CHAPTER I

INTRODUCTION

1.1 Background

Nepal is a small land locked, least developed country in south Asia, which lies between two giant countries, Tibetan part of China in the north and India in the remaining three sides. Nepal's economic growth rate remained below 5.0 percent in the last six years because of the country's precarious economic circumstances. The growth rate in fiscal year 2006/07 is 2.5 percent. Agriculture sector is the mainstay of Nepalese economy that still absorbs 65.6 percent of total labour of the country. The contribution of the agriculture sector to GDP is 39 percent. With a population of about 25 million, the average population growth is 2.24 percent per annum (Economic Survey 2006/07).

Despite nearly sixty years of planned development, Nepal is predominantly an agricultural country and agriculture sustains the livelihoods of majority of population. Industrialization is at incipient stage and bulk of the income comes from the export of commodities.. Landlocked situation, Peace and Friendship and Trade and Commerce Treaties with India (1950), open door policy for Nepalese workers and vital trade links to the outside world through India strongly influence Nepal’s development policies and strategies. Still, reducing the costs of transit is a major policy challenge for Nepal to become competitive in the world economy and realize the goal of economic and diplomatic diversifications. The new economic policy of finance and service has weakened the base of traditional manufacturing that was the base of its industrial development. Before 1951, the foreign trade of Nepal was limited namely USA and France. Before the Second World War Nepal used to import from the countries such as England, Japan, Singapore and export her agricultural products like jute.

Nepal started to institutionalize its trade in the fiscal year 1956/57 when it initiated its development plan. Its trade relation with India and Tibet is very old. Now, it has established its trade relation with more than one hundred countries. Similarly, it has acquired financial support form many countries and donor agencies. Realizing the fact that foreign trade is an appropriate means for rapid economic development, the country is giving importance to the sustainable development of the external sector adopting trade promotion policies in different times. Consequently, the volume of trade has been increasing gradually.

In the present emerging concept of globalization and open liberal market economy, international trade is seen backbone of national economy. Increase in foreign trade can help to increase in the living standard of people of that country which in turn helps to increase in the national income. No country can achieve rapid economic growth without mobilizing foreign trade. So Nepal's industrial future heavily depends upon the nature, structure and trends of foreign trade. This shows foreign trade plays a vital role for any country and more essential factor for developing country like Nepal.

This study is fully concentrate to analyze Nepal's both export and import trade structure and movement of trade with problems and prospects. The aggregate foreign trade to overseas and India take place under consideration of study in between period 1996 - 2006.

1.2 Statement of the Problem

Even though Nepal has embraced multilateralism and regionalism (MTA/RTA) by endorsing the framework of the World Trade Organization (WTO), South Asian Free Trade Area (SAFTA) and Bay of Bengal Initiatives for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) in the recent years, inadequate bilateral trade agreements with various countries across, Asia and

Europe has impeded diversification of trade, according to experts. Nepalese trade position has been facing trade deficit that continue to grow. That's why foreign trade occurs under the observation. Most of the policies are export oriented when import is treated as source of revenue.

Nepal is very much dependent on foreign aid and foreign investments and import component of foreign trade stands significant. In the development process of a less developing country like Nepal, foreign trade plays a vital role in order to bring in sustainable long-term economic growth. In Nepal, agriculture is the backbone of the economy due to the fact that more than percent of economically active population are still dependent on agriculture. Agriculture product is basically primary product and they have a constant demand in the market of Nepal's exporting partners. On the other hand industrial products are still not mature. Nepal's foreign trade sector has not been able to create trade diversification. So the behavior, movements and structure of foreign trade should b e analyzed.

1.3 Objectives

- To study structure of foreign trade between Nepal with India and overseas.
- To analyze the movement of Nepalese import and export

1.4 Significance of the Study

Nepal has been facing fundamental trade deficit and no favorable position of terms of trade with both destination India and overseas. Entering into World Trade Organization (WTO), country has more importance of foreign trade. Trade between India and Nepal has been more dominating owing to lack of trade diversification of trade towards overseas. Trade treaty between India and Nepal was modified in 1996.This study is little descriptive and mainly concentrate the study between 1996-2006. To analyze export and import composition and to investigate their effects on economy has the major concern of this study. Movements of foreign trade occur under the consideration of the study. These are the main importance of the study. To update the foreign trade data is another significance of this study.

1.5 Limitations

- This study is limited to the availability of the statistical data, time, resources, and upto date literature concerning the area of study.
- 10 year time span that from 1996-2006 has chosen under consideration
- Simple statistical tools are used to examine the determinants of export and import.
- Emphasis has given to analysis of present trend followed by export and import structure.

1.6 Statistical Tools

Based on the secondary sources of data, the study has made an attempt to derive a conclusion with regard to the established objectives of this study. The required secondary information so far as possible are collected from World Bank Report, Nepal Rastra Bank Publications, National Planning Commission and Government of Nepal (GON), reports published by Ministry of Finance, Reports and the data issued by Trade Promotion Centre Price index, net barter terms of trade, ratio, percentage and graphs are used to analyze the trend and structure of trade between Nepal and rest of the world. Regression equations are used to estimate the determinants of Nepalese export and import. Data and information with regard to trade patterns between Nepal and rest of the world have been used from the published and unpublished research papers, books, periodicals, journals, Internet websites and official sources.

The information on foreign trade is classified by SITC groups not by specific commodity and by country. The primary products are summed of (0+1+2+4) and manufacturing goods are summed of (3+5+6+8+9). Similarly, SITC 7 is given separately. This study starts with the description of the development of foreign trade with its historical prospective. Simple statistical tools and have been used to analyze the data. The variables used are as follows.

(i) Price index: in order to calculate price index the following stastical formula has been used.

$$I = \frac{p_i}{p_o} | 100$$

Where, I = Price Index

P_i = Export Price or Import price of the current year.

P_o = Export Price of Import price of the base year

(ii) Net barter terms of trade (ToT):

In order to calculate net barter terms of trade the following formula has been used:

$$N = \frac{p_x}{p_m} | 100$$

N = Net barter terms of trade

P_x = price index of exports

P_m = price index of imports

Analysis of terms of trade:

If N < 100, export performance is weak compared to import

If N > 100, export performance is better than import

If N = 100, both exports and imports are taking the same direction

(iii) GDP: Refers to the market price of the total flow of goods and services produced by Nepal over a specified time period, nominally a year. It is obtained by valuing outputs of goods and services at market prices. It should be noted that all intermediate goods are excluded, and only goods used for final consumption or investment are included.

1.6.1 Data Processing and Analysis

The relevant statistical information from the selected sources was processed with the help of a computer especially by SPSS programmes. The study consists of describing the role and systematic presentation of patterns, composition and direction of Nepalese foreign trade. The study arranged systematically, simple arithmetic analysis like ratio, percentage and graphs were computed to make them comparable and explanatory by using the method of descriptive analysis. GDP is measured at current and constant price.

Data Analysis

Simple Linear Regression Model

The simple linear regression analysis includes the regression equation with only one independent variable. If two variables say x and y are linearly related and y is a linear function of x, then the regression of y on x be formulated as:

$Y = a_o + a_1X$

Y= dependent variable

X = independent variable

a_o, a_1, = regression parameter

Multiple Regression Analysis

The regression equation with more than one independent variable is called multiple regressions. Therefore general form of multiple regression equation is

$Y = f(x_1, x_2, \ldots..x_n)$

Or $Y= a_o + a_1x_1 + a_2x_2+ a_3x_3 + \ldots\ldots a_nx_n$.

It should be noted that the relation between the dependent variable and independent variables is a linear one.

Coefficient of Determination R^2

It shows the percentage of the total variation of the regressed variable that can be explained by the regressor variable.

$$R^2 \text{ X} \frac{Explained\ \ Variation}{Total\ \ Variation}$$

o < R^2 < 1

The higher the value of R^2 the better the fit.

Adjusted coefficient of multiple determination $(\overline{R^2})$

The use of additional explanatory variables in the function leads to the rise in the value of coefficient. To take account of this $(\overline{R^2})$ the adjusted coefficient of multiple determinations is used. The expression will be given as:

$$(\overline{R^2}) = 1 - \frac{ESS\ /\{n \text{ Z} (k \text{ Z} 1)\}}{(TSS\ /(n \text{ Z} 1)}$$

$$\text{X} 1 - \frac{Error\ \ Sum\ \ Square}{Total\ \ Sum\ \ Square}$$

$$= 1 - (1 - R^2) \frac{(n \text{ Z} 1)}{(n \text{ Z} k \text{ Z} 1)}$$

Here, $(\overline{R^2})$ means the adjusted R^2.

