

# Nepal's Trade Sector: Review, Repercussions and Recommendations

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*That the trade sector plays a highly instrumental role in attaining high and sustainable economic growth is indisputable. However, Nepal's policy regime has not been very effective in improving trade competitiveness. Although policy measures have been announced both to identify new exportable products and encourage diversification of export markets, these have hardly been executed. Weak infrastructure, poor human resources, absence of quality standardization of exports, dearth of a strong legal framework and frequent policy reversals, among others, have restricted the country in improving its international competitiveness. Still, owing to the emerging trend of a competitive and market-oriented global economy, these issues need to be properly addressed. With reference to regional and multilateral agreement, the country should undertake a two-pronged strategy according priority to multilateral trade negotiations under the World Trade Organization as well as to strive for effective and meaningful regional trading arrangements such as the South Asian Free Trade Area (SAFTA) and the Bay of Bengal Initiative for Multi-sectoral Technical and Economic Cooperation Free Trade Area (BIMST-EC FTA) which it is currently pursuing. Other measures suggested by this paper for boosting trade competitiveness include, among others, technological upgrading, investment in infrastructure, appropriate legal framework compatible with regional and multilateral agreements, new trade policy, setting up of export processing zones and credible policy.*

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## I. INTRODUCTION

Trade is crucial to developing and least-developed countries (LDCs) for a variety of reasons. Firstly, it is often the principal mechanism for achieving the benefits of globalization. Countries win when they gain market access for their exports and new technology through international transfers, and when heightened competitive pressure improves the allocation of resources.

Secondly, the continuing reallocation of manufacturing activities from industrial to developing and LDCs provides many opportunities for expanding trade both in goods and in services. And finally, the growth of trade is firmly buttressed by international institutions. The World Trade Organization (WTO),

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established in 1995, is the primary institution in generating a commercial environment suitable to the multilateral exchange of goods and services.

The dynamism of international trade during the past two decades in particular, and its growing influence on international economic relations, has increased attention, especially in LDCs, on its contribution to economic growth. The link between trade, development and growth is a symbiotic one. Trade allows specialization based on comparative advantage, and assists countries to upgrade production processes and increase value-added through a more efficient use of resources. Increased competition that accompanies specialization and productivity growth has been instrumental in cementing the linkages between trade and growth. Also notable has been the process of market liberalization that has opened up trading avenues for new countries and products.

With the undertaking of market-oriented economic reforms in the early 1990s, Nepal increased its integration into the world economy. The principal components of the reform programs included liberalization of trade and industrial policies and rationalization of the foreign exchange regime. The core elements included reduction and restructuring of import duties, dismantling of most quantitative restrictions and import licensing requirements, and introduction of full convertibility for current account transactions.

Although Nepal is one of South Asia's most open and trade dependent economies, the country has not been able to fully exploit the potential for export growth since its exports are focused in a few products and markets. Against this foreground, this paper is organized as follows. The next part assesses the role of the trade sector and its contribution to the Nepalese economy during the last decade. The major policies linked to this sector and other pertinent issues are evaluated in the second part. In Part III, an attempt is made to determine the causal relationship between growth in GDP and growth in exports as well as between growth in manufacturing exports and income growth. For this purpose, the Granger causality test is employed. The overriding problems of the external sector together with guidelines for its revival are highlighted in Part IV. The final part concludes this paper.

## II. TRADE SECTOR REVIEW

### *Trade Liberalization*

Acknowledging the significance of trade in the economic development process, Nepal has been shifting towards liberal and market-oriented trade policy since the mid-1980s that was accompanied by various reform programs in 1992. The policymakers in Nepal have based their trade liberalization policies on a set of two hypotheses: a) liberalization of industrial and trade policies will boost industrial efficiency by providing greater access to imported intermediate inputs, capital goods, and technology, exposing local producers to both internal and international competition, thereby forcing them to lower costs, and removing curbs on the

growth and size of firms so as to exploit the scale economies; and b) improvement in efficiency and the subsequent reduction in costs will stimulate domestic demand and enable Nepal's industrial goods to compete abroad, thereby relaxing demand-side constraints on industrial growth.

It was after the balance of payments crisis in mid-1980s, that Nepal initiated the trade liberalization program under the Economic Stabilization Program supported by the 18-month stand-by arrangement reached with the IMF in 1985.<sup>1</sup> The system of import quotas from third countries was dismantled and the import license auction system was introduced in July 1986. Then, with the completion of Economic Stabilization Program, the country undertook the three-year Structural Adjustment Program supported by the IMF and the World Bank in 1987.

Trade reforms were expedited in the early 1990s with the introduction of the partial convertibility in the current account on March 1992. This replaced the system of administrative control over import by the market mechanism. The partial convertibility system attempted to provide a built-in device to bring about a favorable impact on the current account and the BOP position. It also assisted in loosening the grip of bureaucracy on economic activities and promoting open competition in the market.

In order to achieve the full benefits of integrating the Nepalese economy with the world economic system, the government announced the full convertibility of current account transaction on February 1993. This automatically implied that the entire volume of trade would be conducted on the basis of the market exchange rate. The number of items put under the import auction was cut down to six. Later in July 1993, the new budget abolished the import auction license system altogether. Keeping only a few items under licensing, the government put all the items under the OGL. With this, the government completely did away with quantitative restrictions on import.

In the past, long and open border with India restricted the country's flexibility in framing and implementing independent economic policies. Consequently, Nepal had been subjected to negative spillover effects of inward looking and inefficient industrial system in India. But this gradually changed in the early 1990s when India embarked upon bold trade liberalization programs, including the drastic lowering of barriers to imports of capital goods and other inputs into production. Subsequently, Nepal also started to capitalize on the opportunity to open up as carried out by India.

One point is clear. The speed of Nepalese liberalization is guided by the pace of liberalization in India and the geo-political realities of the country. Hence, full

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<sup>1</sup> Even before the liberalization era, measures such as bonus system, dual exchange rate system and export subsidy were introduced to boost exports. However, as they failed to generate intended impact on exports, they were removed. In 1987, export duty drawback system was introduced under which exporters could get a refund on duties, which included both import taxes and sales tax paid on imported inputs. The bonded warehouse scheme introduced in October 1988 was an alternative scheme to the duty drawback system and assisted the carpet industry to get a refund on taxes paid on its imported raw materials.

liberalization of the Nepalese trade regime in a short period may neither be attainable nor be desirable. Nonetheless, policy commitments need to be realized, and for this substantial improvements may be warranted in the bureaucratic and administrative sectors, including removal of impediments and barriers such as procedural delays.

### *Plan Objectives and Trade Patterns*

Although the Ninth Plan (1997-2002) had laid down certain objectives such as a) maximum utilization of commerce sector for the overall economic development of the country and expanding the benefits of foreign trade to the rural areas, and b) diversification of trade and strengthening of backward linkages to make the export trade stable, these objectives were hardly met.

According to the Tenth Plan (2002-2007), the two-fold objectives with regard to foreign trade are to a) make the commerce sector liberal, competitive and market-oriented for the overall growth of the country by extending returns accomplished from external and domestic trade up to the people's level through excessive participation of the private sector and to b) increase contribution of commerce sector to the GDP progressively through import substitution and export promotion. The main strategies for attaining these dual objectives are through making the export trade competitive and market-oriented, the diversification of both country-wise and commodity-wise trade and the strengthening of the interlinkages between industry, commerce, agriculture and other economic sectors. The core policies are to generate competitiveness in the commerce sector in line with global and regional trade agreements, to ensure easy market access for Nepalese manufactured products, to expand transit facilities, to set up export processing zone (EPZ) and to accord priority to exports of hydropower, software, labor and other services.

