Chapter V
DYNAMICS OF NEPAL'S INTEGRATION WITH THE OUTSIDE WORLD IN TERMS OF TRADE AND PAYMENTS

5.1 Evolution of Nepal's International Trade

Traditionally, Nepal's foreign trade was limited to Tibet and India. After 1956, Nepalese trading agencies were confined to few number of border points. In 1980, however, Nepal and China agreed to open 21 trade routes across the Tibetan frontier. Treaty arrangements with China strictly regulate the passage of both traders and pilgrims in either direction across the border. Up until 1989, treaty agreements between India and Nepal allowed for unrestricted commerce across 21 customs posts along the border, and duty-free transit of Nepalese goods intended for third-party countries through India. In 1989, a breakdown in the treaty renewal negotiations resulted in retaliatory actions on both sides (Shrestha, 2003). The government, formed after the restoration of democracy in 1990, took the initiative to extend the trade treaty which was approved by the Government of India.

Under the renewal of the bilateral trade treaty with India in 1997, Nepalese goods entered India essentially duty-free and quota-free. As a result, exports to India grew for years. The most recent India-Nepal Treaty of Trade has been extended for seven years from October 27, 2016 without any change in the existing treaty that was revised the last time in October 17, 2009. Earlier, the treaty was signed in March 2002. There is a mechanism for renewing automatically for the next every seven years, with the condition that its provisions can be amended or modified with the mutual consent of both the countries.

As per the renewals of the trade treaty, there is a provision to allow Nepalese manufactures to enter the Indian market on a non-reciprocal, preferential, or duty-free basis, with rules of origin less restrictive than the international norm.[19] However, in response to the Indian manufacturers' demand, it specifies quotas, which are fixed at lower levels compared to the Treaty in 1997, for four sensitive imports; vegetable fats, acrylic yarn, copper products, and ferrous oxide, all at volumes less than the prevailing Nepalese exports to India. The imposition of some non-tariff and quasi-tariff barriers by India, the damage to production caused by the intensification of the country's decade-long insurgency (1996-2006), a rapid decline in demand from Nepal's main third-country export destinations, the US and Germany, in the post-9/11 environment and the global economic slowdown were the major factors responsible for the decline in the growth rate of Nepal's exports.

The statistics reveal that Nepal’s international trade performance as reflected in trade balance has been weaker in recent years. The import volume is increasing at a high pace compared to that of export. As such, the gap between import and export has been widening resulting in the rise of the volume of trade deficit (Table 5.1 and Figure 5.1). This has constrained the current account surplus on the one hand, while domestic prices have gone up as a result of huge pressure exerted especially on the prices of less elastic imports, due to depreciation of NPR against foreign currencies on the other.

Nepal is an import-based economy. As such, her trade balance is historically skewed towards imports, partly because the demand for industrial inputs and consumer goods has grown rapidly while local production has grown at a slower pace. Considering the total trade data of four decades from FY 1974/75 to FY 2014/15, Nepal's average export and import as percentages of GDP had been

[19] Nepal's manufactures can have up to 70 percent foreign content instead of the international norm of less than 50 percent.

observed at 7.03 percent and 22.98 percent respectively resulting in an average trade deficit of 15.95 percent (Table 5.1). With respect to India, the average exports and imports reflected 3.31 percent and 11.24 percent of GDP respectively, indicating an apparently unsustainable merchandise trade deficit of 7.93 percent (Table 5.3).

Table 5.1

Direction of Nepal's International Trade

As percent of GDP*

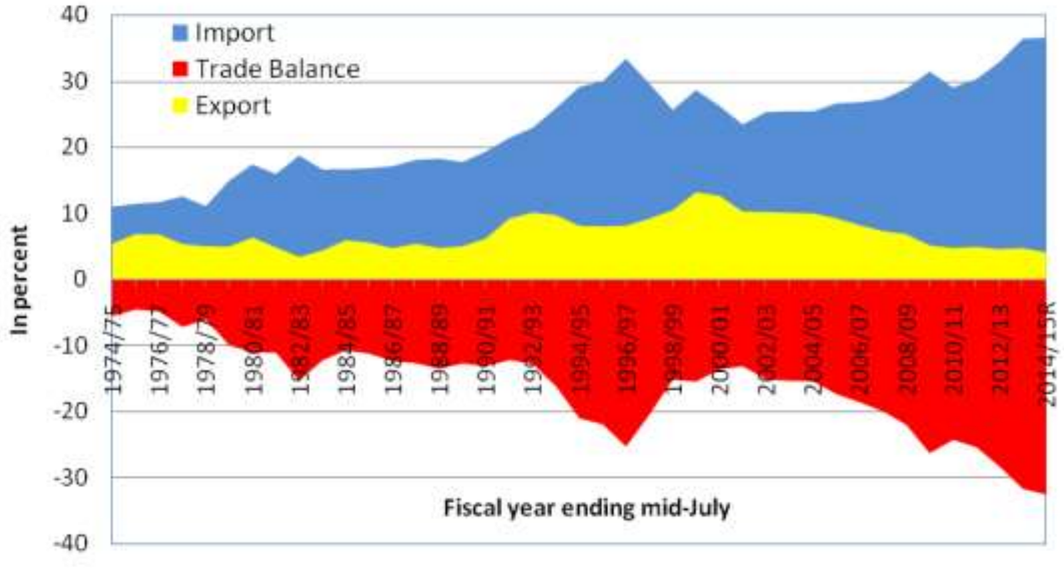
Fiscal Year	Export	Import	Total Trade	Trade Balance
1974/75	5.36	10.93	16.29	-5.57
1975/76	6.82	11.39	18.21	-4.58
1976/77	6.74	11.62	18.36	-4.88
1977/78	5.30	12.52	17.82	-7.22
1978/79	4.96	11.04	16.00	-6.08
1979/80	4.93	14.90	19.83	-9.98
1980/81	6.30	17.35	23.65	-11.04
1981/82	4.81	15.91	20.72	-11.10
1982/83	3.35	18.67	22.02	-15.32
1983/84	4.34	16.58	20.92	-12.24
1984/85	5.88	16.62	22.50	-10.74
1985/86	5.52	16.76	22.28	-11.24
1986/87	4.68	17.08	21.76	-12.39
1987/88	5.35	18.03	23.38	-12.68
1988/89	4.70	18.22	22.92	-13.52
1989/90	4.99	17.72	22.71	-12.73
1990/91	6.14	19.30	25.43	-13.16
1991/92	9.17	21.37	30.54	-12.20
1992/93	10.07	22.86	32.93	-12.79
1993/94	9.68	25.88	35.56	-16.20
1994/95	8.05	29.05	37.10	-21.01
1995/96	7.99	29.91	37.90	-21.92
1996/97	8.07	33.35	41.42	-25.28
1997/98	9.15	29.58	38.73	-20.44
1998/99	10.43	25.59	36.02	-15.16
1999/00	13.13	28.59	41.72	-15.46
2000/01	12.61	26.20	38.81	-13.60
2001/02	10.22	23.37	33.59	-13.16
2002/03	10.14	25.26	35.41	-15.12
2003/04	10.04	25.39	35.43	-15.35
2004/05	9.96	25.36	35.32	-15.40
2005/06	9.21	26.57	35.78	-17.36
2006/07	8.16	26.75	34.91	-18.59
2007/08	7.27	27.21	34.48	-19.94
2008/09	6.80	28.79	35.60	-21.99
2009/10	5.10	31.38	36.48	-26.28
2010/11	4.71	28.98	33.69	-24.28
2011/12	4.86	30.23	35.09	-25.36
2012/13	4.54	32.85	37.38	-28.31
2013/14	4.68	36.36	41.05	-31.68
2014/15	4.02	36.53	40.56	-32.51
Average	7.03	22.98	30.01	-15.95

