepal has been permitted to import goods from India by payment in freely convertible currency. The Indian exporters are entitled to all the export benefits made available by India for such exports in freely convertible currency. These steps are expected to further facilitate Indo–Nepal trade and economic co-operation.

The revolving stand by credit extended by India to Nepal has been enhanced from the level of IC Rs. 350 million to Rs. 500 million. The term of this agreement has been extended from one year to three years. The liberalised guidelines announced by Government of India in January 1993, for investment in joint ventures abroad by Indian entrepreneurs, would facilitte setting up such ventures in Nepal.

As a follow up of understanding reached in water resource cooperation during the visit of Nepal's Prime Minister to India in December 1991, it has been agreed to have a time frame for investigations and preparation of report, etc., on the Karnali, Pancheswar, Sapta Koshi, Budhi Gandaki, Kamala and Bagmati projects. Exploration of the possibility of private sector participation in setting up of hydel projects has also been emphasised. Pancheshwar and Budhi Gandaki projects will be undertaken on a priority basis. Supply of water to Nepal under the Sharada Barage Agreement will be maintained.

With a view to implementing the bilateral agreements concerning trade and transit which emerged from the joint communique in October 1992, India and Nepal have signed three letters of exchange. They relate to : the provisions relating to improvement and simplification of the regime for export of Nepalese manufactured items to India on a preferential basis; movement of Nepalese private commercial vehicles between Nepalese border and Calcutta, Haldia; and easier Nepal to Nepal movement of Nepalese vehicles and goods through India which have resulted removal of proforma clearance system and introduction of new system-internationally accepted practice of the *Certificate of Origin* to be issued by the Nepalese exporters. The provision to include labour added in Nepal in calculating the component percentage of Nepalese manufactured items eligible for preferential entry into Indian market and the agreement to lower the total percentage composition of Nepalese and, or Indian materials are expected to enhance and broaden the scope of Nepalese exports. More Nepalese manufactured items are likely to come within the perview for allowing duty free and quota entry.

In addition to the steps finalised during Indian Prime Minister's visit to Nepal in October 1992, Nepal's full convertibility on trade account is bound to give a boost to Indo–Nepal economic cooperaion. Deflection of third country goods from Nepal to india is expected to get reduced in the long run. Volume of unrecorded trade may get reduced and that of recorded trade may go up to that extent. With the opening up of Indian economy; availability of third country goods that were earlier channelled through unrecorded trade practices from Nepal, will increase in India. Now Nepal will be able to import commodities from India in convertible currencies without restriction. This freedom from restrictions will enhance the level of transaction and India's exports to Nepal will increase. Share of India in Nepal's total trade has been declining fast.

Measures announced by the Prime Minister of India in his recent vistit in October 1992' and steps taken by India and Nepal towards liberalisation are expected to check the decline in trend in Indo–Nepal trade and augur well for the future.

SELECTED REFERENCES

Muni, S. D. (1992), *India and Nepal : A Changing Relationship,* Konark Publishing Pvt. Ltd., New Delhi

The Times of India, 23 April, 1993.

The Economic Times, 13 and 15 February, 1993.

Bleger, Mario and Gyorgy Szafpary (1992), "The Gulliver Effect and the Optimal Divergence Approach to Trade Policies : The Case of Nepal", *World Development*, Vol, 19, 2/3.

The Economic Journal of Nepal,Vol.17, No.2,Issue 66,April-June1994 ©DOE. TU

BOOK REVIEW

Tamang, Devika Gill Gerard J., and Thapa, Ganesh, B., eds. (1993) *Indigenous Management of Natural Resources in Nepal,* HMG/Ministry of Agriculture/Winrock International, Policy analysis in Agriculture and Related Resource Management, Kathmandu, pp. 375+xi, price not mentioned.

The belief that natural resources are infinite made inefficient and extravagant use of natural resources in the past. But the globe is finite and so are the natural resources. such a realization occurred to many intellectuals including those of developing countries, and at times found expressions in international gatherings. The most prominent one is the *Earth Summit* held at Rio in 1992, where the government of the nations made a plea for sustainable development.

The concept of sustainable has many ramifications. However, there is a consensus among economists that sustainable development is to be defined in terns of non–declining per capita well being over time and that the conditions for achieving sustainable development involve some formulation relating to constancy of capital. Two broad schools of thought on constant capital exist. *Weak Sustainability School* requires that overall capital be constant, whereas *Strong Sustainability School* involves constant capital but with a further restriction of constant natural capital.