Where, n = number of observations

K = the number of independent variables

T - Test

The t- ratio is the significant test of the regression coefficients. It indicates whether, the hypothesis should be accepted or rejected. The t-test is used when the number of parameters is less than 30 (n<30). It is computed as

$$t = \frac{Estimated\ Regression\ Coefficient}{Respective\ Standard\ Error}$$

$$= \frac{a_i}{\sqrt{var\ a_i}}$$

If t lies in the critical region (i.e. t > t ~) for the chosen level of significance for (n - k - 1) degree of freedom, we accept the alternative hypothesis. This concludes b_i is statically significant.

F- Test

To test the significance of the regression equation, F- test is done. It is calculated by

$$F = \frac{Variance\ Explained\ by\ Regression}{Unexplained\ Variance}$$

If F is greater than the tabulated value of F at ~ level of significance with K, (n-k-1) degree of freedom, we reject the null hypothesis and it is concluded that the regression equation is significant at ~ level of significance.

CHAPTER II

REVIEW OF LITERATURE

The mercantilist advocated the principle of balance of trade. Classical economist assumed "laissez faire" doctrine who believed in economic liberalism that on free trade. Father of economics Adam Smith pointed out the benefit of unrestricted trade. According to him free trade guarantees division of labour which inturn increases labour productivity ultimately resulting in increase aggregate wealth of country.

Roy (1977) in his article "*A Note on Nepal's foreign Trade*" observes the implication of duel exchange rate system imposed by GON. Dual exchange rate system will be paid for the amounts they are entitled to receive in convertible foreign currencies in accordance with the second rate of exchange of the U.S. dollar, fixed at 16 Nepalese rupees to a dollar. The second rate of exchange will be applicable to all imports except "development goods and materials". The basic exchange of all convertible foreign currencies will be based on the official exchange rate of U.S. dollar of twelve Nepalese rupees to a dollar.

Major findings:

- The increasing trade deficit is a serious concern for Nepal
- The incentive bonus scheme allowed for many exchange rates depending upon the commodity exported overseas.
- Often alleged over invoicing of export that is associated with the incentive bonus scheme.
- The dual exchange rate system is expected to provide some relief to export.
- Hence, it appears that nibbling with exchange rate alone to take care of the payment position is hardly adequate since by all indications trade

deficit is tending to become woven inextricably into the very fabric of the Nepalese economy.

The author has recommended the following points.

- The dual exchange rate system must be under careful vigilance.
- Since there is a dangerous possibility that Indian currency may be purchased and taken to India for buying dollar, which in turn can be transferred elsewhere or registered in Nepal as export earnings, which results in loss for Nepalese economy.
- It is also likely that the long predominance of illegal trade along the border will be successfully countered resulting in trade gain for both the countries.

Poudyal (1988) in his book "*Foreign Trade Aid and Development in Nepal*" tries to analyze the behaviour and determinant of macro- economic variables such as investment, saving, export and import. He deals with the structure of foreign trade, direction of foreign trade, determinants of trade patterns, commodity and geographic concentration of exports and imports, instability in export earnings and terms of trade. He has explained the achievements and shortcomings of export diversification schemes introduced in the 60's and 70's for the purpose of diversifying Nepal's trade in terms of goods and geographical patterns. He has estimated linear, log linear, without lags and with lags.

Major findings:

- Nepal's export to India and overseas shows that domestic supply factor is the most crucial variable in determining export of these countries.
- While export to India appears to be highly elastic with respect to Nepal's agricultural GDP and relative price between the Indian and Nepal's market.

- Empirically, income and foreign aid are the major determinants of imports.
- Export diversification policies are not so well designed and implementation side is so poor.

The author has recommended the following points.

- Policy should be directed towards the programmed oriented import substitution and diversification of export.
- Implementation of policy should sound and effective.

Shrestha (1994) in a research report on "*Direction of Nepal's Foreign Trade*" concerns about the structure and balance of payment situation of Nepalese trade. This study emphasizes Nepal's terms of trade and gain from trade. He tries to identify the major challenges faced by the country and suggests the most viable solutions to the problems of Nepal's foreign trade. He tries to separate study of geographical pattern of trade viewing the trade with India, Tibet, overseas and SAARC member countries.

Major findings

- Within the period 1982- 1992, export value increased by 12 folds and import value increased by 5 fold trade deficit accounted to Rs. 19011.9 million. Continuous trade deficit is hampering Nepalese economy.

- Owing to Policy and behaviour of GoN is India – oriented, the trade deficit is becoming more widened with India.
- Imports from overseas may continue to increase by big percentage in the years to come.
- Tibet has successfully enjoyed the benefits from the trade arrangements while Nepal remained the sufferer.

- The movement of our export has taken a right direction since 1990/91 only. However, the term of trade was below 100 during the whole period.
- Study shows that Nepal is still far away from the gains of international trade, though the terms of trade shows a satisfactory trend in the economy.
- The major bottleneck of our country is geography.

The author has recommended the following points.

- GON should take attention on balance of payment situation and Nepal's terms of trade and gains from trade.
- GoN must immediately take certain concrete steps to expand its export trade and improve the country's foreign trade situation in the years to come.
- Government should focus on empowerment and environment friendly policies for private sector
- Appropriate protection of domestic industries should be given.
- Developing of joint venture business is essential.

Shah (1999) "*The Study of Nepal's Foreign Trade: 1965-97*" M. A unpublished thesis seems quite different study in the field of foreign trade. She took three objectives; to study Nepal's foreign trade, to analyze exports and to examine imports. There are five chapters in her dissertation. The information of foreign trade is taken by SITC. She used mathematical tools, foreign trade multiplier, linear equation and regression analysis.

Major findings:

- Nepal's foreign trade is non-uniform with trade in GDP.
- Export multiplier and import multiplier finding are 10.72 and 2.19 respectively

- Marginal propensity to import and saving on average are 0.3143 and 0.1413 respectively.
- Annual exponential growth rate of the specified macro economic variables that are varied from 10 percent to 21 percent. Growth rate of GDP at constant price (1974/75 = 100) is only 3 %.

The author has recommended the following points.

- The detection of non-stationary time series data, and accordingly choosing the functional form.
- Specification of the variables to analyze the structural changes caused by various economic measures can be done with the help of dummy variable analysis.
- The estimates should be used with precaution because of quality of data and presence of auto correlation.

Singh and Singh (1999) in their Article "*Nepal's Foreign Trade: the changing scenario of commodity composition and Direction*" states that the role of foreign trade in the economic development of a developing country like Nepal They focused on important issue Nepalese foreign trade, which is the pattern of commodity composition, classified as import commodity composition and export composition. Another dealing of their study is the direction of Nepalese foreign trade; cause of a study of direction of trade indicates country international relations, facilities for trade and linking of Nepal. They examined Nepalese trade direction in terms of destinationwise exports and imports.

Major findings:

- Nepal is a primary product producing country; her terms of trade remain unfavorable.
- Under these circumstances, production, productivity and efficiency are to be generated which is possible by foreign trade in the short run.

- Import commodity composition of Nepal is more diversified than the export commodity composition.

The authors have recommended the following points.

- Under economic reforms at global level i.e. liberalization and globalization; Nepalese economy is to be made compatible with these changes.
- Cost of production should be reduced.
- Efficiency and competitiveness have to be generated.
- To improve BOP, Nepal should increase export and decrease import.
- Export can be encouraged by improving the quality of products, reducing cost of production, generating export surpluses, encouraging research and development,
- Import substitutes should be encouraged by adopting improved indigenous technology curving non-essential and Luxury imports, controlling growth of population and diversifying its exports and imports markets.

Sharma (1999) in his article, "*Nepal's Foreign trade: Trends and Issue*" attempts to assess the current trends and major issues facing the Nepalese foreign trade sector. The discussion focus on trade policy reforms with reference to export and trade with South Asian Association for Regional cooperation (SAARC) countries. He attempts to discuss issues relating to Nepal's entrance to the world trade organization (WTO). He explains that the government holds the view that these multilateral cooperation arrangements cannot be fully exploited without joining the WTO. Nepal intends to integrate into the multilateral trading system to increase the supply of tradable items, both goods and services, to attract foreign investment and to gain better market. Nepal has recently submitted a memorandum on foreign trade regime to the WTO office.

