Nepal's Foreign Trade

Status, Problems and Prospects

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Abbreviations

ADB	Asian Development Bank
ADS	Agriculture Development Strategy
BIMSTEC	Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation
FY	Financial Year
GDP	Gross Domestic Product
IFC	International Finance
LDC	Least Developed Country
NLSS	National Living Standard Survey
NRS	Nepalese Rupee
NTIS	Nepal Trade Integration Strategy
NTM/B	Non-Tariff Measure/Barrier
SAARC	South Asian Association for Regional Cooperation
SAFTA	South Asian Free Trade Agreement
SAPTA	South Asian Preferential Trade Arrangement
SPS	Sanitary and Phytosanitary Measures
TBT	Technical Barriers to Trade
TEPC	Trade and Export Promotion Center
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
USD	US Dollar
WEF	World Economic Forum
WTO	World Trade Organization

Introduction

Nepal is country located between two emerging economic nations – India and China. The World Bank ranked the country 186th out of 210 countries in the world in terms of GDP per capita. Similarly, the country has been ranked 157th out of 197 countries in terms of human development by the United Nations. National estimates suggest 13 percent of the population live in absolute poverty (CBS 2011)[1]. In such scenario, poverty reduction and human development has remained one of the most important objectives of Nepal government and therefore, national level policies have prioritized reduction in poverty as an important objective[2].

Studies have shown that trade can have significant impact on growth (Frankel & Romer 1996) (Frankel & Romer 1999). Noguer and Siscart have found that 1 percent increase in openness was associated with 1 percent rise in per capita incomes (Noguer & Siscart 2005). Similarly, studies have also shown that indirectly, trade effects investment (Levine & Renelt 1992), human capital (Frankel and Romer 1999) and factor productivity (Alcala & Ciccone 2004) and while the overall literature on the impact of trade on employment is not clear, it has been widely established that trade increases productivity of labour in both export and domestic sector (Clerides, Lach, & Tybout 1998) (Aw, Chung, & Roberts 2000), and since higher productivity leads to better wages, trade can lead to higher wages in the long run. Higher growth and higher wages lead to reduction in poverty.

Consequently, the Nepalese policy regime has also recognized the important role played by trade in boosting country's economic growth and reducing poverty. The new trade policy (2009) has identified economic development and poverty alleviation as its major objective and therefore, has recognized that increasing income and employment opportunities by increasing competitiveness of trade in goods and services is an important means for alleviating poverty. Similarly, the National Trade Integration Strategy (NTIS 2010), a national strategy aimed at increasing the export capacity of Nepal, has recognized 'inclusive growth' as an important objective. The 19 products selected by the strategy for export promotion have been selected, *inter alia,* on the basis of their possible socio-economic impact. Similarly, the new Industrial Policy's first objective is to increase the export of industrial products along with growth in national income and employment through enhancement of quality and competitive industrial products and productivity and the most recent draft of the possible Agriculture Development Strategy (ADS) has recognized that Nepal's competitiveness in the agricultural sector is low and therefore, increasing the competitiveness of this sector is essential for redressing large food and agriculture trade deficit.

Yet, as shall be seen, Nepal's trade performance is woeful. In 2012/13, its trade deficit was NRS 524 billion, almost 25 percent of the country's GDP. In the last ten years, its deficit has been rising at more than 21 percent per annum. Along with its trade deficit, its trade dependency is

[1] The NLSS III defines people consuming less than 2,200 calories per day and without access to essential non-food items are absolutely poor.
[2] See Poverty Reduction Strategy and three year plans.

steadily rising with increasingly higher amount of exports and imports concentrated in India. It is only due to foreign currency earned from remittances that Nepal has been able to sustain such rising and secular deficit over the years. Non-performance of Nepal in trade sector therefore, has been an important impediment in faster growth of the country and therefore, reasons behind the non-performance should be studied. Hence, this report addresses the status, problems and the prospects of Nepal's foreign trade in greater detail.

The Nepal-German Trade Promotion Programme which is implemented under the guidance of the Nepalese Ministry of Commerce and Supplies and supported by the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH, acting on behalf of the German Federal Ministry for Economic Cooperation and Development (BMZ) supported SAWTEE in preparing this report. SAWTEE is a regional network with an overall objective to build the capacity of concerned stakeholders in South Asia in the context of liberalisation and globalisation.

Nepal's trade performance

Trade, over the years, has played an important role in Nepalese economy. Since the beginning of the decade, trade has comprised of more than one third of Nepalese GDP with the trade to GDP ratio consistently hovering above 35 percent till the fiscal year 2009/10. Since then, there has been an insignificant decline in the ratio of trade and GDP which has fallen to less to around 33 percent in the financial year 2012/13. Yet, the same period has seen dramatic rise in trade deficit. Nepal has historically been a trade deficit nation. Data taken from 1975/76 till now show that Nepal has always imported more than it has exported. However, the dominance of import in the total trade, though, is a more recent phenomenon. In 1975/76, the ratio of trade deficit to total trade was mere 21 percent, a figure which stands at more than 77 percent in FY 2012/13. In the last ten years, the trade deficit to GDP ratio has increased by incredible 64 percent rising from 15.1 percent of GDP to almost 25 percent of GDP.

Table 1: Total trade and Trade Deficit on Nepal in terms of its GDP

Fiscal year	02/03	03/04	04/05	05/06	06/07	07/08	08/09	09/10	10/11	11/12	12/13
Total Trade/GDP	35.4	35.4	35.3	35.8	34.9	34.5	35.6	36.5	33.6	34.4	33.0
Trade Deficit/GDP	-15.1	-15.3	-15.4	-17.4	-18.6	-19.9	-21.9	-26.3	-24.2	-24.9	-24.9

Source: Economic Survey 2012/13

Non-performance of Nepal's exports coupled with steady rise of imports in recent times has been the cause of rising deficit. Trend of Nepalese export sector has been erratic at best. Since 2002/03, the average rate of growth of exports has been 4.88 percent. Financial year 2011/12 was the best year for Nepalese exports which saw exports rise a substantial 15.4 percent. Nepal also recorded negative growth in three financial years in the same time period. Imports, however, have been rising alarmingly. The average rate of growth of imports has been 16 percent since 2002/03 and except for three financial years, imports have been at growing double digit rate.

Table 2: Figures related to exports and imports of Nepal

Fiscal year	02/03	03/04	04/05	05/06	06/07	07/08	08/09	09/10	10/11	11/12	12/13
Export /GDP	10.1	10.0	10.0	9.2	8.2	7.3	6.9	5.1	4.7	4.8	4.0
Import/GDP	25.3	25.4	25.4	26.6	26.8	27.2	28.8	31.4	28.9	29.6	29.0
Export (goods) (annual	6.4	8.0	8.9	2.6	-1.4	-0.2	14.2	-10.2	5.8	15.4	4.2

change)											
Import (goods) (annual change)	15.8	9.6	9.7	16.3	12.0	14.0	28.2	31.6	5.8	16.5	20.4

Source: Economic Survey 2012/13

Composition of Nepal's trade

Composition of imports

As can be seen from the table, petroleum products form the most important components of Nepal's imports. When taken together, petroleum products constituted of more than 17 percent of Nepal's total imports in FY 2012/13. Among other items, gold and billet, homeopathic medicaments, motorcycles and rice were other important import items for Nepal in the same fiscal year. What is immediately striking in the list is that items like "machinery"[3] do not feature at all among Nepal's imports. In fact, "machinery" do not feature among the 50 most imported items by Nepal[4]. Also notable is the absence of import as well as export of electronic items including computers. In the era of electronic technology, trade of electronics can be seen as an important proxy of country's state of development and Nepal's lack of trade of these items further highlights the shortcomings of Nepalese economy. Furthermore, examination of Nepal's 50 most important imports reveal that fertilizers and tractors and to some extent, construction and iron and steel products, are the only products which can be claimed to have productivity enhancing effect on the economy and rest of the items are dominated by petroleum products, transport machinery including motorcycles and cars, and food related items. Therefore, it is not only the volume of imports, but its composition too which is worrying for Nepal. Similarly, more than 20 percent rise in the import of food items is also indicative of rising dependency of Nepal on food imports.

