SOME TRADE PROBLEMS OF LANDLOCKED NEPAL

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THE OBJECTIVE OF this paper is to present an analysis of certain trade problems of Nepal and to outline remedial action towards their solution. The paper is divided into four sections. The first gives a brief background of the trade situation. In the second section, trade treaties of Nepal with India are reviewed. The third examines the import entitlement scheme adopted by Nepal to meet its trade problems, while the final section presents a summary and conclusions.

Geographically sandwiched between India and China, Nepal's basic trade problems emanate from a huge commodity concentration and a high geographic centralization in its export trade. As presented in Table 1, over the period of ten years from 1960 through 1970, more than 98% of its total exports have been confined to India. Over the same period, its imports from India, even though they have shown a sign of gradual contraction, still account for over 90% of Nepal's total imports. The excessive dependence on one market for its entire foreign trade places Nepal in a unique problematic situation. While the small size of the country impels Nepal to resort to international trade, its geographical position limits its option to trade with countries other

TABLE 1: Nepal's Geographic Trade Concentration

Year	Exports to India (in thousand rupees)	Exports to India (as a percentage of total exports	Imports from India (in thousand rupees)	Imports from India (as a percentage of total imports)
1960–61	209,737	99.73	397,982	94.25
1961–62	265,221	99.50	444,414	98.93
1962–63	287,653	99.43	604,025	99.16
1963–64	291,171	97.87	604,557	98.52
1964–65	440,562	98.78	818,867	98.48
1965–66	375,106	98.77	781,989	97.64
1966–67	426,321	98.62	481,268	96.64
1967–68	392,980	99.33	477,776	92.33
1968–69	572,159	99.61	747,882	93.24
1969–70	489,247	99.16	854,671	91.62

SOURCE: Nepal Rastra Bank, *Quarterly Economic Bulletin,* April 1974.

than India. Trade with India thus presents itself to Nepal as a combined situation of monopoly and monopsony. Furthermore, India is also a transit country providing Nepal with an access to the sea. The cumulative effects of all these factors have apparently resulted in a weak bargaining position for Nepal as a trading partner in Indo-Nepal trade.

Looking at the export structure of the country, one notices that food alone, defined as SITC Code 'O', accounts for 60% of Nepal's total export earnings. But it has been seriously questioned whether Nepal is genuinely a food surplus country. This surmise is indeed substantiated by sporadic food deficits in the hill regions when the country's export data for the same year boast of a bulk of food exports. The national income accounting definition of exports, EXP = TS− ADD (where EXP = Exports, TS = Total Domestic Supply and ADD = Aggregate Domestic Demand), thus represents a real export earning state of a country only when ADD truly reflects the total domestic demand. When ADD is an underestimate, the exports as a result become an overestimate. In Nepal's case, this appears to be true due to the fact that there is a regional disparity in food consumption levels between the hills and the Terai (southern plain) regions. Under normal transportation conditions, food surpluses from the Terai would have been transmitted to the food deficit regions of the hills, but the lack of adequate transportation facilities has prevented the marketable surplus of the Terai from reaching the inaccessible hill areas. This has resulted in the transformation of the marketable surplus of the Terai into exports to India. It is thus obvious that the exports to India from Nepal have an artificial appearance of domestic savings. In the event of improved transport facilities between the two regions, that surplus would be reduced substantially.

The hills provide a mere 28% of the cultivated land, but must support 58% of Nepal's total population. The man/cultivated land ratio is 3000 persons per square mile in the hills as opposed to 880 for the Terai. A realistic population policy necessitates that the hills be released from their staggering over-population, and yet the impact of such policy could mean further reduction in the export volume, at least in the short run, resulting from a sharp increase in an aggregate domestic demand that has otherwise been suppressed.

Besides, in a separate study made by one of the authors, India's mean elasticity of demand for Nepal's food with respect to the ratio of India's national income to its agricultural income has been found to be substantially greater than unity.[1] The income elasticity has been derived from the following behavioral equation:

1 Omkar L. Shrestha, "Foreign Trade Model of Nepal: 1960/61–1969/70: Some Aspects of Its Trade with India" (Ph.D. diss., University of Hawaii, 1975).

$$X^D_F = 35.2062 - \underset{(5.4765)}{} 11.9199\, Y^I_{AG}/Y^I - 8.0704\, P^X_F/DMP^I_F$$

$$\quad (5.4765) \qquad (2.4013) \qquad\qquad (0.7271)$$

$R^2 = 0.9319 \qquad \delta^2/s^2 = 2.64$

(Figures in parentheses refer to standard error.)