The Tenth Plan has identified the following problems with regard to Nepal's trade sector: a) dependence on a few commodities and markets; b) reliance on import of raw and semi-finished materials; c) weak backward and forward linkages of the production of exportable products; and d) rising trend in the volume of trade deficit. To tackle these problems, the Plan has laid down the following policy measures:

- Exports will be augmented through commodity-wise and country-wise diversification through the identification of exportable commodities of comparative advantages.
- For generating employment opportunities and raising income of the rural people, stress will be accorded on increasing the production and export of agro-based industrial products and enhancing their qualities.
- There will be special arrangements for market, information dissemination, technology, financial support and transport facility. Standardization of the exportable commodities will be made at the international level and their competitiveness in the world market will be enhanced.

- HMG will provide ample support to the private sector by disseminating information concerning present and prospective export markets, flowing of trade information and intensifying the monitoring and evaluation process.
- The arrangement of tax-free EPZs together with the provision of necessary acts and laws will be made for promoting the export sector.
- To make the country's external trade more simplified, economical, reliable, and business-oriented, the existing acts, laws, institutional processes and coordinating system will be assessed and reformed.
- Export of hydropower, computer software and labor and other services will be given due thrust in addition to commodities listed as exportable.
- In order to acquire advantages from the membership of the WTO, the trade sector will be made competitive in such a way so as to be consistent with various trade agreements.
- Nepal's trade will be integrated with the global trade regime by developing a multi-modal transport system.

During the ten-year period FY 1994/95 to FY 2003/04, total trade increased from Rs. 81.3 billion to Rs. 190.2 billion. During this period India's share in total trade of Nepal increased from 28.0 percent to 57.6 percent, while the share of overseas countries plummeted from 72.0 percent to 42.4 percent. If just the last two years are compared, that is, FY 2002/03 and FY 2003/04, there was a growth of 8.0 percent in total foreign trade. Moreover, total trade with India soared by 12.5 percent while trade with other countries rose by just 4.9 percent in FY 2003/04 compared to FY 2002/03. These are all depicted in Appendix 1.

Total exports increased from Rs. 17.6 billion in FY 1994/95 to Rs. 53.9 billion in FY 2003/04. Between FY 2002/03 and FY 2003/04, exports rose by 8.0 percent. Exports to India went up by 16.4 percent while exports to other countries fell by 1.6 percent. Still, the share of India in total exports remained at 57.1 percent in FY 2003/04 compared to 52.9 percent in FY 2002/03, while the share of other countries in total exports was placed at 42.9 percent in FY 2003/04 compared to 47.1 percent in FY 2002/03. In FY 1994/95, the contribution of India and other countries to total exports was 17.7 percent and 82.3 percent, respectively.

Total imports, on the other hand, went up to Rs. 136.3 billion in FY 2003/04 from Rs. 63.7 billion in FY 1994/95. While total imports catapulted by 9.6 percent in FY 2003/04 in comparison to FY 2002/03, imports from India and third countries soared by 11.0 percent and 7.7 percent respectively. Similarly, as illustrated by Appendix 1, the share of India in total imports stood at 57.8 percent while that of other countries remained at 42.2 percent in FY 2003/04, compared to their shares of 30.8 percent and 69.2 percent, respectively, in FY 1994/95.

Between 1994/95 and 2003/04, trade deficit soared by 79 percent. However, when comparing FY 2002/03 and FY 2003/04, trade deficit has gone up by 10.7 percent and reached Rs. 86.4 billion. This was ascribed to the 7.8 percent rise in trade deficit with India and 15.0 percent rise in trade deficit with other countries.

An assessment of commodities according to SITC grouping does not display any noteworthy changes in the composition of goods exported between FY

1994/95 and FY 2003/04 as illustrated in Appendix 2. Accordingly, as in FY1994/95 manufactured goods classified chiefly by materials, miscellaneous manufactured articles and food and live animals are the major exportable items in descending order even in FY 2003/04. The shares of these items in total exports stood at 43.8 percent, 28.5 percent, and 11.6 percent, respectively in FY 2003/04 compared to 52.5 percent, 32.7 percent and 8.9 percent, respectively, in FY 1994/95. Similarly, manufactured goods classified chiefly by materials, machinery & transport equipment, and mineral fuels & lubricants accounted for 26.8 percent, 18.9 percent, and 16.1 percent of total imports, respectively, in FY 2003/04. Their respective shares in FY 1994/95 were 39.7 percent, 20.5 percent and 7.4 percent.

In terms of product diversification, while comparing FY 2003/04 to FY 2002/03, the principal commodities that contributed to the increase in exports to India included soap, toothpaste, thread, M.S. pipe and plastic utensils. However, exports of vegetable ghee, pulses, cardamom, copper wire rod, pashmina and ayurvedic medicine to India fell. On the other hand, the major commodities that contributed to the decline in the exports to other countries were readymade garments and pashmina. There was an increase in the exports of woolen carpets handicrafts, tanned skin, pulses and silverware and jewelleryes to other countries. It should be noted that between FY 1994/95 and FY 2003/04 that some uniformity has been maintained in the export intensity with regard to goods exported to India although some fluctuations in the annual export of various commodities existed.

With regard to exports to other countries, Nepal's export to other countries till recently was dependent on primarily on exports of carpets and readymade garments. While carpets and readymade garments formed 88.6 percent of total exports to other countries in FY 1994/95, these two items accounted for 65.8 percent in FY 2003/04.<sup>2</sup> In between FY 1994/95 and FY 2003/04, there has not been much significant change in the commodity composition of exports to overseas countries. One major exportable commodity that emerged during this period was pashmina whose export value amounted to Rs. 1.1 billion in FY 2003/04.

The annual import requirements of Nepal are quite volatile in nature, and primarily consist of development goods, machinery and equipment, consumer items, petroleum products and industrial raw materials. The import of gold has

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<sup>2</sup> With regard to carpets, weak demand and problems relating to quality as well concerns over child labor in importing countries had an adverse impact on export of carpets leading to a deceleration in the second half of the 1990s. Though some many problems have been taken care of, the growth of carpet exports has not picked up as in the late 1990s. With respect to readymade garments, export growth initially can be attributed to the spillover of Indian exports, owing to quota limitations on India. However, exports of readymade garments that benefited from preferential treatment under the Multifibre Arrangement (MFA), encountered problems as international trade regulations underwent modifications. The decline in garment exports could be ascribed to the supply bottlenecks and the industry's inability to compete with other South Asian countries. Beginning January 1, 2005, trade in textile and clothing products is no longer subject to quotas but is governed by the general rules and disciplines laid down in the multilateral trading system. This will lead to a further decline in garment exports as the country has now to compete with China, India and Southeast Asian countries, among others. A clearer explanation is provided in Ministry of Industry, Commerce and Supplies (2004).

been declining since FY 1997/98 and considerably after FY 2000/01 following the liberalization of gold imports in India.<sup>3</sup> Compared to exports, imports are diversified and several commodities possess similar shares of total imports in the top rung, especially with regard to imports from overseas.