Table 3: Import composition of Nepal

S.N.	Commodities	F.Y. 2010/11	F.Y. 2011/12	F.Y. 2012/13	Annual Change % (2011/12-2012/13)	Share of imports (2012/13)
1	High speed diesel oils and vapouring oils	40,829,901	50,107,064	57,493,329	15	9.56
2	Gold	10,720,989	25,773,887	26,009,969	1	4.33
3	M.S Billet	16,849,331	16,965,578	22,236,504	31	3.70
4	Liquefied petroleum gases	12,817,605	18,119,038	22,041,314	-	3.67

[3] The HS Code for capital intensive goods and equipment are classified as machinery under HS Code 84.
[4] Both India and China have machinery as well as electronics in their top 5 imports.

5	Sprits including Petrol	10,692,136	14,612,884	16,557,276	13	2.75
6	Crude soyabean oil	8,115,443	10,131,122	10,909,747	8	1.81
7	Homeopathic medicaments not put up in measured doses or in forms or packings for retail sale	7,728,591	8,846,329	9,893,584	12	1.65
8	Motorcycle with reciprocating internal combustion piston engine of a cylinder capacity exceeding 50cc but not exceeding 250cc	7,084,418	6,687,452	9,403,872	41	1.56
9	Semi milled or wholly milled rice, whether or not polished or glazed	1,965,481	5,752,454	9,236,276	61	1.54
10	Kerosene type jet fuel	5,355,025	7,620,538	8,863,769	16	1.47
	Total	397,535,942	498,161,074	601,207,525	21	

Source: TEPC (in 000 NRS)

Composition of exports

Carpets have remained the most important items of export for Nepal. They constitute a little over 7 percent of Nepal's total exports. Similarly, other fabric related items like woven fabric, just bags and sacks, single yarn, and woollen shawls are other important exports of Nepal. These items are accompanied by agricultural products like cardamom and lentils and iron and steel products. In fact, an overall examination of Nepal's largest 30 exports reveal the domination of three aforementioned category i.e. iron and steel products; agriculture products; and textiles, garments, carpets and woven fabrics. Industrial products other than iron and steel are conspicuously absent from the list. In fact, not a single machinery related product is found in 70 of Nepal's largest exports. These data clearly reveal that Nepal has been unable to export high value added items and still has to depend on traditional low value added items like primary agricultural goods and handicrafts. This also points to a possible structural deficiency in Nepalese economy which still is largely dependent on primary sector for employment and a low industrial base.

Table 4: Export Composition of Nepal

S.N.	Commodities	F.Y. 2010/11	F.Y. 2011/12	F.Y. 2012/13	Annual change (2011/12 - 2012/13	Share of exports (2012/13)
1	Carpet, knotted of wool or fine animal hair	4,920,085	6,001,657	5,660,341	-5.7	7.32
2	Woven fabric obtained from strip or the like	3,659,690	5,175,358	5,342,943	3.2	6.91
3	Cardamom	2,043,716	3,496,733	3,849,995	10.1	4.98
4	Tubes, pipes and hollow profiles of iron and steel	1,373,601	2,020,447	2,919,914	44.5	3.77
5	Wire of iron or non-alloy steel, plated or coated with zinc	1,777,830	2,423,059	2,732,103	12.8	3.53
6	Lentils	3,349,101	2,677,970	2,677,319	0	3.46
7	Jute bags and sacks	2,112,879	2,342,476	2,545,345	8.7	3.29
8	Flat rolled products of iron or non-alloy steel, of a width of 600 mm or more, plated or coated with corrugated zinc	3,031,827	2,409,130	2,513,504	4.3	3.25
9	Single yarn, containing 85% or moreby weight of polyester staple fibres	2,363,373	2,932,154	2,379,303	-18.9	3.08
10	Woolen shawls, scarves, mufflers, mantillas, veils and the like	1,635,629	1,908,766	2,179,794	14.2	2.82
	Total	64,562,444	74,089,060	77,350,709	4.4	

Source: TEPC (in 000 NRS)

Table 5 shows the value of exports of products which have been identified in the National Trade Integration Strategy (NTIS). As is apparent, except for silver jewellery, honey and lentils, export of most items have increased since 2008-09. Similarly, all products except lentil have posted positive annual growth rate[5]. There is an immediate need to address the concerns related to the

[5] The 743 percent growth rate posted by honey is deceiving. The figure has been skewed by a 3200 percent rise in export seen between 2009-10 and 2010-11. It is clear that export of honey has actually declined in absolute value since 2008-09.

declining sectors and sectors which have grown slowly (e.g. carpet industry) because these products not only carry export potential but also have high socio-economic impact for the domestic population.

Table 5: Export of products included in NTIS

	2065/66 (2008-09)	2066/67 (2009-10)	2067/68 (2010-11)	2068/69 (2011-12)	2069/70 (2012-13)	Avergae annual growth rate
	Value (NPR)	**Value (NPR)**	**Value (NPR)**	**Value (NPR)**	**Value (NPR)**	
Carpet	5,350,578,526	4,256,170,747	4,920,084,782	6,001,657,007	5,660,340,816	2.86
Iron and Steel	9,227,927,782	10,016,264,589	10,120,304,000	11,319,820,867	11,637,554,488	6.06
Pashmina	1,993,725,692	1,423,437,460	1,722,300,934	1,964,152,220	2,249,646,118	5.24
Wool	591,663,750	631,569,374	1,149,277,290	1,279,611,281	1,114,696,071	21.79
Cardamom	1,345,353,227	1,171,597,401	2,043,715,936	3,496,733,092	3,850,339,604	35.68
Tea	1,240,863,639	1,195,318,183	1,549,890,974	1,573,650,836	2,043,220,024	14.34
Ginger	403,467,571	456,013,528	281,949,027	507,590,352	1,332,452,601	54.35
Lentil	5,660,780,851	3,744,921,809	3,349,100,685	2,677,969,900	2,677,319,358	-16.12
Essential oil	16,070,323	9,280,477	36,518,404	35,740,065	66,665,109	83.91
MAPs	762,140,982	440,462,666	711,229,267	805,496,418	1,274,374,689	22.68
Honey	2,437,680	229,568	7,666,790	1,898,094	20,608	743.73
Silver jewellery	393,073,791	195,269,736	394,481,801	227,158,778	208,135,514	0.23

Destination of trade

Asia is the most important source of import and destination for export for Nepalese product. More than 92 percent of Nepal's imports come from Asia and more than 78 percent of its exports go to Asian countries. Europe and the two American continents combine to provide a little over 5 percent of Nepal's total imports. However, more than 10 percent of Nepal's exports go to European Union (EU) and almost 10 percent of items go to America. It is also clear from **Table 10** that Nepal's trade dependence with Asia has increased significantly, especially in its export sector. The rise in Asia's share has been accompanied by a fall in share of exports to America.

Table 6: Source and destination of Nepalese imports and exports (NRS)

	Imports			Exports		
S.N	Countries	F.Y.2012/13	Share	Countries	F.Y.2012/13	Share
1	India	397,957,920	66.19	India	51,788,460	66.95
2	China, P. R.	68,304,882	11.36	U.S.A.	5,750,120	7.43
3	U.A.E.	37,224,150	6.19	Germany	2,761,250	3.57
4	Indonesia	9,585,617	1.59	Bangladesh	2,730,217	3.53
5	Thailand	9,436,891	1.57	China, P. R.	2,176,749	2.81
6	Argentina	8,079,229	1.34	U.K.	1,584,159	2.05
7	Malaysia	5,680,449	0.94	France	1,053,139	1.36
8	U.S.A.	5,207,770	0.87	Turkey	1,053,019	1.36
9	Japan	4,663,186	0.78	Japan	962,276	1.24
10	Korea R	4,599,478	0.77	Italy	785,297	1.02

Source: TEPC

Table 7: Nepal's trade with SAARC members

	2003/04		2009/10		2010/11		2011/12		2012/13	
	Export	**Import**	**Export**	**Import**	**Export**	**Import**	**Export**	**Import**	**Export**	**Import**

Direction	% In Total	% In Total	% In Total	% In Total	% In Total	% In Total	% In Total	% In Total	% In Total	% In Total
India	97.5	98.7	88.6	99.4	91.4	99.4	93.6	99.3	93.1	99.3
Bangladesh	1.3	0.8	7.5	0.4	7.4	0.4	4.7	0.5	4.9	0.5
Bhutan	0.2	0	3.5	0.1	0.9	0	1	0.1	0.6	0.1
Maldives	0	0	0	-	0	0	0	0	0	0
Pakistan	0.9	0.2	0.2	0.1	0.3	0.1	0.4	0.1	0.3	0.1
Sri Lanka	0	0.2	0.2	0	0	0.1	0	0	0	0
Afghanistan	0	0	0	0	0	0	0.2	0	1.1	0