X^D_F = India's import demand for Nepal's food, SITC Code 'O'

Y^I_{AG} = Agricultural income of India

Y^I = National income of India

P^X_F = Nepalese export price of food as faced by India

DMP^I_F = Domestic food price in India

The high relative income elasticity of the Indian demand for food imports indicates the susceptibility of Nepal's export earnings to the agricultural conditions in India. This renders Nepal's earnings from the export of food to India relatively unstable.

Nepal's imports from India have been found to be highly income elastic. The Nepalese income elasticity of demand for imports from India has been found to be 2.61, indicating that Nepal's imports are likely to grow more rapidly along with the increase in income resulting from the country's development efforts. The above mean income elasticity has been computed from the following equation:

$$M = 10.0925 + 0.0949\, Y^N - 0.0952\, P^N_M/DMP^N + 0.2273\, ML$$

$$\quad (2.6127) \qquad (0.0779) \qquad (0.0151) \qquad\qquad (0.0956)$$

$R^2 = 0.8572 \qquad \delta^2/s^2 = 2.86$

(Figures in parentheses refer to standard error.)

M = Nepal's total imports from India

Y^N = Nepal's national income

P^N_M = Nepal's import price index

DMP^N = Nepal's domestic price index

ML = Import lagged

The vulnerability of Nepal's export earnings as indicated above combined with its highly income elastic imports thus poses a serious problem to the balance of trade of the country. In these circumstances, if substantial improvement is not made in its exports in general and agriculture in particular and if imports expand relatively faster, the indications are that its balance of trade will grow worse. So far the deficits in the trade balance have been met by the transfer of unrequited capital, but this manner of meeting deficits cannot be relied upon indefinitely.

Summing up, Nepal's main trade problems can be identified as, first, a continuing trade concentration both in terms of market and commodity exports, and second, increasing deficits in its balance of trade. Both of the problems are likely to linger for some time to come. Since they are structural in nature, they are long run problems that require long run remedies for their solution. In view of the trade concentration by market, trade diversification has been put forward as a solution to all problems and has been stressed as one of the cherished objectives in the past several development plans. However, it appears that there has not been any significant movement towards that goal and Nepal's foreign trade concentration in terms of both commodity and market has remained virtually the same. This requires a critical study of the policies so far pursued with the intended objective of trade diversification. But before such a study is undertaken, it will be useful to review the trade treaties between Nepal and India which govern Nepal's trade relations with its major partner.

Trade Treaties Between Nepal and India

Nepal's concentration of trade in terms of market, as discussed in the previous section, has been greatly influenced by its trade treaties with India, with whom it has a 500 mile border. Three treaties during the past 25 years have regulated trade relations between the countries. The current trade treaty expired in August 1976.

All three trade treaties have allowed for free trade between India and Nepal. The 1950 Treaty, however, imposed restrictions on Nepal that obligated it to adopt the same rates of tariff imposed by India as the minimum rates on its imports from third countries and stipulated that Nepal should not undersell its exports to India. This was to be achieved by levying an export duty that ensured that the landed price of imports from Nepal into India should not be less than the price of equivalent Indian manufactures.

Considerable criticism was voiced against these provisions.[2] A valid comment was made that while India wanted a common external tariff requiring Nepal to adopt the same Indian rates for imports from third countries so that the association of Nepal with India would amount to a customs union, the benefits of such a customs union could be realized at their best only when the association is one of equal status. If the members of a customs union have different levels of development, there is a greater likelihood of gains going to the member country which is more advanced in economic development and far bigger in size and resources. Further, there is also the fear of the emergence of economic dualism in that the advanced country with a headstart in industrialization may dominate the less advanced member country in manufacturing

[2] B. P. Shreshtha, *An Introduction to the Nepalese Economy* (Kathmandu: Ratna Pustak Bhandar, 1966), pp. 161–163.

and reduce it to the level of being a supplier of primary goods.[3] In the long run, there is also a fear that investment flows in terms of capital and skill both from within the region and outside the region would be increasingly drawn to the industrial centers of the advanced member country. If these polarization effects[4] are allowed to grow, the political future of the association of the member countries of unequal sizes would be uncertain. In the theoretical literature on the subject, the remedies suggested are redistribution of gains from the advanced country to the less advanced countries, regulation of investment flows and regional development, all supervised by an effective supranational agency.