Major findings:

- The trade deficit of Nepal has been increasing over the period of 1991/92 – 1996/97.
- Though export has increased at the average rate 11 percent per annum and import has increased at the average rate of 24.7 percent during the period.
- The ratio of trade deficit to GDP ratio increased from 12.6 percent in 1991/92 to 27.3 percent in 1996/97.
- Export – GDP ratio during the period was 9 percent in average while the import GDP average ratio was more than 29 percent.
- Huge gap of export – GDP ratio with import – GDP ratio which is not a favorable indication for the Nepalese economy.
- Nepal has been actively participating in many multilateral economic cooperation programs.
- One of the major challenges for Nepal to achieve higher economic growth is systematically unfavorable foreign trade balance characterized by low level of export trade and increasing volume of imports of both consumption goods and investment items.
- One vital missing factor in the domestic front for Nepal is to benefit maximally from the WTO is a consistent set of strategies and policy instruments to boost-up quality production in sufficient amount for low bulk high value selective commodities.

The author has recommended the following points.

- Domestic consumption should curtail in order to reduce import from India.
- Export should expand through supply management of selective items.
- The necessity of reasonable tariff protection.
- Adjustments in exchange rate regime.

Subedi (2003) in his unpublished M.A. thesis "*Nepal's Foreign Trade: The Changing Scenario of Size, Composition and Direction*" intends to look over the composition of overseas trade. His study is limited to 10 years time span of 1991-2001. He simply used secondary source of data and presented the data on tables and compare the data from different angle.

He reviewed the implementation of different trade policies implemented by GON and point out the significance of reforms measures taken by the government. He touches in brief on different policies of the Government such as Structural Adjustment Programme, Trade policy 1992, Industrial Enterprises Act 1992, Exporters' Exchange Entitlement Scheme (EEE), Dual Exchange Rate System, and Exchange Convertibility System. He also tries to show the composition of Nepalese import and export by standard international trade classification (SITC) and direction of trade.

Major findings:

- Performance in each and every plan has remained quite low and less effective in speeding up the total volume of trade.
- The percentage share of export decreased from fourth plan i.e. 36.04% to sixth plan 22.48% and then slightly increased in seventh plan with 39.49% share on export.
- Dual exchange system could not serve the basic objective of the country because exporters did not pay any attention to the question of creating basic and favorable infrastructure for the expansion of the country's export trade.

The author has recommended the following points.

- GON should make appropriate export plan.
- Domestic markets should expand.
- Initiatives should be given to private sectors.
- Nepalese trade should be diversified.

- Improvement of trade and transit treaties and searching the alternative routes of trade and progressive tax system should be of immediate concern for nation's prosperity

Khanal (2006): "Foreign Trade of Nepal: Trend and Structure" M. A unpublished thesis tries to analysis the Nepalese trade structure and trend within the period 1990 -2004. He put forward General Objective: To study structure of foreign trade between Nepal and rest of the world and to analyze trend of Nepal's foreign trade. Specific Objective as: To estimate the determinants of exports and imports, to analyze Nepalese foreign trade policies and reform measures, to recommend necessary measures for future improvement. He has overviewed the history of Nepalese trade, plan wise trends of trade, volume of trade, policy adopted by government of Nepal, composition of trade by SITC, terms of trade. He has estimated determinants of export and import using regression equations. he has pointed out the strength and weakness of Nepalese trade and recommended for future course of action.

Major findings:

- The total export has increased over the various plans ranging from Rs. 628.1 million in first plan to Rs. 206529.4 million in ninth plan which is about 328 times more than that of first plan.
- Within 1990-2004, total volume of export value is increased by 7 times which was 7387.5 million rupees in 1990/91 increased to 53910.7 million rupees in 2003/04.
- Total volume of import was 23226.5 million rupees in 1990/91 increased to 136277.1 million rupees in 2003/04.
- The EEE scheme neither helped in expanding the export base nor contributed to reduce the dependency on India.
- Treaty of Trade 1996 has indeed played a crucial role in the foreign trade structure of Nepal.

- During the 14 year study period; there is 20-fold increment on total value of export trade whereas the total value of import with India increased about 11-fold.
- The high share of manufactured items compared to primary goods imports endorses the poor development of the economy.
- Destination wise terms of trade with India was less than overseas countries during 1990 - 1998
- During the study period, the share of export in GDP is found on an average about 10 percent.
- The fitted regression equations prove that there is direct relationship between export and GDP as well as there exist positive association of export with agricultural GDP and non- agricultural GDP and one period lag export so far.
- On the import side, import also has significant and positive association with gross domestic product as well as positively associated with the ratio of GDP and population of Nepal. However, there exist negative relation occurs with import and real exchange rate.

The author has recommended the following points:

- As soon as possible political settlement must be assured with the coordination of all the stakeholder of the nation.
- To reduce imports, domestic industries should be encouraged to produce consumer goods
- Export should be increased by improving the quality of product, introducing new commodities, reducing cost of production, generating export surpluses, encouraging research and development.
- Nepal should give higher priority to remove the nation's deficit problem by adopting long-term measures like penetration to export market and effective application and execution of import substitution regime.

Kafle (2006) in an article "Effectiveness of Trade Policy in Nepal" tries to focus on trade promotion efforts taken by GON on the basis of different plan period. She also maintains different policy measures of GON She overviews the entire features of International trade. She observes trade deficit, export import ratio and composition of Nepalese trade based upon primary and manufacture goods.

Major findings:

- Concentration of export trade in a few items and destinations
- Dependence on the import for raw materials
- Weak forward and backward linkage
- Policy adopted till now are not sufficient
- Small basket of export and too limited market are the serious matters for the country

The author has recommended the following points:

- Nepal should be able to fully use the transit route via Kakarvitta - Fulbari – Bangalabandh to expand foreign trade
- Government should create fovourable environment for investment and should facilitate private sector to enhance the production activities.
- In order to increase exports, production of exportable items must be enhanced, new exportable item that have comparative advantage should be identified.
- Production of agriculture and other primary goods also would be enhanced as the modern tools, seeds, fertilizers etc could reach in all regions of the country.
- Policy should focus on (a)establishment of industries that utilize local resources and fulfill local needs as well as can have production surplus to export (b) massive promotional activities for tourism

After reviewing literature based on foreign trade it is concluded that Nepalese trade has been facing trade deficit problem due to lack of sound export base and lack of effective government policy towards export promotion.

CHAPTER III

STRUCTURE OF NEPALESE FOREIGN TRADE

3.1 Total Volume of Trade

Total volume of Nepal's export was Rs. 95.47 million in 1956/57. It has increased to Rs. 53,910.7 in 2003/04 Rs. 58,705.7 million in FY 2004/05 consequently increased to Rs. 60,234.1 in FY 2005/06. Within a period of half century its total export increased 630 fold. Within the same period the value of imports increased from Rs. 169.89 million to Rs.173, 780.3 million. Within the same period imports increased 1022 fold.

Within 10 years, table 3.1 shows that our export value increased Rs. 22,636.5 million in FY 1996/97 to Rs. 60,234.1 million in 2005/06 which is about by 2.66 times. Whereas import value increased Rs. 93,553.4 million in 1996/97 to Rs. 173,780.3 million in 2005/06 which is about 1.85 Times only. However, imports value is 1.4 times the export value. Being the heavy share of import in total trade, Nepal's trade balance has remained always negative. The total trade deficit of Nepal in 1996/97 was Rs. 70,916.9 Million. During 10 years period trade deficit increased to Rs. 113,546.2 Million in 2005/06, which is about 1.8 times the export value. Trade deficit seems quite disappointing for the last fiscal years. However it seems fluctuating in different fiscal years. Except in FY 2001/02, there is continuous increasing trend of total volume of export and import trade in succeeding fiscal years.

Narrow base of exportable production, high transit and transportation cost, land-locked situation, unfavorable environment for industrial development are crucial factors for unfavorable trade balance.

Table 3.1

Total Volume of Trade (1996/97 – 2005/06)

(In million rupees)

Fiscal year	Total export	Total import	Trade balance
1996/97	22,636.5	93,553.4	-70,916.9
1997/98	27,513.5	89,002.0	-61,488.5
1998/99	35,676.3	87,525.3	-51,849.0
1999/00	49,822.7	108,504.9	-60,033.1
2000/01	55,654.1	115,687.2	-60,444.1
2001/02	46,,944.8	107338.9	-60,394.1
2002/03	49,930.6	124,352.1	-82,366.4
2003/04	53,910.7	136,277.1	-73,950.6
2004/05	58,705.7	149,473.6	-90,767.9
2005/06	60,234.1	173,780.3	-113,546.2

Source: Economic Survey 2006/07 and Nepal Rastra Bank, Quarterly Economic Bulletin, Mid-Oct 2007.

