



Graduate School of Development Studies

The Causes of Trade Deficit of Nepal

A Research Paper presented by:

Rajan Silwal

(Nepal)

in partial fulfilment of the requirements for obtaining the degree of
MASTERS OF ARTS IN DEVELOPMENT STUDIES

Specialization:

**Economics of Development
(ECD)**

Members of the examining committee:

Dr Lorenzo Pellegrini

Dr Howard Nicholas

The Hague, The Netherlands

November, 2008

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Inquiries:

Postal address: Institute of Social Studies
 P.O. Box 29776
 2502 LT The Hague
 The Netherlands

Location: Kortenaerkade 12
 2518 AX The Hague
 The Netherlands

Telephone: +31 70 426 0460

Fax: +31 70 426 0799

Acknowledgements

First and foremost, I would like to extend my cordial thanks to my supervisor Dr Lorenzo Pellegrini for his kind guidance. He has been a continuous source of inspiration and encouragement and under his advice; this journey of my research has been incredibly exciting and smooth.

The 'seed' of this research paper was an outcome of the discussion with my second reader, Dr Howard Nicholas. He has always boosted my morale by providing me with detailed comments and suggestions to ensure that I learn the basics of research. I am glad to be able to extend my special thanks to him.

I am indebted to the Government of Nepal for nominating me to pursue this degree and to the Netherlands Fellowship Programme for providing me with this wonderful opportunity.

Other important names that I wish to acknowledge for their inspiration and assistance along the way are Li-Mie Wu, Almas Mahmud, Shiva Raj Bhatt, Ajaya Krishna Shrestha, Conchesta Kabete, Sintayehu Hailu Alemu, Iftekhar Ahmed Robin, Makhahliso Nokana and Joy Misa. Similarly, I would like to extend my sincere thanks to all staff members of ECD programme in ISS.

Last but not least, I express my gratitude to my parents, my wife Nita, my sons Abhinav and Anurag, and my nephew Sharad for their continuous support and for the sacrifices they have made during my stay and study abroad.

I am fully responsible for all the errors and omissions, if any, in this research paper.

Rajan Silwal
The Hague
12th November, 2008

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List of Acronyms

AAN	Action Aid Nepal
ADB	Asian Development Bank
ARIC	Asia Regional Integration Center
BD	Budget Deficit
BoP	Balance of Payments
CF	Capital and Financial Account
ch.	Chapter
CA	Current Account
CBS	Central Bureau of Statistics
CPI	Consumer Price Index
EG	Economic Growth
ER	Exchange Rate
EU	European Union
FDI	Foreign Direct Investment
FY	Fiscal Year
GCI	Global Competitiveness Index
GDP	Gross Domestic Product
GDS	Gross Domestic Saving
GNP	Gross National Product
G & S	Goods and Services
GoN	Government of Nepal
IFWG	Integrated Framework Working Group
ILO	International Labour Organization
IMF	International Monetary Fund
IRe	Indian Rupee
LLDCs	Land-locked Developing Countries
LPI	Logistics Performance Index
M	Import
M1	Narrow Money
M2	Broad Money
MFA	Multi Fibre Agreement
MoF	Ministry of Finance
MS	Money Supply
n.a.	not available
n.d.	no date
NESPEC	Nepal Social Development and People's Empowerment Centre

NRB	Nepal <i>Rashtra</i> Bank
NRe	Nepalese Rupee
OLS	Ordinary Least Squares
PI	Political Instability
REER	Real Effective Exchange Rate
RER	Real Exchange Rate
RMG	Ready-made Garment
Rs	Rupees
SAARC	South Asian Association of Regional Cooperation
SAWTEE	South Asia Watch on Trade, Economics and Environment
S-I	Saving-Investment
TB	Trade Balance
TD	Trade Deficit
TEPC	Trade and Export Promotion Centre
TFP	Total Factor Productivity
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNIDO	United Nations Industrial Development Organization
US	United States
WB	World Bank
WDI	World Development Indicators
WGI	World Governance Index
WTO	World Trade Organization
X	Export

Abstract

This research paper has discussed the principal causes of trade deficit trade deficit of Nepal. Efforts have been made to sort out the external as well as internal sources of trade deficit. Based on exploratory data analysis and using the data during 1976-2004, this paper has found that both external shocks and internal factors are responsible for the ongoing trade deficit. Specifically, demand and price shocks in the big economies of the world have shown inevitable impacts on Nepal's trade balance. Among others, internal bottlenecks such as lack of competitiveness, geopolitical aspects, economic policies, bilateral agreement with trading partner are also found responsible in determining the direction of trade balance. Contrary to some conventional theories and experiences, this paper does not find strong and convincing relationships of budget deficit, excess money supply, real exchange rate, and economic growth with trade deficit in the context of Nepal.

Relevance to Development Studies

Foreign trade is not only the barter of goods and services across borders but also an efficient channel of exchanging labour, capital, technologies, opportunities and cultures. In many economies, trade has worked as an engine of growth. In a broader sense, trade and development are interdependent. And, trade has prospects and problems. Diagnosis of problems leads towards various alternatives to cure them. Indeed, development does start from identification of needs or problems at first. On this ground, this paper proves its relevance to Development Studies.

Keywords

Export, Import, Trade Balance, Trade Deficit, Trade, Nepal, GDP

Chapter 1

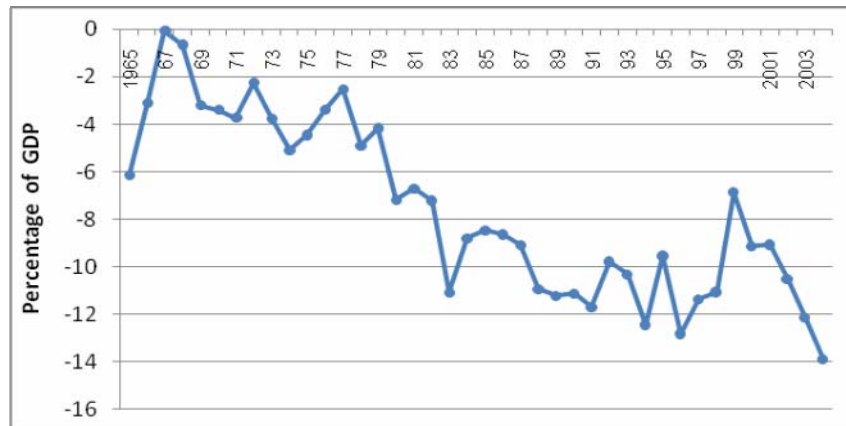
Introduction

1.1 The Background

Trade is one of the means to achieve growth, employment, and welfare. In many countries, trade has a significant share in the Gross Domestic Product (GDP). International trade is pivotal when countries are not self-reliant in factors of production, consumer goods and capital goods. In the 19th and 20th centuries trade had played a major role to accomplish global economic growth. In several developed countries, international trade and long-term capital flows acted as 'engine of growth' in bringing rapid economic growth and development (Oke 2007). Rodrik (2001: 23) rightly argues that no country has grown without international trade. External trade is one of the main sources of foreign exchange earning which is necessary to import capital goods plus other consumer goods and services that are not produced domestically. In business and Economics, foreign trade has always been emphasized for comparative advantage and one of the major components contributing to GDP. A persistent and high deficit in international trade is less likely to resemble the good health of an economy, leaving the question of its sustainability.

Nepal, a small economy having 49% of contribution by trade in its GDP (2004) has been running a trade deficit (TD) since 1965 (Figure 1.1)¹.

Figure 1.1
Trade Balance of Nepal since 1965 (in Goods & Services)



Data Source: World Bank(WB), 'World Development Indicators (WDI)-2007, '

The deficit is incurred mostly in merchandise trade and partly in income. The current account which includes trade, services and transfer income has also been negative since 1977; however, it has shown a positive sign after 2002 (Figure 3.8) contributed by significant increase in remittances (see Appendix-

D). Nepal has a high (44% of total deficit, on average) TD with India² – a main trading partner and bordering country. Moreover, the TD with rest of the world is also significant. According to Bajracharya and Sharma (as cited in Devkota n.d.), 'the trade deficit continued to grow unbridled, and is increasingly posing a serious challenge to the various economic structure of the nation'. Figure 1.1 has explicitly shown two trends. First, after 1967 the deficit has worsened in every successive decade. Second, there are sudden and sharp upturns and downturns.

Besides, the deficit was relatively low until 1970s but it kept worsening after 1980 except for some exceptional upturns in 1985, early 1990s and 1999. Moreover, the oscillations are very frequent and the magnitudes of them are equally interesting for a study.

1.2 Policy Relevance and Justification

Foreign trade helps consumption of those goods and services which are either unprofitable to produce domestically or not feasible due to various reasons. Likewise, the need of capital, capital goods and technology are also met by means of trade. A favourable balance of trade is expected to generate foreign currencies necessary for the imports of capital as well as consumption goods and services. Moreover, it is one of the means of bridging the saving gaps in an economy. The balance of trade, being a key component of the current account, can have far-reaching impact on economic growth, development and balance of payments. The government of Nepal has realized the export sector as an engine of growth when this sector was blooming in 1990s.

'Nepal's exports have played a positive role since the 1986-90 periods. During this period, their contribution to economic growth increased to 10 percent, from 2 percent for the previous period (1976-85). Exports were an engine of economic growth during the 1990s, particularly during the period after economic reforms, 1991-95' (MoICS³, as cited in Prasad 2007: 19).

The export policy of the eighth five-Year Plan (1975-80) of Nepal clearly recognizes that the unfavourable balance of payments led by a TD of the country is responsible for negative effects on the economy and a slower industrialisation. Sharma and Bhandari (2005: 30) see that 'Nepal's foreign trade has tremendously been suffering from successive deficit which can have negative effect on foreign currency reserve of the country and thereby invite macro economic instability.'

Identification of the causes of TD is crucial in the sense that a country can hardly incur TD of significant size forever. This identification, in fact, is the diagnosis of the problem which can suggest necessary policy prescriptions to be pursued. Given the higher contribution (almost 50%) of trade to GDP, the ongoing trend of TD would no longer be ignored for growth and development of the country. More importantly, sources of financing a deficit are very important and the issue of sustainability of TD hinges on the sources of financing. Despite various sources to finance a TD, an underdeveloped economy like Nepal naturally faces number of limitations to tackle the deficit. These limitations are the agriculture and service-dominant structure of the

economy, amount of foreign exchange reserve, capacity to increase gross domestic savings, capital flow and its structure, debt servicing capacity, volatility of international labour market and hence the flow of remittances and so on. In its study report, UNCTAD⁴ (1999: 84) has shown that '... with some notable exceptions, the relationship between trade balances and economic growth in developing countries has taken an unfavourable turn during the past decade'. Hence, TD is a problem to accelerate economic growth. A TD of 'Nepalese size' (13.9% of GDP in 2004) requires an intensive investigation of principal causes as the first step to address the problem.

1.3 Research Objectives and Questions

The main objective of this research paper is to identify the principal causes of trade deficit in the country. The research paper hence aimed at answering the following research question -

What are the principal causes of trade deficit of Nepal?

1.4 Research Hypothesis

The following two hypotheses have been made in this research:

- a) External shocks (demand and price) are the main causes of Nepal's TD.
- b) Internal bottlenecks (trade and economic structure, competitiveness, geography, conflict) and policy environment (trade, fiscal and monetary) factors are secondary causes.

These hypotheses have been tested on the basis of theoretical and empirical foundation but no statistical tests are pursued due to the limitations mentioned hereafter.

1.5 Data and Methodology

All the data are from secondary sources in this paper. In most of the analytical part, the study period is 1976-2004 (see section 1.6). The major sources of data are the World Bank, Nepal *Rashtra* Bank (NRB), International Monetary Fund (IMF), Ministry of Finance (Nepal), Central Bureau of Statistics and Integrated Framework Working Group (IFWG). Regarding the methodology, this study relies on exploratory data analysis. Relevant cross-country comparisons have been done among the South Asian neighbouring countries as well as major trading partners.

1.6 Scope and Limitations

This study captures only the principal causes of Nepalese TD. There can be a number of micro and macro factors which have in one way or another causal relationship with the TD. Given the constraint of time, academic purpose of the study and other resources, those subsidiary issues have not been considered in the analysis. All the inconsistencies and insufficiencies seen in the data gathered from various sources can have bias in inferences. Data from Nepalese

sources are based on fiscal year whereas the data from World Bank and other international organizations are produced in calendar year. Thus, it might have erroneous interpretation. The analysis mostly depends on exploratory data analysis which has its own limitations compared to other sophisticated data analysis methods, especially in the attribution of causal relationship between dependent and explanatory variables. Since time-series data analysis requires relatively a longer data series of all dependent and independent variables, I have not chosen the method due to the deficiency of data corresponding to some key variables. Most of the data series are available from 1976 till 2004. Hence, I have chosen the time frame.

To the extent, cross-country comparison has been made to validate some indicators or findings; they should be carefully understood since these countries possess varied economic, political, and geographic characteristics. The special Nepal-India trade relation – where the border is open and an unauthorized trade between them is claimed to be significant in size (Taneja et al. 2004: 43) – may also delimit the identification of real problem.

Lastly, TD has multiple implications on the various macroeconomic concerns. The question of significance of TD on economic growth, employment, and its sustainability issue is definitely important. However, I have not discussed these issues given the limitation of data, lack of time, appropriate methodology and intensity of the question at large. Similarly, despite the presence of high TD with India in formal and informal trade, where a single research can be made, I have pursued my analysis in an aggregate package with other countries. Nevertheless, to the extent that data was available and a special justification needed, I have incorporated them.

1.7 Organization of the Study

This paper has been organized into five chapters. The second chapter is devoted to review of literature and theoretical framework. Thus it comprises relevant literature, theories and empirical findings; and related Nepalese studies in foreign trade.

The third chapter discusses the structure and direction of Nepal's foreign trade over the decades. It describes the general story of TD in Nepal. In addition, a brief summary Nepal' trade policies are given.

Chapter four, the main part of analysis deals with the causes of TD. The last chapter summarizes the conclusions drawn from the analysis and presents some policy recommendations.

Chapter 2

Review of Literature and Theoretical Framework

This chapter has first overviewed the main debates made by different scholars regarding the causes and implications of TD in general. It goes further by summarizing empirical studies about the causes of TD in different countries. Finally, based on the empirical studies, the theoretical (also analytical) framework has been designed.

2.1 Literature Review

There are considerable numbers of literature regarding the TD. For some, it resembles a problem; for others it does not. An overview of trade account of different countries suggests that many countries are passing through a TD and this issue has been discussed in national, international, economic and political arena.

The debate on TD is most likely to revolve around its impact on the economy, way to finance it and its nature (causes, size and persistence) in question. There are writers and institutions focused on analyzing the issue from the viewpoint of developed and developing countries. In the former case, voices are raised to say that it is not a problem per se while in the later there are studies which have shown that TD retards growth and development thereby inviting financial crises, deindustrialization, unemployment, and so on. Here are some arguments on the issue.

Analyzing the US context Mueller (2006) contends that the problem is not the deficit itself but the way to get rid of it when foreign financing stops. In support of the 'no problem' side, the author argues that capital inflow is the sign of an attractive and growing economy. Griswold (1998) for example, considers the TD not as bad news, not resulting from unfair trading practices of other countries and nor due to lack of competitiveness but due to emergence of other factors in the macro economy not directly related to trade. The author claims that TD simply resembles the mirror image of a surplus in the capital account and the growing economy of a country propelled by high investment. In contrast, in line with the 'worry position', the arguments are that TD leads to a higher external debt which can crash down any time in the future alongside stopping of foreign financing. Some other US scholars view the TD as '...not all good, not all bad, and certainly not irrelevant' (Byrne and Derbin 2003). Their justification is that it can create unemployment or high external debt or financial and political problems (not all good). It also helps fill low domestic saving and social welfare due to higher consumption (not all bad); and not irrelevant in the sense that it has association with macroeconomic variables.