The latter view resembles Ciriacy Wantrup – Bishop Safe *Minimum Standard* approach and emphasizes on the critical role of natural capital. Because of the growing importance of natural capital, it is necessary that this be managed efficiently. As to the question of whether the indigenous management involving local technology suitable to the local conditions or the non-indigenous management characterized by modern, imported technology is an efficient way to use natural resources is of central concern underlying the sustainable development. The book under review focuses on indigenous management of different natural resources in Nepal and therefore, it can be taken as a commendable effort.

The book is an outcome of a two-day professional workshop on indigenous management of agriculture and related resource management organized by Ministry of Agriculture, HMG of Nepal in collaboration with Winrock International. The objectives of the workshop were; i) to discuss the effectiveness of the indigenous system for natural resource management, and ii) how to incorporate these indigenous management system in existing policies and legislation concerning natural resource management.

The book combines papers of biological and social scientists on different themes covering crops, soils, forestry, irrigation, pest control, presented at the workshop. Thus, the book contains a horrendous wealth of knowledge particularly in view of limited literature available in he field of indigenous management of resources in Nepal.

Divided into three parts, the book contains 24 papers. Part One is a synthesis covering four papers written by the scholars of long standing experience in the agriculture and resource management sector. Papers on farm resources are included in Part Tow, whereas community resources form the subject of Part Three. The farm resources that receive attention in the papers are crops, livestock, soils, agroforestry and risk and insurance. Similarly, among the community resources irrigation,pasture, forest are covered in the third part of the book.

Dr. Thapa, one of the editors of the book, is correct in saying that indigenous knowledge and systems of managing agriculture and other natural resources have existed in Nepal for centuries. But in the past few decades because of the practice of borrowing improved technology from outside and imposing them on the farmers, the indigenous management systems were ignored in the formulation and implementation of natural resource management policies. Dr. Thapa holds that local users of natural resources are often more competent and knowledgeable as resource managers than highly trained outsider professionals, because local users have extensive knowledge about the exact local physical conditions and history of the resource. But he does not mean that indigenous system does not have any imperfections.

Dr. Gill points out two compelling reasons for studying indigenous management system in country like Nepal. To him such a study represents a genuine effort to achieve people's participation in development process. In fact, indigenous management is a classic example of people participation. A study on indigenous management helps support the view that uneducated people at times are more knowledgeable than educated ones. The second reason for studying indigenous management lies with the cost effectiveness of the indigenous management systems.

Dr. Gill seems to be quite aware of statistical fallacies and therefore, points that the condition of natural resources is not that bad as it is reflected by the government statistics. he corroborated this statement citing different studies including his own. It is true that the quality of the data on natural resources and agriculture is very poor. But it is also equally true that there is no up to date information on natural resources like forest. In view of this fact whether the cultivated area in the country is declining (Carson 1992) seems to be conjectural. However, Schultz's *poor but efficient hypothesis* also holds in case of Nepalese farmers because they are not the irrational users of the natural resources. Some times they become irrational because of incorrect government incentives and/or because of other compelling reasons that derives from their abject poverty.

The second and the third parts of the book contain papers that describe the indigenous management of different agricultural crops and natural resources. Therefore, these are worth reading to have a practical knowledge about how to manage the resources from the indigenous knowledge. Community forestry is an outstanding example of how the indigenous management helps the conservation of resources. This program is widely acclaimed and serves as a model for the other countries.

Part two of the book explains about the indigenous management of some vegetable crops and potato. But their share in the national income is quite low. It is known that food crops mainly paddy, maize and wheat dominate the scene of Nepalese agriculture. Thus any effort dealing with indigenous management of the these crops can be more useful for the policy implication. In this respect, the book under review is failing in its effort to propagate about the indigenous management of crops.

However, the book is timely effort and is worth for reading. It can be useful for all the development practitioners dealing with the conservation of fragile natural resources of the country. Moreover, there is need of propagating indigenous management systems to the university students of the respective disciplines.

Dr. Bishwa N. Tiwari
Central Department of Economics
Tribhuvan University, Kirtipur,
Kathmandu, Nepal.

Yoko Watanabe
Intern, UNDP
Kathmandu, Nepal.