Source: TEPC

Table 8: Nepal's trade dependency with India

Direction	**F.Y. 2003/04**	**F.Y. 2009/10**	**F.Y. 2010/11**	**F.Y. 2011/12**	**F.Y. 2012/13**
Exports					
India	57	65.5	66.4	68.7	67
Others	43	34.5	33.6	31.3	33
Total	100	100	100	100	100
Imports					
India	58	57	65.2	64.5	66.2
Others	42	43	34.8	35.5	33.8
Total	100	100	100	100	100

Source: TEPC

Country-wise analysis shows that more than two thirds of Nepal's trade is with India. United States of America and European countries like Germany, France, and the United Kingdom are other importers of Nepal's products but their share is almost insignificant compared to India's. The US for instance, is destination to only around 7 percent of Nepal's exports, and Germany's share is mere 3 percent. Similarly, India remains the major source of Nepal's imports as well. Besides China which supplies around 12 percent of Nepal's imports and UAE's 6 percent, other exporters have tended to be almost negligible. Even in the South Asia region, India is home to

more than 93 percent of Nepal's exports and astonishing 99 percent of Nepal's import. India's dominance of Nepalese market has increased over the years. As can be seen in **Table 8,** in FY 2003/04, only 57 percent of Nepal's exports went to India, a share which has risen by 10 percent in the last nine years. Result in the import side is also comparable with the import share from India rising from 58 percent to 66 percent.

Table 9: Percentage of Regions in the Total Imports of Nepal (in '000 NRS)»

Regions	F.Y. 2004/05		F.Y. 2005/06		F.Y. 2006/07		F.Y. 2007/08		F.Y. 2008/09		F.Y. 2009/10		F.Y. 2010/11		F.Y. 2011/12		F.Y. 2012/13	
	Value	%Comp	Value	%Comp	Value	%Comp	Value	%Comp	Value	%Comp	Value	%Comp	Value	%Comp	Value	%Comp	Value	%Comp
Asia	133,168,624	89.8	144,045,678	89.65	172,613,922	88.15	210,960,285	89	253,639,823	87.16	335,249,735	89.26	362,813,945	91.27	456,649,649	91.67	556,798,436	92.61
Africa	247,004	0.17	285,968	0.18	987,758	0.5	779,029	0.33	952,153	0.33	629,622	0.17	2,014,751	0.51	2,452,459	0.49	2,250,588	0.37
America	4,240,470	2.86	5,019,890	3.12	9,576,030	4.89	11,189,288	4.72	12,033,144	4.14	12,048,120	3.21	14,304,723	3.6	16,974,997	3.41	18,842,555	3.13
EU	6,179,382	4.17	6,317,197	3.93	8,209,226	4.19	8,995,147	3.79	15,841,115	5.44	15,471,183	4.12	9,937,885	2.5	11,566,234	2.32	13,064,313	2.17
Europe (Excluding E.U.)	1,707,920	1.15	2,567,145	1.6	1,705,981	0.87	2,532,672	1.07	5,363,771	1.84	6,164,978	1.64	5,596,581	1.41	7,673,752	1.54	7,254,264	1.21
Oceania	2,750,829	1.85	2,442,046	1.52	2,715,495	1.39	2,573,855	1.09	3,170,938	1.09	6,042,233	1.61	2,868,057	0.72	2,843,983	0.57	2,997,369	0.5
Total	148,294,229	100	160,677,924	100	195,808,412	100	237,030,276	100	291,000,944	100	375,605,870	100	397,535,942	100	498,161,074	100	601,207,525	100

Source: TEPC

Table 10: Percentage Composition of Regions in the Total Exports of Nepal (in '000 NRS)»

Regions	F.Y. 2004/05		F.Y. 2005/06		F.Y. 2006/07		F.Y. 2007/08		F.Y. 2008/09		F.Y. 2009/10		F.Y. 2010/11		F.Y. 2011/12		F.Y. 2012/13	
	Value	%Comp	Value	%Comp	Value	%Comp	Value	%Comp	Value	%Comp	Value	%Comp	Value	%Comp	Value	%Comp	Value	%Comp
Asia	42,583,	72.8	43,716,	73.1	45,067,	76.4	45,689,	78.1	53,151,	77.4	48,012,	78.7	49,870,	77.2	57,919,	78.1	60,923,	78.7

	843	6	308	3	084	8	118	4	007	8	008	7	982	4	984	8	945	6
Africa	42,882	0.07	108,488	0.18	295,960	0.5	103,935	0.18	616,813	0.9	129,171	0.21	107,878	0.17	344,055	0.46	129,658	0.17
America	8,150,929	13.95	7,711,411	12.9	6,248,116	10.6	5,479,202	9.37	5,895,145	8.59	4,850,217	7.96	5,318,519	8.24	6,570,535	8.87	6,596,268	8.53
EU	6,934,896	11.87	7,329,040	12.26	6,477,781	10.99	6,355,463	10.87	7,610,586	11.09	6,767,064	11.1	7,621,290	11.8	7,899,061	10.66	7,749,684	10.02
Europe (Excluding E.U.)	607,931	1.04	728,394	1.22	597,911	1.01	638,678	1.09	862,556	1.26	781,624	1.28	1,309,990	2.03	952,197	1.29	1,497,753	1.94
Oceania	123,340	0.21	183,233	0.31	240,245	0.41	207,963	0.36	460,745	0.67	409,520	0.67	333,785	0.52	403,228	0.54	453,402	0.59
Total	58,443,821	100	59,776,874	100	58,927,097	100	58,474,359	100	68,596,852	100	60,949,603	100	64,562,444	100	74,089,060	100	77,350,709	100

Source:TEPC

This rising dependence on India has been one of the major problems for the Nepalese economy. Dependency on trade with a single country can have multiple drawbacks. In the short run, demand shock, change in trade policy (see preference erosion) or change in demand pattern in the trade partner's market can lead to sudden fall in nation's export. Similarly, in the import side, sudden rise in prices of products of the trading partner can lead to substantial deterioration of the balance of payments, especially more so if the products in question are inelastic in nature. Both cases are equally relevant to Nepal. Furthermore, in a dynamic sense, most important benefits of trade accrue because of its ability to improve economic production efficiency. In being dependent on a single nation for export as well as import, benefits of competition and efficiency get side-lined. There is also additional drawback of allocation of resources specific towards India's needs which can lead to loss of competitiveness in areas where Nepal enjoys better comparative advantage in the international market.

Problems related to exports

In this chapter we discuss various constraints, domestic as well as external, that are prohibiting the expansion of export from Nepal. The focus mainly lies on possible barriers to trade in the external market, various macroeconomic problems related to trade, and supply side constraints.

Barriers to trade:

India

As per the Indo-Nepal Trade Agreement 2009, virtually all Nepalese products enjoy duty free access to Indian market except for four specific products viz. zinc oxide, vegetable oil, copper products and acrylic yarn which face quantitative tariff quota. Therefore, for most Nepalese exports to India, tariffs are not the prohibitive factors. However, other measures like para-tariffs and non-tariff measures have been the major source of problems for Nepalese exports.