In a research for International Monetary Fund (IMF), Ghosh and Ramakrishnan (2006) perceive the CA deficit from three perspectives, as the

difference between the value of exports and imports of goods and services; gap in national investment and saving; and inter-temporal trade. If the deficit is due to high [external] investment, according to the authors, it does reflect only a low level of savings and no need to worry provided investments are channelled to output growth. Similarly, there is no harm of importing more goods, the authors contend, thereby incurring a TD today and exporting the same tomorrow enjoying a surplus. In addition, if the deficit is easily financed by foreign capital as done by Australia and New Zealand, it is not bad but it can be bad if there is problem of financing the deficit due to withdrawal of private financing as in Mexico in 1995 and Thailand in 1997 (ibid).

Udwadia and Agmon (1988) view the TD from economic, political and moral standpoint and argue that it is a "no problem" situation. The authors argue that any potential crises due to a persistent TD are overstated by political and moralistic perspectives and it has little implication with the economic impacts. From a political corner, the argument is that a trade surplus is contended as 'good for the country' and a must for those who think that power comes from profit. On moral ground the deficit is 'bad' when people say, 'do not consume more than your means' and 'save for a rainy day' (ibid). However, the authors have acknowledged the interplay of these three perspectives to turn the TD as a problem.

The Sunday Times (27 July 2008) offers a critical write-up about TD and clusters the ideas from optimistic and pessimistic sides. Depending upon the nature of imports and its utilization, a TD can be assessed whether or not it helps grow the economy. It is good if the imports are made to boost the production of tradable goods and/or investment goods. It is not bad if it does not create a problem of Balance of Payments (BoP) or run out the foreign exchange reserves of the country or it is only caused by short-term cyclical shocks. The Paper writes, if the deficit is due to the building of infrastructure of the nation or the industrial base, or the imports of raw materials or due to high inflow of foreign aid and foreign direct investment (FDI) into productive sector; no need to worry since they will recover the deficit in the nearest future. Hence the question is not the TD per se but the underlying rationale behind it. The paper rightly emphasizes that irrespective of the BoP surplus, a TD is likely to raise a problem of higher external liabilities in the future which will further deteriorate the importing capacity of the economy and distort the much needed resources towards the debt repayment and servicing.

Moon (2001, 2005) presents extensively in his papers about how a TD hampers the economic growth of countries and leads to accumulation of higher foreign liabilities, dependence, distortion of national priorities, slower growth and development, and potential financial crises as in Latin American and East Asian countries in the past. Moon (2006: 22) has carefully criticized the neoliberal claims that '...the North-South divide could be narrowed, if only the poor countries would emulate the economic policies of the rich'. The author argues that '... it is not their expansion of trade volumes that should be copied but their prudent avoidance of trade deficits *in the past and present*' [emphasis added] (ibid). From the above discussion, it is clear that (i) trade deficit is existent in many countries; (ii) economists have different perceptions to consider it as a problem; and (iii) regarding the sources of problem.

2.2 Review of Empirical Studies on Causes of Trade Deficit

Saruni (2007) has uncovered three main factors responsible for Tanzania's persistent TD. The author has used government expenditure, household consumption, real exchange rate (RER), FDI, income from the rest of the world and trade liberalisation in his log-log ordinary-least-square (OLS) regression model for the data during 1970-2002. The paper finds that the government expenditure, FDI and income from abroad played a positive role in the determination of trade balance (TB) despite the negligible coefficient of the FDI. On the other hand, household consumption, RER and trade liberalisation deteriorated the TB. Some of the findings in Saruni's paper are in line with theories and some are not but his OLS approach for time series analysis suffers some methodological limitations.

The UNCTAD (1999: 95-7) presents an econometric analysis of TB using the panel data of 16 countries over 26 years. Here, TB to GDP ratio is dependent variable whereas growth, purchasing power of exports, growth rate in industrial countries and economic liberalisation are explanatory variables. It is found that the acceleration of growth rates in developing countries increased the TD while liberalisation worsened it significantly. Likewise, better terms of trade and rapid economic growth in industrial countries helped lessen the TD in developing countries.

A wider concept of TB is represented by the CA and the determinants of which are often very same as the determinants of TD. Purohit (2007: 54) found that the determinants of India's CA deficit are not the widely believed changes in stock of money or fiscal balance. The author highlights the lack of competitiveness (in the manufacturing sector), supply-side constraints of domestic economy and inflation through international price shocks (in oil and food) as some major determinants of TD, and CA deficit in turn. The analysis is based on time series data from 1970-2005 in the regression analysis and the variables are CA to GDP ratio, excess money supply (MS), gross fiscal deposit, real effective exchange rate (REER), and Capital-Output ratio. However, the author has largely pursued exploratory data analysis.

Onafowora (2006) examined the causal relationship between budget deficit (BD) and TD in case of Nigeria using a regression model with the data from 1970-2001. The study variables are TD, BD, MS, domestic income, discount rate, and RER. The author has found a positive long-run relationship between BD and TD. But contrary to the conventional theory, the paper highlights that the causality runs from TD to BD since Nigeria is highly dependent on the export of petroleum products. In addition, the paper has observed a positive correlation of TD with MS and depreciation of domestic currency. Meanwhile, increased domestic income and rising interest rates had worsened the TD (in Nigeria) in the long-run. It is due to the fact that the former raises the demand for foreign goods and services while the later encourages capital inflow that necessitates appreciation of home currency; and again more imports from abroad.

Anoruo and Ramchander (1998) investigated relationship between 'twin deficits' in five developing countries using time series data (1957-93). The authors have included both the developed (for example, the US) and

developing countries in their study. The analysis is based on vector autoregressive model and the direction of causality between the two deficits has been tested by the Granger causality test. The study revealed that the TD causes BD and not the vice versa. That is, a worsening of TD forces the government to spend more to help minimize the domestic hardships. However, in case of Malaysia, the authors noticed a weak bidirectional relationship too. In the model, short-term government interest rates, the trade-weighted ER of the local currency, GDP, and inflation rate have served as explanatory variables. Contrary to the documented cases in the US and other developed countries, the authors have found a unidirectional causality from current (trade) accounts to BD. Furthermore, the causality between increase in GDP and TD was significant only in the case of India and Malaysia.

Calderón et al. (2000) in their research for the World Bank found that 'current account deficits in developing countries are moderately persistent'; an increase in domestic output gives rise to a higher CA deficit; terms of trade loss or appreciation of RER; and an increase in international interest rates or higher growth rate in industrial economies lessen the CA deficit in developing countries. The research is based on cross-country panel data of 44 developing countries covering the period from 1966-95. The variables under study for pooled time-series are private and public saving rates, international real interest rate, the extent of BoP control, RER, the share of exports in gross national disposable income, national income (domestic and international), and the terms of trade.

2.3 Nepalese Studies

To the best of my knowledge no previous study has been done which was investigating the causes of TD of Nepal. However, there are some writers and organizations who have expressed their concern on weak export performance and TD. In almost all cases, the authors have raised their arguments on the problems like inadequate diversification (ADB⁵, 2004; SAWTEE⁶ 2006), lack of competitiveness (Bhatt 2005, IFWG⁷ 2003: 9, MoF⁸, 2004/05, Poudyal 2007, Shaakha 2008, Sharma 2004), overvalued ER due to the fixation of Nepalese Rupee (NRe) with Indian Rupee (Panta 2007), and worsening terms of trade (Singh 2008), external shocks (Koirala et al. 2005). Similarly, structural bottlenecks and landlockedness (Devkota n.d., Shaakha 2008), absence of investment-friendly policy environment (MoF 2004/05) [pace of] trade liberalisation (Bhatt and Sharma 2006), changes in international demand or the 'demand shocks' (Shaakh 2008), insurgency and strikes in the country (Koirala et al. 2005), and to some extent bilateral trade treaty with India (Koirala et al. 2005, MoF 2003/04) are also considered responsible for the TD. Most of these arguments are made in institutional publications, newspapers, and public forums. Some of them are briefly discussed here.

The ADB (2008) and IFWG (2003) see the reduced competitiveness in readymade garments (RMG), pashmina and woollen carpets as responsible for declining exports to overseas⁹ countries thus leading to TD. On the other hand, in its report, SAWTEE (2006: 7-9) emphasizes that Nepal's export diversification policy is hardly effective and the trade with India constitutes a

big share of deficit. The report claims that the growth in imports has outweighed the export growth which has propelled the deficit further. Prasad (2007: 22) sees both the role of weak export capacity and imports of luxury goods in the TD of Nepal among others. The author claims that the composition of export basket of Nepal is not diversified compared to its widely varied imports.

According to Sharma (2004), 'India's abnormal profit motive reflected in trade negotiations and tariff and non-tariff barriers imposed infrequently upon Nepal is also causing heavy trade deficit and hence, damage to the Nepalese economy.' Similar arguments are put by Koirala et al. (2005), Prasad (2007) and ADB (2004) that underline the restrictive Nepal-India Trade Treaty for damaging exports of Nepal after 2002 which is responsible for a two-digit TD.

There are opposing views about the ER regime and the TD of Nepal. One view emphasizes that the fixed ER with the Indian currency is detrimental to the Nepalese trade whereas another view perceives it beneficial in general (The Kathmandu Post, 2 June 2003). Devkota (n.d.), using a regression equation, investigated the causality between RER and TB of the country. The author found that ER devaluation is not helpful to achieve improvement in TD; and devaluation alone hardly helps minimize the TD if it is not supported by other economic tools.

Regarding the causal relationship between budget deficit and CA deficit, Acharya (1999: 56-9) found that Nepalese '...budget deficit is significantly explaining the current account deficit'. And, the author sees consistency in the neo-classical doctrine – a higher level of fiscal deficit leads to higher level of CA deficit. Regarding the impact of trade liberalisation in Nepal, Acharya and Cohen (2008) have demonstrated that both the budget and trade deficits do widen under the one-time liberalisation of ER and trade due to the appreciation of domestic currency. The authors have estimated the TD 0.53% and 1.43% more than the baseline value under trade liberalisation, and trade and ER liberalisation respectively.

2.4 Theories on Causes of Trade Deficit

From the review of literatures it is obvious that there are a number of causes of TD in different countries. Among them, fiscal and monetary policies, external shocks (particularly, demand and price), trade liberalisation, economic growth, lack of competitiveness and landlockedness are major ones. In this sub-section, efforts have been made to outline the theoretical framework on the basis of these determinants. It has also been considered as the analytical framework for this research. They are discussed one by one.

2.4.1 External Shocks and Trade Deficit

In an open economy, either the demand shocks or the price shocks transmitted from global economy can produce unfavourable circumstances in a country's TB and macroeconomic stability. The Asia Regional Integration Center (ARIC n.d.) states how a slowdown of growth in major economies, particularly the US and the frequent hikes in the oil prices are transmitted across countries via

trade, investment, financial flows and movement of workers and their remittances. Some other external shocks can emerge from global interest rate and shifts in fiscal and monetary policies of big economies (Jansen 2008). The transmission of shocks is observed in the asset prices, domestic interest rates, appreciation/depreciation of ER, imbalances in trade and current account and real economic activities. Nevertheless, the impact of shocks depends on a country's degree of trade openness, capital inflows, and size of the economy.

Besides, the ARIC (n.d.) states that a supply-side shock that has risen from a sharp rise in imported input (for example, energy), for which demand and supply are relatively inelastic is more likely to raise the output price, slower growth but higher inflation. The rise in output prices will end up in a loss of competitiveness thereby causing smaller exports and TD. The price shocks directly hits the terms of trade, for example, Schwartz (1989: ch. 4) states that in the U.S. the terms of trade and the TD moved together after the World War II where changes in the domestic demand for imports and residual supply of exports were two driving forces behind the TD. Conversely, the demand side shocks appear from the sudden and sharp decrease in the demand for imports by major economies. The demand shocks, according to Solanes et al. (2007), transmit their effects through two channels – the RER and domestic product and these effects are stronger. Desamanya (2006) contends that except internal imbalances, a sudden increase in oil price will worsen the TD, create disturbances in overall BoP, losses in country's foreign exchange reserves and pressure on the ER. Similar arguments are given by Vatansever and Kutlay (2008), Manrique (2004) and ADB (2005) in the context of other countries.

2.4.2 Fiscal Deficit and Trade Deficit

As mentioned in the earlier section, there are two lines of thinking and conclusions that the causality runs from BD to TD or vice versa. Whether we see at broader perspective of CA deficit or a component of that – the TD, the causality is not the same. In macroeconomic accounting, national savings are disaggregated into private and public savings. And, obviously, fiscal/budget deficit indicates government dissaving. The relation between them can be shown as below (Mueller 2006):

$$i) X-M = (Sp-Ip) + (T-G)$$

$$ii) NX = S - I$$

Where X, M, Sp, Ip, T, G, S, I and NX stand for export, import, private saving, private investment, tax revenue, government expenditure, national saving, national investment and trade balance respectively.

In equation (ii) a negative national saving due to higher public dissaving or budget deficit (higher the private investment and bigger the G-T) will lead to a negative TB. Symbolically,

$$iii) -NX = S < I$$

The alternative argument is that the TD is not because of a dissaving but by higher private investment which leads to a higher output, and hence not "bad". In this connection, equation (iii) can be interpreted in terms of CA deficit and total of financial and capital account of the BoP as below:

$$\text{iv) BoP} = \text{NX} + \text{CF} = 0$$

$$\text{v) } -\text{NX} = \text{CF}$$

Where, CF is total of capital and financial account which compensates the current account and/or trade deficit. Here too, two kinds of arguments are found. For some, a negative CA is financed by a positive CF, hence the inflow of capital is the "cause" for the negative TB. For others, TD is due to low public and private saving and public debt. Citing Truman, Purohit (2007: 17) contends that CA deficit and fiscal deficits are not the twins on analytical and behavioural ground even though they are the two main components (saving and investment) of national income. When gross domestic saving is smaller than the investment to be made then - induced by a high interest rate - inflow of foreign capital is possible which again leads to a similar-sized net inflow of foreign goods and services – overshooting the exports (Elwell 2008). The author argues that the larger the saving-investment gap, the larger is the inflow of foreign capital thereby producing a still larger TD. According to Labonte and Makinen, national saving and investment are the crux of TD in a country. The greater the imbalance between investment and saving the higher the TD, which will further be propelled by budget deficits. Moreover, given a private investment boom and decline in private and household saving, TD is magnified (Labonte and Makinen 2005).

One of the underlying contentions in explaining the causality from BD to TD is that if fiscal deficit is financed by printing new money; it will create expansionary effect in the economy and the demand for more capital and consumption goods will rise thereby promoting a higher import. In contrast, BD necessitates a higher interest rate which encourages capital inflow, appreciation of domestic currency, loss in export competitiveness and eventually a TD. Nevertheless, empirical studies have shown mixed results, that is, countries have different experiences (Purohit 2007: 17-8).

2.4.3 Monetary Policy and Trade Deficit

Excess money supply (MS) and ER regime are other two variables which have relationship with TD. They are briefly discussed here in the light of two major alternative approaches that explain the TD, namely, elasticity approach and the monetary approach. According to Ardalan (2003), the elasticity approach underlines the role of ER on TD and BoP adjustments, which treats exports and imports as dependent on relative prices. Besides, the monetary approach discusses the mechanism on the basis of demand for and supply of money in an economy. The elasticity approach suggests that the TB is determined by the over or undervaluation of a currency. Under Keynesian system, the author argues that devaluation leads to changes in the prices of domestic goods against the foreign goods implying a change in terms of trade that brings changes in the TB. Alternatively, an overvaluation of domestic currency deteriorates the export competitiveness and induces more imports from abroad giving way to TD (ibid). Given the domestic and foreign prices, an increase (decrease) in RER indicates the depreciation (appreciation) of domestic currency which is expected to improve (worsen) the TD. However, empirical

studies have suggested that over or undervaluation of a currency does not necessarily produce expected outcome since export and import of a country do depend on price elasticities of traded goods.