While comparing FY 2003/04 and FY 2002/03, the major imports from India that witnessed an increase included chemicals, chemical fertilizer, medicine, other machinery & parts, vehicles & spare parts, electrical equipments, petroleum products, M.S. wire rod, M.S. billet, and cold rolled sheet in coil. On the other hand, imports of textiles, cement, rice, agricultural equipment and parts, hot rolled sheet in coil and thread from India dropped. With regard to imports from third countries, the principal items that exhibited an augmentation included betel nut, crude palm oil, crude soybean oil, chemical fertilizer, writing and printing paper, copper wire rod & scrapes, steel rod & sheet, telecommunication equipment & parts, raw wool, zinc ingot, aircraft & spare-parts, other machinery and parts and thread. Likewise, the following items disclosed a fall in imports from other countries: raw silk, textiles, readymade garments, transport equipment and parts, video television & parts, computer parts, medical equipment & tools, and medicine.

There exists a geographical concentration in Nepal's exports, the top four major trading partners in FY 2003/04 being India, USA, Germany and United Kingdom. Analogously, the country's imports have been primarily from India, Singapore, China and Thailand.

In aggregate, the following conclusions may be derived relating to the foreign trade position of the country:

- No significant change has been recorded with regard to the composition of exports, especially with regard to overseas countries.
- No noticeable change has been observed with respect to the diversification of export markets.
- The export/import ratios, which indicate the degree of trade-off between exports and imports, have been slightly going down after FY 2000/01 as shown in Appendix 3.
- Appendix 3 indicates that there have been some fluctuations in the contribution of exports to the GDP. While exports/GDP stood at 8.0 percent in FY 1994/95, it rose to 13.6 percent in FY 1999/2000 before going down to 10.9 percent in FY 2003/04. Similarly, while the contribution of imports in GDP was 29.1 percent in FY 1994/95, it rose to 33.4 percent in FY 1996/97 before dropping to 27.5 percent in FY 2003/04.

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<sup>3</sup> In terms of imports from India, a provision was introduced in FY 1992/93 whereby certain items could be imported from India through the payment of convertible currency. This list has included 39 items as of mid-July 2004 and more are likely to be added to the list based on the basis of the structure of foreign currency reserves of the country, the effect on value addition and competitiveness of the industries and the prospect of export promotion. Details are given in NRB (2004).

- The share of manufactured good exports in total exports has gone down from 87.1 percent in FY 1994/95 to 80.6 percent in FY 2003/04. Conversely, the share of primary good exports has climbed up from 12.9 percent in FY 1994/95 to 19.4 percent in FY 2003/04.

### *Trade Policy of 1992*

The Trade Policy of 1992 focused on promoting sustainable trade to enhance the national economy by undertaking open and liberal policies, and by allowing wider participation of the private sector. It also accorded priority to new product development, trade diversification, reduction in imbalances and coordination with other sectors of the economy. These objectives highlighted outward orientation with particular stress on export development. The role and significance of the private sector were also clearly recognized. The salient features of the policy were: a) minimal role of public sector; b) undertaking of liberal and dynamic trade policy and procedures; c) stress on production and export of quality goods and services, d) simplification of tax procedures, and d) strengthening of institutional development.

The export policy acknowledged the need for an effective formulation and implementation of macro-economic policies. The strategies included, among others, the following: a) making the Nepalese currency partially convertible ultimately leading to its full convertibility; b) delicensing of exports except those banned or under quantitative restriction (QR); c) implementation of duty drawback system by devising suitable mechanisms; d) setting up of the EPZ; e) exemption from all charges and income tax on exports; f) simplification of procedures; and f) strengthening of export capability through proper development of infrastructure, backward and forward linkages, and institutional and manpower development, and improvement in product marketing and promotion activities.

In the import sector the major strategies consisted of the following: a) linking imports with exports; b) delicensing of imports, except for those on the quantitatively restricted list or in the auction system; c) reducing transit costs; and e) simplification of procedures.

However, the majority of the measures announced in the Trade Policy of 1992 have not been implemented to the desired extent. For instance, neither the EPZ nor the Nepal Trade Promotion Organization has been set up.

### *Nepal-India Trade and Transit Treaty and Trade Integration in South Asia*

Trade between Nepal and India is guided by the Nepal-India Trade Treaty first signed in 1991 and later modified in 1996. The treaty was further renewed on March 3, 2002. Unlike the Treaty signed in 1996, several new restrictions were introduced such as stricter Rules of Origin (RoO) and incorporation of safeguard clauses. The new Rules of Origin (RoO) encompass: (a) value addition (domestic content) requirements of 30 percent of ex-factory prices (from March 2003), and

changes in tariff heading (CTH) at the four-digit level of the harmonized system code. For manufactured exports of Nepal, that cannot satisfy the CTH criteria, the new Rules of Origin demand that these products have undergone a sufficient manufacturing process within Nepal, determined on a case-by-case basis. Moreover, four Nepalese items would now be permitted to enter free of basic customs duty into the Indian market on a fixed quota basis.<sup>4</sup>

The ten-year trade figures in Appendix 1 depicts that India's share in Nepal's trade has been gradually rising, especially during the last four years, but overseas trade still accounts for more than 40 percent of both imports and exports. Herein lies the significance of transit facilities for Nepal. With regard to the Nepal-India Transit Treaty signed between the two countries on January 5, 1999, there is the provision of the automatic renewal of the transit treaty every seven years. Under this Treaty, India provides port facilities at Calcutta and Haldia for the country's trade with overseas countries. Fifteen transit routes to Calcutta/Haldia are specified. Nepal can also utilize the facilities at Mumbai Port (including the Jawaharlal Nehru Port Trust) and Kandla Port for third-country trade. Moreover, import insurance is needed only for the sensitive goods. The godown facility at Calcutta airport and the provisions permitting Nepali importers to hand over the original copy of Custom Transit Declaration at the Indian customs should ease the import and export of goods.

While the South Asian Association for Regional Cooperation (SAARC) was set up when its Charter was formally adopted on December 8, 1985 by the Heads of State or Government of Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka, the agreement on South Asian Preferential Trading Arrangement (SAPTA) took off only in December 1995. The SAPTA accord attempted to reduce tariffs and non-tariff barriers among the SAARC member countries. SAPTA was envisaged primarily as the first step towards the transition to the South Asia Free Trade Area (SAFTA), leading subsequently, towards a Customs Union, Common Market and Economic Union. The four rounds of SAPTA had led to the coverage of more than 5,000 tariff line items. However, studies have demonstrated that the SAPTA process did very little in stimulating regional trade.<sup>5</sup> The process was very lengthy and slow. Again, at least in the first two rounds of the SAPTA, non-tariff barriers (NTBs) were not considered for removal with the granting of tariff preferences. The other problems were that a) the tariff cuts were not deep enough, b) a wide range of goods was not subject to preferential tariffs and (3) some actively traded goods were left out from preferential tariffs.

The SAFTA agreement was signed at the 12<sup>th</sup> SAARC Summit in January 2004.<sup>6</sup> It is to come into force on January 1, 2006. The SAFTA aims at a)

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<sup>4</sup> While 100,000 tons of vegetable ghee would be permitted to enter India each year free of basic customs duty, 10,000 tons of acrylic yarn, 7,500 tons of copper products, and 2,500 tons of zinc oxide would also be allowed.

<sup>5</sup> This is illustrated in Mukherji (2002) and Kemal (2004).