* at Producers Prices

Source: 1. NRB, Quarterly Economic Bulletin, Vol. 50, January 2016

2. GON, MOF, Economic Survey, 2016

Figure 5.1
Nepal's International Trade as Percent of GDP



Between FY 1996/97 and FY 2002/03, there has been a substantial reduction in Nepal's overall trade deficit (Figure 5.1) attributed mainly to the quota-free export of vegetable fats, acrylic yarn, copper products, and ferrous oxide granted by the 1996 Treaty. As the 2002 Treaty scrapped such quota-free exports of these four items, the trade deficit started widening after FY 2002/03, as seen in the graph above.

5.1.1 Major Trading Partners

In FY 2014/15, India, Peoples Republic of China, United Arab Emirates, Indonesia and Thailand were the country's major import partners contributing 63.73 percent, 12.85 percent, 4.81 percent, 2.04 percent and 1.28 percent of total imports respectively. The major export destinations in the same year were India, USA, Germany, Peoples Republic of China and United Kingdom with a share of 64.47 percent, 8.99 percent, 3.61 percent, 2.72 percent and 2.56 percent respectively. So far as facilitating the trade among top ten trading partners is concerned, Nepalese currency has no exchange facility with the currencies of

Indonesia, Bangladesh, Afghanistan and Turkey. This increases transaction costs with these countries. Table 5.2 shows the top ten trading partners of Nepal on the basis of exports and imports along with their shares in respective totals.

Table 5.2
Top Ten Trading Partners of Nepal

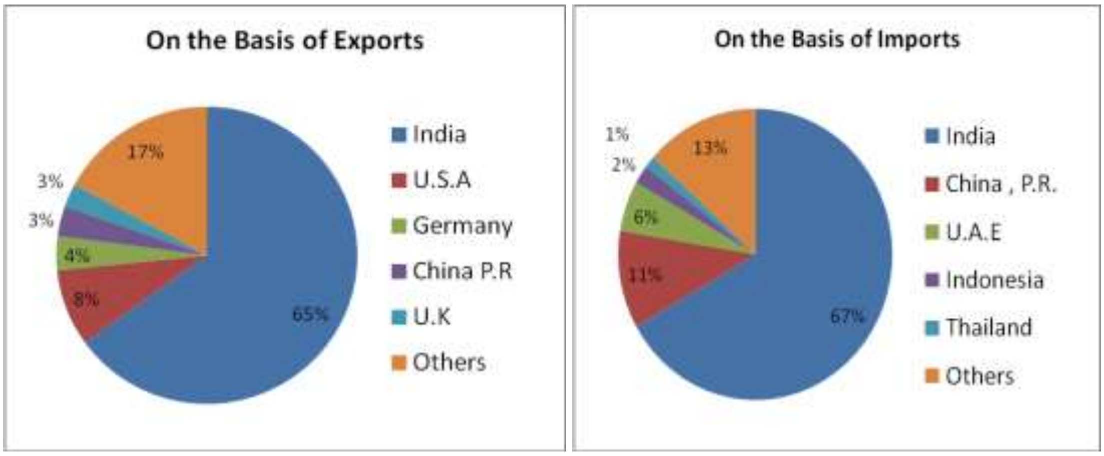
In Million USD

Rank	On the Basis of Exports			On the Basis of Imports		
	Country	Amount	% in Total Exports	Country	Amount	% in Total Imports
1	India	620.0	65.1	India	5,029.7	66.7
2	U.S.A	79.1	8.3	China , P.R.	819.3	10.9
3	Germany	35.3	3.7	U.A.E	424.2	5.6
4	China P.R	31.1	3.3	Indonesia	160.4	2.1
5	U.K	24.4	2.6	Thailand	99.3	1.3
6	Bangladesh	22.3	2.3	Argentina	80.9	1.1
7	Afghanistan	15.9	1.7	Brazil	72.2	1.0
8	France	13.9	1.5	Malaysia	69.6	0.9
9	Turkey	13.2	1.4	U.S.A	66.0	0.9
10	Japan	10.9	1.1	Germany	64.5	0.9
11	Others	86.5	9.1	Others	650.7	8.6

* in FY 2014/15.

Source: Foreign Trade Statistics of Nepal for FY 2014/15, TEPC (2016)

Figure 5.2
Top Trading Partners on the Basis of Exports and Imports



The preceding table (Table 5.2) and figures (Figure 5.3) indicate that India's share in exports and imports is predominant, viz., 64.47 percent in exports and 63.73 percent in imports. The percentage shares of exports and imports of the top three destinations and sources are 77.07 percent and 81.39 percent respectively. The second and third position in exports is accounted for by USA and Germany and in imports by People's Republic of China and United Arab Emirates.

5.1.2 Indo-Nepal Trade

The economic relationship between Nepal and India is unique. Nepal's geographical location, historical ties and the open border between countries have linked the Nepalese economy irrevocably with India. The prospect for developing export markets with India is easier as there are minimum transportation constraints as compared to the mountainous north. Research and studies reveal that both the countries have comparative cost advantages in trading between themselves for several reasons, e.g., historic trade relations, geographical proximity, identical culture and similar agricultural production. Further, there are cultural, linguistic, ethnic, social and family links between people living in India and Nepal, particularly along border areas. Government and private sector institutions’ service delivery and the economic activities are also more or less similar. Trade relationship between these two countries often goes beyond economic motivations as it is significantly influenced by the socio-cultural norms and values. Thus, the trade relations between Nepal and India are characterized by unique features. India continues to be Nepal’s largest trade partner, biggest supplier of foreign investment and the greatest source of tourists. The economic cooperation between Nepal and India is based on the free and spontaneous movements of goods and services across 1,868 km of Nepal-India border. The non-existence of a visa system has created a better environment for carrying out free trade between the two countries (Shrestha 2003, p. 7).

Historically, the Indo-Nepal trade was conducted by private sector businessmen of both the nations for a long time without any formal trade treaty. The first formal bilateral trade agreement between Nepal and British India was signed in 1923. Prior to this, an attempt was made in 1791 to enter into an agreement during the British rule in India, which could not happen. The most important treaty between Nepal and India is the Trade and Commerce Treaty signed in 1950, with the underlying spirit and framework remaining today with some minor amendments. Trade dependence on India has increased over the years as has the merchandise trade deficit, which is being largely financed by remittances. If informal trade is taken into account, the dependence would be even higher. The open border facilitates trade, but also makes unquantifiable smuggling hard to control (Ministry of Commerce and Supplies, 2010a, p. 127).