The monetary approach is founded on the famous Quantity Theory of Money postulated by Friedman¹⁰ which suggests that disequilibrium in the current account and/or BoP is essentially, though not exclusively, a monetary phenomenon (Ardalan 2003). Under monetary approach, the demand for money¹¹ is considered as stable and any increase in MS by the authority will overshoot the real demand for money. The excess money in the system will be diverted into goods and bonds (foreign and domestic) and hence the process of equilibrium in money market will drive to current account and/or trade deficit (Hallwood and MacDonald 1986 as cited in Purohit 2007: 12). Here, the inherent supposition is that an excess MS will give rise to inflationary pressure that makes a country's exports relatively dearer than that of trading partners. This will result in loss of competitiveness and a current account or trade deficit (Purohit 2007: 13). The critics of the monetary approach emphasize that monetarists' assumption of constant velocity of money alongside fixed real output (due to full employment hypothesis); inclusion of non-interest bearing M1 (or narrow money) in the definition of money stock;¹² and the presumed link between changes in money balances and capital flow are neither convincing nor clear (Ardalan 2003, Nicholas 2008b, Purohit 2007). Even the argued automatic adjustment in trade and current account by the ER under the floating ER regimes is questionable (Nicholas 2008a).

2.4.4 Trade Liberalisation and Trade Deficit

It is argued by neoclassical line of thinking that liberalisation of economy is very likely to gain benefits from the free trade that brings competition, comparative advantage, efficient allocation of resources, higher FDI flow and externalities (Chang and Grabel 2004: ch.7). In its report, UNCTAD (1999: 87-90) presents an explanation that how a 'big bang' type liberalisation process of developing countries lead to TD. In the absence of a selective and appropriately sequenced liberalisation coupled with effective measures to promote competitiveness and exports, the report states, liberalisation of imports can cause a TD. In the report, instances of Argentina, Colombia, Mexico, Philippines, Thailand and Turkey have been given where a rapid liberalisation was followed by large inflows of capital, currency appreciations and a mounting TD ending into a crisis (ibid. p.90). Similarly Moon, (2001: 23), Chang and Grabel (op.cit. ch.7) have also supported that the trade liberalisation policy is one of the reasons of TD. Dollar and Kray (as cited in Moon 2001) have shown that the TD in open economies is larger than in closed economies by 2.09% of GDP. In their study, Parikh and Stürbu (2004: 18) observed a worsening TD after liberalisation in many developing countries of Asia, Africa and Latin America.

2.4.5 Economic Growth and Trade Deficit

High economic growth (EG) in the home country (trading partner) worsens (improves) the TD due to higher demand for capital plus consumer goods and services from abroad (home country) while a weak EG in trading partners dampen the demand for domestic exports and leads to TD (Elwell 2008, UNCTAD 1999). The main explanation here is that growth needs additional investment, which necessitates inflow of capital in a country and makes the saving-investment (S-I) gap or the TD bigger. But Gould and Ruffin (1996) do not see any relationship between EG and TD in the long-run. On the other hand, UNCTAD (1999: 79-80) and Moon (2001) found that TD hampers the subsequent growth due to the 'bleeding' of investible surpluses from the economy and other macroeconomic disturbances. Hence, the causality between these two variables is not the same for all countries. It depends on country-specific characteristics like level of development, size and structure of the economy, integration with the global economy and other macroeconomic variables.

2.4.6 Lack of Competitiveness and Trade Deficit

Competitiveness is a broad concept which has different interpretations and methods of measurement. According to Ezeala-Harrison (1999: 53), '... a country is competitive if its industries have an average level of total factor productivity (TFP) greater than or equal to that of its foreign competitors'. The author asserts that TFP measures the combined productivities of not only all factors of production but also socioeconomic institutions and infrastructures as well in an economy. This micro-level parameter based on productivity and cost helps assess the competitiveness of a country. A country is said to be competitive provided its firms and industries maintain average level of unit costs lower than its competitors (ibid). But, the study underlines that a country can be competitive with respect to technology and scale of production but not under the cost considerations. Moreover, the author rightly argues that competitiveness in terms of cost is not a single indicator and hence productivity should also be accounted. The limitation of cost competitiveness is such that it suffers from any changes in international currency and instabilities, if any, in the global monetary system. Regarding the macro parameters of competitiveness, the degree of economic liberalisation and sound institutional and infrastructural framework are important to exhibit a country's competitiveness that is considered constant in this regard (ibid. p.55). There are various indicators for measuring the competitiveness of countries. They are discussed in chapter 4. Purohit (2007: 54), Hossain (2004) and Mueller (2006) attribute lack of competitiveness in the manufacturing sector as one of the important determinants of TD in India, Bangladesh and the US respectively.

2.4.7 Landlockedness and Trade Deficit

The UNCTAD (2007: 167) has disclosed that landlocked countries incur TD in manufactured goods since they largely rely on the exports of limited

numbers of goods while they import far more (see Figure 3.1). Another argument is that the high import costs due to expensive transportation and delivery-lag will lead to higher cost of production that are targeted for exports (ibid). Gusep (2005) too argues that landlockedness causes imports to be overcharged and exports to decline in their value. To quote him, '[i]t has been calculated that a landlocked country experiences, on average, a very substantial deficit in trade (around 70%) in relation to a coastal country of a similar level of development' (ibid). Interestingly, Snow et al. (2003) have disclosed that compared to their coastal transit countries the landlocked countries do export, on average, 60% less value per capita. Obviously, decreased exports result in a TD. Higher transport costs coupled with unpredictable delays in transit hampers the export competitiveness of landlocked countries thereby making their imports more expensive which leads to a smaller trade volume and diseconomies of scale (ADB 2006: 6). Focusing on the costs of landlockedness, Arvis et al. (2007), emphasize, '[w]eak positioning in the global market entails low trade and prevents most LLDCs from reaping scale economies.'

2.4.8 Political Instability, Conflict and Trade Deficit

The issue of causality between political instability (PI) and TD is debatable. The PI can arise from many sources like changes in current power structure, social disorders, insurgency, economic crises, inefficiency of government, foreign interests/interventions and so on. In Nepal among others, the Maoist insurgency, arguably one of the internal shocks remained a main determinant of PI for a decade. During 1995-2006, there were twelve prime ministers in power that best provides a glimpse of PI in the country. According to Koirala et al., PI is likely to increase the TD since businessmen look for high profit by importing more goods when there is policy uncertainty and government is in defence of its continuity. The argument is that the import is an easy means to meet domestic demand rather than production at home (Koirala et al. 2005: 68). The authors have shown a positive relationship between PI and TD in their regression model. Kumar (2005: 20-21) has exemplified the impact of Nepal's conflict as the closing down of industries and enterprises, declining tourism and hence surge in imports and a deficit in trade. The causality between conflict and TD is most likely an empirical question rather than a theoretical underpinning.

Chapter 3

Structure and Direction of Foreign Trade of Nepal

In this chapter, efforts have been made to present the structure and direction of foreign trade of Nepal. The composition of import and export baskets is taken into consideration to analyse the structure which can have direct and/or indirect relationship with the ongoing TD. Similarly, the direction of foreign trade is discussed with the help of trade balance – positive or negative.

3.1 Trade Structure

The commodity-wide data that are available (since 1996) for export (see Table 3.1 and 3.2) and import baskets (Appendix: A-B) of Nepal display that there are limited number of manufacturing goods in the former while the latter contains varieties of capital and consumer goods.

Table 3.1
Exports of Some Major Commodities to India (In Million Rupees)

Items	Two-year total				
	1996-97 ¹³	1998-99	2000-01	2002-03	2004-05
Agricultural products	2908.3	3169.8	4592.3	4376.60	5565.4
Forest Products	262.6	486.1	688	653.60	1065.1
Ghee (Vegetable)	1580	5889.4	10641.7	6771.30	8497.6
Jute Goods	1285.3	1975.6	2924.3	3781.60	5330.3
Thread	n.a.	1169.2	2503.8	2872.60	4112
Tooth Paste	1208	3554.3	3640.1	2481.60	2013.8
Polyester yarn	875.8	1001.1	1844	1771.40	5372.6
Textiles	n.a.	253.9	1011.8	2658.70	5151.2
Zinc sheets	n.a.	58.7	85.3	3755.90	4072.2
Copper wire rod	n.a.	631.5	4702.1	557.40	835.9
Juice	n.a.	399.7	756.4	1386.90	2230.9
Plastic utensils	n.a.	302.5	1464.8	2000.10	2169.9
Others	5685.6	6728.8	16678.8	20588.80	28214.1
Total	14020.6	33751.4	53986.4	57207.10	79631.6

Source: NRB, 'Quarterly Economic Bulletin' Various Issues and author's calculation

Out of total exports to India, the combined share of agricultural and forest products are exhibiting an increasing trend. Though there are some dozens of manufactured items that are exported to India, few of them have maintained a significant share in the total transaction. The export share of vegetable ghee,

jute goods and thread hold more than 20% of the total share. Products like toothpaste, polyester yarn, textiles, zinc sheets, plastic utensils and juice are other main export items. After the introduction of new bilateral trade treaty with India in 1996 there was a remarkable increase in the exports of some manufacturing and agricultural products. But alongside the revision of the treaty in 2002 by introducing some restrictive quota provision (see Appendix-E) for some Nepalese products the growth rate of exports declined.

Nepal's exports to other countries (other than India) contain low-tech products. Woollen carpets, ready-made garments (RMG) and pashmina together hold more than 65% of the total export to these countries. However, the exports of RMG and woollen carpets have shrunk since the mid 1990s (Table 3.2).

Table 3.2
Exports of Major Commodities to Other Countries (In Million Rupees)

Items	Two-year Total				
	1996-97	1998-99	2000-01	2002-03	2004-05
Woollen Carpet	17365.3	19662.1	14804.8	10997.5	11707.4
Readymade Garments	12970.4	23644.3	20957.7	21440.1	12328.7
Pashmina	n.a.	2665.0	5366.2	2221.7	2627.6
Handicraft (Metal and Wooden)	277.1	391.6	467.7	978.5	1075.1
Silverware and Jewelleries	364.9	456.1	485.6	716.4	645.6
Pulses	1386.6	1002.8	717.1	495.6	298.2
Nepalese Paper & Paper Products	149.1	289.9	397.2	541.6	496.8
Total	36129.4	51747.6	48612.5	46634.2	39308.2

Source: NRB, 'Quarterly Economic Bulletin', various Issues and author's calculation

After mid 1990s, there were some external shocks such as global economic slowdown, less demand from the US and Europe after the September-11. Besides, the conflict became more intensified in the country.

The import baskets from India and other countries include varieties of goods. They are as basic as agricultural products to high-tech manufacturing goods. In case of India, the most dominant are manufactured goods, petroleum products, raw materials, medicines and significant size of agricultural products. It reveals the extent of Nepal's dependency on India. Accordingly, most of the Nepalese imports from other countries are relatively price-inelastic manufactured goods. Out of them, thread, raw wool and silk for the production and export of RMG, woollen carpet and pashmina are mentionable. Likewise, gold and silver, petroleum, machineries, electronics, transport equipments and parts are other key imports. Some of them are essential capital goods which enhance the productive capacity of the economy

and are likely to strengthen the future exports of the country. And, some others are purely consumption and luxurious goods which generally propel the TD.

3.1.1 Overseas Trade Composition of Nepal

Apart from India Nepal's overseas trade is mainly concentrated to America, European Union (EU) and Asian countries. Other European countries outside the EU hold less weight in terms of value. Similarly, trade with Africa is very negligible while in case of Oceania, the export is quite low but the share of import and the TD is noticeable (Table 3.3).

Table 3.3
Composition of Overseas Trade of Nepal (%)

Destination	Exports to					Imports from				
	2002/ 03	2003/ 04	2004/ 05	2005/ 06	2006/ 07	2002/ 03	2003/ 04	2004/ 05	2005/ 06	2006/ 07
Asia (Excluding India)	13.1	17.8	18.8	15.8	19.4	74.1	72.1	74.6	68.9	71.0
Africa	0.0	2.1	0.2	0.5	1.7	0.2	0.6	0.4	0.5	1.2
America	55.6	44.3	41.7	40.5	36.3	5.9	7.0	7.1	9.9	12.0
EU	29.2	32.5	35.5	38.5	37.7	15.2	11.5	10.5	11.8	10.3
Europe (Excluding E.U.)	1.7	2.8	3.1	3.8	3.5	2.1	2.5	2.9	4.8	2.1
Oceania	0.4	0.5	0.6	1.0	1.4	3.7	4.5	4.6	4.6	3.4
Total Value (in Mn NRs)	23581	23172	19526	19062	17198	57303	57100	59618	53534	79936

Source: Trade and Export Promotion Centre, Nepal

On average, the export to Asian countries (other than India) is improving regardless of decreasing trend of total exports. Asian countries have been supplying significant (almost 72%) size of Nepal's imports and the deficit with them is tremendous. America and EU countries are the major destinations of Nepal's export. After the September-11, the export to America started gradually to decline and it was further propelled by the ending of Multi Fibre Agreement (MFA) in December 2004. Hence, the 'demand shocks' was a visible reason for the declining export to the US.

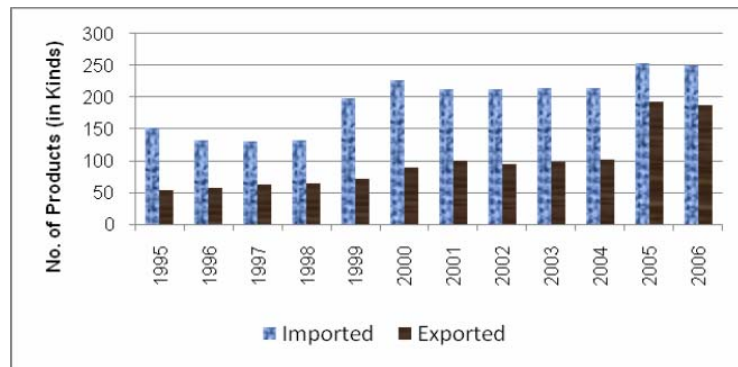
Accordingly, the EU countries appear as an expanding market for Nepalese exports. Import from the EU area displays a decreasing trend and the trade surplus with them has been expanding. Even the export to non-EU countries is increasing despite the downward trend of total exports during the latest years. Currently, the whole Europe emerges as an area of advantage for overseas trade. However, the total value of exports to these countries has been continuously falling whereas imports have shown a mixed pattern of falling

and rising. It will not be a mere coincidence as total import has suddenly increased in 2006 – the end of ten-year long armed conflict in the country.

3.1.2 Number of Products Exported and Imported

Measured in number of commodities in kinds, the imports of Nepal until 2004 is almost double than its exports. From 2005 onwards, the gap is declining however (Figure 3.1). Its exports are not as diversified as imports, and to a great extent, Nepal depends on imported goods.

Figure 3.1
Number of Products: Exports and Imports

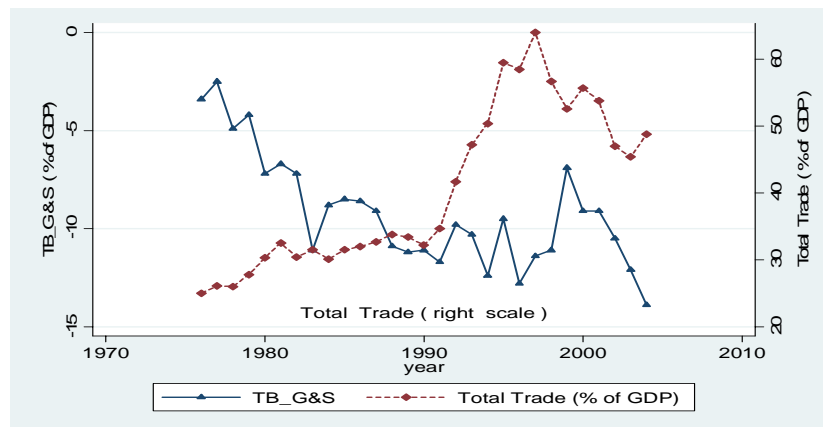


Source: WB, 'World Trade Indicators-2008'

3.2 Direction of Foreign Trade of Nepal

The size of total foreign trade in terms of GDP has been following an upward trend until 1997 but after 1997 it has been declining contrary to trend of TD (Figure 3.2).