The 1950 Treaty did not make any mention of these issues and it appears in hindsight that neither of the two signatories had any appreciation of the problems posed by a customs union. Only the next treaty signed in 1960 showed some understanding and sought to recognize the unequal status of Nepal in a trade association with India.

The second provision, namely that Nepal should not undersell its manufacturers in India, also invited criticism on the ground that the emerging manufacturing sector in Nepal would not be able to meet the Indian competition anyway; but it was felt that where a comparatively infant Nepalese industry was able to make a headway, it should be encouraged rather than discouraged and priced out of market. Though theoretically the criticism is valid, realistically speaking, the manufacturing sector of Nepal was then an extremely small part of its total economic activities and hence the immediate impact of this provision was minimal. However, this might have discouraged and slowed down the process of industrialization.

The 1960 Treaty displayed an awareness of the critical atmosphere and hence a spirit of accommodation towards the less developed partner. Though the treaty deliberately used the term "Common Market" towards which the trade relations were designed to move, there was no attempt to spell out the issues posted by a customs union, much less a common market which is a far more advanced concept (a common market visualizes free movement of factors of production in addition to free flow of trade).

The 1960 Treaty did not require the Nepalese tariff structure to be in consonance with the Indian tariff structure and, hence, provided freedom for Nepal to have its own tariff structure for imports from third countries. The Treaty also enabled Nepal to impose protective duties or quantitative restrictions on imports from India so that the infant industries in Nepal could be able to overcome the initial handi-

[3] R. F. Mikesell, "The Theory of Common Markets and the Developing Countries," in R. F. Harrod and D. C. Hague, eds., *International Trade Theory in a Developing World* (London: Macmillan, 1963), pp. 205–229.

[4] A. O. Hirschman, *The Strategy of Economic Development* (New Haven: Yale University Press, 1958).

caps of development. Thus, the 1960 Treaty sought to meet the valid criticisms of the earlier treaty by enabling Nepal to pursue an independent tariff policy with respect to third countries and to pursue a policy of protecting infant industries against imports from India. In essence, the association became one of a free trade area rather than a customs union since it enabled both the partners to have different tariff structures, permitting free trade between the member countries.

The 1960 Treaty was replaced by the Treaty of 1971. The new treaty imposed a condition that Nepal's exports to India should have at least 90% of Nepalese or Indian and Nepalese materials. This particular provision provoked considerable comment in Nepal,[5] as it was directed at the export to India of Nepalese nylon fabrics and stainless steel mainly acquired from third countries. These were then manufacturing activities in which little value was added by the Nepalese exporters and, thus, had no impact on the domestic economy in terms of generating income, output, and employment opportunities. (In the next section, a reference to these industries will be made in regard to diversification of trade in commodities.) In one way this provision of the 1971 Treaty can be looked on as having a salutary effect on Nepalese production for exports with its emphasis on the role of linkage effects in terms of a larger impact on the economy. But it is not clear as to why such a high percentage came to be imposed. Any economic activity, let alone an export industry, in an emerging economy such as Nepal has to depend on certain tradable inputs. Substantial imports in terms of chemicals, cement and similar intermediate goods are needed even if the major component is a domestic raw material, such as raw jute, tobacco or leather. Furthermore, in case of exports, the standards of specification and quality are far stricter and naturally more care has to be taken and, thus, import content understandably would be somewhat higher than for goods meant for domestic consumption. In an infant economy like Nepal, 10% as the maximum permissible import content seems to be too low a figure. In the absence of an input-output table for Nepal, it is difficult to pin it down to a specific percentage. However it appears reasonable to reduce the requirement of 90% (indigenous and/or Indian materials) to a substantially lower figure.

Talks had been held in New Delhi on the replacement (or renewal) of the 1971 Treaty on an informal basis in mid-1975 and more formally in June 1976. An Indian mission came to Kathmandu in August 1976 for further discussions, but these were also inconclusive. The 1971 Trade Treaty, thus, lapsed as of 16th of August. Meanwhile, both sides have agreed to continue the trade relations between the two countries on the same basis as before, until they come to a mutually acceptable

[5] P. C. Lohani, "Indo-Nepal Trade and Transit Treaty of 1971," *The Motherland*, Kathmandu, August 23, 1971.

agreement. There is thus a legal obligation on both governments to adhere to the procedures and principles established under the 1971 treaty. This kind of situation would probably be unacceptable over the long term to both New Delhi and Kathmandu, so a new trade treaty seems likely. But it may take some time for an agreement to be reached on mutually acceptable terms.