3.2 Volume of Trade and Balance of Trade with India

Table 3.2 shows that in FY 1996/97 total volume of export trade with India was Rs. 5,226.2 million. It has increased to Rs. 40,714.7 million in 2005/06 that is about 7.8 fold increment during 10 years study period. Similarly volume of import to India in FY 1996/97 was Rs 24,853.3 million increased to Rs. 107,143.1 million in 2005/06 that is about 4.3 times increment. Though the value of export is increasing trend, the trade deficit with India is quite discouraging which was Rs. 19,627.1 million in 1996/97 increased to Rs. 66,428.4 million in 2005/06 that 3.38 fold increment during the study period. There is tremendous increment on value of import too. The share of export to total trade with India seems lowest that of 23.1 percent in starting of study period ie in 1996/97. However, the share of export took positive direction from 1996/97 onwards and continuous increment till 2000/01. In 2001/02, the India's share of export on total trade hyper jumped approached to 73.8 % share on total trade. Which again declined on succeeding period but in our study's final year i.e in 2005/06, the share of export to India has occupied about 67 percent

Consequent time period, the share of import with India has also increased. In 1996/97, it was 26.6 percent share to India which approached to 61.6 percent on 2005/06 onwards. However, in 2001/02, the percent share of import has enormously increased approached to 72 percent. Then it started to decline with two succeeding fiscal years. Again it started to increased in 2004/05 accounted to 59 percent share to India. In last year of study i.e in 2005/06, the share of import to India has occupied about 62 percent.

Table 3.2

Volume of Trade with India (1996/97 – 2005/06)

FY	Export (Rs in million)	Import (Rs in million)	Trade balance (Rs in million)	% share on total export	% share on total import
1996/97	5,226.2	24,853.3	-19,627.1	23.1	26.6
1997/98	8,794.4	27,331.0	-18,536.6	32.1	30.7
1998/99	12,530.7	32,119.7	-19,589.0	35.1	36.7
1999/00	21,220.7	39,660.1	-18,439.4	42.6	36.5
2000/01	26,030.2	45,211.0	-19,180.8	46.8	39.1
2001/02	27,956.2	56,622.1	-28,665.9	73.8	72.1
2002/03	26,430.0	70,924.2	-44,494.2	52.9	57.1
2003/04	30,777.1	78,739.5	-47,962.4	57.1	57.8
2004/05	38,916.9	88,675.5	-49,758.6	66.3	59.3
2005/06	40,714.7	107,143.1	-66,428.4	67.6	61.6

Source: Economic Survey 2006/07 and Nepal Rastra Bank, Quarterly economic Bulletin, Mid- Oct 2007

3.3 Volume of Trade and Balance of Trade with Overseas

Table 3.3 shows that in FY 1996/97, total volume of export trade with overseas countries was Rs. 17,410.3 million. It has increased to Rs.19, 519.4 million in 2005/06. During the study period 1996-2006, there is 1.1-fold increment in total value of export. On the import side total value of trade with overseas in 1996/97 was Rs. 68,700.1 million. It has decreased to Rs.66, 636.2 million in 2005/06. It shows that There is balanced increment on both export and import value of overseas trade. After FY 1996/97, Trade deficit with overseas had been slowing down till FY 1998/99 onward. Again it started to increased in two succeeding fiscal years. Then again it started to decline in FY 2001/02. From 2004/05 it has increased and approached to Rs. 47,117.8 million in 2005/06 which is not still more than the trade deficit account of FY 1996/97.

The percentage share of overseas trade to total export is accounted highest 76.9 percent in 1996/97 and the lowest contribution is recorded 26.2 percent in 2001/02. It has been occurring very much fluctuate tendencies. From 1996/97 till 2001/02, the percent share of export to overseas became peak to bottom with gradual decreasing trend. Though the last two fiscal years' share is quite increasing, it could not exceed about 50 percent share on total export. However there is again disappointing trade with overseas that is recorded about 32 percent share only following the last two fiscal years. This indicates that the Nepalese trade diversification policies are not in favor of overseas countries.

On the import side there is not much fluctuation of share of import to overseas since 1996/97 till 2000/01. It was around 65 percent contribution of overseas import to total trade. But there was drastic decline of its share in 2001/02 which is accounted 28 percent only. Then again it took positive direction in the three succeeding fiscal years. In the final year of study period there is 38.3 percent share of overseas import.

Table 3.3

Volume of Trade with Overseas Countries (1996/97 – 2005/06)

FY	Export (Rs in million)	Import (Rs in million)	Trade balance (Rs in million)	% share on total export	% share on total import
1996/97	17,410.3	68,700.1	-51,289.8	76.9	73.4
1997/98	18,719.1	61,671.0	-42,951.9	68.1	69.3
1998/99	23,145.6	55,405.6	-32,260.0	64.9	63.3
1999/00	28,602.0	68,844.8	-40,242.8	57.4	63.5
2000/01	29,623.9	70,476.2	-40,852.3	53.2	60.9
2001/02	18,988.6	50,766.9	-31,778.3	26.2	28.1
2002/03	23,500.6	53,427.9	-29,927.3	47.1	43.1
2003/04	23,133.6	57,537.6	-34,404.0	42.9	42.2
2004/05	19,788.8	60,798.1	-41,009.3	33.7	40.7
2005/06	19,519.4	66,637.2	-47,117.8	32.4	38.3

Source: Economic Survey 2006/07 and Nepal Rastra Bank, Quarterly Economic Bulletin, Mid- Oct 2007

3.4 Composition of Nepalese Foreign Trade

The composition of foreign trade shows the level of the development of the country. Nepalese export commodity composition has little diversified than import commodity composition. Here goes the composition of Nepalese foreign trade analysis on the basis of standard international trade classification (SITC) as well as brief account of dominant commodities on particular.

According to S.R. Poudyal's SITC classification, the following Table 3.4 and 3.5 shows the composition of Nepalese export accordingly manufacture goods and primary commodities. Whereas manufactured goods are captured with the sum of SITC (3+5+6+8+9). And primary goods are accounted with the sum of SITC (0+1+2+4). Though there is SITC 7, we are neglecting here to analyze the export trade composition due to this item is consider separate one.

Major SITC Commodity Groups

0 = *Food and Live Animal*

1 = *Tobacco and Beverages*

2 = *Crude Materials, inedibles except fuels*

3 = *Mineral, Fuels and Lubricants*

4 = *Animal and vegetable oil and fats*

5 = *Chemical and Drugs*

6 = *Manufactured Goods classified mainly by materials*

7 = *Machinery and Transport Equipment*

8 = *Miscellaneous Manufactured Articles*

9 = *Commodity and Transaction not classified according to kind.*

3.4.1 Composition of Nepalese Export

Table 3.4 shows that during the study period 1996- 2006, the share of manufactured goods (SITC 3, 5, 6, 8, 9) ie five items was Rs. 18,924.6 million in 1996/97. It has increased to Rs. 46,307.2 million in 2005/06. It has been playing dominant role in Nepalese export which has been constant tendency during the study period on an average at around more than 78% share in total export. In 1996/97, around 84 percent of export was covered by manufactured commodities. During the same time the share of primary commodities dropped to 16.1 percent. After that it was around more than 20 percent share in two succeeding fiscal years. On 2001/02, there can be seen shift towards primary commodities. For instance, the share of manufactured goods has declined to 71 percent. However following years there is again domination of manufacture commodities export on Nepalese trade.

Table 3.4

SITC Composition of Nepal's Export (1996/97 – 2005/06)

FY	Total Export (Rs in Million)	Manufactured goods (Rs.in Million)	% share of manufacture goods on total export	Primary Goods (Rs.in Million)	% share of Primary goods on total export
1996/97	22,636.5	18,924.6	83.6	3,652.7	16.1
1997/98	27,513.5	21,686.0	78.8	5,769.4	21.0
1998/99	35,676.3	27,737.3	77.4	7,841.6	22.0
1999/00	49,822.7	41,283.6	82.9	8,148.6	16.4
2000/01	55,654.1	45,602.9	81.9	9,707.3	17.4
2001/02	46,944.8	33,294.2	70.9	13,285.8	28.3
2002/03	49,930.6	38,404.3	76.9	11,318.4	22.7
2003/04	53,910.7	42,869.4	79.5	10,422.1	19.3
2004/05	58,705.7	45,521.1	77.5	12,977.0	22.1
2005/06	60,234.1	46,307.2	76.9	12,725.0	21.1
Average			78.6		20.6

Source: Economic Survey 2006/07 and Nepal Rastra Bank, Quarterly Economic Bulletin, Mid- Oct 2007

On the primary goods side, table 3.4 shows that during the same time frame on an average at around 21% share has occupied by primary goods export. The share of primary goods (SITC 0,1,2 , 4) was Rs. 3,652.7 million (20.45 percent) in 1996/97 and it reached to Rs. 12,725.0 million (21.1 percent) in 2005/06 .