Figure 3.2
Movements of Total Trade and Trade Balance

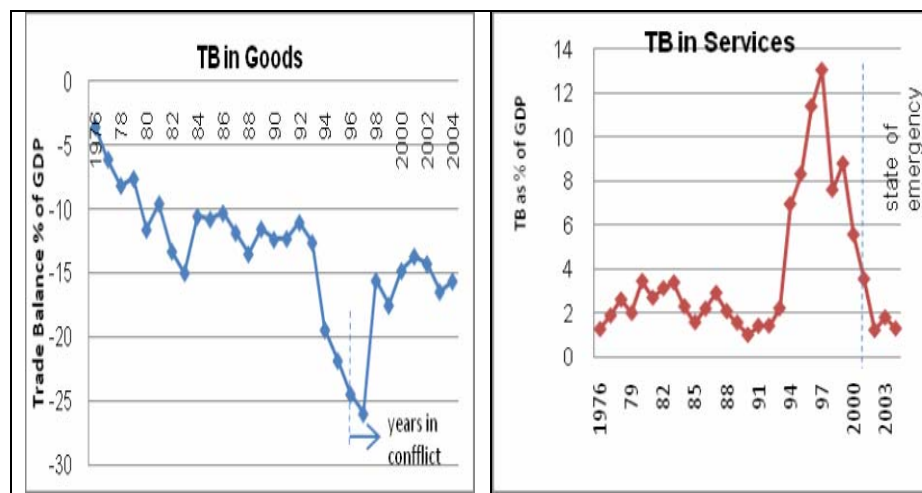


Source: WB, 'WDI-2007'

As the share of exports and imports went down for some years after the mid 1990s, the total trade also followed a similar path. Fall in imports was stronger than the exports. The reasons are discussed in chapter 4. Throughout the study period the direction of TB remained always negative. There are some historical events in the country which have influenced its external sector. Nepal adopted the economic liberalisation policy in 1984/85 which was further speeded up after 1991. In 1989-90, India imposed economic sanction on Nepal which had had detrimental impacts in Nepalese economy (Blanchard et al. 2000: 247, Shrestha 2007). A new industrial policy was in effect in 1992 which was a complement to the external trade. Likewise, Nepal and India established a fixed ER regime in 1993 and all foreign currencies were cross-pegged with Indian currency. On the other side, the Maoist insurgency started in 1996 which lasted in 2006. During the insurgency, the economic environment of the country was non-conducive, even damaging (Bhattarai 2005:20). The country's economy faced both the internal and external shocks due to massacre of the Royal family in Nepal and the terrorist attack in the US in 2001. Finally, in April 2004 Nepal accessed the membership of WTO which further opened the door for imports and exports. These issues are reiterated in chapter 4.

On average, TD in goods is showing an increasing trend after 1976 except mild improvements in some years (Figure 3.3). Nepal has experienced a surplus in service account since 1976. It ranges from one to four per cent until 1993 and post 2002.

Figure 3.3
Trade Balance in Goods and Services



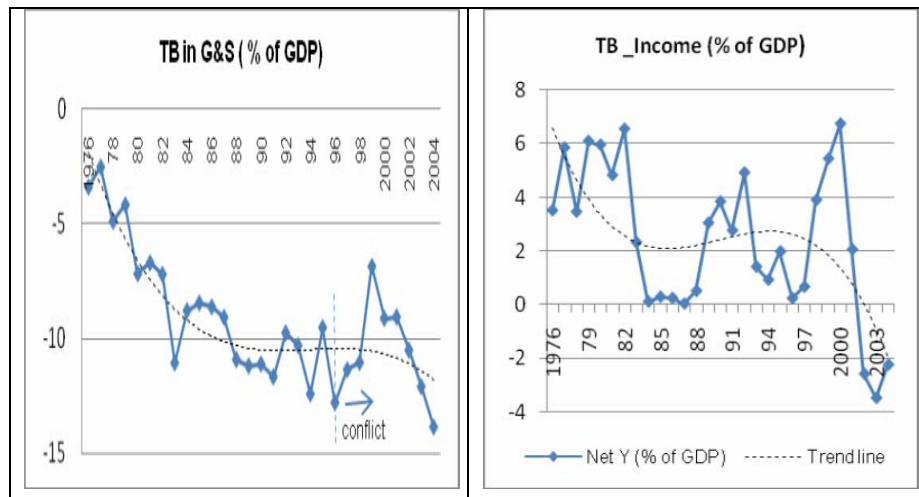
Source: WB 'WDI-2007'

After 1994 the tourism industry was booming until it peaked in 1997 promoted by the national campaign 'Visit Nepal 1998'. It has sharply declined after 1999 as the conflict in the nation intensified and security condition deteriorated. The State of Emergency imposed by the government and the Royal massacre are two strong causes, among others, for the decline of service trade. The trade

surplus in the service sector is not sufficient to compensate the total deficit in goods, however. The combined trade balance in goods and services is again negative due to the higher deficit in goods. It is distinct that the combined trade balance is following the movement of TD in goods. Nevertheless, in late 1990s a significant surplus in service account has compensated similar-size deficit in goods.

Accordingly, from 1976 to 2001, the income account was positive and higher than the surplus in service account despite a number of oscillations (Figure 3.4).

Figure 3.4
Trade Balance in Goods and Services (combined) and Income

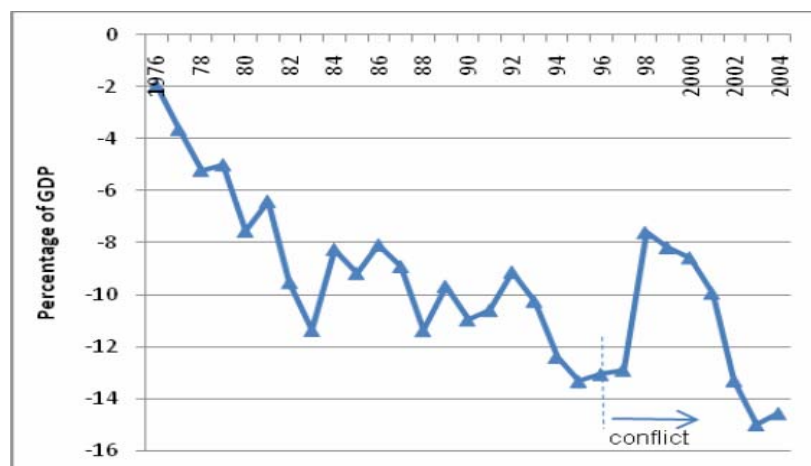


Source: WB 'WDI-2007'

It sharply declined after 1982 as there was a global recession in that year. The recessionary effect hit this sector in the succeeding years. After 1984 the country initiated liberalisation of economy and the income account remained almost zero in those initial years. It was measured nearly 7% of GDP in 2000 when remittances were soaring. Interestingly, it went negative after 2001. The impact of September-11 (terrorist attack in the US) could be one of the possible answers for the downturn in worsening income balance. During the study period the average net income was 2.4% of GDP which was offsetting some of the deficit in merchandise trade. However, the oscillating nature of income account does not resemble it as a reliable source for the Nepalese economy.

The overall balance of trade in goods, services and income is also negative and following the movement of deficit in traded goods (Figure 3.5). It has, however, reached around 15% of GDP after 2002 mainly due to the negative income balance in that period.

Figure 3.5
Trade Balance in Goods, Services and Income (Combined)



Source: WB, 'WDI-2007'

3.2.1 Movement of Trade with India and Other Countries

India was a main destination for Nepal's export until 1985 but it did not remain so after mid 1990s to late 2000 (Table 3.4). After the economic liberalisation of 1985 and new political system in 1990, Nepal's export started expanding to 'other countries'. In the peak period (2001) of armed conflict in Nepal, and WTO membership in 2004 the exports to other countries have narrowed down. As the MFA quota ended in 2004, Nepal too suffered from it (Shaakha 2008). As a result, the export to other countries declined from 2005 onwards. The decline in imports from other countries during 2001-05 can be the new provision of petroleum imports from India.

Table 3.4
Periodic Trade Balance (1976-05)

Period	Export to			Import from		
	India	Other Countries	Total	India	Other countries	Total
1976-80	678.4(56)	532.7(44)	1211.1	1589.8(56.6)	1219.7(43.4)	2809.5
1981-85	1143.4(60.7)	738.9(39.3)	1882.3	2961.9(45.7)	3515.2(54.3)	6477.1
1986-90	1180.9(27.2)	3157.2(72.8)	4338.0	4683.6(31)	10445.9(69)	15129.5
1991-95	2244.5(13.8)	14063.5(86.2)	16308.0	15260(32.4)	31787.3(67.6)	47047.3
1996-00	12525.7(36.1)	22157.6(63.9)	34683.3	32702.8(34.5)	62028(65.5)	94730.8
2001-05	31490.5(58.9)	21996.7(41.8)	53487.2	75176.7(56.8)	57268(43.2)	132444.6

Source: NRB, 'Quarterly Economic Bulletin' Various Issues, (percentage are given in parenthesis)

3.2.2 Direction of Deficit Compared to Trading Partners

Table 3.5 supplies the direction of deficit compared to some key trading partners and neighbouring countries. There are Bangladesh, Pakistan and Sri Lanka incurring a TD as big as the magnitude in Nepal. However, differences are distinct in their direction, for example, the trend of deficits in Bangladesh and Pakistan is decreasing in every successive period while Nepal is experiencing an upward trend.

Table 3.5
Trade Balance (Goods and Services) in Different Countries (% of GDP)

Period	1976-80	1981-85	1986-90	1991-95	1996-00	2001-04
Nepal	-4.4	-8.5	-10.2	-10.8	-10.3	-11.4
Bangladesh	-10.0	-9.3	-7.2	-5.4	-5.9	-5.5
Pakistan	-10.3	-11.5	-8.5	-3.3	-2.6	0.1
Sri Lanka	-7.6	-13.5	-10.3	-10.0	-8.1	-7.1
India	-1.5	-2.2	-1.5	-0.4	-1.4	-1.5
China	-0.2	-0.1	-0.4	1.5	3.2	2.4
Germany	-3.18	-3.19	-0.56	-0.26	4.73	3.85
Japan	0.4	1.8	2.3	1.9	1.3	0.9
United States	-0.7	-1.6	-2.2	-0.9	-2.2	-4.1

Source: WB, 'WDI-2007' and author's calculation

In the latest decade, Nepal's TD as percentage of GDP is nearly double of Bangladesh. In 1976-80, Nepal's position was twice as better than Bangladesh. After 25 years (2001-04), Nepal's position is twice as 'worse' than Bangladesh. Sri Lanka was on the same path as Nepal until 1981-85 but it has been improving its position after 1986-90. Pakistan shows a similar trend as Sri Lanka but the degree of improvement is far better than all the countries on the list. India, on average, shows smallest size of deficit among South Asian countries. Accordingly, China exhibits negligible size of TD until 1986-90. After 1996-00 however, it enjoys a trade surplus.

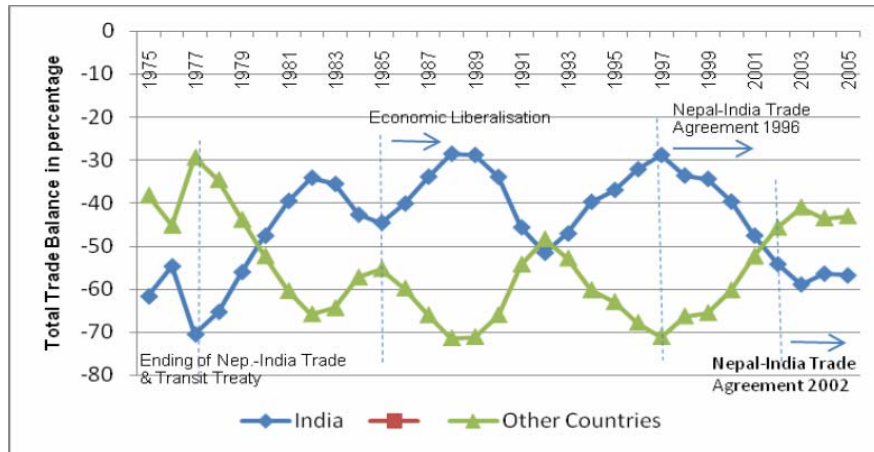
Likewise, Germany has shown a rapid progress in its TB. Currently, it is one of the biggest countries having a trade surplus. Japan has always had a trade surplus since 1976 to date. The USA was relatively better off in 1976-80 and 1991-95 having a TD of quite a small size. It has shown an increasing trend in rest of the period. To conclude, Nepal's ongoing trend of TD and its size is critical compared to its neighbouring countries and trading partners.

3.2.3 Trade Deficit in Goods: India and Other Countries

The TD of Nepal is volatile since 1965 (Figure: 1.1 & 3.6). Until 1979, the deficit (in merchandise) with India was higher than all other countries (Figure 3.6). During 1980-1991 and 1993-2001, the deficit with India lagged significantly behind the other countries. After 1980, as Nepal was expanding its

trade relation with newer countries the TD with India downsized along with the volume of trade. Further, in that period the prevailing trade treaty with India expired.

Figure 3.6
Trade Balance with India and Other Countries



Source: Nepal Rashtra Bank, 'Quarterly Economic Bulletin' Various Issues (Fiscal Year Adjusted)

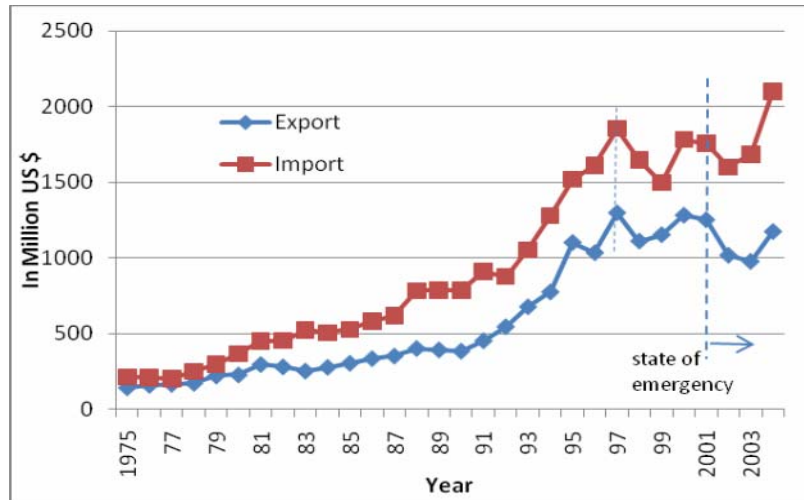
The deficit with India has been again rising after 2002 due to the new provision of petroleum imports. The 'upgraded' bilateral trade treaty in 2002 with India brought about many changes in the ongoing trade structure. Around 1989/90, we can see that the deficit with India was at its minimum due to the reduced imports from India when it imposed an economic sanction on Nepal. Nepal succeeded to improve its TD with India during 1997-99 when the exports of vegetable ghee, toothpaste, polyester yarn, pashmina and thread increased under the favourable trade treaty signed in the end of 1996.

Regarding the TD with other countries, it has reached the highest (71%) point in 1989/90 and 1996-98. As argued earlier, the economic sanction imposed by India diverted the Nepalese imports to other countries. During 1996-98, imports of petroleum, aircraft spare parts, machineries, and some industrial raw materials were sharply increasing. The deficit has been reduced since 1998. Increased exports of readymade garments, pashmina and other handmade products could be the possible reason for this upturn.