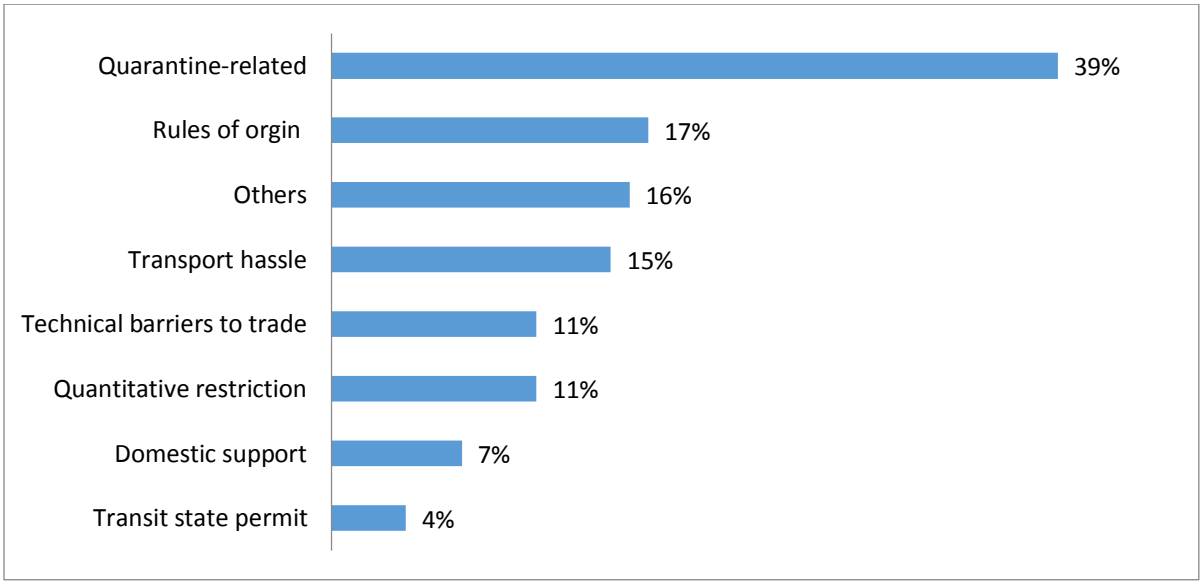
Existence of para-tariff barriers have been one of the restricting factors behind lag in exports to the country. Adhikari and Sapkota found that Nepalese exports face countervailing duties, education cess, and special additional duties in the India market. They also claimed the existence of a discriminatory practice where Nepalese exporters are levied taxes on finished products while the Indian producers are levied taxes on their inputs. Furthermore, non-uniformity of para-tariffs was found to be another problem which was especially more problematic for small and medium enterprises. The report found that countervailing duties, followed by special additional duties and education cess were the most important para-tariff barriers faced by Nepalese exporters in India (Adhikari & Sapkota 2012).

Similarly, Rules of Origin (ROO) criteria mentioned in the latest trade treaty between the two countries is one of the major non-tariff barriers while exporting to India[6]. A study by Raihan found that more than 30 percent of Nepal's export potential to India remains underutilized due to the ROO requirement (Raihan 2009). It also mentions that ROO and sensitive lists are two of the most constricting barriers to trade for the entire South Asian region. While the argument for ROO has been to promote industrialization in Nepal, records show no prior experience of the success of ROO in promoting industrialization. Additionally, for LDCs like Nepal, fulfilling the 30 percent ROO requirement is highly unfeasible (Adhikari & Khadka 2011), especially considering the inflation in Nepal and depreciation of Nepalese rupees vis-à-vis all major foreign currencies (Adhikari & Sapkota 2012).

Adhikari and Sapkota also found that SPS and TBT related problems were some of the most important problems for Nepalese exporters. Testing requirements more pertinent than others in this regard. Non-availability of testing facilities at Indian borders, non-accreditation of Nepalese laboratories with their Indian counterparts, time and cost required for testing, were all deemed

[6] The Nepal India Trade treaty requires that value addition on exports be at least 30 percent of ex-factory price of articles and a change in tariff heading at four digit level of harmonized system code.

highly prohibitive for Nepalese trade[7]. Besides, Indian regulations on packaging, labelling, plant quarantine, and documentation were also highly prohibitive.



Source: (Adhikari & Sapkota, A Study Report on Nepal India Trade, 2012)

SAARC

Nepal is a member of South Asian Agreement on Regional Cooperation (SAARC) and therefore, has to comply with the regulations of South Asian Free Trade Agreement (SAFTA). Under SAFTA, except for items included in the sensitive list, the members countries have agreed to reduce the existing tariffs by pre-determined rates under specific period of times (See Table). Therefore, in theory, members of SAFTA enjoy better market access in the region and therefore, enjoy comparative advantage in terms of tariffs. Estimates show that successful integration of the region can accrue significant benefits to the member countries (Chatterjee & George 2012) (Dayal, Das, Banga, Iyengar, & Ahmed 2008).

Table 11: Phases of Tariff Rate reduction in SAFTA

	SAFTA Member	Existing tariff rate	Tariff	End year for implementation
Phase I	Non-LDCs (India, Pakistan and Sri Lanka)	Above 20 percent	Reduce to 20 percent	2008*
		Below 20 percent	Reduction by 10 percent annually	2008

[7] The report mentions that in one instance, a successful product testing and registration in India took eight months.

	LDCs (Bangladesh, Bhutan, Maldives, Nepal)	Above 30 percent	Reduce to 30 percent	2008
		Below 30 percent	Reduction by 5 percent annually	2008
Phase II	Non-LDCs (India and Pakistan)	Below 20 percent	Reduce to 0-5 percent	2013**
	Sri Lanka	Below 20 percent	Reduce to 0-5 percent	2014**
	LDCs (Bangladesh, Bhutan, Maldives, Nepal)	Below 30 percent	Reduce to 0-5 percent	2016***

Source: (Sharma 2012)

Yet member countries have not been able to enjoy the possible advantages of the regional cooperation agreement. Studies show that level of intra-regional trade in the region hovers around just 5 percent of total trade by the individual countries. Nepal too, has not been able to enjoy the benefits accruing out of SAFTA. As can be seen from Table 7, Nepal is completely dependent on India as its trade partner in the South Asian region with more than 99 percent of its imports coming from India and more than 93 percent of its exports going to India. While there has been a rise in exports to Bangladesh in recent years, trade with other South Asian countries has remained negligible.

The most important hindrance in the trade between the South Asian countries remains the issue of sensitive lists. Table below shows the impact of sensitive list on exports to Nepal. Just to take an example from the table, while only 6 of 19 items exported by Nepal to Bangladesh fell under Sensitive list, those 6 products consisted of 97 percent in terms of value. While 2 of those items entered Bangladesh duty free, the remaining 6 products faced tariffs ranging from 7 percent to 25 percent. Similarly, the corresponding rates were 10 percent to 25 percent for Pakistan, 28 percent for Sri Lanka, and 50 percent for Bhutan (keeping in mind that trade to these countries are negligible).

Table 12: Sensitive lists of various SAARC countries

	Total Number of Sensitive lists		Coverage of Sensitive list as % of Total HS Lines	
Country	Non-LDC	LDC	Non-LDCs	LDCs
Bangladesh	1,254	1,259	24	23.9
Bhutan	157	157	3.0	3.0
India	865	744	16.6	14.2
Maldives	671	671	12.8	12.8
Nepal	1,335	1,299	25.6	24.9

Pakistan	1,191	1,191	22.8	22.8

Source: (Dayal, Das, Banga, Iyengar, & Ahmed, 2008)

Table 13: Nepal's export products under Sensitive list of SAFTA members

Market	No of items on sensitive list (SL)	No. of items exported by Nepal	No. of exported items on SL and their percentage of export value	No. of exported items on SL entering duty-free	Applied tariff on exported items on SL	Applied tariff on exported items outside SL
Bangladesh	1,233	19	6 *(97.6)*	2 [year 2008]	0%, 7%, 10%, 12%, 25% (2 sub-heading) [year 2008]	0%, 5% (6 sub-headings) 12%, 23.75% (7 sub-headings) [year 2007]
Pakistan	1,169	17	5 *(48.5)*	0 [year 2010]	10% (1 sub-heading), 25% (4 sub-headings) [year 2010]	Required to have reduced it to 0-5 % by July 2009
Sri Lanka	1,042	6	2 *(14)*	0 [year 2009]	28% (1 sub-heading), 28% and a specific duty of Sri Lankan Rs 5/kg (1 sub-heading) [year 2009]	Required to have reduced it to 0-5 % by July 2009
Bhutan	150	51	1 *(0)*	0	50%	19%, 28.5% or 35% (45

				[year 2007]	[year 2007]	sub-headings) 9.5% (2 sub-headings) 0% (2 sub-headings) [year 2007]

(Adhikari & Khadka, Nepal and SAFTA: Issue, Prospects and Challenges, 2011)

Besides the tariff barriers, various para-tariff and non-tariff barriers also constrain export of products to South Asian countries.

The requirements of Rules of Origin of SAFTA are identical to that of India Nepal Trade Treaty. Therefore, the complications associated with the ROO to India are valid for rest of the South Asian region as well. Consequent to the stringent ROO requirements, Nepal hasn't exported single item to any SAARC country under SAFTA which goes on to show the extremely prohibitive nature of ROO (Sharma 2012). Besides the ROO, customs requirements including the excessive documentation requirements and delays at the customs remain other important NTBs in South Asia. Custom procedures and facilities in the South Asian region are also non-harmonized and therefore, the incompatibility of custom procedures and poor infrastructure of customs also lead to rise in time and costs. as per an ADB report, documentation procedures and SAPTA certifications have also been imposed and while "there is scope for regional cooperation in addressing NTBs, there is little scope for resolving the barriers which is a matter of negotiations amongst the governments" (Dayal, Das, Banga, Iyengar, & Ahmed 2008). The report also estimated that if political constraints and non-tariff measures are addressed, then trade in the region can rise by as much as 40 percent.