On the export composition of Nepalese foreign trade, the share of primary goods, according to table, in nominal value, is increasing continuously but its share in total export has noticed almost unchanged during the study period. The share of manufactured goods in total export increased significantly but the worth considering fact is that Nepalese exports are limited to few items.

3.4.2 Composition of Nepalese Import

The pattern of commodities composition considers an important issue of Nepalese trade structure. The following table 3.5 shows the share of manufacturing goods and primary goods on import according to SITC classification.

During the 10-year study period, Table 3.5 shows that Nepalese share of import on the basis of SITC manufacture goods has occupied on an average more than 61 percent. It was Rs. 65,952.6 million in 1996/97. It has increased to Rs. 112,366.3 million in 2005/06. In 1996/97, there was more than 70 percent share of these manufacture goods. Though there is fluctuation of percent share of these items, there is not less than 60 percent share on total value of import trade.

On the primary goods side, during the 10-year study period, on an average the share of primary products (SITC 0, 1, 2, 4) occupies 19 percent. This was Rs. 13,805.9 million in 1996/97 and approached to Rs. 35,219.6 million in 2005/06. There is gradual increment of share of primary commodities since 1996/97 till 1999/00 onwards. In 2000/01, it was dropped to 17 percent. Again it started to increased till 2003/04. Again it can be seen shift towards the export of manufactured commodities in succeeding years till 2005/06..

Table 3.5

SITC Composition of Nepal's Import (1996/97 – 2005/06)

FY	Total Import (Rs in Million)	Manufactured goods (Rs.in Million)	% share of manufacture goods on total Import	Primary Goods (Rs.in Million)	% share of Primary goods on total Import
1996/97	93,553.4	65,952.6	70.5	13,805.9	14.8
1997/98	89,002.0	57,536.8	61.6	14,730.5	16.8
1998/99	87,525.3	51,420.3	58.7	18,041.3	20.6
1999/00	108,504.9	64,753.1	59.7	23,203.9	21.4
2000/01	115,687.2	72,610.1	62.8	20,049.3	17.3
2001/02	107338.9	66,203.2	61.6	21,671.9	20.2
2002/03	124,352.1	77,257.5	62.1	26,392.5	21.2
2003/04	136,277.1	81,817.1	60.0	28,765.8	21.1
2004/05	149,473.6	95,151.9	63.7	28,059.6	18.8
2005/06	173,780.3	112,366.3	64.6	35,219.6	20.3
Average			62.5		19.3

Source: Economic Survey 2006/07 and Nepal Rastra Bank, Quarterly Economic Bulletin, Mid- Oct 2007

During study period there is domination of manufacture commodities in comparison to primary commodities on both export and import composition. Due to lack of competitive goods and not diversification of commodity –wise trade, Nepalese trade could not able to shift towards primary goods.

3.5 Share of Exports on GDP

Every nation has its own economic strength which can be measured by national gross domestic product (GDP). GDP accounts the overall output of the nation throughout the year. It indicates the nation's economic capability. Export trade is considered an important aspect to raise GDP. In developing economics like Nepal, export trade no doubt plays vital role. Export enhances capability to develop an industrial base and it is one of the major sources of generating foreign exchange required to import goods, raw materials and technology.

Table 3.6 shows that share of export to nominal GDP in current price. It can be seen fluctuating trend of export's share to GDP that is minimum around 9 percent to maximum about 14 percent. Export - GDP ratio has observed during 10 year study is about 11 percent. In this globalization context it is quite disappointing. However in FY 1996 it was around 9 percent contribution on Nepalese gross domestic product with gradual increment till 2000/01. Then the share of export to GDP started to decline in succeeding year. Though it occupies almost constant after FY 2002/03 till the last year of study period ie. In FY 2005/06 which is around 11 percent.

Table 3.6

Share of Export on Gross Domestic Product (1996/97 – 2005/06)

(In Million rupees)

FY	GDP	Export	Export/GDP
1996/97	269,570.0	22,636.5	9.39
1997/98	289,798.0	27,513.5	9.49
1998/99	330,018.0	35,676.3	10.81
1999/00	366,284.0	49,822.7	13.60
2000/01	393,473.0	55,654.1	14.14
2001/02	406,138.0	37,862.8	9.31
2002/03	437,546.0	49,930.6	11.41
2003/04	474,919.0	53,910.7	11.35
2004/05	508,651.0	58,705.7	11.54
2005/06	557,869.0	60,234.1	10.79
Average			11.18

Source: Economic Survey 2006/07 and Nepal Rastra Bank, Quarterly Economic Bulletin, Mid- Oct 2007

3.6 Empirical Observation of Nepalese Trade

We have estimated the linear equations to determine the contribution of exports and import. Total volume of export in different time periods is considered as dependent variable whereas gross domestic product, agriculture GDP and Non-agriculture GDP are considered as independent one. The regression is carried out within 1996/97 -2005/06 (appendix 1). The fitted equations are based on constant data. No attempt has been made to correct the problem of serial correlation. In all statistical analysis, figures in parentheses below the coefficients for independent variables indicate respective t- values. All the statistical values are computed from computer via SPSS programmers. All of Variable name, labels are as following.

Variable Name & Variable Label

Variable	Level
T	Time
GDP	Nominal Gross Domestic Product
GDPAG	Nominal Agriculture Gross Domestic Product
GDPNAG	Nominal Non Agriculture Gross Domestic Product
Xt	Total Value of Exports
Mt	Total Value of Imports
Eqn	Equation
Dep	Dependent Variable
ao	constant
a1	coefficient of first independent variable
a2	coefficient of second independent variable

Simple linear Regression models for exports in matrix form

Eq^n	Dep .var.	Cons	Independent variables			R^2	Ad.R^2	F
			GDP	GDPAG	GDPNAG			
1	Xt	- 4950.600	0.904 (5.996)			0.818	0.795	92.94
2	Xt	-4583.173		0.303 (4.391)	0.603 (3.425)	0.819	0.766	89.031

Eqn 1 : Xt = ao + a1GDP

Eqn 2 : Xt = ao + a1GDPAG + a2GDPNAG

First equation shows that there is significant positive relationship between total foreign export (Xt) and GDP. The fitted equation is a good fit with R^2 = 0.79 which indicates that 79% of variation in foreign export (x) are explained by independent variable GDP. The F value is also significant at the level of 5 percent and indicating that there is strong association of variables in question. On an average Nepalese economy one million of export is capable of generating additional income worth Rs. 0.904 million.

Equation 2 shows that there exist positive relationship between volume of export with agricultural GDP and non- agricultural GDP. The coefficient of independent variables is significant at 5% level of significance, as indicated by its higher t-value ie. greater than t0.05 = 2.145. However the equation itself is a best fit with adj R^2 = 76.6 percent of the variation in dependent variables being explained by the independent variable respectively. However, larger F- value is indicating that there is strong association of variable in question.

Above fitted equations are depicting that in comparison to agricultural and non agricultural GDP, there is higher effects of non agricultural GDP to expand export in comparison to agricultural GDP.

Simple Linear Regression models for imports:

By observing the relationship between total import and gross domestic product we have the following findings where the equation is

Eqn: 3 Mt = ao + a1GDP

R^2 = 0.918, adj R^2 = 0.908 , F= 90.124 , t= 9.49, constant = -2995.93, a1= 0.958

In this equation, we can see that there is positive relation between import and GDP. According to adj R^2 , 90.8 % of the total variation of import is explained by GDP. There is significant relationship between GDP and import which is indicating by respective t- values with 9.49 > $t_{0.05}$ = 2.145. The greater F- values is depicting that there is strong association of variable in question. This equation shows that increase in total import is capable to generate GDP.

CHAPTER IV

MOVEMENT OF NEPALESE FOREIGN TRADE

4.1 Historical Consideration of Nepalese Foreign Trade

Throughout the rule of Kirats, people of Nepal used to sell wool, herbs and handicrafts to several Indian markets. This trade was prolonged during Malla period as they focused in activities such as arts, metal casting, wood and bronze carving, sculpture etc and exported to Tibet and India. Arniko help to swell cultural developments across the East and Southeast Asia. King of Kathmandu Pratap Malla and the King of Gorkha Ram Shah, tried to broaden their pressure in Tibet. In 1625-30, Ram Shah twice tried to expand influence in Tibet. His second effort was successful and reached to Kukurghat. He controlled Kerung for a short time.