3.2.4 Growth Rate of Exports and Imports

If the annual volume of trade is followed by, on average, a higher import growth than the export – a persistent trade deficit cannot be denied. From Figure 3.7, it is apparent that the average growth rate of import has led the export growth. The average gap is either widening or maintaining a constant pattern over successive years leading to a never-ending deficit. The noticeable decline of both variables in 1998 was due to decline in the imports of traded goods and downturn in the service sector. In 2001, there was a State of Emergency in the country which pushed back the trade sector for some years.

Figure 3.7
Export and Import (Goods only) Nepal

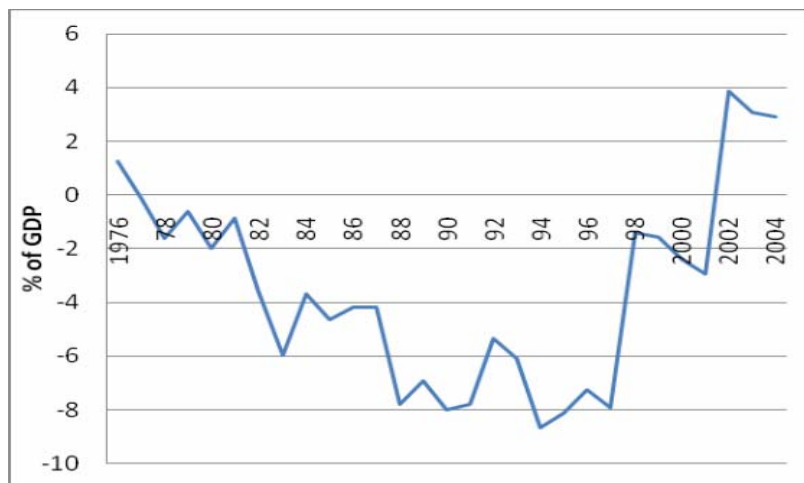


Data Source: WB, 'WDI-2007'

3.2.5 Current Account Balance

The CA of Nepal is influenced by the magnitude and direction of deficit in traded goods. It has remained negative throughout 1977-2001 (Figure 3.8). A sharp improvement in the CA balance can be noticed since 1998. It has gained positive sign after 24 years in 2002. Increasing trend of remittances and surge in foreign aid can be two potential causes of this improvement.

Figure 3.8
Current Account Balance



Source: WB, 'WDI-2007'

3.2.6 Nepal's Trade Policy

Nepal's trade was limited to India and Tibet (China) until 1960s. In the third five-year plan (1965-70), Nepal's priority was to diversify the export while substituting the imports with the application of high tariff barriers and quotas. The objectives were to narrow down the TD and promote industrialization and diversification of the economy (SAWTEE 2007). Besides, the government of Nepal was adopting a dual ER system, a cash subsidy programme, duty exemption on exportable commodities, simplification of licensing and custom procedures. Meanwhile, introduction of a new industry and trade policy were additional efforts made by the government (ibid).

Nepal introduced its first trade policy in 1983. The key features of this policy were delicensing of exports, removal of income tax on export earnings, introduction of duty drawback system, harmonization of custom procedures, and establishment of National Export Trade Development Council (Khanal et al. as cited in SWATEE and AAN 2007: 12-3). Trade Policy 1992 is thought to be a milestone in Nepal's history of trade policy. It was the outcome of government's ongoing effort on economic liberalisation. It has clearly emphasized on the promotion of internal and external trade; more roles to private sector; diversification of foreign trade in terms of commodities and destinations; realization of backward linkages, enhancement of employment through trade and reducing the ongoing trade imbalances (ibid). Moreover, Trade Policy 1992 removed any import taxes on raw materials, exemption of income tax on the export earnings, no licensing for trade¹⁴. It has accepted the State's role as a catalyst and advocated for the massive involvement of private sector.

In this regard, the policy put forth the plan of privatising public sector trading enterprises and was implemented partly. Still, there are a few big trading corporations under the State control. It has pursued policies to attract FDI through a liberal industrial policy.

In order to maintain coherence among policies, necessary reforms were made in fiscal, monetary and foreign exchange policies. Specifically, the provision of full convertibility in trade and services sector was an encouraging factor. The Indian currency is fully convertible in the country. More importantly, it has not only agreed to implement effectively all the bilateral and multilateral existing trade treaties but bringing up the new ones into place so as to promote foreign trade. Though export promotion is the core of this policy, it has realized and categorized the need of imports in order to flourish the economic development. It focuses on the sustained foreign trade sector by narrowing down the import-export gap. There are no more restrictions to import raw materials, consumer goods, industrial machinery, and services.

Chapter 4

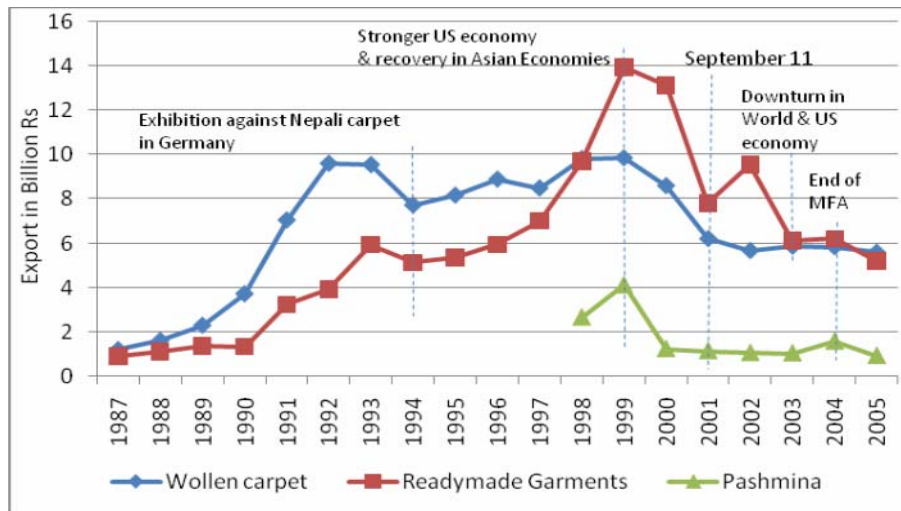
Analysis of Causes of Trade Deficit of Nepal

In order to answer the research question the analysis has been framed in light of the theories discussed in chapter 2. It captures both the external and internal sources of TD. Specifically, external shocks, budget deficit (fiscal policy), excess MS and ER misalignment, direction of economic growth, trade competitiveness, economic liberalisation, landlockedness, and political instability are considered as main focus variables. Comparison of some relevant statistics of Nepal's neighbouring countries and trading partners has also been made as a complement. Since India is a neighbouring country and a main trade partner, its greater influence on Nepalese TB is examined depending on available data.

4.1 External shocks and Trade Deficit

External shocks (mainly from demand and price), as already discussed in section 2.4.4, play a role in the trade and current account balances of a country. Depending upon the nature of external shocks, trade balance of a country is expected to change its direction and magnitude. Figure 4.1 exhibits the pattern of external demand shocks emerged in the world economy and its resultant impact on the export sector of Nepal¹⁵. Since ready-made garment (RMG), woollen carpet and pashmina¹⁶ are three major items of Nepalese export to overseas countries, they have been chosen as focus variables.

Figure 4.1
External Demand Shocks (Key Commodities)



Source: NRB 'Quarterly Economic Bulletin', Various Issues) and MoF 'Economic Survey 2003/04'

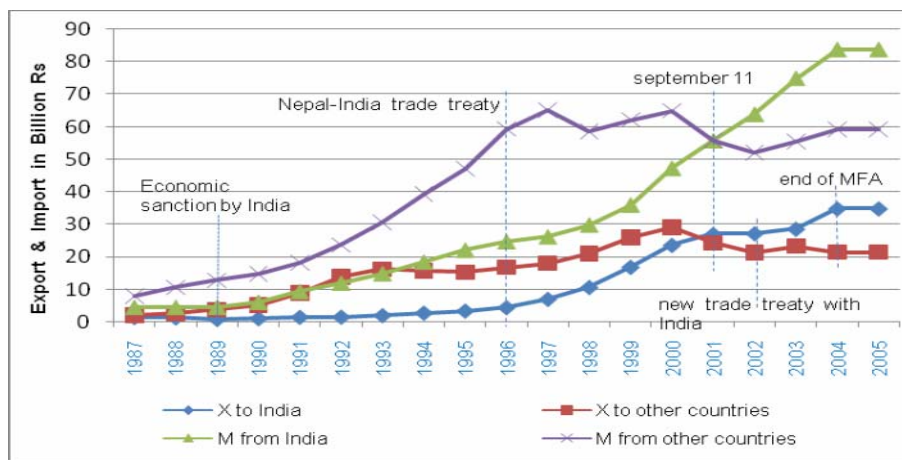
Export of Nepalese carpet and RMG was rapidly increasing until 1993. But as there was an exhibition in Germany regarding the use of child labour in making of Nepalese carpets, and its documentary broadcast by Panorama television news (in April 1994) the demand for which drastically declined in Europe and the US (NESPEC as cited in Chakrabarty 2007: 73). The demand shocks in Nepalese woollen carpet export can best be understood by the following statement:

'One of the main reasons of the carpet shock in 1994-95 was due to anti child labor demonstrations in Germany and other importing countries. Accusations by national and international non-governmental organizations almost led to a complete boycott of Nepal's carpet export' (Chakrabarty 2007: 72).

Nepal could not maintain its fast growing exports of carpet thereafter since Germany and the US were the two biggest importers of Nepalese carpets. Throughout the second half of 1990s, the world and US economy were booming, and the East Asian economies were stepping towards recovery despite the crisis in Russia and Mexico. Their positive effect can be seen in the figure. Exports of both the RMG and woollen carpets reached their peak in those years. The incident of September 11 and its inevitable impact in the US and world economy is quite clear in the figure. Exports of all the three key products have sharply gone down due to decreased demand. Though the export of RMG climbed up in 2002 it could not sustain the same pace and position due to the next downturn in the world and the US economy 2003. Another demand shocks for Nepalese exports appeared in 2005 when the Multi Fibre Agreement was terminated in December 2004. The decline in the exports of RMG can be seen in Figure 4.1.

Besides, the impact of these demand shocks can be seen even in the overall exports and imports to other countries but not necessarily to India (Figure 4.2).

Figure 4.2
External Demand Shocks: India and Overseas Countries (All Commodities)

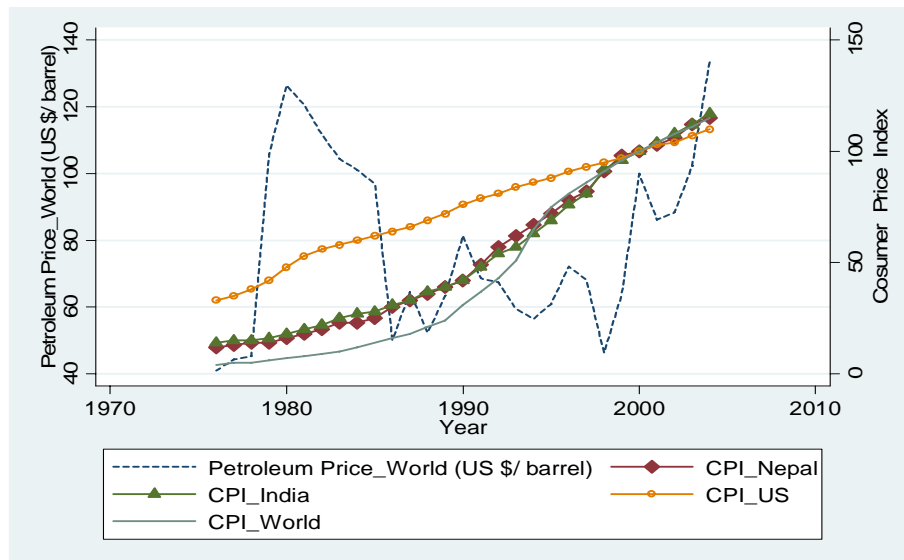


Data Source: NRB, 'Quarterly Economic Bulletin' Various Issues

The external demand shocks resulting from the 'carpet shock' in 1994/95 and September-11 were strong enough to influence the total export to overseas countries; however, they produced low or no impact on the export to India. The impact of termination of MFA is also seen in the aggregate exports to overseas countries. The demand shock in Indian market for Nepalese products was apparent in 1989-90 when India imposed an economic sanction on Nepal. Likewise, the demand for four key commodities of Nepal in India was largely contracted due to the restrictive quota provision in the renewed bilateral trade treaty 2002. Mohanty (2003) also sees the role of trade and transit treaty on India's trade surplus with Nepal. To sum up, demand shocks are heavier and responsive to the exports to overseas countries. These shocks are relatively less responsive in case of India. Furthermore, it is possible that the impact of those external shocks could have retained some leverage from the domestic 'shocks' like the royal massacre in 2001 and the Maoist insurgency during 1996-2006.

Another face of external shocks is price shock that can hit the trade balance of a country. The impact of price shocks in Nepal, as in other countries, is generally transmitted from the rise in the price of petroleum products. Though terms of trade is a good measure to examine the effect of price shocks, due to unavailability of longer time-series data, I have chosen annual consumer price indices (CPI) of Nepal, India, the US and the world as a proxy. These indices have been plotted against the average price of crude oil in the world (Figure 4.3).

Figure 4.3
Oil Price Shocks, Inflation and Direction of Nepal's Foreign Trade

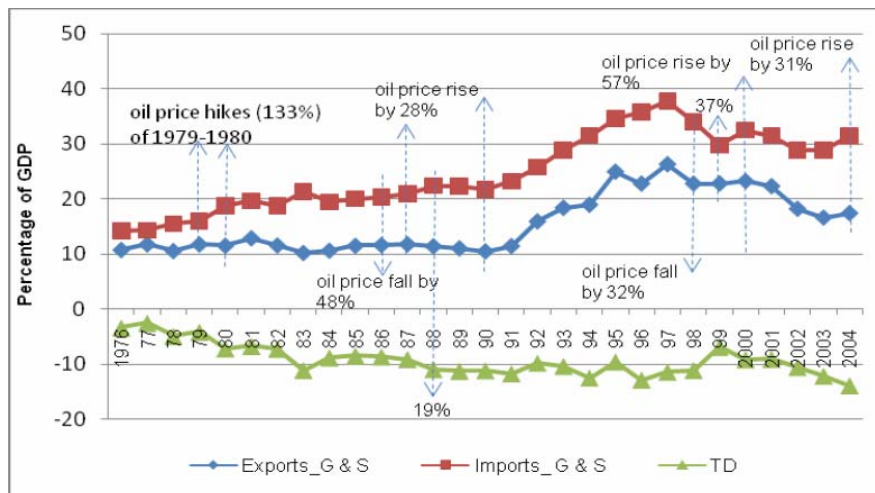


Source: IMF 'International Financial Statistics CD-ROM' and WB, 'WDI-2007'

Inflation in the world and Nepal has not shown a noticeable shift in their inflation curves despite the oscillatory prices of crude oil including the biggest

hike in 1979-1980 and two other soaring peaks in 2000 and 2004. The inflation in India was almost the same with Nepal while it was remarkably high in the US until mid 1990s. It is true that the inflation in Nepal was significantly higher than the world until 1994. From 1995 onwards the gap between them is small. Given the historic 133% rise in 1979 and another 18% rise in 1980 in the price of petroleum, the rate of change in CPI of Nepal is small. Some possible reasons could be the limited extent of integration (in 1979-80) with the global economy, smaller size of external trade and foreign dependence, and smaller demand for petroleum products. Interestingly, despite the sharp fall in oil price in 1986 and 1998 the world's as well as Nepal's inflation has continued to rise as usual. Logically, Nepalese exports due to higher rate of inflation at home than in the rest of the world are less competitive and hence TD is not a surprise. Accordingly, as the world and domestic inflation are almost the same after 1995, there cannot be seen a uniform improvement in the ongoing TD (Figure 4.4).