Similarly, cases of high para-tariffs in important South Asian trading partners in South Asia are also well documented. While India's case on para-tariffs have been highlighted earlier, Bangladesh also imposes various para-tariff measures under "other duties and charges" including supplementary duties, regulatory duties, VAT, and infrastructure development surcharge. Reports also show that while Bangladesh's tariff barriers reduced considerably in the last few decades, para-tariffs have also increased substantially (Sharma, 2012).

Table 14: Percentage share of NTBs to all NTBs faced by SAARC Countries

Non-Tariff Barrier	Share (%)
SPS, TBT and other related measures	86.3
Tariff Quota	9.8
Anti-dumping Measures	7.4
License Requirement	5.3
Countervailing Measures	1.2

Source: (Dayal, Das, Banga, Iyengar, & Ahmed, 2008)

International Market

At international market as well, non-tariff barriers remain extremely important for Nepal. Issues of NTMs are especially most relevant to agriculture based countries like Nepal. Agriculture based products tend to be most regulated products especially as they are concerned with food products. UNCTAD estimates that while agricultural products of low income countries face upto 5 percent of tariff when NTMs are taken into account, the level of restrictiveness rises at about 27 percent (UNCTAD, 2013). Items included in the NTIS have regularly reported facing various NTMs. For instance, EU does not recognize honey produced by bees other than Apis Mellifera as honey. Since Nepal has more than 5 types of bees and Apis Mellifera honey therefore is only a fraction of Nepal's honey, a significant proportion of Nepal's honey, therefore, gets automatically disqualified because of this regulation. Similar NTMs have been reported in MAPs, essential Oils, cardamom and tea. Therefore, market access for the most important Nepalese products have become difficult because of these measures and since cost of compliance remain extremely high, most local producers cannot afford to comply with such measures.

Macroeconomic Challenges

Effective rate of protection

Since pursuing the trade liberalization policies, Nepal's tariff rates have gradually declined. However, recent tariff structures have pursued with low levels of tariff for inputs and higher tariffs for finished products. For instance, tariff rates for importing silver powder, dust and other unprocessed silver items stands at 5 percent while the manufactured silver jewellery face 30 percent tariff (if imported from outside the SAARC region). Such pattern is noticed across various products. Such patterns of tariff can have multiple implications for the Nepalese industries and market: first, the effective rates of protection for exporters can turn negative[8], and

[8] A purely theoretical illustration has been taken here. Take the case of Nepalese carpet industry. The tariff imposed by the customs for the woollen products (raw) necessary for producing carpet is 5 percent. Meanwhile, like silver jewellery, the tariff imposed on final carpet products is 30 percent (see Customs

second, the producers therefore, switch to the domestic market instead of exporting abroad. Further studies have shown that effective rate of protection in Nepalese economy ranges from 28 percent in agriculture items to up to 927 percent in some assembly activities. Such patterns of protection can have, what is known as, cascading effects on products which favour low value-added activities, distort investment decisions and provide protection-based incentives to industries that should be open to robust competition (Nepal 2003).

Exchange rate imbalance

Nepal has been following the pegged exchange rate with Indian currency since 1993 where INR 1 equals NPR 1.6. Estimates of national inflations rates of the two countries (both WPI and CPI) suggest that the both currencies have been maintaining their valuation against the prices, i.e. the real exchange rate between the two countries is reflective of the peg. However, notwithstanding its value against the INR, the Nepalese rupee is losing its competitiveness in the international market. When valuation of the currency is done as per the Real Effective Exchange Rate[9] studies have clearly shown that Nepalese currency is appreciation and the overvaluation has been hurting Nepalese economy.

Pant and Panta (2009) found that while Nepalese currency's value against Indian rupee was being maintained, the REER of the country had risen by 6 percentage points between 2000/2001 and 2006/07. The findings of the study are further corroborated by the country study of the IMF which used multiple methods to evaluate the REER of NRS. The IMF study found that on an average the REER had appreciated by 8 percent over 2009-10. It also found that using various methods of Macroeconomic Balance Approach, External Sustainability Approach and Purchasing Power Parity Approach, each approach found that Nepalese currency was overvalued by as much as 10, 26 and 19 percent respectively. The study states that "the real effective rate has appreciated in recent years and appears overvalued, suggesting the external

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Tariff 2013/14 published by the Ministry of Finance). We assume that as with most other handicraft sector, the value added by the carpet industry comes out to be 30 percent on inputs. Similarly, by taking average from the world exports prices across all the nations, we have derived the average price of carpet, or world carpet price to be USD 40 per kg of carpet (taken from Trade Map)[8].Considering the value of Nepalese exports also came very close to the same figure, we conclude that this price is reflective of the world prices. The unit price for Nepalese carpets taken from the same source was derived to be USD 38.79. Assuming 30 percent value added, the prices of inputs for Nepalese carpets would then be USD 29.84. Now, 5 percent tariff on the inputs, however, raises the price of inputs to USD 31.33 and 30 percent tariff on the final product raises the price of imported carpets in domestic market to USD 50.46. This implies that producers in Nepal would be able to sell the same product at prices 28 percent higher than world prices and due to import tariffs on inputs the value added by the exporters falls to 25.75 percent implying negative protection of 4.25 percent for Nepalese exporters. It is easy to comprehend therefore that producers of carpet in Nepal are tempted to sell their products at Nepalese market itself given higher chances of profit in the country rather than exporting abroad. Lack of effective competition for the domestic producers would also lead to less incentive for raising productivity for the firms which is further detrimental for Nepalese carpet industry in the long run. Because the case of tariff differential for inputs as well as final products are generally applicable across most products, the case of negative effective tariffs is also generally applicable in Nepalese economy.

[9] The REER measures the real value of country's currency against the basket of the trading partners of the country. Its dependency therefore is not merely with one country's currency but with all trading partners of the country.

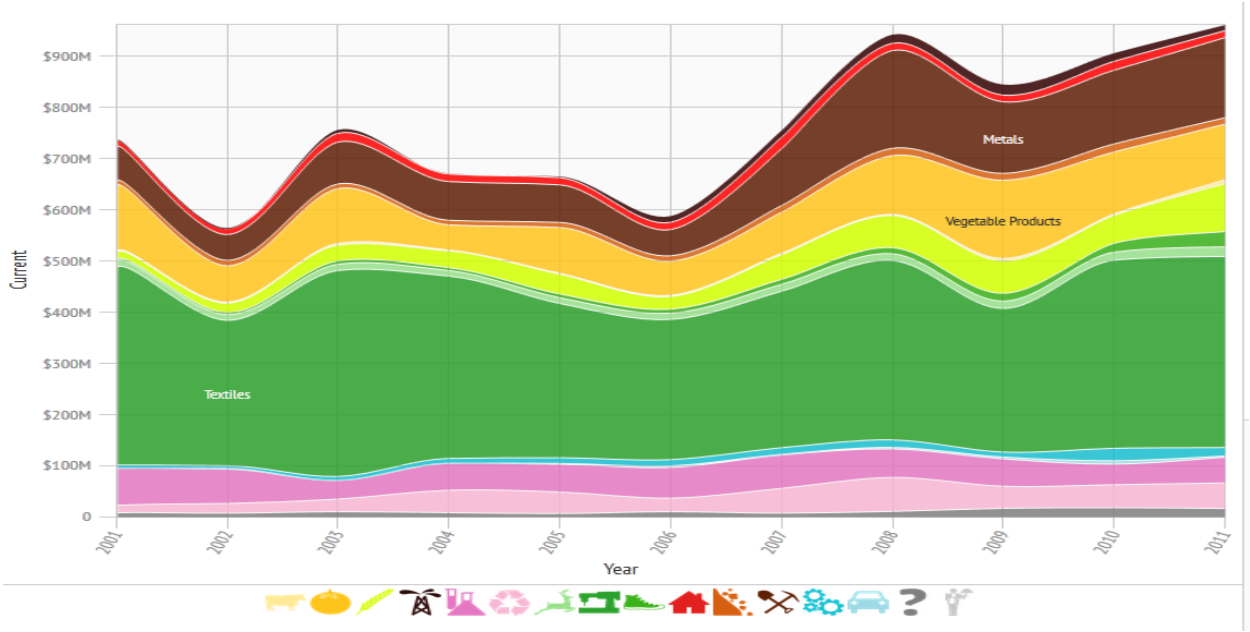
current account deficit is likely to remain under pressure over the medium term" (IMF, 2011). Latest study by Bruegel (2012) also found that since 2007 Nepalese currency had appreciated by more than 10 percent. Rising currency valuation has rendered Nepalese products less competitive in external market (Darvas, 2012). Therefore, due to the overvaluation of the Nepalese currency, Nepalese products are selling at higher prices in the international market reducing their competitiveness.