<sup>6</sup> The SAFTA was initially mooted at the 8<sup>th</sup> SAARC Summit in New Delhi in 1995 when it was proposed that it should be effective by 2005. The effective date of SAFTA was changed to 2001

enhancing mutual trade and economic cooperation; b) eliminating trade barriers; c) promoting conditions of fair competition; d) building effective mechanism for implementation and resolution of disputes; and e) furthering regional cooperation. Under the treaty, the non-LDCs are required to bring down their tariffs to 0-5 percent by 2013, except Sri Lanka which is required to do so by 2014. However, non-LDCs need to bring their tariff to 0-5 percent for the products of LDCs by 2009 with regard to products of export interest to the latter. The LDCs, on the other hand, need to bring down their tariffs to 0-5 percent by 2016.

The SAFTA treaty affirms the existing rights and obligations under the Marrakesh Agreement establishing the WTO and other treaties and agreements to which SAARC members are signatories. It calls for free movement of goods in the region via elimination of tariffs, para-tariffs that include border charges and fees and non-tariff restrictions on movement of goods and any other equivalent measures. The SAFTA framework has also incorporated simplification and harmonization of standards, customs clearance, import licensing, import financing by banks, transit facilities particularly for landlocked countries, and enhancing intra-SAARC investment, among others.

During the fifth meeting of the Committee of Experts (CoE) in October, 2004, it was agreed in principle to evolve common RoO for the SAFTA. The SAFTA RoO would be based on value addition approach. This is a major change from what the SAARC countries agreed to earlier on—to evolve RoO on product-to-product basis adopting all applicable approaches. Agreement was also made for lowering the sensitive lists, which incorporate commodities that will not be subjected to trade liberalization program, considerably from the proposed level of 20 percent of the total tradable items. The CoE needs to conclude its SAFTA negotiations by June 2005 and proceed on to make preparations for its enforcement from January 1, 2006.

All in all, the SAFTA is expected to enter into force on the due date upon completion of four procedural formalities: formation of sensitive lists; rules of origin, revenue loss compensation mechanism and ratification by the all member states.

The SAFTA agreement in its present form also needs to be scrutinized from different perspectives. In the first place, it includes only trade in goods and excludes the crucial services sector. It has overlooked the existing and potential national competitive advantage that the SAARC member states have in sectors like tourism and hospitality (Nepal, Maldives, Sri Lanka), retailing of electricity (with Pakistan's surplus power, Nepal and Bhutan's hydel-power capacities), transmission/distribution of gas (Bangladesh), and health services (India), and a host of other services.

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together with the formation of a Group of Eminent Persons (GEP) to draw up a roadmap for SAFTA at the 9<sup>th</sup> SAARC Summit in Male in 1997. At the 10<sup>th</sup> SAARC Summit in Colombo in 1998, the GEP report was submitted which suggested that a more practical timetable for SAFTA was 2008. It was decided to have a 'Framework Treaty' by 2001. Due to regional politics, the preparation works for SAFTA got delayed. Finally, in January 2004 the SAFTA accord was signed.

Two, the agreement is silent on how SAFTA is going to integrate the existing bilateral free trade agreements (BFTAs) between some SAARC countries (such as the Nepal-India BFTA and the Indo-Lanka BFTA) into the SAFTA agreement. Moreover, rules and regulations for the effective implementation of the Trade Liberalization Program and granting of special and differential treatment to the LDCs (Bangladesh, Bhutan, Maldives and Nepal) have not been clearly addressed.

### *Nepal's Entry into the WTO and the BIMST-EC*

Nepal officially became the 147<sup>th</sup> member of the World Trade Organization (WTO) on April 23, 2004. By joining the WTO, Nepal can fully enjoy the rights that all members have under the WTO agreements, such as non-discrimination by other WTO members and the ability to use the WTO's dispute settlement procedure. Broad commitments were made in 11 services sectors and 70 sub-sectors out of a total of 170 classified by the WTO. Nepal accepted an average tariff binding of 42 per cent in agricultural products and around 24 per cent in industrial goods.

Among the commitments on legislation with respect to the trade regime, Nepal agreed to amend or enact 38 various acts and regulations to become compatible with WTO provisions. For instance, the country is required to implement fully the provisions of the Agreement on Sanitary and Phytosanitary Measures and Agreement of Technical Barriers to Trade (TBT) by January 1, 2007. With respect to the Agreement on Trade-Related Intellectual Property Rights (TRIPs), as an LDC, Nepal needs to develop a new Industrial Property Act, which will include all the substantive provisions of the TRIPs agreement. It would encompass all categories of industrial property and would incorporate the basis for an adequate enforcement and be promulgated no later than January 1, 2006. The country has to introduce legislation on anti-dumping, countervailing duties and safeguard measures within one year from the date of accession, in order to safeguard its local industries against unfair trading practices by the exporting countries.

Thus, there are various challenges that Nepal will face. The country needs to seek alternative revenue avenues to finance developments gradually, changing laws and regulations to make laws compatible with WTO commitments and obligations, developing transparent mechanisms and creating institutions and financing the cost of negotiations coupled with recourse to legal measures and implementation.

Nepal became a member to the Bay of Bengal Initiative for Multi-sectoral Technical and Economic Cooperation (BIMST-EC) in February 2004. The other members of this regional trading group are Bangladesh, Bhutan, India, Myanmar, Sri Lanka and Thailand. BIMST-EC's six core areas of cooperation, *inter alia*, are agriculture, energy, fisheries, tourism, trade and transportation.

The Framework Agreement on BIMST-EC FTA was signed on February 8, 2004 at Bangkok during the 5<sup>th</sup> BIMST-EC Economic Ministers' Meeting. The FTA agreement would first start on trade in goods from 2006, while the FTA on trade in services and investment would begin from 2007. In line with the

agreement in trade in goods, the products excluding those included in the negative list would be subject to tariff cut or elimination on two tracks: fast track and normal track. With respect to negotiations for trade in services, emphasis would be given to the progressive elimination of substantially all discrimination between or among the member countries and/or prohibition of new or more discriminatory measures, except for measures allowed under specific Article of the WTO General Agreement on Trade in Services.

The draft agreement consists of 27 articles and encompasses areas such as rules of origin for BIMST-EC FTA, trade liberalization program, customs and trading procedures, sensitive list, global safeguard and BIMST-EC's transitional safeguard, among others. The members are to develop a modality for dispute settlement arrangement, anti-dumping measures, subsidy and countervailing measures and non-tariff measures to foster free trade in the region.

During March 8-10, 2005, a meeting of the third round of Trade Negotiation Committee (TNC) of BIMST-EC took place in Kathmandu where the preliminary framework of rules of origin and dispute settlement mechanism, the two crucial provisions of the BIMST-EC FTA accord, was adopted. The detailed rules and regulations relating to this framework would be finalized through negotiations at the future meetings.

BIMST-EC FTA is a step to free trade among countries in two of the fastest growing sub-regions of Asia, South-east Asia and South Asia. This FTA could act as a link between the AFTA (ASEAN Free Trade Area) and the SAFTA.