Bilateral trade between India and Nepal has galloped since the renewal of the trade treaty in 1996. It received further impetus after the signing of the revised trade treaty in 2009, which has provisions that allow Nepalese products easy access to Indian markets. India and Nepal have a treaty of transit, which confers transit rights through each other's territory through mutually agreed routes and modalities (Ibid., p. 30). In successive modifications and renewals of the treaty, transit facilities for trade between Nepal and other countries were established in India at the port of Kolkata.

INR constitutes an important foreign currency for current account purposes and official investment in Treasury Bills of Indian government. India has also reciprocated by accepting export receipts in INR with respect to Nepal. Nepal had introduced current account convertibility in NPR since FY 1992/93. Under this regime, no restrictions are imposed for carrying out transactions and making payments on the current account. Nepal has not gone for capital account convertibility both with India and the rest of the world. The buying and selling rates vis-à-vis INR used to be freely market-determined before 1960. To avoid fluctuations and inconvenience caused to people on account of such fluctuations, the exchange rate was pegged from 1960. This practice has been continuing to this day. The current exchange rate of INR 1= NPR 1.60 has been in operation since 12th February 1993. The peg system was conveived to play a facilitating role for Nepal's trade with India. Nepal has also allowed import of raw materials and other industrial intermediate goods from India by payment of USD. During FY 2002/03 to FY 2014/15, on an average, 17.27 percent of Nepal's import from India occurred in USD and the rest in INR (Table 5.4).

Table 5.3
Indo-Nepal Trade

As percent of GDP

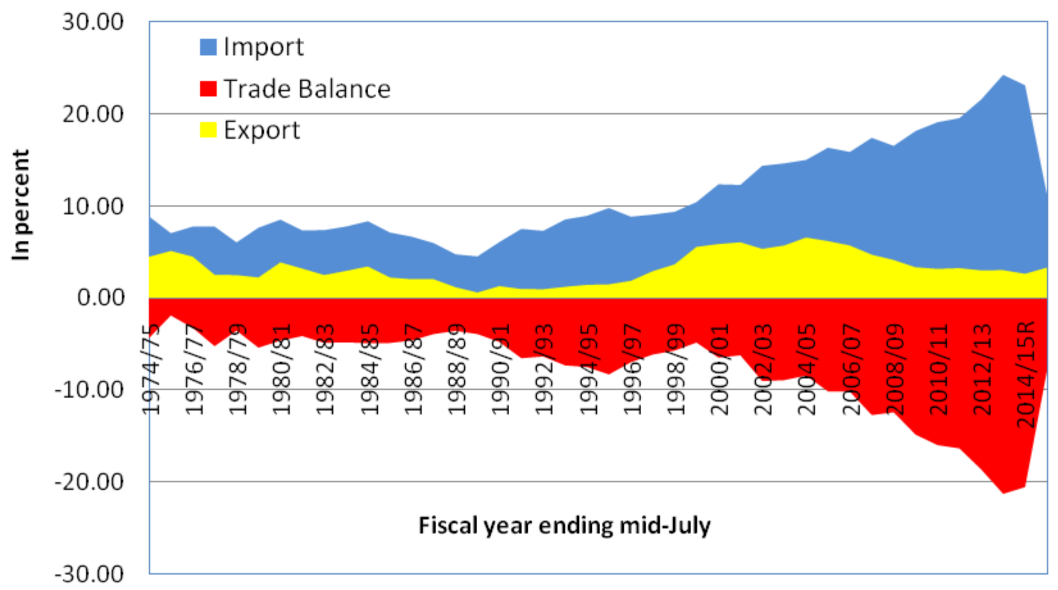
Fiscal years	Export	Import	Total Trade	Trade Balance
1974/75	4.50	8.89	13.39	-4.39
1975/76	5.14	7.05	12.19	-1.92
1976/77	4.51	7.77	12.29	-3.26
1977/78	2.52	7.78	10.30	-5.25
1978/79	2.49	6.05	8.54	-3.57
1979/80	2.23	7.65	9.88	-5.42
1980/81	3.89	8.54	12.42	-4.65
1981/82	3.21	7.36	10.57	-4.15
1982/83	2.49	7.39	9.88	-4.90
1983/84	2.95	7.78	10.74	-4.83
1984/85	3.44	8.36	11.80	-4.92
1985/86	2.23	7.12	9.35	-4.90
1986/87	2.04	6.67	8.71	-4.63
1987/88	2.04	5.98	8.01	-3.94
1988/89	1.16	4.75	5.91	-3.59
1989/90	0.58	4.52	5.10	-3.94
1990/91	1.29	6.08	7.37	-4.79
1991/92	0.97	7.52	8.49	-6.55
1992/93	0.95	7.31	8.26	-6.37
1993/94	1.21	8.55	9.76	-7.34
1994/95	1.43	8.95	10.38	-7.52
1995/96	1.48	9.80	11.28	-8.32
1996/97	1.86	8.86	10.72	-7.00
1997/98	2.92	9.08	12.01	-6.16
1998/99	3.66	9.39	13.05	-5.73
1999/00	5.59	10.45	16.04	-4.86
2000/01*	5.90	12.39	18.28	-6.49
2001/02	6.08	12.32	18.41	-6.24
2002/03	5.37	14.41	19.78	-9.04
2003/04	5.73	14.67	20.40	-8.94
2004/05	6.60	15.04	21.65	-8.44
2005/06	6.22	16.38	22.61	-10.16
2006/07	5.73	15.92	21.65	-10.19
2007/08	4.73	17.46	22.18	-12.73
2008/09	4.15	16.58	20.73	-12.44
2009/10	3.35	18.20	21.56	-14.85
2010/11	3.17	19.16	22.33	-15.99
2011/12	3.25	19.60	22.85	-16.35
2012/13	3.01	21.65	24.66	-18.64
2013/14	3.03	24.33	27.36	-21.29
2014/15^R	2.63	23.19	25.82	-20.55
Average	**3.31**	**11.24**	**14.55**	**-7.93**

*Petroleum imports shifted to India from other country import.

Source: 1. NRB, Quarterly Economic Bulletin, Vol. 50, January 2016.

2. GON, MOF, Economic Survey 2016.

Figure 5.3
Indo-Nepal Trade as Percent of GDP



Considering the data of four decades from FY 1974/75 to FY 2014/15, Nepal's average export and import to India as percentages of GDP are observed at 3.31 percent and 11.24 percent respectively, showing an average trade deficit of 7.93 percent of GDP. In FY 2014/15 alone, Nepal's export to India was 2.63 percent of GDP while the import from India amounted 23.19 percent of GDP, marking a trade deficit of 20.56 percent of GDP.

Nepal's export basket to India mainly comprises zinc sheets, threads, polyester yarn, jute goods, textiles, juice, GI Wire, large cardamom and a range of other semi-processed and processed food products.[20] Similarly, the import basket mainly contains petroleum products, motor vehicles and their parts, M. S. Billet, machinery and spares, cold rolled sheet in-coil, medicines and hot rolled sheet in-coil.

[20] G.I. sheets and wire, processed from raw materials imported from India have emerged as major export items from Nepal to India.