Policy structure and implementation

There is lack of clarity in Nepalese policies with regards to the items of export. First and foremost, there are items included in the NTIS which look to have very little socio-economic impact and look to promote technology which can hardly promote capital intensity in other sectors. Iron and Steel products and Instant noodles are two such items of NTIS which have very small target group and the ripple effects from the promotion of such products can be very little. Moreover, the government has yet to form a committee or a working group to promote the NTIS products exclusively. Along with the same, government policies are disjointed in nature and at times are even prohibitive of trade. For instance, as per the budget announcement, the government declared cash subsidies of 2-3 percent for exporters for any exports generating convertible currency implying any exports to countries except India. However, since India is the major trading partner for majority of Nepalese products, including many of the products identified by the NTIS and the Trade Policy 2009, majority of Nepalese exporters therefore, are de facto devoid of the benefits accorded by the budget policy.

Similarly, while the policies since the advent of liberalization in 1992, while the policies have generally targeted reduction in tariffs and deregulation of market, labour market deregulation has not occurred in Nepal. Similarly, problems related to insolvency and creditors' protection still persists which creates a hostile environment for foreign investors to come and invest in Nepal. As World Bank notes, "Nepal has no real framework for insolvency: the provisions on liquidation in the CO are considered to be inadequate and have not been used in practice and there is no provision for reorganization during insolvency. There is possibility in law to void transactions designed to harm creditors (fraudulent conveyance) and non-financial companies do not have minimum capital or net worth requirements" (Bank, Report on the Observance of Standards and Codes: Corporate Governance Country Assessment, 2005).

Export composition and diversification



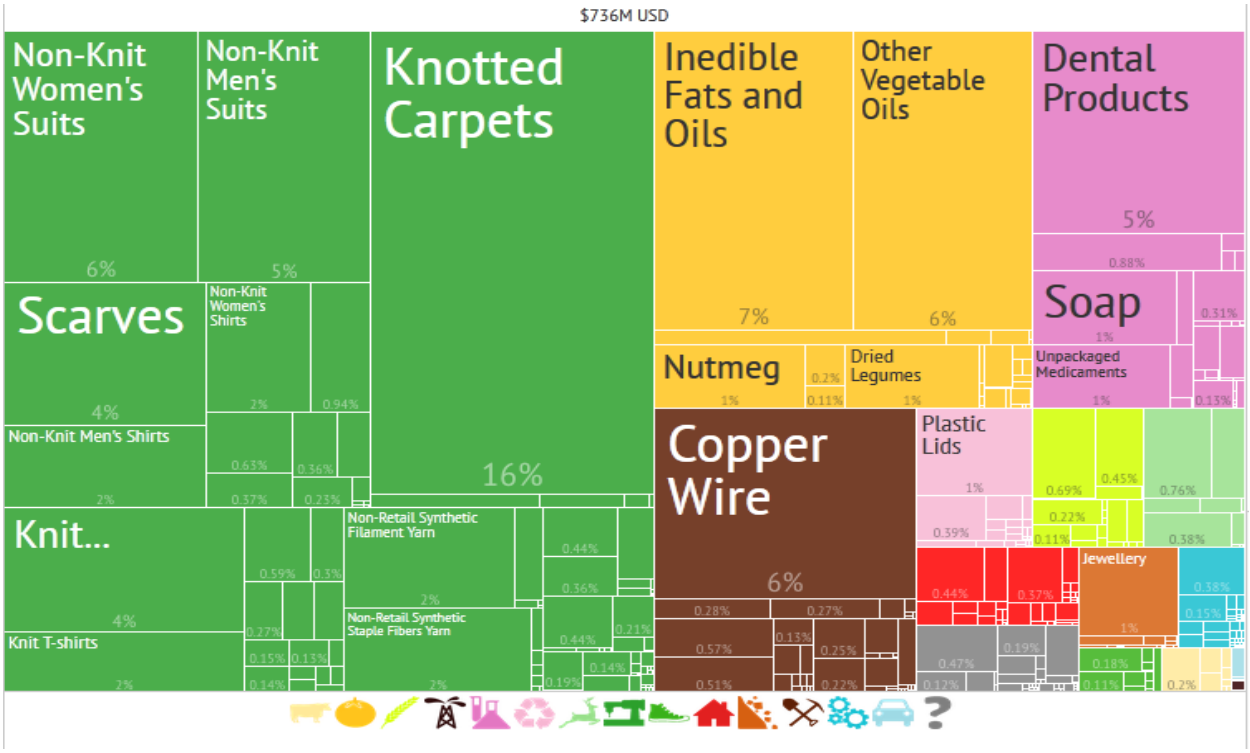
Dependency on low value added items is not only detrimental in the short term but also can have long term effects. As Hausmann et al. explain, reliance on low value added products leads to promotion of products requiring similar skill sets and value added and therefore, likelihood of producing low value added item increases if the country is already dependent on value added items. More importantly, if the world demand for low value added items decline, then migration of skill sets to other low value added items are difficult. Meanwhile, adoption of production methodology for high value added products lead to spill overs that promote similar high value added products and drive innovation for future (Hausmann, et al.). The promotion of high value added products however, requires increasing the 'economic complexity' of the country which entails accumulation of knowledge in the economy and therefore, movement of the country towards knowledge economy. Sufficient supply side problems need to be tackled in this regard, most important of which is the acquisition of sophisticated production knowledge (Hausmann, et al.).

Export diversification and participation in the global value chain are essential modes of external participation. While the traditional theories of trade emphasize on the importance of specialization in their competitive advantages, focus on labour intensive products for exports in these nations can lead them to be stuck in low value added products. Similarly, specialization and focus on a single product can lead to disastrous economic consequences should the demand of the products decline dramatically.

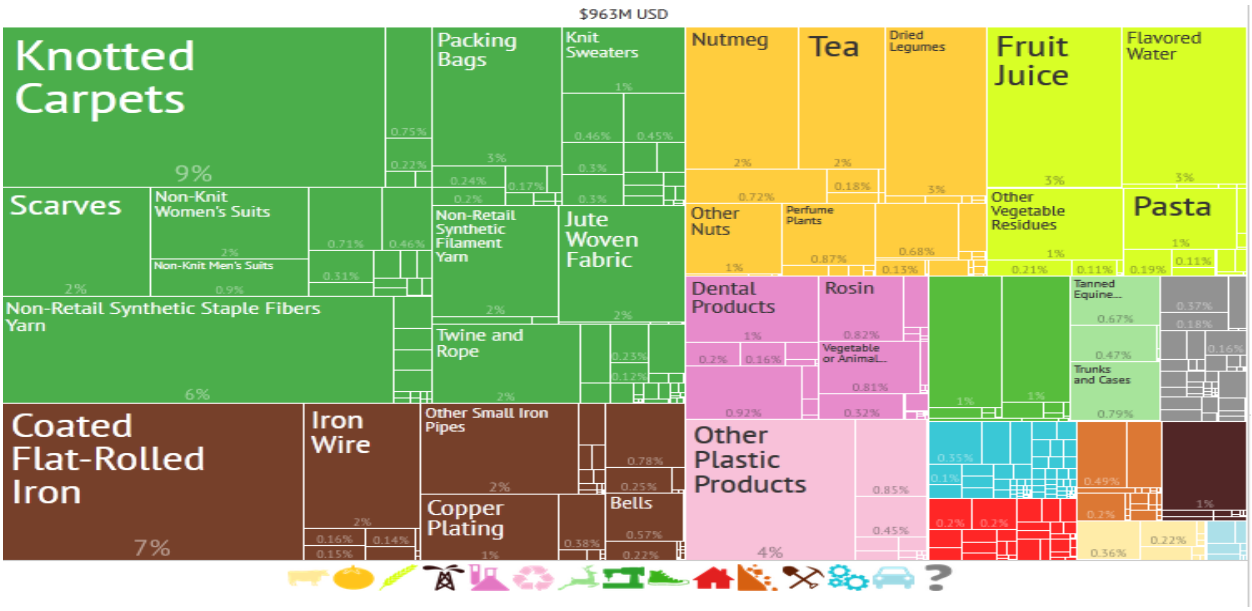
Literature shows that excessive 'concentration phenomenon' is believed to be a major factor behind the instability of export revenues globally and therefore, effective diversification can prevent the economy from any exogenous shocks. In this scenario, it would be extremely beneficial for Nepal to find effective measures to diversify its exports, not only in terms of items

exported but also in terms of their nature. However, there has been a clear lack of any such progress in the country.