### III. CAUSAL RELATIONSHIP BETWEEN GDP AND EXPORTS

This section attempts to determine the status of the causal relationship between growth in GDP and growth in exports as well as between growth in manufacturing exports and growth in GDP. The Granger causality test is applied to affirm such relationship between the foregoing variables.<sup>7</sup>

The tests are based on the following equations:

$$Y_t = \beta_0 + \sum \beta_{1k} Y_{t-k} + \sum \beta_{2l} X_{t-l} + u_t \quad (1)$$

$$X_t = \gamma_0 + \sum \gamma_{1k} X_{t-k} + \sum \gamma_{2l} Y_{t-l} + v_t \quad (2)$$

where Y and X are the variables to be examined, u and v are mutually uncorrelated white noise errors, t denotes the time period and k and l are the number of lags. For this study purpose, the equations are presented as:

$$Y_t = \beta_0 + \sum \beta_{1k} Y_{t-k} + \sum \beta_{2l} X_{t-l} + u_t \quad (3)$$

$$X_t = \gamma_0 + \sum \gamma_{1k} X_{t-k} + \sum \gamma_{2l} Y_{t-l} + v_t \quad (4)$$

$$Y_t = \delta_0 + \sum \delta_{1k} Y_{t-k} + \sum \delta_{2l} MX_{t-l} + u_t \quad (5)$$

<sup>7</sup> For an extensive elaboration of the Granger causality test, please refer to Han (2003) and Siddique and Selvanathan (1999).

$$MX_t = \alpha_0 + \sum \alpha_{1k} MX_{t-k} + \sum \alpha_{2l} Y_{t-l} + v_t \quad (6)$$

where  $Y_t$ ,  $X_t$  and  $MX_t$  represent GDP, exports and manufactured exports, respectively.<sup>8</sup>

The Granger procedure is applied in order to ascertain the direction of causality between the variables under study. The Granger causality test demands for stationary time series data. Generally, economic variables have unit roots and they are non-stationary in nature. So, it is customary for the researchers to depend heavily on co-integration technique to demonstrate the long-run relationship between the variables under study. In the bivariate case where the variables are co-integrated, the probability of the existence of error correction model is high. In other words, in such cases, there is some adjustment process in the short-run that prevents the errors in the long-run relationship from becoming larger.

The following equations are employed to test for the null hypothesis of non-stationary against the alternative of stationary as mentioned below:

$$dx_t = a + bt + cx_{t-1} + u_t \quad (7)$$

$$dx_t = a + bt + cx_{t-1} + \sum \delta_1 dx_{t-1} + u_t \quad (8)$$

where  $dx$  represents the difference of the variable  $x$  under study,  $t$  denotes time and  $u$  is an error term.

The data under study covers the period from FY 1977/78 to FY 2003/04. However, the number of observations has been reduced by one or two depending upon the degrees of integration. For regression purposes, real GDP is taken as a determinant for income. Absence of data on export prices prohibited the preparation of real exports. However, GDP deflators were used as a proxy and accordingly, based on these deflators, real export figures were computed. The same GDP deflators were applied for computing real manufacturing exports. Both tests for non-stationary and co-integration were conducted and the variables in the difference forms exhibited better results. Accordingly, the Granger causality tests were conducted on the basis of the improved series.

The Engle-Granger Error Correction procedures were applied and the following results were arrived at:

$$\Delta Y_t = 0.05394 + 0.278 \Delta Y_{t-1} + 0.01071 \Delta X_{t-1} + 0.06214 ecm_{t-1} \quad (9)$$

(4.796)    (0.956)    (0.286)    (0.510)

$$R^2 = 0.063 \quad \text{Adjusted } R^2 = -0.078$$

$$\Delta Y_t = 0.05377 + 0.268 \Delta Y_{t-1} + 0.002612 \Delta MX_{t-1} - 0.154 ecm_{t-1} \quad (10)$$

(5.060)    (1.260)    (0.100)    (-1.487)

$$R^2 = 0.178 \quad \text{Adjusted } R^2 = 0.054$$

<sup>8</sup> While data for exports and manufactured exports (SITC 5-9) are taken from NRB (2004a), data of GDP are taken from different publications of the Central Bureau of Statistics.

$$\Delta X_t = 0.238 + 0.680 \Delta X_{t-1} + 4.544 \Delta Y_{t-1} - 0.647 ecm_{t-1} \quad (11)$$

(3.387)    (2.816)    (2.454)    (-3.283)

$R^2 = 0.401$     Adjusted  $R^2 = 0.316$

$$\Delta MY_t = 0.217 + 0.409 \Delta MX_{t-1} + 2.422 \Delta Y_{t-1} - 0.191 ecm_{t-1} \quad (12)$$

(2.310)    (1.796)    (1.283)    (-1.146)

$R^2 = 0.167$     Adjusted  $R^2 = 0.048$

All coefficients in Equation (11) have correct signs. The statistically highly significant error term implies that GDP growth causes export growth. Additionally, the magnitude of the coefficient suggests that 65 per cent of the disequilibrium in the previous period is made up for in the current period. Similarly, all coefficients in Equation (12) present correct signs and the error term infers that growth in income may cause growth in manufacturing exports. Likewise, equation (10) indicates that growth in manufacturing exports may lead to the growth of GDP; however, the period of disequilibrium is very high. Equation (9) does not support the fact that exports growth causes income growth.

The aforesaid findings are tested by F-statistic.

TABLE 1. Granger Causality Test

Causality	F-statistic
GDP → Exports	6.748**
Exports → GDP	0.849
GDP → Manufactured Exports	2.188
Manufactured Exports → GDP	2.366

→ indicates that the left hand side variable causes the right hand side variable.

\*\* the F-statistic is significant at 5% level of significance.

The statistically significant F-statistic confirms the fact that GDP growth is one of the prominent factors leading to the growth of exports in the country. This strongly supports the previous finding. The insignificant F-statistic suggests that growth in income does not lead to growth of manufacturing exports. Similarly, the growth in manufacturing exports does not lead to income growth. However, these two results are not consistent with the above findings. The statistically very insignificant F-statistic is unable to show that export growth gives rise to GDP growth.

To conclude this section, extensive testing on pattern of causality between exports and economic growth demonstrates that exports do not seem to cause the growth of GDP in the Granger sense. However, causality in the opposite direction, namely, from economic growth to exports, is statistically supported.

#### IV. TRADE-RELATED BOTTLENECKS AND REMEDIES

This section of the paper delineates the major problems, both structural and policy-related, of the trade sector and provides guidelines to resolve them.

##### *Technological Mastery*

Technological mastery is an essential condition for industrial upgrading, sustaining competitiveness and entering markets for high-valued goods. Technological weaknesses in Nepal include the low level of technology deployed in productive activities, almost total absence of local technological capability, including the inability to adapt and utilize new technologies, and a lack of resources to procure new technologies.

Due to weak technical and management capabilities, the Nepalese exporters are not able to adhere to the complex and detailed specifications, required by importers from other countries in terms of quality, size, delivery time and packaging, among others. In view of the competitiveness in the international markets, the exporters need a better understanding of elements of their production cost to be able to conduct realistic and crucial price negotiations with buyers. Their almost total lack of such capacities is aggravated by differences in 'business culture'. The business culture in the international market involves quick and timely deliveries, with minimal space for flexibility in fulfilling contracts.

It is crucial for the country to initiate measures to improve productive capacities and make significant gains in productivity and competitiveness through technological upgrading, especially as many of its productive activities utilize sub-optimal technologies at present. The implementation of a successful technology policy, however, depends on a skilled and educated labor force to tackle the many issues relevant to acquisition, utilization, absorption and generation of technology. It also depends on the country's capacity to invest in research and development (R&D) especially to promote locally developed technologies that have an effect on productivity growth, and to establish a link between R&D and production units.