In 1775, a treaty signed by Nepal and Tibet made to close eastern route way and used Kuti and Kerung including a number of other small routes. War between Tibet and Nepal had occurred due to various causes but were harmoniously settled. The land-locked geography isolated Nepal from the center of world flows of goods, people and ideas and increased costs for trade and commerce.“The Alaichi Kothi in Patna, India, was established. Prime Minister Jung Bahadur Rana was instrumental in getting a bilateral agreement popularly known as the Treaty of Thapathali signed between Nepal and Tibet in 1856. The agreement, envisaged the stationing of a Nepalese Bhardar or Vakil (envoy) in Lhasa while Nepalese trade agencies were established at Kuti (Nyalam), Kyerong, Shigatse and Gyanze.

In the latter part, a trade treaty was signed with British India on December 1923 that allowed unrestricted import of British goods to Nepal. The Rana regime had established Development Board to promote economic activities.

Trans-Himalayan trade routes continued for the people of northern border while Terai was modernizing itself due to the spillover effects of economic development taking place in India. In 1950, Nepal joined the democratic community of nations. During 1960-1990 Nepal adopted state-led industrialization and import substitution oriented economic policies. Nepal had a small entrepreneurs, poor transportation and education, communication was undeveloped and traditional social structure of caste dominated attitude towards rational social change.

Landlocked situation, Peace and Friendship and Trade and Commerce Treaties with India (1950), open door policy for Nepalese workers and vital trade links to the outside world through India strongly influence Nepal's development policies and strategies. Still, reducing the costs of transit is a major policy challenge for Nepal to become competitive in the world economy and realize the goal of economic and diplomatic diversifications. The new economic policy of finance and service has weakened the base of traditional manufacturing that was the base of its industrial development.

4.2 Movements of Terms of Trade in Nepal

Terms of trade is the ratio of the index of export prices to the index of import prices. The general concepts is that an improvement in the terms of trade when there is a relative increase in export price or a relative fall in import prices. Adverse situation takes place when there is a relative rise in import price or a fall in export prices.

If, ToT > 100 implies that the performance of the nations export is favourable compared to its import

If, ToT < 100 implies that the performance of the nation's export is unfavourable compared to its import.

If, ToT = 100 implies that both export and import are moving in the same direction.

The effect of changes in the terms of trade should be appraised in the light of other relevant effects like changes in productivity, demand, total exports and imports, employment etc. The terms of trade has been calculated for 1996-2006 taking 1974/75 as a base year i.e. assuming that the total export and import value of 1974/75 is 100.. The basic ground for selecting 1974/75 as the base year is that the actual effort for Nepalese trade diversification was made since 1971 and its effect in Nepal was seen after 1974/75 and data are available since 1974/75 only. Where the value of export of base year = Rs. 889.6 million and the value of import of base year = Rs. 1814.6 million.

Table 4.1

Nepal's Terms of Trade (1996/97 – 2005/06)

(Base year: 1974/75 = 100)

Fiscal year	Price index of export (p_x)	Price index of import (p_m)	Terms of trade (ToT)
1996/97	2544.6	5155.6	49.3
1997/98	3092.8	4906.8	63.1
1998/99	4010.4	4823.4	83.1
1999/00	5600.6	5979.5	93.7
2000/01	6256.1	6375.4	98.1
2001/02	5277.0	5918.0	89.1
2002/03	5612.7	6852.8	81.9
2003/04	6060.1	7510.0	80.6
2004/05	6599.1	8237.3	80.1
2005/06	6770.1	9576.8	70.7
average			79.0

Source: Economic Survey 2006/07, and Nepal Rastra Bank, Quarterly Economic Bulletin, Mid – Oct 2007

Table 4.1 shows that the terms of trade of Nepal is not favourable. During the study period 1996- 2006, the term of trade of Nepal is found on an average 79 i.e below 100. In Starting of study period it was below 50. After that it has gradual increment in three succeeding fiscal years and approached near to 100 though the terms of trade could never exceed 100 within the entire the study period. This shows that the terms of trade was improving till FY 2000/01. Then it started to decline continuously in succeeding fiscal years with falling down to 70.7 in FY 2005/06. Within these years, there was a fluctuation in terms of trade. This is because a smooth growth of import price than export price. This tendency of terms of trade indicates that the Nepalese export performance is weak compared to import. So, Nepal is still far away from the gain of international trade, though the terms of trade show satisfactory trend in the economy.

4.3 Terms of Trade with India

Assuming base year 1974/75, total volume of export to India Rs. 746.7million equals to 100 and total volume of import to India Rs. 1475.7 equals to 100 Table 4.2 shows that during the 10-year study period, Nepal's terms of trade with India on an average is found 81.4. A term of trade with India in 1996/97 was only 41.6 this is because the import price increased more rapidly than export price. After that TOT took positive direction. The positive direction remained in 2000/01 with ToT 113.8 Then after ToT came back below 100. In FY 2005/06 it has covered only 75.1.this is quite discoursing scene in perspective of Nepalese trade. This situation clearly indicates that Nepal's export performance with India is worse than the import. Nepal has been losing its economy perspective from foreign trade with India. These unfavourable happenings suggest that immediate action should be taken by government with strategically. Import should be controlled in terms of both commodity and value.

Table 4.2

Terms of Trade with India (1996/97 – 2005/06)

(Base year: 1974/75 = 100)

Fiscal year	Price index of export (p_x)	Price index of import(p_m)	Terms of trade
1996/97	699.9	1684.2	41.6
1997/98	1177.8	1852.0	63.6
1998/99	1678.1	2176.6	77.1
1999/00	2841.9	2687.5	105.7
2000/01	3486.0	3063.7	113.8
2001/02	3743.9	3837.0	97.6
2002/03	3539.6	4806.1	73.6
2003/04	4121.7	5335.7	77.2
2004/05	5211.8	5873.5	88.7
2005/06	5452.6	7260.5	75.1
average			81.4

Source: Economic Survey 2006/07, and Nepal Rastra Bank, Quarterly Economic Bulletin, Mid – Oct 2007

4.4 Terms of Trade with Overseas Countries

Assuming base year 1974/75, total volume of export to Overseas Rs. 142.9 million equals to 100 and total volume of import to Overseas Rs. 338.9 equals to 100 Table 4.3 shows that the terms of trade with overseas countries have a fluctuation movement, some ups and downs within the study period 1996-2006. it remained on an average 86.4 during 1996- 2006.However, on an average ToT of overseas seems so satisfactory in comparison to terms of trade with India. In 1996/97, the terms of trade with overseas countries was below 60.1. But four succeeding years till 2000/01, ToT with overseas countries was near to 100. It clearly throws the light that export to overseas countries is increasing more rapidly than import. In other words Nepalese export performance is better than import and gained something from overseas countries. In 2001/02, ToT with overseas countries was quite discouraging having the value below 100 owing to import from overseas countries increased more than the export. While during the 1998- 2000 it was improved as compared to pervious years but could not exceed 100. Once again, In 2002/03 ToT crossed the value of 100 i.e. approached to 104.3. Again it started to decline in succeeding year having below 100. In 2005/06 it has occupied the value only 69.5. This situation suggests that Nepal has to diversify its exports to overseas countries in terms of both commodity and value.

Table 4.3

Terms of Trade with Overseas Countries (1996/97 – 2005/06)

(Base year: 1974/75 = 100)

Fiscal year	Price index of export	Price index of import	Terms of trade
1996/97	12183.6	20271.5	60.1
1997/98	13099.4	18197.4	71.9
1998/99	16197.1	16348.6	99.0
1999/00	20015.4	20314.2	98.5
2000/01	20730.5	20795.6	99.7
2001/02	13288.0	14979.9	88.7
2002/03	16445.5	15765.1	104.3
2003/04	16188.7	16977.8	95.4
2004/05	13848.0	17939.8	77.2
2005/06	13659.5	19662.8	69.5
average			86.4

Source: Economic Survey 2006/07, and Nepal Rastra Bank, Quarterly Economic Bulletin, Mid – Oct 2007

4.5 Exporters' Exchange Entitlement (EEE) Scheme

This system is also called as Bonus system that GON introduced in 1961 to promote and diversify export to India and overseas countries. Under this scheme, overseas exporters were provided a bonus in the form of convertible foreign exchange which could be used to import wide range of semi-luxury and luxury goods from overseas countries except some restricted items. This scheme was very profitable for export to overseas due to the incentive provided under the scheme. Due to the provision of bonus system under the EEE scheme, there was significant increment in the export from India to overseas countries. During this period, Nepalese trade grew substantially in terms of volume and directions. As a result, India's share in the total trade started to decline. Though the EEE scheme was successful in diversifing Nepal's foreign trade from India to overseas countries and augmenting foreign exchange though not successful in creating strong trade sector capable of supporting the economy on sustainable basis. Over invoicing of exports and under invoicing of imports, Lack of product diversification and Gradual emergence of unscrupulous trade practices has occurred. Consequently, in 1977 Dual Exchange Rate System replaced the EEE scheme.