As can be seen, the composition of exports of Nepal between 2001 and 2011 are remarkably similar. They are also indicative of pattern of production which is highly dependent on low value added items. Textiles, vegetable oils, consumer beauty products, and metallic products have been the major items of export from Nepal. There is also a noticeable lack of products involving any level of technological sophistication. Export of machinery (indicated by the blue colour boxes) is miniscule. Export of chemical items (indicated by the pink colours) is also limited to consumer beauty and medicaments. Its lack of export product diversity was reflected by the Diversification Index published by UNCTAD which ranked Nepal 134 out of 174 countries in terms of its export diversity. Therefore, Nepal's lack of export diversification and its export composition is hurting its trade balance. This trade pattern is also indicative of a country with low technological and knowledge capital infrastructure. Therefore, attention needs to pay to promote products and services incorporating technological sophistication lying higher in the production value chain.



Nepal's composition of exports in 2001



Nepal's composition of exports in 2011[10]

Supply side problems

The most important constraints with regards to the export in Nepal relate to the supply side. Since joining the WTO Nepal has access to the global market and most importantly, because it is a least developed country, its products are afforded practically duty free access across the globe. Similarly, the country also enjoys completely duty free access to the Indian market provided certain conditions related to the rules of origin are complied. Yet, Nepal has been unable to utilize these opportunities. There are supply-side problems for doing so and each of which will be analyzed in this section.

Geographical Challenge

Similarly, lack of access to sea has been another problem for Nepal. It is well documented that cost of trade for landlocked countries is far higher than those with access to sea. Estimates report that cost of trade for landlocked countries can be double than of maritime countries (Faye, McArthur, Sachs, & Snow 2004). Further studies show that the cost of transport charges paid by the landlocked least developed countries is almost three times more than tariff levied by developed countries (Chowdhury & Sandagdorj 2006). Besides the higher cost of transport for landlocked, countries, problems of transit tend to be important as well. In this regard, Nepal is completely dependent on India for transit access. As Faye et al. mention, dependency on transit routes also means dependence on political relations with the country providing transit access, maintaining health political relations with India therefore, becomes imperative for Nepal. The case of Bhutan and Nepal forms interesting case study. To illustrate, Snow et al. found that Bhutan enjoys far more comfortable transit passage compared to Nepal due to its special

[10] Accessed from http://www.atlas.cid.harvard.edu/explore/product_space/export/npl/all/show/2010/

relationship with India (Snow, Faye, McArthur, & Sachs 2003). Nepalese exporters also have to face various problems at different State customs related to freight tariffs, unreported monetary payments to officials, and at the port of Kolkota, which is the primary port of export for Nepalese products. (Kharel 2009). The high cost of transportation and transit is therefore, reflected in the cost of export of Nepal.

Table 15: Time and Cost of export's for South Asian Countries

	Bangladesh	Bhutan	India	Nepal	Pakistan	Sri Lanka
Time to export (days)	25	38	16	41	21	20
Cost to export (US$ per container)	1025	2230	1120	1975	660	720

Source: (IFC 2013)

As can be seen, the cost and days required to export products from Nepal and Bhutan is significantly higher any other South Asian countries. The South Asian average, without including Bhutan and Nepal, for cost to export comes out to be USD 881.25 which is much higher than the cost for Nepal. Similarly, the days required to export is also 20.5 for rest of South Asia compared to 41 for Nepal. What is clear from the table is that cost of trade for Nepal is more than double than that of cost of trade for other South Asian countries with maritime access. Therefore, coupled with high domestic transport cost high cost of transit transport is one the major reasons why the Nepalese products are uncompetitive in the international market.

Infrastructure

Nepal is one of the poorest countries in the world. Lack of basic infrastructure remains one of the most important obstacles for progress of the country. As per the Global Competitiveness Index, Nepal ranks 117 out of 148 countries in terms of its competitiveness. The Index gives Nepal 1.9 out of possible 7 in terms of its infrastructure[11]. The country is ranked below all other South Asian countries except Pakistan in the index showing the poor quality of services provided by the social sector as well as infrastructure. Results of the GCI are further reflected in the national reports of the country. Inadequate infrastructure has been identified as the most binding constraint to economic activity in Nepal by the ADB (ADB 2009)**.**

Table 16: GCI Indicators of South Asian countries

Global Competitiveness Index	Nepal		India		Bhutan		Bangladesh	Pakistan			Sri Lanka	
	Rank	Score	Rank	Score	Rank	Score	Rank	Score	Rank	Score	Rank	Score

[11] Here the infrastructure includes the quality of roads, railroad, ports, air transport, electricity supply and telecommunications.

GCI 13/14	117	3.7	60	4.3	109	3.7	110	3.7	133	3.4	65	4.2
Basic requirements (60%)	105	4	96	4.2	84	4.4	113	3.8	142	3.3	77	4.5
Infrastructure	144	1.9	85	3.7	87	3.6	132	2.4	121	2.7	73	4
Efficiency enhances (35%)	128	3.2	42	4.4	125	3.3	108	3.6	104	3.6	69	4
Goods market efficiency	127	3.7	85	4.2	121	3.9	89	4.1	103	4	37	4.6
Labor market efficiency	133	3.7	99	4.1	29	4.7	124	3.8	138	3.5	135	3.5
Financial market development	95	3.8	19	4.8	123	3.3	102	3.7	67	4	41	4.5
Technological readiness	133	2.6	98	3.2	132	2.6	127	2.7	118	2.9	93	3.3
Market size	100	3.1	3	6.2	143	1.8	45	4.4	30	4.7	61	3.9

Source: (WEF 2013)

Electricity

First issue that needs to be addressed here is the lack of electricity in the country. While the annual energy demand in the country is 4,833 GW, total supply of energy equals only 3,859 GW. That is a deficit of almost 1,000 GW per annum (Adhikari & Sapkota 2012). In 2011, the peak demand for electricity in the country was 946.1MW while the available energy averaged just about 440MW over the year. Use of diesel generators to accommodate the lack of electricity has led to further import of petroleum products which has worsened the balance of payment situation of the country and added to the cost of production (Pandey, Adhikari, & Sijapati, 2012). Lack of electricity has been primarily due to absence of hydro-power plants in the country, more so of reservoir based plants, result of which has been insufficient production and non-availability of electricity during winter season[12].

Transportation

The next challenge is that of transport. Nepal's terrain is mostly mountainous in nature. Only 17 percent of the country falls in the Terai zone which is flat in nature and the rest of the terrain

[12] Reasons for low levels of production despite high hydro-electricity potential is mainly political in nature. Development plans, including the three year plans (see Tenth Plan, Water Resources Strategy 2002), have regularly emphasized the importance of generating electricity in the country. Yet, problems of land acquisition and relocation compensation frequently emerge. Another problem has been the inefficient operation of the NEA, the sole producer and distributor of electricity in the country. The public enterprise is a highly politicized and has been regularly running on losses (Adhikari & Sapkota 2012).

consists of hills and mountains. This had led to difficulty in providing for transport in many of the regions of the country and therefore, till now, 2 districts in Nepal do not have any access to roads and 18 districts in Nepal have no access to all weather roads. Consequently, the quality and density of road in Nepal is far worse compared to countries elsewhere, including the South Asian region.

Table 15: Quality and density of Nepal's road infrastructure

Descriptions	Nepal	India	Bangladesh
Road density, km/km2 of land (2007)	121	2226	2079
Paved road (% of total) (2010)	53.9	49.5	9.5
Length of rail route available, km (2011)	32	63974	2835
Air transport registered carrier departure, world-wide (2012)	34745	660862	20778

Source: World Bank 2012, MoF 2013

An effective transport system promotes economic activities, provides access to other basic infrastructures and reduces the cost of trade by access to cheaper inputs and provision of market. Lack of roads and its poor quality therefore, has led to higher costs of transport for Nepal and made products produced in various remote parts of Nepal uncompetitive for export.