The Import Entitlement Scheme

A major policy instrument adopted to diversify Nepal's trade was the "Exporters' Exchange Entitlement Scheme" initiated in 1962–63. The chief objective behind the scheme was to increase exports to third countries rather than to India by specifically reserving incentives to exports to third countries only. Under the scheme the exporters were allowed to retain 90% of foreign exchange earnings. They were initially permitted to import any commodities of their choice to the extent of 60% of these earnings and the remaining 40% was to be spent on development goods. These ratios, and the privileges attached thereto, have changed several times over the past decade. In 1976, exporters were allowed to retain two entitlement ratios ranging from 45% to 60%. The types of goods allowed to be imported also changed over time, and in 1976 25% of the bonus earned had to be used to import "development goods," 50% "consumer goods," and 25% "luxury goods."

The policy, for several reasons, did not appear to yield the results desired. The scheme stressed only the geographical aspect of diversification without consideration to commodity diversification. The incentives thus granted to the industries exporting to countries other than India also led to a distortion in the country's allocation of resources in a very unforeseen way. According to Pashupati Rana, the exporters took the opportunity to import materials such as nylon fabrics and stainless steel in large quantities under the scheme's provisions for free imports of any goods to the extent of 60% of export earnings, added very little value to these commodities, and exported them to India, which had closed its doors to the imports of these commodities from other countries.[6] In a way these exports to India could be construed to constitute a departure from the traditional exports, but the diversification in exports was essentially spurious. Thus, export earnings were frittered away on unproductive goods and efforts that can be rightly defined as misallocation of scarce resources. This so-called diversification in exports to India came to a halt when the latter put an end to the import of both nylon fabrics and stainless steel goods from Nepal. These industries, which purported to have added value domestically to the imports of these commodities, disappeared over-

[6] Pashupati S. Rana, *Trade* (Kathmandu: Center for Economic Development and Administration, 1972).

night. This clearly brings out the undesirable manner in which the resources were spent under the scheme until India stopped importing these goods. The domestic impact of these industries were very minimal in terms of generation of income, output, and employment opportunities since the value added in these industries was virtually negligible.

Another aspect of the scheme which could be criticized is that a percentage of the export receipts were supposed to be spent on so-called development goods. But these were not defined in any clear and concise way, and led to the importation of goods unconnected with export industries.

The import entitlement scheme covered only a small part of Nepal's foreign trade since the proportion of trade with India to total trade was substantial and it was excluded from the purview of the scheme. Consequently the benefits from the scheme were confined to a small part of the total export sector. Had the scheme been drawn in a different way, such as promoting the export of processed primary goods rather than agricultural raw materials without any geographical discrimination, the gains from the scheme would have covered the total export sector and would have encouraged the development of processed goods industries. The impact of the scheme in terms of generation of income, output, and employment opportunities would have been diffused to the entire economy. This would have created a sound industrial base in the country and would also have met, at least partially if not totally, the domestic demand for processed goods which are now being imported from India. This would reduce dependency upon India in the long run. Furthermore, this could also open up new markets in third countries when Nepal gains experience in making the processed goods to meet domestic demand. Thus, it appears that the twin objectives of reducing the country concentration and commodity concentration in trade could have been achieved with a greater assurance of covering the total export sector and generating the multiplier effects throughout the economy.

Summary and Conclusions

Nepal's trade problems emanate from market and commodity concentration. Furthermore, its unique geographical position and free trade relations with India have rendered these problems more difficult to solve.

The policy instruments to tackle these problems need to be more comprehensive and concerted than the import entitlement scheme. Both commodity and market concentrations have to be approached simultaneously. Measures to achieve diversification in trade indeed become part of the general developmental efforts of the country, which themselves give rise to deficits in balance of trade. For laying a firm industrial base, creation of infrastructural facilities is necessary. This requires substantial imports of capital and intermediate goods.

Nepal has no energy resources other than potential hydro power, and it has had to depend on imports from India for coal as well as kerosene and other petroleum products requirements. Since 1974, India has stopped exporting POL products to Nepal. Under the new arrangement, Nepal imports crude oil from overseas which is unloaded at Bombay, and receives in return refined oil and other POL products processed at Barauni, an Indian city closer to Nepal than Bombay. Similarly for intermediate goods such as iron and steel in its various categories and non-ferrous metals, Nepal's dependence on its neighbor and third countries has to continue for some time due to a lack of mineral resources. A similar situation prevails with regard to imports of electrical and non-electrical machinery and transport equipments.