4.6 Dual Exchange Rate System (DER)

GON introduced Dual Exchange Rate System in 1977. The main purpose of DER system was to diversify trade to overseas countries, to control the import of luxurious goods and to improve deteriorating terms of trade. Two exchange rates were fixed; One of the official rate and other as the depreciated rate. The basic (official) rate of exchange was fixed at US $ 1 = RS 12 and the depreciated second rate was fixed at US $ 1 = RS. 16. The basic (official) rate was applicable for importation of certain development goods and essential commodities with view to increase the production of exportable items.

The depreciated second rate was only applied for importation of luxurious commodities. All the earning from overseas exports was converted at the second rate to encourage the exports. Under this scheme, incentives were granted to encourage export to the overseas countries and to expand the production base. The purpose of the DER system was the same as EEE system only difference is that DER system was implemented to control importation of luxurious goods. Due to attractive incentive provided by government to overseas exports under DER system, market diversification only changed the direction of export from India to overseas without expanding the production base.

4.7 Adoption of Flexible Exchange Rate System

In 1983, GON adopted this system also known as currency basket system. For the enhancement of export competitiveness in international market, Nepal shifted towards flexible exchange rate regime partially. In this system, exchange rate of Nepalese Rupees used to be adjusted with the change in the value of major trading currencies except Indian Currency. After the adoption of this policy, exports increased significantly. When the basket system was adopted, exchange rate of US dollar was Rs. 14.20 and when the system was removed formally in 1992 it had moved up to Rs. 43.10. Out of total increase of Rs. 28.90, about two- third depreciation was through self- adjustment. However, in this context of fixed exchange rate with Indian currency, such system would create broken cross rates between Nepalese and other convertible currencies. In order to correct such discrepancies, the rupee was devalued in 3 occasions by the government. In order to further facilitate foreign trade, Nepal adopted partial convertibility system in 1992 and then subsequently full convertibility in 1993 in current account.

4.8 Forward Exchange Rate Facility

The system of forward exchange rate facility was introduced in the country only for the interest of exporters. This facility was to be made available only in the case of US dollor through the commercial banks. All the transactions conducted with the clients by the commercial banks were to be covered with the central bank. In this system importers normally have the option of passing on the burden of depreciation of currency to consumers, but exporters have to compete in the global market. Therefore, any additional cost which they might have to incur due to the adverse movement of the exchange rate would have to be absorbed by themselves. Since the system was for the protection of exporters from any unforeseen downward movement of the foreign currency, the rate quoted by the central bank always used to be in discount rate. The logic behind this was the exporters would go for this facility only when there is a probability of exchange rate going down. Throughout the period, since the normal movement of US dollar/Rupee exchange rate was the consistent depreciation of the domestic currency, practically exporters seldom used this facility such system was ceased by the NRB after the adoption of partial convertibility in 1992.

4.9 Import License Auction System

Export and imports are usually interlinked. In order to enhance production base and thereby exports, adequate capital goods and raw materials have to be imported. Therefore, imports also should be liberalized and facilitated. considering this, the import license action system for the import of 88 classes of commercial goods was introduced dividing these goods into 3 sub – groups in 1986 and further refining and increasing the groups into 5 in 1990 as group

A: essential raw materials,

B: basic consumer goods

C: luxury goods

D: goods which are highly liable to deflection to India

E: those consumer goods which are largely handled by small traders who could not meet the minimum required amount of an import license.

4.10 Partial Convertibility

In order to facilitate trade and thereby to promote export, "partial convertibility" policy was adopted in 1992 allowing the exchange rate of convertible currencies to be determined by the market forces. In this system, market rate was applicable to 65% of export earnings in the beginning and subsequently it was increased to 75%

4.11 Full Convertibility

Nepalese Rupees was made fully convertible for the current account transaction in 1993. Under this policy all the foreign currency proceeds were permitted to be converted at market rates. Exporters were permitted to retain 100% of their foreign currency accounts and foreign exchange facility for a large number of items was easily made available. This system exists now as well. After the full convertibility, Nepalese export has taken relatively a higher speed.

Along with full convertibility, there are other policies in effect to encourage export- oriented industries for capacity enhancement and diversification of export. Exporters and other foreign exchange earners are allowed to open foreign exchange account and to keep 100% of their foreign exchange earnings in such account. In order to enhance export base, exporters were provided export and pre – export credit at a concessional interest rate. Similarly, exporters and tourism related bodies are provided a facility of foreign exchange for the opening up and operation of the liaison office and sales and exhibition premises abroad. For the utilization of this facility, exporters have to fulfill some conditions. For the removal of procedural hindrances in the export of the petty items, exporters are allowed to export on bank guarantee rather than letter of credit up to a certain limit. Tourists are allowed to carry handicraft products and carpets up to a certain amount. In order to facilitate exporters to have necessary capital at the least cost, pre- shipment and post shipment credit in US dollor are made available at a concessional interest rate abiding by the existing rules and regulations.

4.12 Trade Policy 1992

The new trade policy was introduced in 1992. The major objectives of trade policy were:

- To increase domestic and international trade through the creation of open and liberal environment in the economy with the growing participation of the private sector.
- To diversify trade by identifying, developing and producing new exportable products through the promotion of backward linkages for making export trade competitive and sustainable establishing backward linkages.
- The role of public sector will be minimized and used as a catalyst to expand the role of private sector in trade.
- To improve balance of payments position by promoting exports to increase foreign exchange earnings as well as by fulfilling internal demand of economic and quality products.
- Production of quality goods and services for internal consumption as well as for exports through effective and appropriate utilization of economic resources.
- Institutional development and information network as well as on monitoring system and quality improvement for the promotion of foreign trade.

Export Policy

The export policy underlines the following fundamental provisions:

- Diversify export of goods and services, Production and quality of exportable products to make them competitive in the international market
- Increase service-oriented activities to promote foreign exchange earnings.
- Effective implementation of duty draw back scheme
- Export of hydro-electricity on a profitable basis.
- Export promotion will be provided on an institutionalized basis

Export Strategies

The export strategy includes:

- Not required licenses for the export of products other than banned or quantitatively restricted items.
- Transparent, smooth and efficient administrative procedures
- Exports will be free from all charges except the service charge other than specified conditions
- Export Promotion Zone (EPZ) will be established.
- Gearing up towards export promotion activities, and trade missions will be opened and institutionalized on the basis of feasibility.
- Export promotion on the basis of an institutionalized basis.

Import Strategies

- Simplify import licensing and control system.
- Reducing transit cost and minimizes pilferage.
- Procedural simplification
- De-licensing of imports except for banned or under qualitative restriction items or in the auction system
- Create competitive industrial and trade environment.

4.13 Trade Policy in the Interim Plan 2007/08- 2009/10

Interim plan have the long term vision by increasing the trade of goods and services with deep forward and backward linkages.

Objective

- To help alleviate poverty by ensuring that the benefits from trade reaches the people through the maximum use of local physical and human resources.
- To mobilize trade to achieve the goal of economic development through the development and promotion of goods with competitive advantages and identifying areas of comparative advantages with the private sector involvement.
- To reform and develop commercial, physical and institutional infrastructure in order to take the maximum advantage arising out of the changes in the bilateral, regional and multilateral trade and transit system.

Strategies

- To make the supply-side strong by increasing production and productivity.
- To develop physical and other infrastructure related to trade.
- To adopt the measure for increasing market access and export promotion.
- To carry out trade facilitation services.
- To develop competent human resources in the trade sector in addition to institutional reforms.

Since the implementation of different policies measures, the expected result has not been achieved so far. Unless and until there is adequate development in infrastructure, utilization of locally available natural resources, attaining of comparative advantage on the production and expansion of trade is not possible.

CHAPTER V

SUMMARY, CONCLUSION AND RECOMMENDATION

5.1 Summary

The study provides a clear view regarding the Nepalese foreign trade structure and movement. With the limitation of time and resources, the study focus on Nepalese trade volume, composition of trade according to SITC classification, policy review, and terms of trade of Nepalese foreign trade. The following information summarizes the picture of Nepalese trade situation and export diversification of Nepalese government in brief.

The total trade deficit of Nepal in 1996/97 was Rs. 70,916.9 Million. During 10 years period trade deficit increased to Rs. 113,546.2 Million in 2005/06, which is about 1.8 times the export value. Trade deficit seems quite disappointing for the last fiscal years. However it seems fluctuating in different fiscal years. Except in FY 2001/02, there is continuous increasing trend of total volume of export and import trade in succeeding fiscal years.