Standardization infrastructure

Another challenge for Nepal, especially in the field of trade is that of lack of standardization infrastructure. Absence of standardization infrastructure and its inability to meet the standards related requirements has been one of the major trade barriers for Nepal (Ojha 2009). Lack of accredited laboratories has remained one of the pressing problems for Nepalese exporters. National standardization institutions, National Bureau of Standards and Metrology, and Department of Food Technology and Quality Control have not been able to meet the needs of Nepalese exporters. To illustrate, the standards of honey prescribed by the NBSM do not match the standards of honey set by India's Prevention of Food Adulteration Rules, and other international bodies. Similarly, many items of export have to be tested in their destination countries because the certification issued by Nepalese authorities is not accepted in those countries. Efforts to improve the two said agencies have been moved very slowly.

Finance

Absorption of finance in Nepal is very low[13]. The World Bank concludes that formal financial institutions do not serve the needs of most Nepalese population, a problem which is more acute for small businesses and low-income households (Ferrari, Jaffrin, & Shrestha 2006). This is more pertinent for the SMEs. Reports have regularly quoted that Nepalese financial sector is

[13] Only 26 percent of household in Nepal have bank account. Only about 38 percent of Nepalese households have outstanding loan, a figure which drops to 15 percent when only formal sector is taken into account (Ferrari, Jaffrin, & Shrestha, 2006).

highly unsupportive to SMEs very small number of Nepalese enterprises (SMEs) utilize credit from financial institutions (Adhikari, Dahal, & Pradhanang 2008) (Bank 2007). An IMF report points out that poor quality of financial institutions is one of primary reasons why Nepal should maintain the current peg (IMF 2011). Similarly, as has been mentioned earlier, lack of effective insolvency policy is another important setback in Nepalese financial sector. Reports also suggest that Nepalese financial service sector is incapable of implementing the Financial Service Sector Requirements under the GATS. The GCI has also ranked Nepal as 95th out of 148 countries in terms of financial sector development further highlighting the poor performance of financial sector in Nepal.

Governance

As per the World Governance Indicators (2012), Nepal ranks 28 out of 100 in Voice and Accountability[14][15], finds itself in the 9th percentile in terms of political stability and absence of violence/terrorism (100 percentile being the best performer), 17th percentile in terms of government's effectiveness, 23rd percentile in terms of its regulatory quality, 27th percentile in terms of its rule of law, and 23rd percentile in terms of its control of corruption. Similarly, Transparency International ranked Nepal 116 out of 175 countries in its annual Corruption Perception Index. Similarly, as per the Global Competitiveness Report, Nepal's performance in terms of indicators like protection of property rights (including intellectual property), public trust in politics, bribes, government spending and regulation, efficiency of legal framework is very poor. The findings are also supplemented by the Doing Business Report which mentions that Nepal's performance in protecting its investors also ranks far below the performance of other SAARC countries[16].

It becomes clear here that government of Nepal has not provided adequate services and protection to the Nepalese citizens and the businesses. A stable and well-functioning government is essential for fostering favourable business climate and an expanding business environment consequently, is essential for improving the productivity and export performance of the economy. However, in Nepal, lack of stable and strong government has been an important impediment. Frequent government changes have halted any systematic implementation of long term plans. Construction of development projects are frequently stalled due to local disruptions and political intervention. Lack of effective governance in Nepal therefore has stifled growth, commerce and investment. In this regard, improvement of the performance of the government is an essential condition for the expansion of export related products in Nepal.

Investment and productivity

As can be seen from the table, Nepal has one of the highest wage to productivity ratio in all of South Asia. This is indicative of low performance high wage rate system currently prevalent in Nepal. It has already been reported that Nepal has one of the most stringent labour regulations

[14] 100 being the best rank and 1 being the lowest rank.

[15] Voice and Accountability Reflects perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media.

[16] Nepal ranks 82nd in this regard out of 185 countries. Bangladesh, India, Pakistan and Sri Lanka rae ranked 25th, 49th, 32nd, and 49th respectively. Only Bhutan fares worse than Nepal ranked at 150.

in all of South Asia. Its system of providing permanency to staff and difficulty in making staffs redundant provides a major obstacle for businesses in Nepal (Pandey, Adhikari, & Sijapati, 2012). Frequent factory lockdowns by the labour unions have been another major problem in this regard. However, the major disruptive element in terms of factory productivity has been the regular load shedding. It is estimated that firms on average lose 22.1 percent of their annual sales due to power outages. Similarly, the 2010 Small Factory Foundation Survey concluded that load shedding had forced the closure of 41 percent medium-scale factories (Pandey, Adhikari, & Sijapati, 2012). This is in addition to the already low productivity sectors Nepal has been involved in. The GCI too in its index of technological readiness shows that Nepal's performance in internet sophistication has been appalling. Same is the case in terms of expenditure in terms of R&D, scientific research institutions, intellectual property rights and effectiveness of value chain system.

Table 17: Wage structure of labourers across South Asia

	Afghanistan	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
Ratio of minimum wage to value added per worker	0.00	0.36	0.00	0.15	0.00	0.77	0.24	0.11

Source: World Bank database

The situation is not better in terms of agriculture either. As the table shows, Nepal's current growth rate of agriculture is among the lowest in South Asia. Aggregate of 15 year growth rate of this sector also shows a similar result. Most importantly, its yield per hectare of land is significantly lower compared to nations like Bangladesh and China. Even more striking is the performance in labour productivity. The ADS Draft report shows that the productivity of labour in agriculture ($794/agricultural labour) is about one fourth the productivity of labour in non-agricultural sector ($3130/agricultural labour).

Table 18: Nepal's agriculture productivity

Country	Average GDP% over 1995-2010	Average Agricultural GDP% over 1995-2010	GDP/cap ($) in 2010	Arable Land/capita (ha) In 2008	Cereal yield (kg per ha) In 2010	Ag GDP/arable land ($/ha) in 2008
Bangladesh	5.6	3.6	673	0.054	3890	1845
China	9.9	4.1	4393	0.082	5460	4467
India	7.2	2.8	1477	0.139	2471	1277
Pakistan	4.2	3.7	1007	0.122	2803	1586
Nepal	4.1	3.0	524	0.082	2374	1665

Source: World Development Indicators at http://data.worldbank.org/data-catalog/world-

The problems of lower productivity have to be addressed by increasing the investment in these sectors. Unfortunately, with regards to investment too, Nepal lags behind most South Asian countries. As can be seen, except for Pakistan, Nepal has the lowest rate of annual growth of Gross Fixed Capital Formation (GFCF) in all of South Asia. Its ratio of GFCF is also amongst the lowest in all of South Asia. Therefore, inadequate investment is being done compared to the national competitors which has led to Nepal falling behind these countries in terms of its productivity. Focus of international communities as well as the government in social sector spending instead of infrastructure has also been another major reasons behind the low levels of capital formation in Nepal (Pandey, Adhikari, & Sijapati, 2012).

Table 19: Gross Fixed Capital Formation in South Asian countries

	Gross Fixed Capital Formation (% of GDP)	**Average Annual Growth of GFCF (2000-2012)**
Afghanistan	16.82	N/A
Bangladesh	26.549	7.88
Bhutan	N/A	7.19
China	46.82	12.539
India	29.59	9.65
Pakistan	13.32	2.65
Sri Lanka	28.88	7.8
Nepal	20.01	3.51

World Bank Economic Indicators

Conclusion

There has been recognition amongst the policy makers in Nepal that trade is an important component of economic growth and that rising trade can result in better economic performance as well as reduction in poverty in Nepal. Yet, Nepal's trade performance has not improved over the years. Its trade deficit is steadily increasing and its export sector is showing no signs of improvement. Despite promotion of various products by important national policies of the country like the Trade Policy and NTIS, export performance of these products has not been satisfactory. Analysis of the reasons behind this dismal performance reveal that several macroeconomic problems, supply side problems and barriers to trade have been hindering growth of exports in the country. Therefore, the immediate concern of the government should be addressing the macroeconomic deficiencies in the economy, tackling the supply side bottlenecks, putting in place infrastructure to comply with international SPS and TBT regulations and pressurizing international governments to lower their barriers to trade.

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