Imports from India in Convertible Foreign Currencies

Bilateral trade between Nepal and India takes place either in INR or in convertible foreign currencies, mainly USD. As India's exports in convertible currency are exempted from excise duty, Nepal allowed imports of industrial machinery and raw materials from India on payment of convertible currency since 1993. NRB, as stated in the Monetary Policy for FY 2013/14, may add some more items in the list in the years to come.[21] As of mid-July 2015, the number of items that could be imported from India by paying convertible currency had reached 161.

Table 5.4

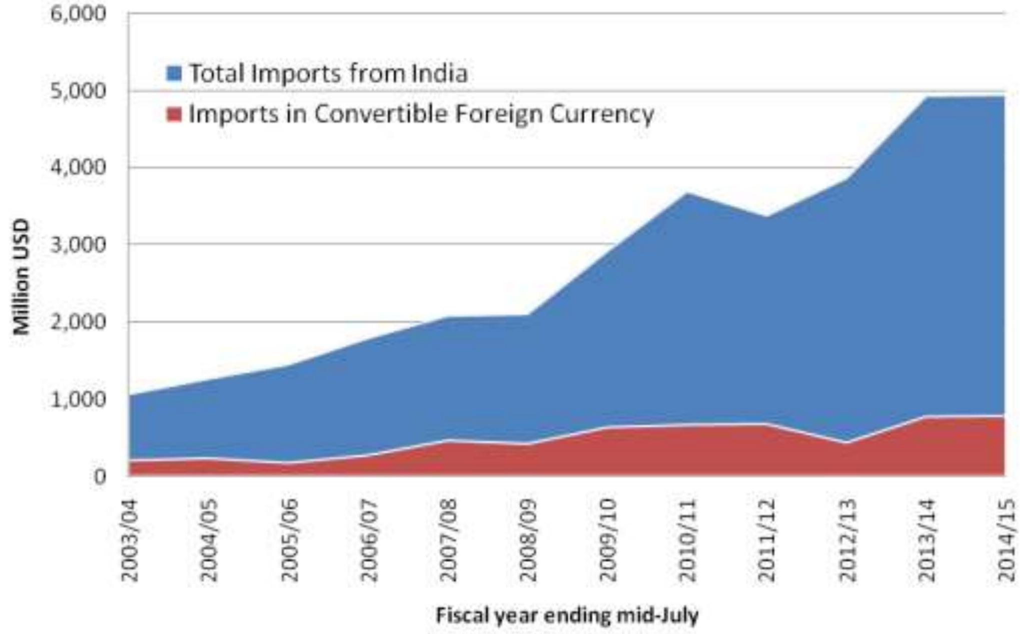
Imports from India Against Payment of USD*

Fiscal Year	Total Imports from India (USD, million)	Imports made in USD (million) from India	Imports in USD as Percentage of Total Imports from India	Annual Growth Rate (Percent)
2003/04	1,062.0	205.79	19.38	-
2004/05	1,260.5	232.17	18.42	12.82
2005/06	1,445.9	172.82	11.95	-25.56
2006/07	1,786.8	273.26	15.29	58.12
2007/08	2,078.5	467.39	22.49	71.04
2008/09	2,099.8	424.43	20.21	-9.19
2009/10	2,916.6	640.82	21.97	50.98
2010/11	3,691.7	673.26	18.24	5.06
2011/12	3,379.1	684.86	20.27	1.72
2012/13	3,863.5	439.57	11.38	-35.82
2013/14	4,983.8	782.38	15.87	77.99
2014/15	4,861.1	775.85	15.96	-0.83
Total/AV	33,429.4	5,772.60	17.27	18.76

* Based on customs data.
Source: Nepal Rastra Bank, Research Department.

[21] The Monetary Policy published by NRB for Fiscal Year 2013/14 states "Additional items will be added as necessary in the list of goods that can be imported from India by paying convertible foreign currency".

Figure 5.4
Imports from India in Convertible Foreign Currencies



Informal trade between India and Nepal

The informal trade between India and Nepal is estimated to be nearly equal to the formal trade. The open border could be misutilized by those who indulge in informal and illegal trade. The number of informally traded items as well as their volume has been increasing in recent years due to rising demand in Nepal not satisfied by domestic production coupled with price and quality differences on the two sides of the border.

Essentially, scrap items, raw leather, spices, tobacco products, bran, betel nuts, some medicinal herbs including *Yarshagumba,* Chinese products (mainly garlic, apples, electrical goods) alcohol, banned drugs and vegetables are being exported to India through unauthorized channels.[22] Due to the weak export base,

[22] There is high import tariff on betel nuts in India and, therefore, they come into Nepal from third countries and are re-exported into India exploiting the open border.

the volume of informal exports from Nepal is very negligible compared to the volume of unauthorized imports which is incomparably very large. Normal consumable goods such as sugar, pulses, lentils, rice, and edible oils, readymade garments and textiles, apparel, tobacco products including processed tobacco or *pan parag (gutkha)*, chemical fertilizers, hardware products and vehicle parts are the top products imported informally from India. Gold and silver, including in jewelry form, are smuggled both ways depending on the price difference in either country.

There are two channels of informal trade; (i) through the custom point by exploiting legal loopholes, (ii) through other unauthorized points by exploiting the porous border between Nepal and India. Similarly, there are three basic causes responsible for informal trade with India. First, India has banned export of some of the items arguing that they are insufficient to meet even the Indian market demand. Second, importers have to pay altogether 20 percent duties at Nepalese custom points while importing readymade garments and textiles. However, clandestine transportation reduces cost to about five percent of what is imposed while importing formally. Third, there are some items on which Nepal has imposed excise duty/VAT though they are exempted from basic custom duty. All these factors are responsible for substantial price differences between the adjoining Nepalese and Indian cities. The price differences are the major cause for the informal trade between these two countries.

There are several reasons for the emergence and growth of informal trade across the border. Karmacharya (2004) suggests that informal trade does not take place just because of the existence of formal trade barriers, but also because of lower transportation, possibility of avoiding procedural delays, lower bribes and prompt realization of payment. However, he too admits that evasion of duty is the prime motive for choosing the informal mode of trade. Therefore, any policy response to tackle the problem should take into account all these factors. In recent years, the informal trade has substantially declined because of tight and honest security administration.

Due to the nature of markets and the open border between Nepal and India, the existence of informal trade cannot be ruled out. However, it is extremely difficult to quantify the size of informal trade between the two countries. Research studies focused at estimating the informal trade between Nepal and India are also very rare. A study, entitled 'Shadow Economies', conducted in 2010 for 162 countries, shows that the informal economy in Nepal is around 37.5 percent of the total size of the economy (Friedrich, Buehn & Montenegro, 2010).

5.1.3 Trade with Countries Other than India

Due to the geographical situation, Nepal's trade with countries other than India involves the transit of goods to and from foreign countries through India. To its credit, Nepal has obtained favorable agreements with its trade partners to offset its landlocked status. But the treaty crisis with India and the failure to agree on Bangladeshi access highlight the country's limited bargaining power.