Figure 4.4
International Price of Petroleum and Trade Performance of Nepal



Source: WB, 'WDI-2007'

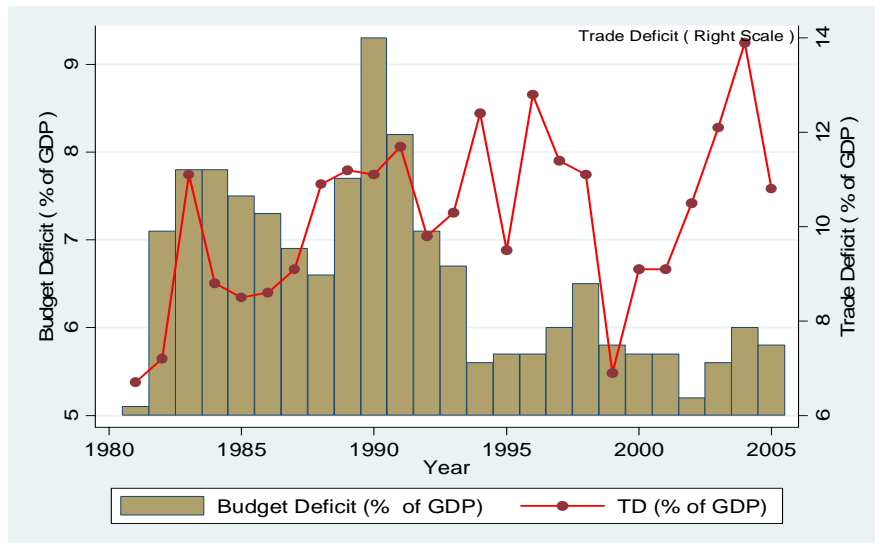
Given the significant rise in price of oil, the amount of import bill has naturally gone up in most of the cases like 1979-80, 2000 and 2004. On the other hand, irrespective of a few exceptions, exports have either contracted or gone insignificant changes. The corresponding increase in TD after the oil price rise is vivid in the years 1980, 2000 and 2004 but surprisingly TD has improved in 1999 despite 37% rise in petroleum. Increase in oil price has not always and immediately led to proportionate rise in TD, for example, in 1979, 1987 and 1990. It is clear from the figure that the inflation brought about by oil price is immediately hitting the import basket but not strongly the export basket. This response is, however, enough to produce a TD since the gap between them widens. And, for a fall in oil price, TD has either declined (in 1998) or stopped from worsening (as in 1986). Likewise, for a relatively smaller

fall in oil price as in 1988, the TD has not been prevented from rising. To sum up, the external price shocks produced by the surge in petroleum price, on average and depending upon the magnitude of rise, is widening the ongoing trend of TD. However, in cases with relatively smaller price hikes, these shocks are not able to produce significant differences.

4.2 Budget Deficit and Trade Deficit

The relationship between budget deficit (BD) and TD (also known as twin deficits) in Nepal has been plotted in Figure 4.5. It is hard to find any unidirectional or bidirectional relationship between these two variables in Nepalese context.

Figure 4.5
The Twin (Budget and Trade) Deficits



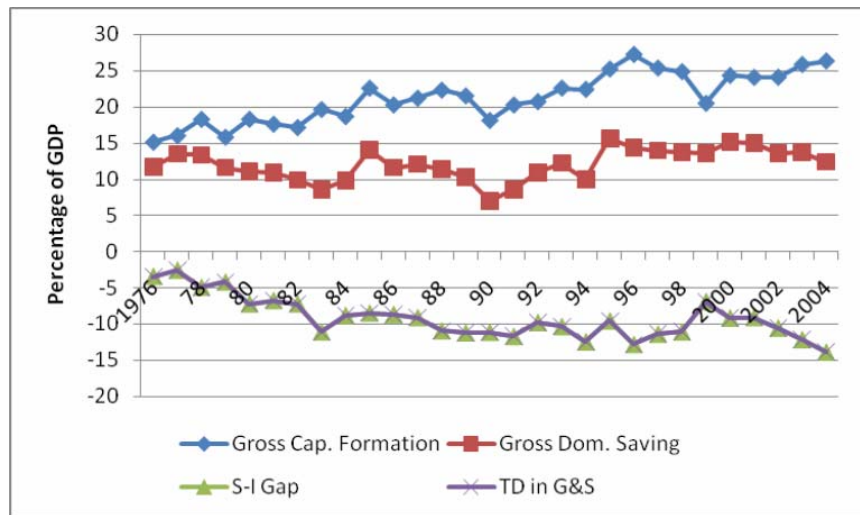
Data Source: MoF, Nepal, 'A Collection of Budget Speeches of Twenty-six Years'¹⁷ (in Nepali) & WB, 'WDI-2007'

There are limited cases where an increase in BD has pushed up the trade deficits or vice versa. For example, from 1981-83 and 2002-05 they have followed similar direction, regardless of magnitude. In other cases, they are exhibiting the reverse directions, for example, 1985-88, 1992-94 or 1995-98. Likewise, the BD during 1982-90 and during 1996-2005 is fairly stable except some exceptions. But, the TD is more volatile. After the stabilisation policy in 1984, the BD has improved for some years but the TD continued to scale up. It can be seen that BD has heavily controlled after 1993, however, the trade deficit kept on swinging. In 1990, there was a new political system (and government) in the country, which adopted an expansionary fiscal policy but the TD remained almost same. In sum, BD in Nepal, do not exhibit a strong

and convincing cause for the ongoing TD. Their movements are hard to predict and contradictory to the previous findings of similar nature.

The role of fiscal policy can also be examined from the size and direction of gross domestic savings (GDS) and investments. As already discussed in chapter 2, the gap between them (Saving and Investment) resembles the exact size of the TD (in Goods & Services) which is distinct in the graph (Figure 4.6). It is obvious from the figure that the gross capital formation has always been higher than the GDS during the study period.

Figure 4.6
Saving-Investment Gap and Trade Balance



Source: WB, 'WDI-2007'

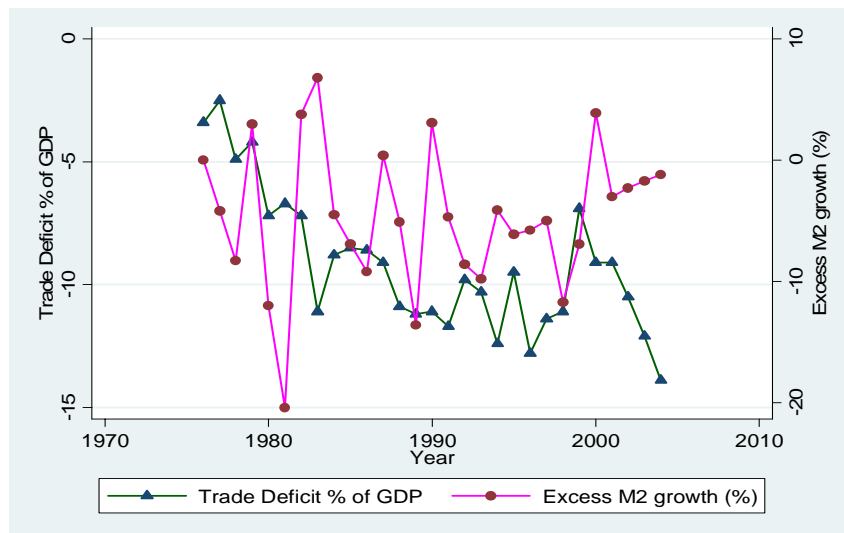
In the figure we notice that these two variables are neither always following the same direction nor maintaining the same gap. In some years, investments are more dominant to determine the size and direction of TD while in other cases savings are more dominant. For number of occasions, they have maintained the same gap thereby keeping the TD fairly stable. Compared to investment, the savings in the economy are found either decreasing or constant irrespective of some exceptional years. It is fair to argue that the negative savings in the public sector (BD) was one of the possible explanations for decreasing or low GDS. The average GDS (1976-04) is around 12% which is too low to cope with the average gross investment of 21 per cent.

4.3 Excess Money Supply and Trade Deficit

As discussed in chapter 2, monetarists believe that excess MS has direct and positive relationship with trade and current account deficit. Figure 4.7 shows the trend of excess MS¹⁸ and TB during 1976-2004 in Nepal. From the graph, it has been clear that these two variables in the context of Nepal are not displaying uniform or consistent movements. For example, given the increase in excess M2 (or broad-money)¹⁹ for 13 occasions, (1979, 1982-83, 1987, 1990,

1994, 1996-97, 1999-00 and 2002-04) the TD has increased 10 times while it decreased in 3 occasions. Similarly, given a decline in excess M2 during 15 occasions, the TD has increased and decreased seven occasions each but remained unchanged once. Furthermore, the magnitude of change in the TD is not same for every change in the excess MS²⁰.

Figure 4.7
Excess Money Supply and Trade Balance



Data source: NRB, 'Quarterly Economic Bulletin and WB, 'WDI-2007'

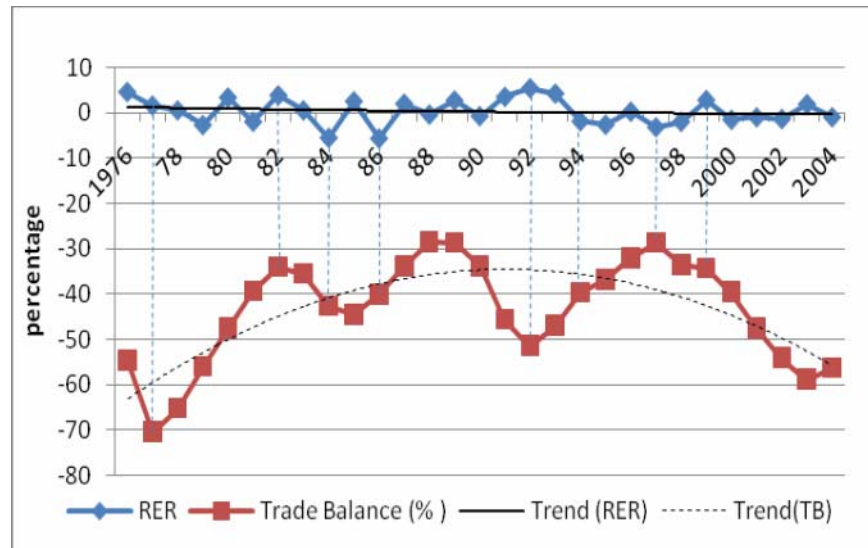
Hence, the TD is changing its direction (and magnitude) not on a uniform and adequate pattern to support the theory of monetarists. It has, of course, contradicted with some previous studies and questioned any causal relationship between the excess MS and TD in Nepal.

4.4 Real Exchange Rate and Trade Deficit

The RER is considered as one of the determinants of a country's foreign trade, trade and current account balances. In case of Nepal, during 1973-1983, Nepalese Rupee (NRe) was dual pegged with Indian Rupee (IRe) and the US dollar. From 1993 onwards, the NRe has been pegged with IRe. All other foreign currencies are cross-pegged with Indian currency. There is full convertibility for Indian currency while other currencies are convertible for specific purposes. The full convertibility with Indian currency has arguably promoted more trade with India. As Nepal's key export products are based on imported raw materials, any depreciation of NRe with the IRe can have damaging effect to Nepal's export since they will raise the cost of production. Figure 4.8 depicts the trend of over or undervaluation of real exchange rate (RER)²¹ and trade balance with India.

Contrary to the longer oscillations and lesser volatility of TB, the RER has smaller oscillations²² but relatively more volatility. Stated otherwise, the magnitude of change in TB is higher than the RER. For example, given the undervaluation in 1977, the deficit scaled by almost 16 percentage points. Similarly in 1984, deficit soared by 7 percentage points despite the undervaluation by 6 percentage points.

Figure 4.8
Movement of RER and Trade Balance with India²³



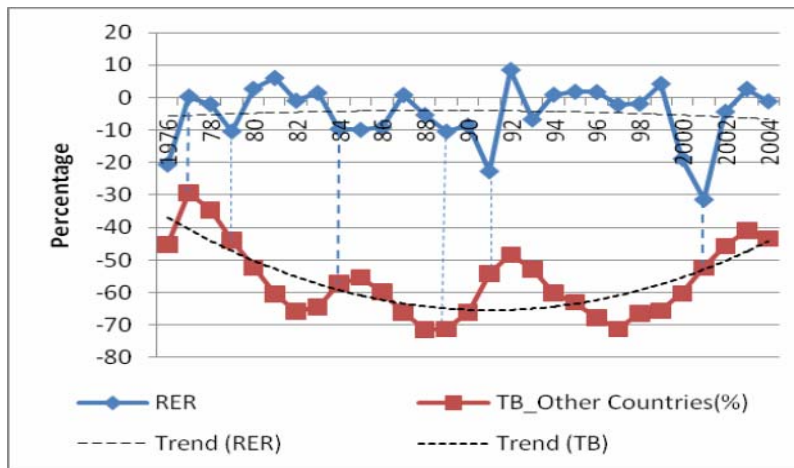
Data Sources: NRB, WB, 'WDI-2007' and author's calculation

The positive impact of undervaluation can be easily noticed in 1986, 1988, 1994, 1995, 1997 and 2004. The overvaluation and resultant worsening of TD are distinct in the years 1992 and 2000. Given a negative and weak correlation coefficient (-0.18) it is easy to understand a non-linear relationship between them. Saruni (2007) in case of Tanzania had found that undervaluation of RER worsened the TD. And, in case of Nepal, Devkota (n.d.) found no significant role of RER in promoting the export. From the discussion, I would argue that the ER is not a strong factor to be attributed as one of the causes of the TD in Nepal. It would be a weak policy measure to correct the Nepal-India TD. The effect of overvaluation or undervaluation of RER depends on given elasticity (greater or lesser) regarding the demand for imports and exports (Thirwall as cited in Purohit 2007: 20).

Figure 4.9 captures the relationship between the RER movement and TB with other countries. Here too, the two trend lines of TB and RER exhibit different patterns. Despite the smaller magnitude of over and undervaluation of domestic currency, TB has been, as in the earlier case, swinging without a consistent pattern. A small correlation coefficient (0.06) has indicated a non-linear relationship between them as also displayed by the figure. is too low to support a linear relationship. Nevertheless, this relationship contradicts with

similar research, for example, Calderón et al. (1999) while analysing the CA deficit of developing countries found that appreciation (depreciation) of local currency increases (decreases) the CA deficit.

Figure 4.9
Movement of RER and Trade Balance with Other Countries



Data Source: WB, 'WDI 2007' and author's calculation

From the discussion, I would argue that the ER has less influence on the TB with other countries. It is possible that due to the elasticity effect of goods in export and import baskets, the power of RER is not effective as it would be. Or, it is equally likely, as Devkota (n.d.) argues, that ER is not a proper means to check TD for Nepal because of its larger import and a smaller export base. Hence, ER could not be a strong policy tool to boost the export of Nepal and overcome the deficit.

Notably, the Kathmandu Post (2 June 2003), analysing the ongoing ER regime, states that an automatic appreciation of NRe with the US dollar resulting from the appreciation of IRe is damaging for Nepalese exports. In contrast, corresponding devaluation of NRe is not easy to raise export competitiveness since they are very likely to produce cost-push inflation in the economy.

4.5 Trade Liberalisation and Trade Deficit

Given a trade/GDP ratio of nearly 50%, an average tariff rate of around 14% and almost no non-tariff barriers makes Nepal as one of the most liberalised and trade-dependent economies in South Asia (IFWG 2003: 8). The process of economic (and trade) liberalisation started in 1985 and geared up after 1990. By 2004 (the year of WTO membership), Nepal continued to broaden the openness and pushed down tariff walls and other kinds of import restrictions. However, when the domestic manufacturing sector is in its infant stage and the country is foreign-source dependent for development finance, the costs of

liberalisation may outweigh its benefits. After 1991, both the exports and import increased significantly compared to the previous decade but it could not minimize the gap between them (see Figure 3.6).