##### *Quality Standardization and Investment in Infrastructure*

Quality control is integral to competitiveness. Problems of quality in Nepal include precision, grading, and standardization. The current low number of industrial firms having ISO-9000 Certification is a glaring demonstration of these problems, which in turn are restricting the ability of local firms to penetrate in principal export markets such as the EU, USA, and Japan.

In the backdrop of the rising competitiveness in the international market for quality standard and the likely negative impact of low quality Nepalese export products on their reliability and the consequent deterioration in the competitiveness, there is a need to undertake quality standardization and improvement programs to maintain the quality of export products. It is also

important to define minimum export quality and a system of compulsory quality inspection and standardization through which each export product has to pass.

Nepal is landlocked and geographically situated away from the major world economic centres; hence, emphasis must be accorded to improve infrastructure and thereby lower business transaction costs. It is, therefore, crucial that the country makes every attempt to attract investment in sound infrastructure development to enhance export competitiveness. More efforts are required for building and maintaining world-class telecommunications, roads and airports. Electricity and energy supply should be consistent and affordable.

### *Competitive Ability and Development of Human Resources*

In this age of global competition, it is not just enough for the Nepalese firms to be competitive at the domestic level. They need to be competitive in the global context for which they should hold some competitive advantage such as economies of scale, cutting-edge technology, marketing strengths, efficient production and distribution systems, and/or cheap labor.<sup>9</sup> The country does not possess comparative advantage in any one of the areas excluding the availability of cheap labor.

Building up skilled human resources is the key for grabbing opportunities for market opening. The priority accorded by the East Asian countries on this area of social development provides a good example of success story, which seems worth replicating by Nepal. In the recent past, human resource has become the key to success in international trade. Three areas could be identified in the context of Nepal. One, there is a need to develop capacities in product innovation. Two, promotion of marketing skills should be accorded top priority. The third area is the personnel in the public sector, particularly institutions relating with trade and commerce. Limitations in trade-related expertise, analytical skills and negotiating skills are the result of the small staff, lack of resources for hiring and training and insufficient experience.

### *Coordination of Trade with Development Strategies and Safeguard Arrangements*

Despite the fact that Nepal has done utmost to open up its economy, the expected beneficial results could not be generated owing to lack of coherence between trade policies and other development policies. Thus, there is a need to coordinate trade and development strategies and process.

Although openness in general is preferable to protectionism, free trade without any safeguards could lead to disaster, as has been demonstrated by the East Asian and the Latin American crisis. It is thus crucial to create space for policy

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<sup>9</sup> Details are provided in Adhikari, Ratnakar and Hiramani Ghimire (2001).

maneuvers, particularly in the economically sensitive sectors. It is in this context that safeguard arrangements are suggested.

### *Commodity and Market Diversification*

Too much reliance on a few low-value export items such as readymade garments and carpets has acted as obstacles in enhancing trading opportunities. The export concentration ratio (denoted as the share of the principal export products [carpets and garments] in the total export value) is quite high.<sup>10</sup> On top of that, while exports of readymade garments and carpets form a large share of the country's export basket, they are insignificant in terms of the international supply, so that the country has no influence whatsoever on the world prices that is advantageous to it. Moreover, hardly any efforts have been made either to reduce their export concentration ratio or to develop into new areas of products or services that could be exported into the international market.<sup>11</sup>

Another problem is the absence of market diversification for the development of the trade sector. For instance in FY 2003/04, about 70 percent of total foreign exchange earnings have been contributed from exports to the United States, Germany and Switzerland.

Thus, Nepal has not seriously taken efforts to develop products, identify product market and establish a link between the two, although the objective of product and market diversification has been adumbrated in all the Plan documents as well as the various policies announced by the Government from time to time. Hence, this is an area where immediate steps should be taken particularly as Nepal has become a member for the WTO and will be bound to face global competition.

### *Remedies for the Post-MFA Phase-out*

Starting January 1, 2005, trade in textile and clothing products is no longer subject to quotas under a special regime outside normal WTO/GATT rules but is based on the general rules and disciplines specified in the multilateral trading system. It has been contended that under either free trade or a global quota system, the new and smaller suppliers would be squeezed out of international markets because of the size and greater productivity of established exporters. Thus, to the extent it is true that, with the elimination of the MFA, trade in textiles and clothing products would tend to be drawn back to the larger exporters like India and China, a small least-developed country (LDC) like Nepal might encounter major problems unless proper steps are undertaken.

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<sup>10</sup> This is elaborated in Ministry of Industry, Commerce and Supplies, *op.cit.*

<sup>11</sup> The growth of exports of readymade garments, for instance, was due to the quota system under the MFA and have already started to go down in the post-MFA era.

To become competitive in the global market, focus should be given to areas such as upgradation of technology as well as establishment of a training institute to improve skill, product specialization for updated fashion and quality among others. The government could play a pivotal role in the development of technical services by permitting the provision of consultancy services through foreign investment.

There is also a need for more investment in productivity enhancement by applying modern technology. Labor laws also need to be made compatible with the garment industry. While formulating the labor policy, issues such as job security, labor strikes and export delivery should also be considered.

Nepal enjoys the GSP facility in EU under the Everything but Arms (EBA) initiative introduced in 2001, which has abolished quotas and tariffs on all imports, including textiles and apparels. The EBA initiative has a significant value to Nepal as it can gain zero duty access to the EU market only under this scheme. Moreover with the extension of the derogation facility to the country by the EU for another two years, garment exports from Nepal to the EU would continue to enjoy exemption from its stricter rules of origin requirement and yet obtain the duty and quota free market access.<sup>12</sup> Hence, the EU market could be more valuable for sustainability in the post-MFA era at least in the short run.<sup>13</sup>

As IMF's Trade Integration Mechanism has assured that assistance from the international community will be provided to LDCs with adjustment difficulties owing to the expiry of the ATC and the restoration of more liberal trade in textiles and clothing, Nepal should take advantage of this facility.

The proposal relating to the creation of a garment processing zone (GPZ) in Nepal appears quite pragmatic.<sup>14</sup> The objective of the GPZ would be to facilitate government strategies for effective implementation of incentives and institution of trade support services within the zone. This would also lower the different types of procedural hassles. A recent study has also suggested the concept of industrial cluster under the GPZ.<sup>15</sup> Under this, a large-scale production with greater control over the management of sourcing and supply chain to lower production cost would take place. For facilitating the mass production with economies of scale, ancillary industries of basic materials for manufacturing of garments need to be developed within the industrial cluster. All the facilities would be located in proximity to the manufacturing zone and to the transit point to reduce delivery time.

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<sup>12</sup> The derogation facility had expired on December 31, 2004.

<sup>13</sup> The Government of Canada also agreed to grant duty free access to Nepalese readymade garments from January 1, 2003, allowing duty-free export of Nepalese textiles and apparels into Canada. As the garment industry is passing through a difficult phase, attempts could also be made to penetrate into the Canadian market which could provide some kind of a breathing space for the time being.

<sup>14</sup> The framework of a GPZ is provided in Shakya (2001).

<sup>15</sup> This concept of industrial cluster is elaborated in Shakya (2004).