Table 5.5
Nepal's International Trade with Countries Other than India*

As percent of GDP

Fiscal Year	Export	Import	Total Trade	Trade Balance
1974/75	0.86	2.04	2.90	-1.18
1975/76	1.68	4.34	6.02	-2.66
1976/77	2.23	3.85	6.07	-1.62
1977/78	2.78	4.74	7.52	-1.96
1978/79	2.48	4.99	7.46	-2.51
1979/80	2.70	7.25	9.95	-4.56
1980/81	2.41	8.81	11.22	-6.40
1981/82	1.60	8.55	10.15	-6.95
1982/83	0.85	11.28	12.13	-10.42
1983/84	1.38	8.80	10.18	-7.41
1984/85	2.44	8.26	10.70	-5.81
1985/86	3.30	9.64	12.93	-6.34
1986/87	2.64	10.40	13.05	-7.76
1987/88	3.31	12.06	15.37	-8.75
1988/89	3.54	13.47	17.01	-9.93
1989/90	4.40	13.20	17.60	-8.80
1990/91	4.85	13.21	18.06	-8.36
1991/92	8.20	13.84	22.04	-5.64
1992/93	9.12	15.55	24.67	-6.43
1993/94	8.47	17.33	25.80	-8.86
1994/95	6.62	20.10	26.73	-13.48
1995/96	6.51	20.11	26.62	-13.60
1996/97	6.21	24.49	30.70	-18.28
1997/98	6.22	20.50	26.72	-14.28
1998/99	6.77	16.20	22.97	-9.43
1999/00	7.54	18.14	25.68	-10.60
2000/01**	6.71	13.81	20.52	-7.10
2001/02	4.13	11.05	15.18	-6.92
2002/03	4.77	10.85	15.63	-6.08
2003/04	4.31	10.72	15.03	-6.41
2004/05	3.36	10.32	13.67	-6.96
2005/06	2.98	10.19	13.17	-7.20
2006/07	2.43	10.83	13.26	-8.40
2007/08	2.54	9.75	12.29	-7.22
2008/09	2.66	12.21	14.87	-9.55
2009/10	1.75	13.18	14.93	-11.43
2010/11	1.53	9.82	11.36	-8.29
2011/12	1.61	10.62	12.24	-9.01
2012/13	1.53	11.19	12.72	-9.66
2013/14	1.65	12.03	13.68	-10.39
2014/15	1.39	13.35	14.74	-11.96
Total/Average	3.72	11.73	15.45	-8.01

* Based on customs data

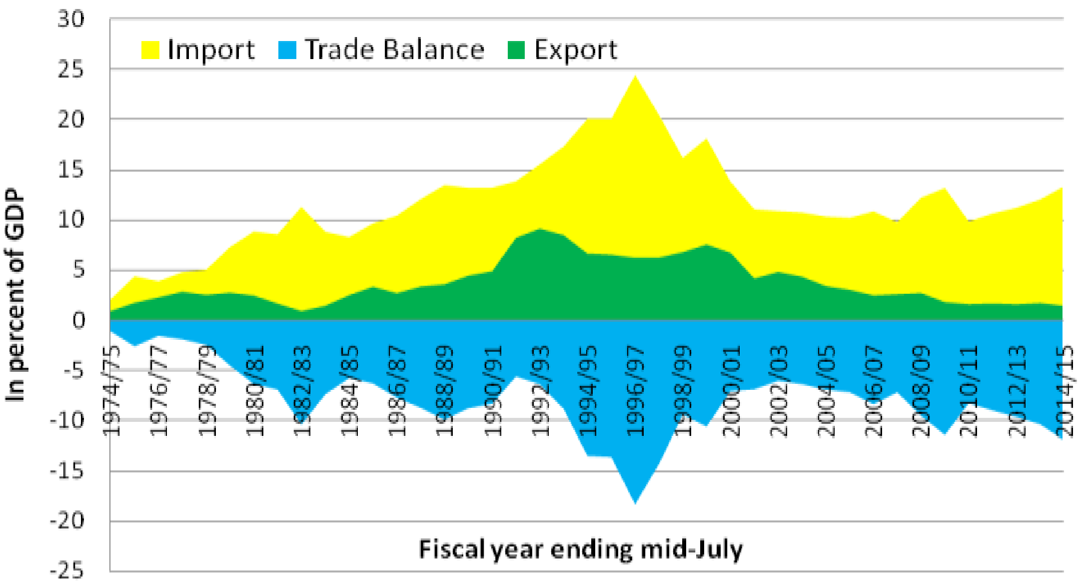
** Petroleum imports shifted to India from other country import

Source: 1. Quarterly Economic Bulletin, Vol. 50, Jan 2016, NRB

2. Economic Survey 2016, MOF, GON

Figure 5.5

Nepal's International Trade with Countries Other than India



Nepal-China/Tibet Trade

Trade with Tibet, mostly the bartering of agricultural produce, went into decline at the turn of the 20th century when the British in India opened alternative routes through Sikkim. The limited Tibetan market and its inaccessibility further hindered the development of barter trade. Trade with mainland China has been rapidly growing in the recent decades. In FY 2014/15, India's share in Nepal's total trade constituted 63.7 percent, while China's share was 11.9 percent and the rest of the world's share was 24.4 percent (NRB, 2016). In recent years, there is a rise in China's share while India's share has not seen such a rise. The Chinese currency (CNY) has been included on the official exchange list of NRB since FY 2002/03. This step could be regarded as a milestone in enhancing bilateral trade with China.

5.2 Legal and Policy Arrangements

5.2.1 Bilateral, Regional and Multilateral Trade Agreements

Nepal has signed bilateral trade agreements with 16 countries so far, including five member countries of the South Asian Association for Regional Cooperation [SAARC], namely, India, Bangladesh, Pakistan, Bhutan and Sri Lanka (Table 5.6).[23] Nepal also has signed bilateral transit agreements with India and Bangladesh. All the treaties and agreements, except with India, are based on the most favoured nation status treatment. Nepal's trade relations with India are based on agreements characterizing special relationships like open border and a unique exchange system whereby trade and payments with India are mostly conducted in INR. However, the imports of industrial raw materials and imports made under the special Petroleum, Oil and Lubricants [POL] agreement, and the concessional tariff system are basically paid in USD. Table 5.6 presents the list of countries having trade agreements with Nepal.

Table 5.6

[23] SAARC is a regional grouping formed in 1985 with membership of eight countries, namely, Afghanistan, Bangladesh, Bhutan, India, Nepal, Pakistan, Sri Lanka and the Maldives.

List of Countries that have Trade Agreements with Nepal

S. No.	Countries	Signed Date/Year
1	India*	1923
2	United States of America	25th April 1947
3	United Kingdom	14th November 1965
4	Russia**	6th August 1970
5	Democratic People's Republic of Korea	11th December 1970
6	Republic of Korea	6th May 1971
7	Arab Republic of Egypt	23rd December 1975
8	People's Republic of Bangladesh	2nd April 1976
9	Sri Lanka	3rd April 1979
10	People's Republic of Bulgaria	4th July 1980
11	People's Republic of China	22nd November 1981
12	Islamic Republic of Pakistan	28th July 1982
13	Czech Republic	12th December 1982
14	Republic of Romania	1st January 1984
15	Government of Mongolia	29th January 1992
16	Republic of Poland	12th May 1992

* Latest treaty on October 2009
** Effective, 13th August 1970
Source: Nepal's Trade & Transit Agreements, TPC (1999).