Regarding imports of manufactured goods, though the past behavior presents a high income elasticity of demand, there is scope for domestically producing simple manufactured goods such as soap and leather products so as to reduce dependence on imports in these commodities. In the short run, however, it appears that the deficits present in the balance of trade for the past several years are likely to persist for some time more as imports would have a substantial edge over exports.

Unless and until substantial energy including hydroelectric power and mineral resources are developed in the country, the trend of deficits in the balance of trade cannot be reversed in the near future. But perhaps the extent of the deficit can be reduced to a tolerable level which can be met through capital inflows. One way of reducing trade deficits is to encourage the processing of primary goods to India and then importing them in processed form. Though it may appear that this would result in a decline in export earnings through the reduction in the export of primary goods to India due to an increase in domestic demand by the newly emerging processing industries, the decline in export earnings would probably be offset by the reduction in imports of processed goods. Apart from the gains in the limited sphere of exchange earnings and savings, a modern industrial base would be established, with the primary processing industries operating in accordance with the principle of comparative advantage. The primary processing industries would not constitute an expensive import substitution measure as they do not militate against the economic criteria of allocation of resources. Further, experience gained in the production of simple processed goods, especially in the area of entrepreneurship and labor skills but also in relation to the linkage effects both forward and backward, would auger well for further industralization in Nepal. As was noted earlier, new markets for processed goods in third countries could be explored with confidence once the ability to meet quality and other specification standards is achieved as a result of specialization.

In addition to the efforts in regard to promotion of earnings from visible items, efforts are needed to exploit the opportunities for earnings from invisible items. Here the importance of tourism can be stressed. Nepal offers unique tourist attractions. A proper exploitation of its natural endowments would strengthen Nepal's balance of payments position. The tourist industry has substantial forward and backward linkages for the economy and would also attract international investment in terms of hotel and resort facilities construction. An appraisal of efforts made in the area of tourist promotion and a bold and coordinated program are needed.

Thus an approach on the above lines is likely to achieve diversification in trade along with the introduction of structural changes in the economy. Further, this does not seem to require any change in the present trade relationship with India, marked by free trade between the two countries. Free trade is to the advantage of both countries since any restriction on trade flows would result in the misallocation of resources and thereby would lower economic welfare. However, there is an exception in the area of protecting Nepalese infant industries in order to enable them to overcome their historical handicaps. There is already a provision in the treaties governing the trade relations between the two countries which enables Nepal to levy protective tariffs on imports from India for the purpose of fostering infant industries. Nepal can and should resort to this in regard to primary processing activities.

A question may be raised at this stage as to the future of Indo-Nepal trade relations. An answer to this question relates significantly to the present overall trade situation. Currently Nepal's trade with the rest of the world is not substantial. It appears, therefore, that the present situation of free trade with India, along with the enabling provision for Nepal to levy protective duties on imports from India and the freedom to have an independent tariff structure on imports from the outside world would be better than a customs union with India. In the event of a customs union, Nepal may have to adopt the same tariff structure as India on imports from third countries, and this is higher than the Nepalese tariff structure. Trade diversion losses resulting from an upward revision of the present relatively low Nepalese tariff structure would have to be realized. Presently the proportion of Nepal's trade with the rest of the world is small, and these trade diversion losses would not be substantial.[7] However, at the present stage of economic development, it appears more desirable to have an independent tariff structure for third countries in order to have less restricted commodities from the rest of the world than would be possible under a customs union with India.

It may be argued that a customs union with India and a conse-

7 T. K. Jayaraman, "Effects of a Hypothetical Customs Union in the Indian Sub-Continent" (Ph.D. diss., University of Hawaii, 1975).

quentially higher tariff structure against the rest of the world would ultimately prove beneficial to Nepal since import substitution would be encouraged in Nepal. The authors, however, doubt whether Nepal would be able to reap any benefits from such a process of import substitution. India, being a more advanced country with considerable natural resources and far greater external economies in terms of skilled labor and managerial talents, would attract import substitution industries. This would force Nepal to turn to India for the same commodities that had been obtained from the rest of the world. This trade diversification would only strengthen the forces of market concentration, the diversification of which has been one of the basic objectives. Further, Nepal would have to experience trade diversion welfare losses. For these reasons the authors feel that within the current framework, Nepal can achieve the twin objectives of diversification in commodities and markets in the sphere of trade along with structural changes in the economy.

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