Table 4.1 shows Nepal's average periodic TB before and after the liberalisation.

Table 4.1
Trade Balance Before and After Liberalisation

Period	Average Trade Balance in G & S (% of GDP)	Remarks
1976-84	-6.2	Before liberalisation
1985-91	-10.2	1 st phase of liberalisation
1992-04	-10.7	2 nd phase of liberalisation
2005-07	-18.6	After WTO membership

Data Source: WB, 'WDI- 2007', CBS (Nepal)

The increasing trend of TD after the economic liberalisation is distinct from the table. Every successive phase of liberalisation in Nepal has been followed by removal or minimization of tariff and non-tariff barriers, encouraged foreign capital inflow, and privatization of public enterprises. The positive relationship between economic liberalisation and the TD is visible from the table. However, we cannot undermine the ancillary impacts of other factors such as Maoist insurgency after 1996 which demolished many economic infrastructures of the country. Likewise the frequent blockades and Nepal-*bandh* during the royal coup regime (2002-05) could also be responsible to some extent. In sum, there could be cumulative role of liberalisation and political instability for the growing TD after 1992 but in the first phase of liberalisation (1985-91), there were no such visible factors to charge except the liberalisation. The experiences of Tanzania and other countries (see section 2.2) also show that TD worsened after liberalisation.

In contrast, Table 4.2 presents the TB in neighbouring countries that does not reveal the same story. The average TD in Bangladesh and Pakistan after the liberalisation has remarkably declined in both phases whereas in case of India, it has increased (decreased) in the first (second) phase. Hence, the generalisation, on the basis of averages, has become a complex job. Nevertheless, there are two important differences in this comparison. Firstly, the reference periods are not the same with Nepal. Secondly, the nature and degree of liberalisation (which is beyond the scope of this paper) plays a vital role to reach an inference.

Table 4.2
Trade Balance in Neighbouring Countries: Before and After Liberalisation

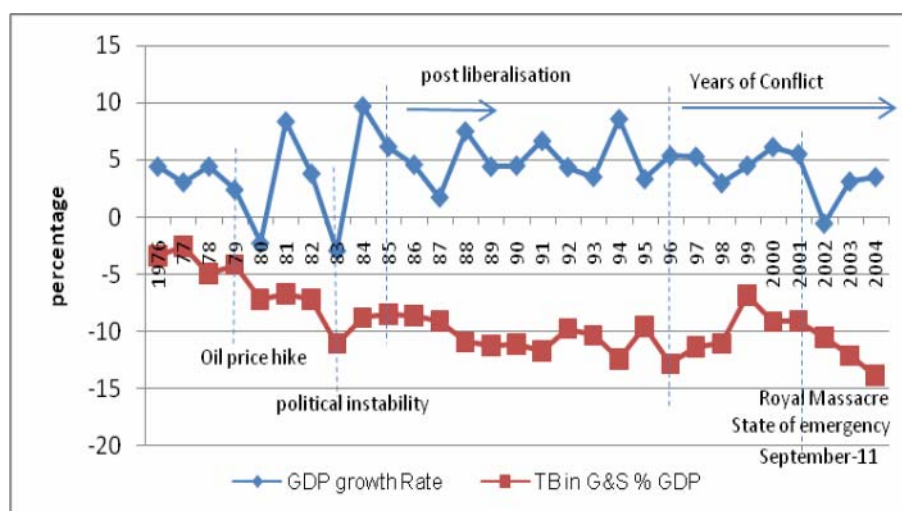
	Period (phase)	Average TB in G & S (% of GDP)	Remarks
Bangladesh	1972-82	-8.7	pre-liberalisation
	1983-90(1)	-7.8	post-liberalisation
	1991-04(2)	-5.6	
India	1965-74	-1.2	pre-liberalisation
	1975-90(1)	-1.7	post-liberalisation
	1991-04(2)	-1.1	
Pakistan	1976-91	-9.5	pre-liberalisation
	1992-96(1)	-3.9	post-liberalisation
	1997-04(2)	-1.9	

Source: WB, 'WDI-2007' and author's calculation

4.6 Economic Growth and Trade Deficit

The EG and TB over the years of Nepal have been plotted in Figure 4.10. In contrast to the TD, the economic growth (EG) rate of Nepal has never reached double digits (the maximum is 9.7% in 1984). As discussed in section 2.4.5, a higher EG is expected to necessitate more imports of capital and consumer goods (and services) thereby leading to a higher TD.

Figure 4.10
Economic Growth and Trade Balance



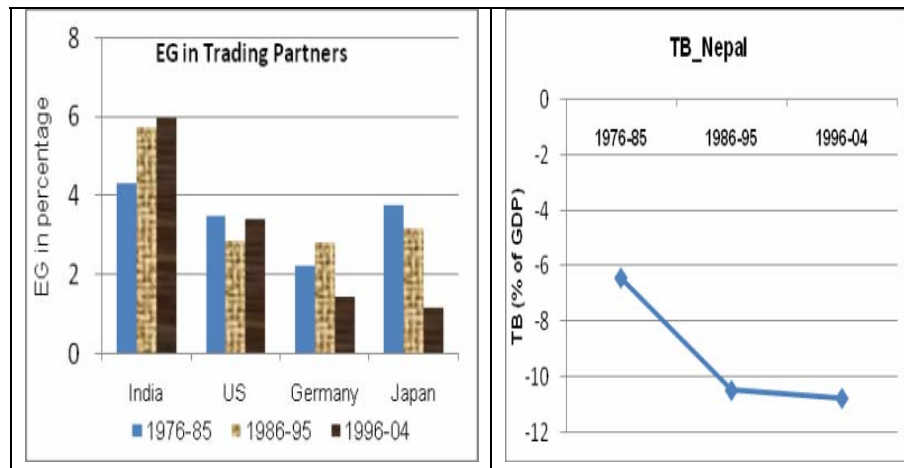
Source: WB, 'WDI-2007'

There are limited cases (for example, in 1988, 1994, 1996, 2000) when an increase in EG has worsened the TD. On the contrary, given the decrease in EG (for example, in 1977, 1980, 1983, 2002) the TD has worsened remarkably.

In remaining years, these two variables are changing the direction nominally or irrespective of the magnitude of changes in each other. One can put his/her argument differently that despite a higher TD, EG has not declined rather increased. The graph, however, does not indicate a clear linear relationship between EG and TD²⁴. But, in comparing the average EG and TD of other SAARC²⁵ countries, a different relationship appears. Nepal's average TD (-9.0%) during 1976-2003 is more than double against the weighted average TD (-4.1%) of five South Asian countries. On the other hand, Nepal's average EG (4.2%) of the same period is significantly less than the weighted average EG (7.0%) of those five countries. It has given ground to argue that a higher TD is likely to cause a slower EG and vice versa. To sum up, the EG rate of the country has no clear leverage to magnify its TD.

Figure 4.11 examines the interrelationship between average EG rate of trading partners and TB of Nepal. Specifically, the figure shows whether or not higher (lower) economic growth in trading partners dampen (worsen) the TD of Nepal due to increased (declined) demand for domestic exports.

Figure 4.11
Economic Growth in Major Trading Partners and TB in Nepal



Source: WB, 'WDI-2007' and author's calculation

Given the increasing EG of India (the biggest trading partner) in successive years; Nepal's TD has been increasing which contradicts with the theory in general (see 2.4.5). Similarly, the movement of EG rates in the US and Germany (second and third biggest trading partner respectively) too do not reflect a uniform response with Nepla's TD. Regardless of the magnitude, Japan has decreasing EG over the years which is somewhat consistent with decreasing TD of Nepal in the same period. As such, there appears no visible relationship between high/low economic growth of trading partners and improving/worsening TD of Nepal. The contradiction might have emerged

from the fact that Nepal's exports to and imports from these countries are too small (in their total trade) to exhibit any consistent pattern.

4.7 Lack of Competitiveness and Trade Deficit

Apart from diversification of product and destination, competitiveness is considered to be one of the major determinants of Nepal's TD (see Section 2.3). Trade competitiveness, in a narrow sense, is primarily linked with average cost effectiveness and productivity. Concurrent fiscal, monetary and trade policies; financial and physical infrastructures, availability and quality of raw materials and human resources are vital determinants of competitiveness. Nepal is a labour-abundant country and hence its labour cost is competitive among the neighbouring countries, however, labour productivity is quite low (Table 4.3).

Table 4.3
Annual Percentage Change of Labour Costs and Labour Productivity of Eight Asian Countries²⁶

Country	Labour Costs	Labour Productivity
Nepal	0.5	4.2
India	2.1	4.4
China	9.0	10.1
Indonesia	8.1	8.2
Thailand	8.4	10.7
Sri Lanka	5.3	0.8
Malaysia	9.1	9.2
Philippines	7.4	10.1

Source: United Nations Industrial Development Organization (UNIDO), *Year Book of Industrial Statistics 2001* and International Labour Organization (ILO) *Year Book of Labour Statistics 2001* in IFWG (2003)

Since Nepal exhibits the lowest growth rate of wages depicted in Table 4.3, the unit labour cost is the lowest among these eight countries. Despite the low labour cost per worker, Nepalese manufacturing sector is passing through a minimum value-added per worker compared to other Asian countries (Table 4.4). Despite the advantages of low unit-cost per labour, Nepal has smaller labour productivity among its neighbouring (and competitor) countries. This low productivity has led to a higher unit-cost of labour in the list (column C).

Table 4.4
Index of Cost Competitiveness Indicators of Nine Asian Countries, 1999

Country	Labour Cost per Worker (A) ²⁷	Value Added per Worker (B)	Unit Labour Cost (C)
Nepal	100	100	100
India	130	205	81
China	180	271	72
Bangladesh	110	130	90
Indonesia	120	276	87
Thailand	480	390	94
Sri Lanka	160	195	105
Malaysia	960	909	93
Philippines	600	742	93

Source: UNIDO, *Yearbook of Industrial Statistics 20001* and ILO, *Yearbook of Labour Statistics 2001* in IFWG (2003)

Likewise, Nepal's competitiveness in regard to infrastructural cost is also higher compared to its neighbouring countries (Table 4.5). On the one hand, the supply of electricity is not regular due to load-shedding, and on the other, the tariff rate is remarkably higher than neighbouring countries.

Table 4.5
Comparative Cost of Electricity and Water Use

Country	Electricity Tariffs \$/kWh (2000)		Water Tariffs for Industrial Use \$/Cubic Meter
	Avg. Overall Tariff	Industrial Tariff	
Nepal	0.093	0.084	0.331 to 0.357
India	0.043	0.064	0.14 to 0.224
Bangladesh	0.041	0.068	0.246
Pakistan	0.065	-	0.074 to 0.191
Sri Lanka	0.079	-	0.14

Source: IFWG (2003)

The Logistics Performance Index (LPI), Global Competitiveness Index (GCI) and World Governance Index (WGI) are believed to intensively measure the challenges and opportunities in the trade performances of countries. Compared to its neighbours (also competitors) and trading partners, Nepal stands the weakest competitor in LPI and GCI while it is relatively better than India but weaker than others in WGI (Table 4.6).

Table 4.6
Logistic Performance Index: Neighbouring Countries and Trading Partners

Index	Ranking			TB in 2004 (% of GDP) ²⁸
	LPI (overall, 2008) ²⁹	GCI (2007-08) in Rank	WGI (Ease of doing business, 2007) ³⁰	
Nepal	2.14	126	111	-13.9
Bangladesh	2.47	111	107	-5.3
India	3.07	50	120	-3.4
Pakistan	2.62	101	76	1.1
Sri Lanka	2.40	77	101	-9.1
China	3.32	30	83	2.6
Japan	4.02	9	12	1.6
USA	3.85	1	3	-4.5
Germany	4.10	7	20	4.9

Source: WB, 'World Trade Indicators-2008' and World Economic Forum, 'Global Competitiveness Report 2008-09'

On the table, higher score in LPI is better than the lower one while smaller score is better in regard to GCI and WGI. The better index (and TB) of developed and emerging nations, on the one hand, and the poor position (and worsening TD) of Nepal, on the other, is easily understandable from the table. Furthermore Nepal, in general, exhibits a weaker competitor (and higher TD; see Table 3.5) among the five countries of SAARC. To conclude, lack of competitiveness is one of the key determinants of TD of Nepal.

4.8 Landlocked Geography and Trade Deficit

As discussed in section 2.3 and 2.4.7, landlockedness makes a country's imports and exports more expensive. Nepal's landlockedness is unique in nature since it is surrounded by India in the East, South and West and by China in the North. The inland transportation with China is confined to few transit points due to the difficult terrain of the *Himalyas* and inadequate road networks. Nepalese exporters have to pay up to 20% more in transportation cost and they bear 50% longer time for delivery of their supplies compared to other suppliers within the region (Shaakha 2008: 235). It fuels the TD via reduced (increased) exports (imports).

In line with the UNCTAD's report (2007: 167), I would argue that the economies of landlocked countries are bound to shrink with low volume of trade which do not benefit from the benefit of economies of scale in transportation. Among others, the reasons for a smaller volume of Nepalese trade are limited road networks, transport facilities, risks and uncertainties, and the size of the market. In Table 4.7, TB of five (landlocked and coastal) South Asian countries has been shown.

Table 4.7
TB of South-Asian Landlocked and Coastal Countries

Category		TB in % of GDP (Periodic Average)		Weighted ³¹ Average (1981-2002) TB % of GDP
		1981-91	1992-02	
Landlocked Countries (LLCs)	Nepal	-9.5	-10.3	-10.5
	Bhutan	-22.1	-16.2	
	Afghanistan	n.a.	n.a.	
Coastal Countries	Bangladesh	-8.0	-5.6	-6.7
	Pakistan	-9.2	-2.6	
	Sri Lanka	-11.7	-8.6	

Data source: WB, 'WDI-2007' and author's calculation

From the table, the individual TD of LLCs in 1981-91 and 1992-02 is higher than the coastal countries ignoring the one exception of Nepal and Sri Lanka (in 1981-91). Moreover, the average TD of LLCs throughout 1981-02 is 3.8 percentage points higher than the coastal countries in the region. Hence, the cross-country comparison has left a ground to attribute the landlockedness as one of the subsidiary determinants of Nepalese TD, which could have direct implication with the economies of scale and competitiveness of the country.

4.9 Conflict and Trade Deficit

During the period of conflict (1996-06), there were undeniably other factors at function which could also influence the TB of the country. Specifically, all the factors discussed in earlier sub-sections were active at the same time. Hence, the causality between conflict and TD is difficult to quantify. And, the effect of conflict is less likely to appear immediately. In observing Figure 3.3 we do not see a significant change in the ongoing TD in goods. The deficit slightly worsened in 1997 but it improved dramatically in 1998 and 2000. Actually, the conflict was not intensified in those initial years and the favourable Nepal-India Trade Treaty signed in 1996 was most likely ameliorating negative effects from the conflict. In 2001, the conflict was in its apex and the TD again faced a downturn exacerbated by other equally stronger factors, viz., September-11 (terrorist attack in the US) and the Royal family tragedy in 2001. Moreover, the renewed trade treaty with India in 2002 was an impediment to the export of some key products of Nepal to India (MoF, 2003/04). The trade in service, however, reveals a continuous (except 1999) downturn after 1997 until 2002 (Figure 3.3). Tourism industry, the major source of service, was severely affected by the conflict which could otherwise compensate some of the deficit in goods (see Figure 3.4, left panel). The average TB in goods and services before and during the conflict has been summarized in Table 4.8.