Nepal accelerated the process of economic globalization and integration with membership in major regional and multilateral trade organizations mainly after the restoration of multiparty democratic polity in 1990s. Trade policy was changed in 1992, with emphasis on trade liberalisation and focus on export-led economic growth in place of the then prevailing import substituting policy regime. Foreign Investment and One Window Policy 1992 was also introduced. Policies such as *bonus system* and *dual exchange rate system* which were formulated in the 1960s with an aim to facilitate international trade have already been scrapped.[24] Currently, there is no need for obtaining any kind of licenses for the import and export of merchandise products except in case of banned or quantitatively restricted items. In this way, the import and export policy have made significant contribution in the trade diversification and modification.

[24] In the late 1960s, Nepal adopted a bonus system under which exporters were given a certain fraction of export earnings for import. The purpose was to promote exports and diversify international trade. But this system was abandoned after the carpet over-invoicing scandal of the late 1970s.

Consistent with the new economic regime, Nepal obtained the membership of the World Trade Organisation [WTO], effective from 23rd April 2004.

However, WTO measures of economic progress were slow while commitments also could not be fully delivered in time. Nepal's aspirations in combination with perceived advantages of regional trade agreements pushed Nepal towards regional economic integration. Nepal became a member of two regional trade agreements, namely, South Asia Free Trade Area [SAFTA] which came into force from 1st January 2006 and the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation [BIMSTEC] effective 1st July 2006. Consequent to the liberalization process, the Nepalese economy opened for international competition.

5.2.2 Trade Policy 2009

The direction and trend of foreign trade move in accordance with the trade policy adopted by the country. Although Nepal's Trade Policy, 1992 embodied several noble provisions, it was found insufficient to address issues of international trade dynamism after affiliation with regional (SAFTA and BIMSTEC) and multilateral (WTO) trading systems, expansion of bilateral free trade area, simplification of trade procedures and development of a new transit system. In the described context, a comprehensive review of the trade policy was urgent. Accordingly, Trade Policy 2009 has been formulated by giving impetus to the promotion of the export sector as the main policy thrust while focusing on achieving sustained trade development by taking into consideration the changed paradigm of internal and international business environment. The main objective of the policy is to support the economic development and poverty alleviation initiatives through the enhanced contribution of trade sector to the national economy. Other specific objectives of the policy are:

- To create a conducive environment for the promotion of trade and business in order to make it competitive at international level
- To minimize trade deficit by increasing exports of value added products through linkages between imports and exports trade
- To increase income and employment opportunities by increasing competitiveness of trade in goods and services and using it as a means of poverty alleviation
- To clearly establish interrelationship between internal and external trade and streamline its development as complementary and supplementary to each other.

The major policy thrust areas in this respect comprise the following: (a) enhancing the role and professional capacity of government and private sector entities, (b) reducing transaction costs through procedural simplification and institutional strengthening, (c) developing policy, institutional and physical infrastructures relating to foreign trade, (d) developing policy and institutional networks for the protection of intellectual property rights and promotion of export of services, (e) providing additional incentives to export oriented industries, (f) market expansion through utilization of opportunities available under bilateral, regional and multilateral trade promotions, (g) establishing Special Economic Zones [SEZ] for export promotion, developing employment oriented skills and entrepreneurship in the trade sector, (h) increasing income and employment opportunities through promotion of trade in services, (i) developing special thrust areas, (j) promoting identification, selection, production and trading of new exportable goods of comparative advantage, (k) linking export-oriented industries with domestic materials, and (l) encouraging exports of goods or services produced for domestic consumption by expanding their production (Ministry of Commerce and Supplies, 2010, pp. 3-22).

Trade policy focuses on four major areas, namely, (i) readymade garments, (ii) carpets and woolen goods, (iii) *pashmina* and silk products, and (iv) handicraft goods. Identified strategic products of large potential development are: tea, large cardamom, pulses, floriculture, precious/semi-precious gems and stones, and gold and silver ornaments, processed leather, vegetables seeds, gingers/dried gingers, herbs and essential oils, handmade paper and paper products, wooden craft products, coffee, honey, oranges and, vegetables (Ibid., p. 39).

5.2.3 Foreign Investment and Technology Transfer Act 1992

The Foreign Investment and Technology Transfer Act 1992 was enacted in line with open and liberal economic policies to attract foreign investment. Nepal as a developing country suffers from massive unemployment and mass poverty. Therefore, she is awaiting full utilization of her resources with necessary investment. However, she is lacking capital as domestic saving is not sufficient to tap the development potentialities, which underscores the importance of FDI as a major source of growth and development. The objective of the Act is to attract and encourage foreign investment in the form of equity participation, direct investment in the domestic production, reinvestment of the earnings derived from such investment, extension of loans, and transfer of technology in the form of the use of any technological right, specialization, formula, process, technical knowhow of foreign origin, use of foreign-owned trade-mark and foreign management.

In order to promote exports, the production base must be enhanced, which requires an adequate level of investment, mostly FDI. FDI is encouraged where trade environment is favourable and attractive, because investors would expect better physical and financial infrastructure, favourable existing rules and regulation and backward linkage and forward linkage facilities before investing. In Nepal, foreign investors are allowed to own up to 25 percent of the stock of listed companies. Regarding the FDI, excluding products related to defense, cigarettes, and alcohol, foreign investment up to 100 percent in medium and large-scale enterprises has been allowed.

5.3 Balance of Payments (BOP) Situation

BOP denotes the change in net foreign assets of the economy within a time period of up to one year. According to Samuelson and Nordhaus (2010), BOP provide a systematic statement of all economic transactions between that country and the rest of the world (p. 707). One of the goals of the monetary policy is to maintain external stability of the economy as reflected in the foreign exchange reserves level, sufficient to finance imports of a specific number of months. Normally, the monetary policies in Nepal have expressed the external sector goal as foreign exchange reserves level sufficient enough to finance imports of eight months of goods and services. During the past 15 years (FY 2000/01 to FY 2014/15), the BOP has been unfavourable for two years (FY 2001/02 and FY 2009/10) but favourable in the remaining 13 years. As a percent of GDP, the BOP recorded the most favourable in FY 2011/12 where the ratio was 8.6 percent followed by 6.8 percent in FY 2013/14 and 6.5 percent in FY 2012/13. As percent of GDP, the BOP was unfavourable in FY 2001/02 and FY 2009/10 by 0.7 percent and 0.3 percent respectively. The change in net foreign assets as a percent of GDP during the 15 years has been calculated at an average of 3.0 percent. The goods and services import coverage of foreign exchange reserves for the 15 years averaged at 9.0 months with the highest (11.3 months) in FY 2014/15 and the lowest (6.8 months) in FY 2010/11. From this it could be concluded that the BOP and foreign exchange reserves registered a satisfactory level of performance in the past 15 years. This could be cited as a commendable achievement of NRB in Nepal's foreign exchange management. However, the FDI during the past 15 years annually averaged at around USD 29.5 million only. So, the progress in attracting FDI has not borne any significantly fruitful outcome in Nepal (Table 5.7).