### *Tariff Determination and Valuation*

The tariff rates on some imported commodities can be different based on how the good is categorized under the different headings of the harmonized codes. These lead to opportunities for arbitrary decisions, delays and corruption. For instance, when a company imports equipment the duty varies depending on whether it is a 'main manufacturing machinery' or not. The same equipment can imply 'main manufacturing machinery' for one company while not for a firm in another company leading to an opportunity for making arbitrary decisions.

The valuation of imported products at customs for determining the import duties is another hurdle for many firms. Customs officials are concerned that firms underinvoice their imports to lower their duties. Hence, these officials make use of 'reference value' which refer to the values that commodities are believed to have, instead of the actual invoice value of the goods. These reference values are normally based on the highest import price historically declared on an invoice, and may overvalue goods significantly when the price of the goods has fallen over time. This is particularly problematic as the reference values are not revised often. To mitigate this problem, proper training should be provided to the custom officials in line with the WTO system of inspection.

### *Strong Legal Framework and New Trade Policy*

The country does not possess a strong, flexible and legal framework for regulating trade. The Export-Import Control Act, 1957 was undertaken primarily with the objective of controlling or prohibiting the export or import of restricted items and those announced by the government from time to time through publication. Moreover, this Act, in the present context, seems to have lost its significance as hardly anything has been mentioned about the process of registration of export-import agencies or houses, export promotion, sharing of information, finance, export incentives, institutional arrangements, and dispute settlement, among others. Hence, this Act should be amended, taking into consideration its compatibility with the WTO provisions. Or else, a separate foreign trade act should be formulated and enacted, for making foreign trade systematic by assessing and consolidating existing acts and regulations.

Moreover, the Trade Policy of 1992 has been outdated. In the present context of globalization and liberalization and as Nepal has joined the WTO, the SAFTA and the BIMST-EC FTA, and is in the process of becoming a member to the Bangkok Agreement, it is exigent that a New Trade Policy be formulated.<sup>16</sup>

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<sup>16</sup> In this context, India announced a detailed Foreign Trade Policy (2004-09), covering a period of five years in September 2004. The twin objectives include: a) to double India's percentage share of global merchandise trade by 2009; and b) to act as an effective tool of economic growth by according priority to employment generation, particularly in semi-urban and rural areas. Nepal could also follow this path by announcing a New Trade Policy valid for a specific number of years.

### *Effective Trade Institution*

The Ministry of Commerce, Industries and Supplies (MOICS) and the Department of Commerce are the major bodies responsible for governing trade in Nepal. There is also the Export Promotion Committee, whose primary objective is the formulation of national policies for export development, monitoring of the export trends and operating the Export Development Fund for export promotion programs. Then, there is the Trade Promotion Centre, which focuses primarily on enhancing and strengthening of foreign trade through export promotional program.

However, it has been quite some time since these institutions have been effective in promoting exports and meeting their objectives. Again, the institutional capabilities to monitor activities and assist in trade information and other services are quite limited. Hence, with the increasing role of the private sector and the rapid development and application of information technology, it appears that the TPC should be reconstituted as adumbrated by the Trade Policy of 1992, and a new Nepal Trade Promotion Organization should be established. One of the tasks of this Organization should be to launch an effective communication campaign to convince importing countries that the goods generated in the country reflect competitiveness and that the competitiveness is based on genuine comparative advantage.

### *Development of Export Processing Zones*

It was in December 1990 that the government constituted a high-level working committee under the chairmanship of the Industry Minister to set up an EPZ in Kathmandu to promote export-oriented industries. An EPZ is an industrial area especially designed for export-oriented industries and it provides the facility of tax exemption on imports of raw materials needed by the manufacturers inside the region. However, the manufactured goods are not allowed to be sold in the country. Even in 1990, five products were identified which could be produced by the industries inside the EPZ: carpets, garments, leather-based products, electric and electronic goods, products based on herbs and jewellery. However, almost fifteen years have passed, and there is no sign of the creation of an EPZ yet. It is crucial that the government takes necessary steps immediately to formulate relevant laws for establishment of EPZs, and measures should be initiated to set up EPZs at appropriate locations.<sup>17</sup>

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<sup>17</sup> In this context it is relevant to mention here that in order to address the poor infrastructural services and administrative inefficiencies emanating from lengthy bureaucratic procedures, Bangladesh developed specially designed EPZs and has been giving support services to industries. The EPZs could be emulated by Nepal since improving the infrastructure in the specified areas can be much faster and cheaper than doing it on a larger geographical area.

### *Reliable Trade Data and Periodic Reviews*

There is scarcity of data on market information, pricing, quality, and level of competition, among others. Similarly, reliable data on trade are lacking as the figures published from one institution is different from the other institution. The proposed Nepal Trade Promotion Organization could be entrusted with this task of creating commodity-wise database relating to investment, production, imports and exports, among others.

Periodic reviews of performance of the country in both regional and international markets need to be undertaken in order to maintain the country's export thrust. Periodic policy analysis should be conducted by all relevant stakeholders in order to minimize the inherent gap between policy formulation and implementation with agreed time frames. This will enable the adoption of the corrective measures to be timely executed. Reviews thus call for capacity in the various institutions to deal with issues such as a) target-setting, b) collection of timely and relevant data, c) analytical skills, and d) information dissemination.

### *Lessons from SAARC Countries*

A comparison of Nepal's export policy with the export policy of both India and Bangladesh reveals that both India and Bangladesh have accorded priority to the growth of specific product-wise exports and exports to new markets by giving special incentives, which is missing in Nepal and which is very crucial in this competitive era for sustainability.<sup>18</sup> India has also given special considerations for the development of backward regions. Both India and Bangladesh have given special protection to the products of small scale and cottage industries to enhance such industries towards exports by rendering double weightage to incentives. So far, Nepal has done little to uplift the backward regions towards the export business; it has provided little protection-cum-incentives to the small scale and cottage industries. Again, there exist no policies in allowing foreign trading houses in export business as well as encouragement to these exporters who improve the quality of product for exports. Hence, reviews of export policies of India and Bangladesh shows that in Nepal there is a need for substantial improvement over the existing export policy.

### *Policy Credibility*

Clear goals in trade must be systemically implemented in order to revive and build business confidence and remove inbuilt skepticism. In order to remove uncertainty and aid exporters in planning, the policies of the government must be perceived to be real, predictable and likely to be sustained within a given

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<sup>18</sup> The export policies of India and Bangladesh are highlighted in Research & Study Centre Pte. Ltd. (RESTUC) (2000).

timeframe. Trade policy measures targeted to promote exporters must thus be compatible with other measures on the fiscal side, balance of payments, etc. For enhancing Nepal's export drive, a demand for political champions who are willing to keep all the parties on track in policy formulation and implementation phases exists. The drive to export must not encounter frequent policy reversals and must not be compromised by other policies that have an adverse impact on the capacity of exporters to deliver.

## V. CONCLUSIONS

Although trade is considered as an engine of growth in economic development of a country, in Nepal there prevails a big gap between the objectives and vision and the current state of affairs in the trade sector. Though Nepal is already a member of the WTO, the institutional and legal structures to implement the WTO agreement have not been properly developed. Market and product concentrations of exports have led to volatile export proceeds. Structural difficulties of trade related services and infrastructures have obstructed to materialize potential comparative advantages.

The country still relies on a relatively small basket of export and a few destination markets. A large proportion of its exports encounter dwindling world demand, demanding an urgent restructuring of its export basket. Similar to other LDCs of South Asia, Nepal has difficulties relating to lack of competitive ability, supply side limitations, high export concentration, and implementation problems that inhibit its ability to seek gains from international trade.