Within 10 year period; there is 7.8 fold increments on total value of trade with India. The share of export took positive direction approached to 73 percent in 2001/02 which again declined on succeeding period. At the same time period, the total value of import with India increased about 4.3 fold. The share of import with India seems not much fluctuating from the study period 1996/97 till 2000/01 on an average of 33 percent. However, in 2001/02, the share of import has tremendously increased approached to 72 percent. Following the succeeding years the share of import started to decline but not less than 50 percent. The share structure of exports and imports of India and overseas countries shows that there is a domination of overseas trade, in the total import and total export trade of Nepal. In the early stages, there was deep domination of trade with India. Now, Nepalese trade direction is diversified from India to overseas countries.

On the export composition of Nepalese foreign trade, the share of primary goods, according to table, in nominal value, is increasing continuously but its share in total export has noticed almost unchanged during the study period. The share of manufactured goods in total export increased significantly but the worth considering fact is that Nepalese exports are limited to few items. In import side, primary goods has maintained its growing tendency in nominal value and share as well. The high share of manufactured items compared to primary goods imports endorses the poor development of the economy. Therefore, it is necessary to build import substitution industries.

During the study period, the share of export on GDP is found on an average about 11 percent. However, there is domination of share of overseas trade on GDP. The fitted equations are depicting that in comparison to agricultural and non agricultural GDP, There is a higher effect of non agricultural GDP to expand export in comparison to agricultural GDP. Similarly there is positive and significant relationship between import and GDP.

During the study period 1996- 2006, the term of trade of Nepal is unfavourable that is found on an average 79 i.e below 100. The main reason for terms of trade always unfavourable is rapidly increased to import price than export price. During 1999 - 2001, terms of trade with India was more favorable than overseas countries. In FY 2005/06 it has covered only 75.1.this is quite discoursing scene in perspective of Nepalese trade. This situation clearly indicates that Nepal’s export performance with India is worse than the import. Nepal has been losing its economy perspective from foreign trade with India. These unfavourable happenings suggest that immediate action should be taken by government with strategically. Import should be controlled in terms of both commodity and value.

The effectiveness of trade promotion and diversification policies could be experience since the decade of 1970s. The bonus system along with other steps taken by the country contributed in the process of diversification. The EEE scheme neither helped in expanding the export base nor contributed to reduce the dependency on India. Consequently, in 1977 Dual Exchange Rate System replaced the EEE scheme. Adoption of flexible Exchange Rate System, Forward Exchange Rate Facility, Import License Auction System following Partial Convertibility and Full Convertibility System were implemented in different time periods. The new trade policy has been implementing since 1992. The basic objective of trade policy 1992 is enhancing trade diversification, to promote private sector participation, production of qualitative and competitive good, and establishment of EPZ. Interim plan is under execution having the strategies of to give continuity to policy reforms, to adopt the measure for increasing market access and export promotion, to carry out trade facilitation services.

5.2 Conclusion

Despite the implementation of a number of policy and procedural reforms to promote the trade sector, numerous problems are still in existence. Nepal has been suffering vicious circle of poverty and economic backwardness. Nevertheless, the outcome has not achieved properly. The share of trade on GDP is about 11%. But export trade has been worsening rather than improving. However, Nepalese trade has some opportunities too.

5.2.1 Problems and Challenges

Export trade of Nepal has not been able to contribute to the economy as expected, due to the following reasons:

- Inability to undertake legal and institutional reforms as expected to support trade.
- Inability to integrate export oriented industries with other sectors of the economy (agriculture, forestry, tourism etc.).

- Lack of forward, backward and parallel inter-linkages within exportable industries.
- The predominance of industries based on imported raw materials.
- The competitive capacity of Nepal's ready made garments being reduced with the expiry of Multi-fiber Agreement.
- Inadequate development of physical infrastructure to support export.
- Lack of full utilization of the existing infrastructure
- Free flow of goods between Nepal and India are serious problems for Nepalese products because of Open border.
- Land-locked situation, mountainous and rugged geographical structure of the country is one of the biggest bottlenecks in Nepalese foreign trade expansion.
- Transit and transportation cost is too high and there is no effective rural-urban linkages practices.
- Due to the adoption of liberal economic policy, government levied international trade tax to generate revenue but it neglected the aspect of import substitution. So, the trade deficit of Nepal becomes more acute.
- Nepalese domestic industries are unable to produce enough goods for Nepalese growing population.
- Less diversification of export on the basis of destination -wise.

Nepal has entered the Multilateral and Regional Trade Regime. The countries within the regional trading arrangement seem to have similar export products. They seem to have better competitive strength than Nepal. So Nepal faces a lot of challenges in the export front, such as:

- To execute programs related to legal, policy and structural reforms in order to comply with the responsibility of trade liberalization arising from the entry to regional trade arrangements.

- To reduce transaction costs by developing physical and trade related infrastructure, in order to expand export trade with the neighboring countries.
- To bring quality in the value chain of the exportable goods through production of competent human resources in the field of commerce and industry.
- To develop a multi-model transport system.
- To reduce the transport cost by managing the supply chain.
- To enhance capacity in bilateral and multilateral trade negotiations.

5.2.2 Strength of Nepalese Trade

- Likelihood of sustainable peace and political stability as a result of a historic agreement at the highest political level
- Membership in Multi-lateral regional and Bi-lateral trade arrangements like WTO, BIMSTEC/SAFTA.
- High economic growth rate and rapid industrialization in neighboring countries
- Potential of hydropower is enough to expand export base as well as other natural resources herbs , mines etc are strength of Nepalese economy
- There are high potentialities of agro based industries too.
- Adequate work force with Low labour cost can easily available through out the country.
- There is great chance to attract various national and international agencies like NRN who are seeking to invest in Nepal, which will enhance trade sector too.
- Donor agencies are seeking to invest in Nepal so that there is high potential to bring FDI to strengenthen export trade oriented industries.

5.3 Recommendations

Although Nepalese government has introduced different policies and measures with regular modification, Nepalese trade could not take positive direction towards the nation's prosperity. However, there is future potential to expand export trade. Therefore, government should take immediate action. This study has some suggestions for the promotion and expansion of Nepal's foreign trade especially exports trade and consequent economic growth of the country. The following measures should be considered.

5.3.1 Recommendations for Policy Makers

- With the enhancement of quality and quantity of production, trade should be diversified country – wise and product – wise.
- Economic liberation should be reflected in the expansion of production activities, export promotion and higher level of import competing rates.
- Emphasis should be given to export promotion and institutional capacity enhancement.
- Implementation of policies should be take care in an effective manner as well as monitoring and evaluation of policies is essential.
- Diplomatic efforts should be started and search appropriate trade and transit route with overseas trade.
- Government role should be defined as catalytic in practice not only on paper. Government should empower and attract the private sector involvement by making environment friendly policies.
- Foreign trade should be directed towards export promotion, import substitution and export diversification. Policies must not be influenced by foreigners. .

5.3.2 Recommendation for Export Promotion

- Government should focus on promotion of small enterprises and through an integrated program to improve skills, entrepreneurship, investment and technology transfer.
- It is necessary to make export plan having the framework of enhancing strategies of export and discouraging the volume of import that can reduce trade deficit problems.
- Export should be increased by improving the quality of product, introducing new commodities, reducing cost of production, generating export surpluses, encouraging research and development.
- GON should focus to Increase the scope of Joint Venture industries.

5.3.3 Recommendation for Controlling Import

- Government should create conducive environment climate in order to increase investment in import substituting industries by utilizing local resources.
- The government should provide different facilities and incentives for import substituting industries.
- Domestic industries should be encouraged to produce consumer goods which can be done by increasing tax on imported items. Tax system should be made more progressive and consider on welfare too.

Finally, it is concluded that to reduce gradual trade deficit government must have the entire export plan towards the enhancement of export by reinventing its policies with strong implementation and monitoring mechanism.

APPENDIX

Appendix 1

Basic Data

FY	Xt	Mt	GDPAG	GDPNAG	GDP
1996/97	22636.5	93553.4	108785	160785.0	269570
1997/98	27513.5	89002	112495	177303.0	289798
1998/99	35676.3	87525.3	132373	197645.0	330018
1999/00	49822.7	108504.9	145131	221120.0	366284
2000/01	55654.1	115687.2	151059	242993.0	393473
2001/02	46944.8	107389	160144	245994.0	406138
2002/03	49930.6	124352.1	171104	266442.0	437546
2003/04	53910.7	136277.1	183117	291802.0	474919
2004/05	58705.7	149473.6	194363	318,288.0	508651
2005/06	60234.1	173780.3	212827	345,042.0	557869

Source: Compiled by Various Economic Survey

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