Table 5.7

Major Indicators of BOP

Fiscal Year	BOP* (Million USD)	Change in NFA as % of GDP*	Import Coverage of Forex Reserve (Months)	FDI (Million USD)
2000/01	-69.9	-1.2	7.9	-0.4
2001/02	42.9	0.7	9.1	-3.6
2002/03	-58.4	-0.9	8.5	12.9
2003/04	-215.9	-3.0	9.6	0.0
2004/05	-81.6	-1.0	8.5	1.9
2005/06	-345.4	-3.9	9.2	-6.3
2006/07	-91.0	-0.8	8.0	5.6
2007/08	-433.2	-3.6	9.2	4.3
2008/09	-573.5	-4.5	9.6	23.4
2009/10	44.7	0.3	6.9	38.3
2010/11	-57.6	-0.3	6.8	90.7
2011/12	-1,485.6	-8.6	10.2	103.8
2012/13	-725.7	-4.1	10.2	95.6
2013/14	-1,325.6	-6.5	10.0	33.3
2014/15	-1,434.0	-6.8	11.3	43.3

* Minus indicates increase or favourable position.

Source: Quarterly Economic Bulletin, Vol. 50, No.4 July 2016, NRB and Economic Survey (various issues), MOF, GON.

Table 5.8 presents the summary of BOP of Nepal at intervals of five years (four years between FY 2000/01 and FY 2004/05 because of non existence of BOP data for 1999/2000 in the new series) spanning the period from FY 2000/01 to FY 2014/15.

Table 5.8

Summary of Balance of Payments (Selected FYs)

In Millions of USD

Particulars	2000/01	2004/05	2009/10	2014/15
A. Current Account	**269.9**	**164.1**	**-378.0**	1071.0
Goods: exports f.o.b.	934.9	852.3	848.7	971.7
Goods: imports f.o.b.	-1,691.1	-2,071.3	-4,926.0	-7531.9
Balance on Goods	**-756.2**	**-1,219.1**	**-4,077.3**	**-6560.2**
Service: Net	**124.6**	**-28.9**	**-220.1**	**273.1**
Services: credit	399.5	369.6	686.7	1476.1
Services: debit	-274.9	-398.5	-906.8	-1203.0
Balance on Goods and Services	**-631.6**	**-1,248.0**	**-4,297.4**	**-6287.1**
Income : Net	**22.8**	**23.3**	**122.5**	**338.6**
Balance on Goods, Services and Income	**-608.8**	**-1,224.7**	**-4,174.9**	**-5948.6**
Transfers: Net	**878.7**	**1,388.8**	**3,797.0**	**7019.5**
Current transfers: credit	897.9	1,440.1	3,865.8	7044.9
Out of which, Workers' remittances	*632.5*	*931.6*	*3,112.9*	*6103.2*
Current transfers: debit	-19.2	-51.3	-68.8	-25.4
B. Capital Account (Capital Transfer)	**82.7**	**22.4**	**169.0**	**146.4**
C. Financial Account (exclu.group E)	**-382.1**	**-363.0**	**105.4**	**175.2**
Out of which, FDI	*-0.4*	*1.9*	*38.3*	*43.3*
Total, Groups A through C	-29.5	-176.5	-103.6	1392.6
D. Miscellaneous Items, Net	**157.4**	**257.2**	**45.0**	**182.9**
E. Reserves and Related Items	**-127.9**	**-80.7**	**58.5**	**-1575.6**
Out of which				
Reserve assets	*-123.6*	*-91.9*	*14.2*	*-1564.1*
Use of Fund credit and loans	*-4.4*	*11.2*	*44.3*	*-11.5*
Change in NFA (-increase)	**-69.9**	**-81.6**	**44.7**	**-1434.0**

Source: NRB, Quarterly Economic Bulletin, Vol. 50, No.2, Mid-Jan. 2016. p 111 and 121.

The table shows increasing trade deficit at a higher rate. For example, the deficit of balance of goods (USD 756.2 million) in FY 2000/01 increased nine fold in a period of 15 years to USD 6,560.2 million in FY 2014/15. Despite this, because of higher remittance inflows which increased from USD 632.5 million in FY 2000/01 to USD 6,103.2 million in FY 2014/15, nearly 10 times in 15 years, Nepal recorded surpluses in the current account and favourable positions in the BOP account in most of the years. In this way, workers' remittances have been helping to maintain external sector stability and increase in foreign exchange reserves. Despite the opening of the economy, FDI inflows into Nepal have remained quite low. The FDI as a percent of GDP has averaged a negligible (0.2 percent) during the past 15 years. Thus, we can conclude that foreign investors are shy of investing in Nepal, signaling that attracting foreign investment has become a herculean task in Nepal. Hence, we need to usher in a necessary conducive environment for promotion of foreign investment in Nepal.

5.4 Payment and Settlement System in Nepal

An efficient and secure payment and settlement system helps a country to boost domestic and international payments. The role and functionality of the payment system has been changing phenomenally with advancement in products and technologies. A Payment and Settlement system has the aim of protecting the rights of users, enhancing efficiency and competition, and ensuring a safe, secure and reliable operating system. Innovation and competition will be essential to the future development of the payments system. In recent years, the development of electronic payment mechanisms, the increase in the number of players in the financial arena, and hacking and fraud attempts in some countries and regions have focused intensive attention on the security of payment system. Nepal has been at a nascent stage of innovation and change in the electronic payment and settlement system. The regulatory changes in this respect comprise the promulgation of Payment and Settlement By-laws, 2015 and establishment of a separate department in NRB.

5.4.1 Infrastructure and Components

New payment and settlement mechanisms have to accommodate present and future requirements of the fast growing global e-commerce and finance. A huge investment is required for the development of a secure, efficient and user-friendly payment and settlement system. Timely update and modification in the system also need more effort and resources. The major criteria for a payment and settlement system are safety, security, soundness and efficiency. Safety addresses risk, so as to make the system risk-free or with minimal risk. Security addresses the issues relating to confidence, with specific reference to users of these systems. Soundness ensures that the systems are developed in a strong and secured environment and their efficiency (cost-effective and user-friendly) has been tested[25].

5.4.2 Current Status

NRB has taken many initiatives towards introducing and upgrading safe and efficient modes of payment systems to meet the requirements of the users and general public at large. There are diverse payment systems, ranging from paper-based system where the instruments are physically examined and settlements are manually operated to the most sophisticated electronic and transfer system which are fully secured and where settlements are conducted on RTGS basis. They cater to both the low-value retail payments and large-value payments relating to the settlement of inter-bank money market, government securities and forex transactions (Giri, 2013). NRB launched the fully automated Electronic Cheque Clearing [ECC] system in November 2011 through the establishment of the Nepal Clearing House Limited (NCHL), as a joint venture with the BFIs of the country. With the compulsory use of MICR cheques effective from October 2015, the ECC system became effective. As such, the payment and settlement procedure was shortened, giving customers instant RTGS cheque realization.

[25] For detail please see National Payment Concept Paper, submitted to NRB (online available at https://www.finextra.com/blogposting/3283/national-payment-policy-in-nepal--a-concept-paper).