Table 4.8
Trade Balance in Goods and Services (% of GDP) in Conflict Period

TB	Nine Years Before Conflict (1987-95)	Nine Years During Conflict ³²		
		1996-2000 (Beginning phase)	2001-04 (Peak phase)	1996-04
Goods	-14.1	-19.7	-15.0	-17.6
Services	3.1	9.3	2.0	6.0
Good and Services	-10.7	-10.3	-11.4	-10.8

Source: WB, 'WDI-2007' and author's calculation

The deficit in goods during the conflict years is higher than the pre-conflict period. Surplus in services remarkably climbed up even in the beginning of conflict. But the worsening effect of conflict is very distinct in the peak phase of conflict where services have sharply declined by 7.3% points. On average, the deficit in goods and services before and during the conflict is almost same. Nevertheless, in the absence of cross-country comparisons and/or application of some econometric model the findings might hold a methodological bias.

Chapter 5

Conclusion and Policy Recommendations

This research paper began with one principal objective and one research question. It solely aimed at answering the principal causes of TD of Nepal. Two hypotheses were made. The first hypothesis was founded on the role of external shocks. Both the demand and price shocks – two main components of external shocks – were analysed to the extent of their visible impacts on Nepalese exports and imports. The second hypothesis was on the foundation of internal bottlenecks; mainly the economic, geographical and political factors.

5.1 Conclusion

The causes of TD in Nepal begin from the existing structure of the foreign trade. It suffers from an absence of export diversification in terms of commodities in particular, and destinations in general. Moreover, the exports basket comprises mainly those commodities which are price-elastic. In contrast, the imports basket includes a full range of diversified products ranging from basic consumption goods to various high-tech commodities that are relatively price-inelastic.

In 1967, Nepal's TD in terms of GDP was almost zero (0.1%) per cent but it never regained that position until 2004. Not only the TD with India grew larger but it also continued after late 1990s. The deficit with other countries (in aggregate) is also high (56% on average). Merchandise trade is found always in deficit while the service sector was in surplus ranging from one to thirteen per cent of GDP. Nevertheless, the surplus in service account was not sufficient to ameliorate the deficit in merchandise. During most of the study period, the income account, though volatile, stood positive. The size of the TD of Nepal is found significantly higher than its neighbouring and other major trading partners.

In regard to validation of the first hypothesis, the analysis provided a ground to attribute the external shocks as stronger causes of TD in Nepal. However, the impacts of these shocks in Nepalese TB are of different magnitudes. Some stronger demand shocks that resulted from the rejection of Nepalese carpets in Germany (in 1994-95), the US and other European countries due to the alleged child-labour use were very powerful in intensifying the TD in late nineties and succeeding years. Similarly, the demand shocks from the aftermath of the September-11 attack (2001), recessionary trends in the US and global economy (in 2002) and the ending of MFA (2004) were also potent to expand the deficits further. It is found that the TD improved alongside stronger US and global economy. In regard to demand shocks from India (there are few cases), there is observed a relatively smaller impact. Particularly, the economic sanction imposed by India on Nepal and the restrictive quota provision in the renewed Trade Treaty 2002 are mentionable. Undeniably, the resultant impacts of demand shocks on TB were stronger but

those factors were not solely responsible. These shocks were much stronger in hitting the exports to overseas countries rather than India. In addition, the price shocks, especially brought about by surge in oil prices were, on average, effective in demonstrating a visible deterioration in the TD. The magnitude of oil-price hikes was important in determining the size of effects. In a number of cases, these price shocks were unable to prove their presence in worsening the TD.

In regard to the second hypothesis, internal factors are also found stronger to determine the direction of TB. But some of them had low or no significant effect. The paper does not see causation between BD and TD. Given the decreasing size of BD in some years, the TD did not exhibit any improvements. Hence, controlling of BD may not serve as a good policy tool to improve the TD.

From saving-investment perspective, it is found that the former, on average, is 9% point lower than the later. In a developing economy like Nepal higher investment (domestic and foreign) is naturally preferred (in normal condition) hence the TD could be attributed to low rate of domestic savings. Accordingly, contrary to conventional theory, this study could not establish a clear and uniform relationship of TD with excess MS and RER. Even in the case of fixed ER regime between India and Nepal, as there are some arguments that Nepalese currency is overvalued, the analysis does not capture a convincing relationship. The ER, thus may not be a stronger policy option to promote the exports in case of Nepal.

Interestingly, the paper uncovers that the average TD of Nepal has been worsening alongside the process of economic liberalisation. Although there were other internal and external factors in play; during 1985-91 the economic liberalisation stood as one of the causes of TD. The findings contradict with the experiences of other South Asian countries where TD has been declining over the years. As the degree, duration and nature of liberalisation do matter, the findings are hard to reject fully. The volume of trade, however, increased (albeit decline in some years of late 1990s) sharply after the liberalisation.

As the paper assessed the causality between TD and economic growth in home country and in major trading partners, if any, no such convincing evidence is found. Nevertheless, an improvement in the US and global economy helped promote the exports of key commodities to overseas countries. In regard to the contribution of higher economic growth (in home country) in magnifying the TD, as argued by some theories and empirics, this paper does not find such causality. Rather, it noticed a slower economic growth given a higher TD. Specifically, it noticed a lower TD and relatively higher economic growth in neighbouring countries.

It is argued in some Nepalese literatures that the lack of competitiveness in merchandise trade is another principal cause of TD. This study has found that Nepal is fairly better in terms of unit-labour cost but productivity is low compared to its trading partners and neighbouring countries. Furthermore, it is a weak competitor in terms of two main indices of competitiveness – the Logistics Performance Index and Global Competitiveness Index.

The paper identifies that the landlocked countries in South Asia including Nepal have higher TD compared to coastal countries of the same region.

Finally, the paper examined the average TD before and after the inception of conflict in the country. The TB in services sharply declined during the peak period of conflict but remarkably increased in the beginning phase. Similarly, the deficit in goods further scaled in that period. However, the overall TB in goods and services during the nine years before and after the conflict was almost the same. After the new trade treaty with India in 2002, the exports of some manufactured goods declined sharply and TD worsened further.

To sum up, Nepal's TB is frequently responsive to external demand and price shocks. Nevertheless, these shocks are not the sole forces in determining the magnitude and direction of Nepalese TB but the internal forces are also influential. Hence, the interplays and overlapping of external and internal forces are the principal causes of Nepalese TD. Surely, during some periods the external shocks are seen dominant and during other internal forces are observed powerful.

5.2 Recommendations

On the basis of overall analysis, the following policy recommendations are made:

Firstly, improvement in the trade structure of the country is a must, which, in turn, requires diversification of exports in terms of commodities and destinations that can help in mitigating the external shocks. The Official publication of the government of Nepal itself acknowledges the damaging effects of Nepal-India Trade Treaty 2002 on Nepalese exports to India. It suggests a better assessment of far-reaching impacts before signing off any bilateral or multi-lateral trade treaties in the future.

Secondly, lack of competitiveness is an immense problem of the manufacturing industry which requires, among others, good infrastructure, skilled human resources, procurement of quality raw materials, favourable fiscal and monetary policies, efficient bureaucracy and investment in research and development.

Thirdly, though not enough to ameliorate the deficit in merchandise trade, the trade in services has always accrued surpluses which resemble a good potential and seek priorities accordingly.

Fourthly, there could be two possible ways to minimize the ongoing level of TD, viz., (i) imports substitution or (ii) exports promotion or both. Nepal's excessive dependency on foreign goods (including raw materials) restricts the scope of imports substitution. In a globalized world and for a member of WTO, exports promotion would be a first choice for Nepal.

Finally, Nepal's trade policy seems sound but is lacking in quality in terms of implementation, evaluation and effective monitoring.

Recommendation for Further Research:

Since the TD with India has been high (44% of total deficit, on average) for a long period the impact study of existing fixed ER regime (after 1993) on Nepalese foreign trade is overdue.

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Notes

¹ According to available data

² In merchandise trade

³ Ministry of Industry, Commerce and Supplies, Nepal

⁴ United Nations Conference on Trade and Development

⁵ Asian Development Bank

⁶ South Asia Watch on Trade, Economics and Environment

⁷ supported by IMF, ITC, UNCTAD, UNDP, WTO and the WB.

⁸ Ministry of Finance

⁹ other than India

¹⁰ Friedman's equation is expressed as $MV = PQ$ or $P = (M/Q).V$ where M, V, P and Q stand for quantity of money, velocity of the money, price level and real output respectively.

¹¹ For monetarists, money is a stock which comprises notes, coins and current account deposit in the banking system also known as M1.

¹² M1 does not capture other monetary measures like credits, bonds, non-commercial bank deposits and securities.

¹³ Combined data for two successive fiscal years, for example 1996/97 and 1997/98

¹⁴ except some exceptions

¹⁵ Commodity wide data are available only after 1987.

¹⁶ No data are available prior to 1998

¹⁷ Fiscal year adjusted into calendar year

¹⁸ The excess MS is calculated as:

Excess MS = (% change in M2 growth - % Change in Real GDP at constant Price)

¹⁹ M2 comprises sum of currency outside banking sector including demand, time, saving and foreign currency deposits of resident sector other than government.

²⁰ The correlation coefficients of the BD to excess MS, and M2 to TD are observed - 0.1 and -0.39 respectively.

²¹ It has been calculated as follows:

$RER = (\% \Delta CPI_D - \% \Delta CPI_{TP}) - \% \Delta NER$, where CPI_D , CPI_{TP} and NER stand for consumer price index of domestic and trading partners, and nominal ER respectively.

In case of other countries different weight has been assigned to the US, Germany, Japan, France and the UK depending on Nepalese exports to them.

²² In the Figure, movements above (below) the x-axis are overvaluation (undervaluation).

²³ Deficit in merchandise trade

²⁴ correlation coefficient = - 0.07

²⁵ South Asian Association for Regional Cooperation that includes Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka.

²⁶ During 1990s

²⁷ A= average labour cost per worker manufacturing, B= value added per unit of labour, C = labour cost per unit of output manufacturing according to the internationally accepted definition of the US Department of Commerce.

²⁸ The data for the USA and Japan is of 2003.

²⁹ It includes, among others, efficiencies in custom and boarder procedures, quality of transports, logistic competence, domestic and international transport costs, number of documents for exports and imports, and days and costs of exports and imports.

³⁰ It is, among others, a main component of this index.

³¹ On the basis of GDP size.

³² Data are available until 2004.

Appendices

Appendix-A Imports of some Major Commodities from India (In Million Rupees)

Item	Two-year Total				
	1996-97	1998-99	2000-01	2002-03	2004-05
Petroleum Products	0	153.6	24137.3	38981.1	59710.7
Textiles	3108.3	5822	7445.7	7461.7	0
Vehicles & Spare Parts	3729.7	5718.1	8894.5	8806.0	10570.8
Medicine	4575.2	5947.9	5669.5	6566.6	7824.8
Other Machinery & Parts	4176.5	4589.9	3974.3	5867.1	7465
M.S. Billet	n.a.	1530.1	5781.5	7774.7	7277.2
Cement	2665.2	3154.3	4934.7	5253.6	4391
Chemicals	3017.7	3807.1	2901	4470.2	5676.6
Agri. Equipment & Parts	731.7	1400.7	1099.9	1187.4	1102.9
Thread	1676.8	2321.5	2389.2	2109.7	4987.7
Cold/Hot-rolled Sheet in coil	n.a.	133.9	3674.6	9424.8	4882.2
Agricultural Products	5331.7	9411.7	6355.6	8225.2	11797
Others	42373.2	59895.5	72309.7	77174.6	88681.9
Total	52184.3	71779.8	111323	149663.7	195818.6
Growth Rate(%)	n.a.	37.6	55.1	34.4	30.8

Source: Nepal *Rashtra* Bank, 'Quarterly Economic Bulletin, Various Issues

Appendix-B
Imports of some Major Commodities from Other Countries (In Million Rupees)

Items	Two-year Total				
	1996-97	1998-99	2000-01	2002-03	2004-05
Agricultural Products	3639.1	3252.41	4004.7	6517.1	5358
Gold & Silver	47983.8	16550.9	7335	470.7	309.1
Petroleum Products	15254.8	16305.9	736.4	581.5	789.8
Other Machinery and Parts	6343.2	6707.1	5592	4396.4	5608.2
Textiles	2081.9	3560.6	4846.4	4784.1	5925.1
Polythene Granules	1953.8	2626.8	4042.3	5634.7	5903.4
Transport Equip. Parts	3386.5	4055	4065.2	3310.1	4063.2
Threads	1238.9	4804.1	5729.8	3433.6	4701.3
Medicine	931.1	980.6	1295.6	1202.4	1810.5
Aircraft Spare parts	1714.1	2671.1	2546.1	3297.3	2276.2
Readymade Garments	609.5	1734.7	2470.5	1887.9	4129.3
Copper wire rod, scrappers & Sheets	1239.8	2104.2	6205.8	1842.5	3338.3
Computer Parts	898.5	1163.4	3656.1	2694.4	2475.9
Raw wool and silk	6308.9	5592.1	3318.9	3729.2	3508.2
Electrical Goods	3149	3778.9	2922.8	3060.1	4172.4
Telecommunication Equip. Parts	2639.2	2616.4	2320.3	4842.7	4230
Others	30999	45746.19	50665.3	59280.8	68836.4
Total	130371.1	124250.4	111753.2	110965.5	127435.3
Growth Rate	-	-4.7	-10.1	-0.7	14.8

Data Source: Nepal Rashtra Bank, 'Quarterly Economic Bulletin', Various Issues

Appendix-C
Correlation Coefficients Between Various Variables: Neighbouring countries

	Correlation Coefficients			Mean	
	TB-Economic Growth	Inflation-TB	M2-TB	TB	Economic Growth
Bangladesh	0.2156	-0.1894	0.7412	-7.27	4.4
China	-0.1824	-0.6209	0.5828	1.02	9.26
India	-0.0817	0.1789	0.0182	-1.4	5.31
Nepal	-0.0755	-0.1183	-0.6195	-9.17	4.19
Pakistan	-0.4636	0.4679	-0.1262	-6.2	5.1
Sri Lanka	-0.1273	-0.5243	-0.1132	-9.51	4.63

Data Source: WB, 'WDI-2007' and author's calculation

Appendix-D
Worker's Remittance Growth in Nepal (in Thousand US dollar)

Year	Amount	Year	Amount
1993	55000	1999	83000
1994	50000	2000	111000
1995	57000	2001	147000
1996	44000	2002	678000
1997	49000	2003	771100
1998	68000	2004	822600

*Source:*WB, 'WDI-2007'

Appendix-E
Restrictive Provision in 'India-Nepal Foreign Treaty of Trade Agreement 2002'

Annexure " C "		
Nepalese manufactured articles allowed entry into India free of customs duties on a fixed quota basis.		
Sl.no.	Nepalese Article	Quantity in MT per year
1	Vegetable fats (Vanaspati)	100, 000 (One hundred thousand)
2	Acrylic Yarn	10, 000 (Ten thousand)
3	Copper products under Chapters 74 Heading 85.44 of the H.S. Code	10,000 (Ten thousand)
4	Zinc Oxide	2,500 (two thousand five hundred)
<p>a. Imports into India of the above four commodities for quantities in excess of the fixed quota mentioned above will be permitted under normal MFN rates of duty, notwithstanding any concession in any other preferential arrangement.</p>		
<p>b. Imports into India of the above commodities will be permitted through the land Customs Stations (LCS) at Kakarbhitta/Naxalbari, Biratnagar/Jogbani, Birganj/Raxaul, Bhairahawa/Nautanwa, Nepalgunj/Nepalgunj Road and Mahendranagar/Banbasa.</p>		
<p>c. The detailed administrative arrangements for operationalisation of the fixed quota i.e. identifying the agencies for allocation and monitoring of exports and imports of fixed quota will be finalised by both the Governments.</p>		

Source: <http://www.infodriveindia.com/Exim/Trade-Agreement/India-Nepal-Free-Trade-Agreement.aspx> (accessed on 18 October 2008)