Integration of Nepal into the global economy is an insufficient but necessary precondition for long-term sustainability of poverty eradication. This can only be attained through an integrated approach, including trade and macroeconomic policy, private sector development and participation, finance, infrastructure, education and other supply-side measures. Regional integration, compatible with multilateral trade rules, can be a paramount stepping stone for Nepal to integrate itself into the world economy and can aid in making liberalization work by enhancing the credibility and transparency of policy reforms.

## APPENDIX 1. Direction of Trade (Rs. in Million)

Fiscal Year	Total Trade					Export					Import				
	India		Overseas		Grand Total	India		Overseas		Total Exports	India		Overseas		Total Imports
	Amount	% Share	Amount	% Share		Amount	% Share	Amount	% Share		Amount	% Share	Amount	% Share	
1994/95	22740.2	28.0	58578.5	72.0	81318.7	3124.3	17.7	14514.9	82.3	17639.2	19615.9	30.8	44063.6	69.2	63679.5
1995/96	28081.2	28.8	69254.4	71.2	97335.6	3682.6	16.1	19198.5	83.9	22881.1	24398.6	32.8	50055.9	67.2	74454.5
1996/97	30079.5	25.9	86110.4	74.1	116189.9	5226.2	23.1	17410.3	76.9	22636.5	24853.3	26.6	68700.1	73.4	93553.4
1997/98	36125.4	31.0	80390.1	69.0	116515.5	8794.4	32.0	18719.1	68.0	27513.5	27331.0	30.7	61671.0	69.3	89002.0
1998/99	44650.4	36.2	78551.2	63.8	123201.6	12530.7	35.1	23145.6	64.9	35676.3	32119.7	36.7	55405.6	63.3	87525.3
1999/00	63546.8	39.4	97849.1	60.6	161395.9	22618.7	43.8	29004.3	56.2	51623.0	40928.1	37.3	68844.8	62.7	109772.9
2000/01	81055.6	47.3	90285.7	52.7	171341.3	26030.2	46.8	29623.9	53.2	55654.1	55025.4	47.6	60661.8	52.4	115687.2
2001/02	84578.3	54.8	69755.5	45.2	154333.8	27956.2	59.6	18988.6	40.4	46944.8	56622.1	52.7	50766.9	47.3	107389.0
2002/03	97354.2	55.9	76928.5	44.1	174282.7	26430	52.9	23500.6	47.1	49930.6	70924.2	57.0	53427.9	43.0	124352.1
2003/04	109516.6	57.6	80671.2	42.4	190187.8	30777.1	57.1	23133.6	42.9	53910.7	78739.5	57.8	57537.6	42.2	136277.1

Source: NRB (2004a).

## APPENDIX 2. Trade by SITC Grouping (Rs. in Million)

SITC Group	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04
Food & live animals	1562.7	1946.6	2661.7	3123.2	3724.5	4240.5	4776.6	5094.2	6100.9	6276.9
Tobacco & beverage	11.3	9.7	14.9	22.8	50.0	117.2	75.6	145.7	138.7	55.2
Crude materials, inedibles except fuel	485.5	768.7	663.5	487.1	469.9	561.3	751.1	624.5	800.1	714.3
Mineral fuels & lubricants	0.0	1.3	1.4	20.9	0.5	2.2	1.3	1.6	5.5	14.5
Animals & vegetable oil & fats	214.1	251.3	312.6	2136.3	3597.2	3229.7	4104.0	7421.4	4278.7	3375.7
Chemicals & drugs	302.3	640.4	1353.4	1968.5	2804.0	3933.2	4041.7	3308.3	3279.0	3865.9
Manufactured goods classified chiefly by										
Materials	9260.3	10455.7	11028.6	11637.1	13539.6	15838.7	18909.3	17394.9	17794.7	23601.7
Machinery & transport equipment	37.1	35.2	59.6	58.0	97.8	390.8	343.6	364.9	208.2	619.5
Miscellaneous manufactured articles	5765.8	5772.2	6540.3	8059.6	11392.8	21509.2	22650.9	12589.3	17281.5	15380.1
Commodity and transactions not classified according to kind	0.1	0.0	0.5	0.0	0.0	0.0	0.0	0.0	43.3	6.9
<i>Total Exports</i>	<i>17639.2</i>	<i>19881.1</i>	<i>22636.5</i>	<i>27513.5</i>	<i>35676.3</i>	<i>49822.7</i>	<i>55654.1</i>	<i>46944.8</i>	<i>49930.6</i>	<i>53910.7</i>
Food & live animals	4464.0	4785.8	5400.5	4929.0	7619.5	10839.0	5994.4	6333.2	9370.5	8554.0
Tobacco & beverages	500.9	508.6	590.7	799.5	846.1	906.5	906.1	717.1	792.2	1026.8
Crude materials, inedibles except fuel	3347.9	4865.9	5487.1	6976.2	6246.7	7012.4	7559.6	6712.7	8479.3	10550.6
Mineral fuels & lubricants	4717.1	5549.3	7160.3	9537.3	8737.5	9097.9	11269.2	15222.3	19944.2	21904.1
Animals & vegetable oil & fats	2056.0	2830.9	2327.6	2025.8	3329.0	4446.0	5589.2	7887.5	7750.5	8634.4
Chemicals & drugs	7193.2	8686.8	8504.2	11077.3	12476.4	14474.2	12941.9	12380.9	14319.5	16544.9
Manufactured goods classified chiefly by materials	25300.6	28129.7	44741.9	32601.6	25638.0	34420.0	41188.0	32889.1	34888.2	36510.5
Machinery & transport equipment	13027.6	15301.1	13794.9	16734.7	18063.7	20547.9	23027.8	19513.8	20702.1	25694.2
Miscellaneous manufactured articles	3057.2	3794.6	4016.4	3974.0	4302.4	6682.8	7210.2	5670.3	6582.7	5103.8
Commodity and transactions not classified according to kind	15.0	1.8	1529.8	346.6	266.0	78.2	0.8	62.1	1523.0	1753.8
<i>Total Imports</i>	<i>63679.5</i>	<i>74454.5</i>	<i>93553.4</i>	<i>89002.0</i>	<i>87525.3</i>	<i>108504.9</i>	<i>115687.2</i>	<i>107389.0</i>	<i>124352.1</i>	<i>136277.1</i>

Source: NRB (2004a).

## APPENDIX 3. Trade Indicators (in percent)

Fiscal Year	Export/Import	Exports/GDP	Imports/GDP	Trade Deficit/GDP	Manufactured Exports/Total exports	Primary Exports/Total exports
1994/95	27.7	8.0	29.1	-21.0	87.1	12.9
1995/96	26.7	8.0	29.9	-21.9	85.0	15.0
1996/97	24.2	8.1	33.4	-25.3	83.9	16.1
1997/98	30.9	9.1	29.6	-20.4	79.0	21.1
1998/99	40.8	10.4	25.6	-15.2	78.0	22.0
1999/00	47.6	13.6	28.6	-15.0	83.6	16.4
2000/01	48.1	13.5	28.1	-14.6	82.6	14.4
2001/02	43.7	11.1	25.4	-14.3	71.7	28.3
2002/03	40.2	10.9	27.3	-16.3	77.3	22.7
2003/04	39.6	10.9	27.5	-16.6	80.1	19.9

Source: NRB (2004a) and computations.

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