5.4.3 Payment and Settlement System for INR

The payment and settlement arrangement in Nepal is different for INR than for other convertible currencies. Though INR is a foreign currency, the exchange regulation towards INR is more liberal due to the bilateral payment arrangement, open border, geographical proximity and the historical and cultural relations between Nepal and India. For the purposes of receipt and payment accompanied by documents, it is convertible for both the Nepalese and Indian citizens. However, for retail transactions, a maximum of INR 25,000 can be exchanged at a single time. The trade payment between Nepal and India is settled in INR. Payments for the import and export of commodities from India are effected in cash through drafts and telegraphic transfers. Thus, LC is not an essential element of trade between these two countries. LC is essential only if payment is to be made in USD, especially for some specified industrial raw materials imported from India. Nepalese commercial banks have maintained their INR agency accounts in Indian banks to settle such payments (Mathema, 2005).

5.4.4 Payment and Settlement System for Convertible Currencies

In Nepal, a current account transaction is convertible while a capital account transaction is not convertible. As Nepal is a member of the ACU, all the trade payments among member countries except India are settled through the clearing system of the Union in ACU Dollars. Moreover, some restrictions are imposed on the usage of foreign currencies since the NPR is not convertible. Some modes such as draft, mail transfer, telex transfer, SWIFT transfer, credit card and ACU Dollars are in use for cross-border payments in convertible currencies. Issue of LC and its settlement is also a popular mode of payment (Ibid.).

5.4.5 Asian Clearing Union (ACU)

ACU, established in 1975, is a payment arrangement whereby the participants settle payments for intra-regional transactions among the participating central banks on a net multilateral basis. The main objectives of the ACU are to facilitate payments among member countries for eligible transactions, thereby economizing on the use of foreign exchange reserves and transfer costs, as well as promoting trade and banking relations among the participating countries. Its specific objectives as stated in the Article II of the ACU Agreement include the following (ACU, 2017):

- Providing the settlement facility on a multilateral basis for payments in current international transactions among the participating countries.
- Promoting the use of participants' currencies in current transactions, thereby effecting economies in the use of participants' exchange reserves.
- Promoting monetary cooperation among the participants and closer relations among the ACU banking systems.
- To provide currency SWAP arrangement among the participants so as to make Asian Monetary Units (ACUs) available to them temporarily.

There are nine member countries of the ACU, each represented by the Central Bank of the respective country, namely, Bangladesh Bank, Royal Monetary Authority of Bhutan, RBI, Central Bank of the Islamic Republic of Iran, Maldives Monetary Authority, Central Bank of Myanmar, NRB, State Bank of Pakistan and Central Bank of Sri Lanka. With the commencement of operations by ACU in 1975, all individual transactions were required to be cleared through the concerned Central Banks. According to the ACU agreement, all payments relating to trade and trade-related transactions among member countries should be routed through the specialized ACU payment system. Settlements are made every two months as per the English calendar in ACU Dollars which is equivalent to the USD. The monetary transactions eligible and ineligible to be settled through the ACU are outlined in Table 5.9:

Table 5.9

Eligible and Ineligible Transactions under ACU

Eligible Transactions	Ineligible Transactions
○ Payments from the resident in the territory of one participant to a resident in the territory of another participant. ○ Payment for current international transactions as defined by the Articles of Agreement of the IMF. ○ Payment permitted by the country in which the payer resides ○ Payments which are in compliance with FERA, rules, regulations, or directions issued thereof and the specific provisions of the ACU Memorandum. ○ Payment for exports and/or import between ACU member countries on deferred payment terms.	○ Payment between Nepal and India; and between Bhutan and India.[26] ○ Payments which are not on account of current international transactions, as defined by the IMF, except to the extent mutually agreed upon between the member countries, and ○ Such other payments as may be declared, from time to time, by the ACU to be ineligible for being routed through the facility provided by the ACU

Source: ACU in Brief, ACU (2017)

5.4.6 Cross Border Payment

Most of the cross-border transactions take place bilaterally. INR is mostly used for transactions with India, whereas convertible currencies are used in case of other trading partners. Draft and TTs are commonly used in cross-border payments between India and Nepal; LC is used when the payments are to be made in convertible foreign currencies against imports of industrial raw materials from India. SWIFT is the most popular means of payment for the third country transactions. Central Bank and BFIs use SWIFT for fund transfers and settlements. The settlement of financial claims takes place at the time when cheques and drafts are presented to the ECC System by the participating banks, in which transactions are settled on RTGS basis with net amounts under ECC. Thus, ECC refers to simultaneous transmission, processing and net settlement of financial claims. Regarding the settlement of securities, both bilateral and multilateral methods of payments are used (NRB, 2005, p. 154). Settlement under ACU transactions are made as per its specialised procedure in every two months.

5.4.7 Role of NRB

The NRB, to discharge its mandate as envisaged in the NRB Act, 2002, “to develop a secure, healthy and efficient system of payment”, is adopting a strategic approach for the reform of the payment and settlement system in Nepal. NRB is responsible for attaining its objectives of achieving a safe and efficient payments and settlement system that effectively contributes to the country’s financial stability and economic growth (NRB, 2014b). The National Payment System Development Strategy has been issued by the NRB on July 3, 2014. Likewise, Payment and Settlement Bylaws, 2015 has also been in operation since July, 2015, of which the first amendment took place in June, 2016.

Commercial banks maintain the clearing account and statutory reserves requirement accounts with the NRB. Changes in the requirement of the clearing account will affect the overall bank liquidity and payment system. It is the lags in clearing and settlement that affect the level of float or items in transit, forcing the commercial banks to maintain a certain degree of liquidity or clearing balances that are necessary. NRB's provision of daylight overdrafts could reduce the need for holding high amounts of clearing balances. The decentralization of clearing accounts to the district offices also affects the level of liquidity (Mathema, 2005). The effectiveness of monetary policy is affected by the efficiency and reliability of the payment and settlement system prevailing in the country.

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[26] Except certain exceptions pertaining to imports from India by an importer resident of Nepal and who has been permitted by the NRB to remit payment of foreign exchange.

5.5 Concluding Note

Nepal's international trade balance is historically in deficit; therefore, the trade sector is responsible for the leakage of precious foreign exchange. This scenario makes it difficult to formulate and implement independent monetary and exchange rate policies in favour of domestic industries and export promotion. Due to the pegged exchange rate regime, it is tough to predict the response of exports and imports to the exchange rate.

Although there has been a significant growth in export since Nepal's openness to outside world, its large import base, especially from India, has always been dominant in the foreign trade. More than 60 percent of the foreign trade is with the southern neighbour, India. A few export items like iron and steel products, woolen carpets, yarns, readymade garments, *pashmina* and raw materials account for the major portion of exports from Nepal. Such trade concentrations on both the dimensions of export commodities and destinations in recent years have exacerbated the trade sector. The geographical diversification of its trade needs to include a shift towards a wider array of manufactured products. The ever-increasing trade deficit is financed by foreign exchange earned as remittance, tourism income, foreign grants as well as loans. The existing pegged exchange rate with India has weakened Nepal's freedom over foreign trade.

Still a developing nation, Nepal is unable to influence the global market to which it exports primary goods at prices that are generally both low and unpredictable. So, Nepal has to adopt appropriate policy measures to reduce the galloping trade deficit. Further, in view of the need to facilitate the payment and settlement of cross-border transactions, the role of ACU has been important among the ACU member nations. That role should be strengthened as a very useful instrument for reducing the transaction cost of foreign trade and its payments.