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Nepal's Widening Trade Deficit

(Some Issues, Challenges and Recommendations)

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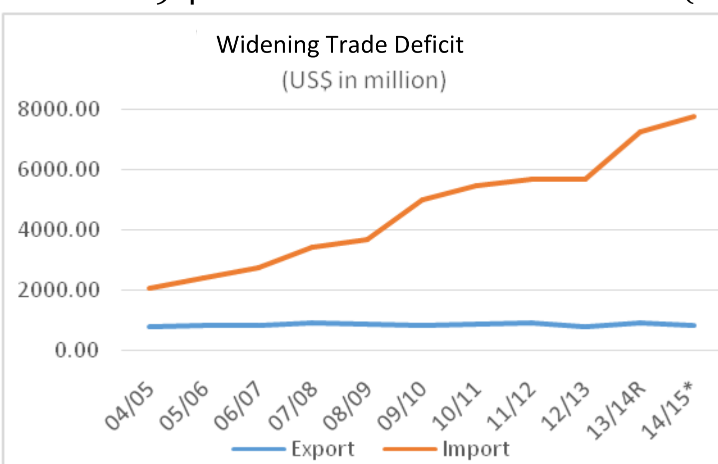
1. Context and Status

The growing and continued mismatch between import and export have resulted in an alarming level of trade deficit in Nepal. Over the years, export has almost been stagnated, and the import skyrocketed. From 1:3 until a decade ago, Nepal's import is now 9 times bigger than export. Available statistics show that the total export, which used to be 9.4% of the Gross Domestic Product (GDP) a decade ago, has squeezed to 5.2%, whereas import has swelled to almost 40 percent GDP- in fiscal year 2004/05 it was 35 percent. During the last decade, import increased by 4.8 folds to Rs. 775 billion whereas export went up just by 1.4 folds to Rs 85 billion. As a result, trade deficit swelled by 6 times in the last one decade and has reached to Rs. 689 billion. The current Three Year Plan, ending on 15 July 2016, aimed at maintaining a trade deficit of 20 percent of the GDP, however, the preliminary estimates and the data indicate such deficit to be around 35 percent of the GDP.



India continued to command a major share in Nepal's foreign trade. With Indian economy's growth accelerating and manufacturing as well as industrial base enhanced further and strengthened, India's share in Nepal's total merchandise trade in the last fiscal year increased to 64 percent - in 2003-4, it was 58 percent. China's trading share with Nepal also doubled in the last 5 years to 12 percent - around one-fifth of the trade with India. The share of other countries continued to decline to 26 percent of Nepal's total trade last year, with Nepal shifting its long-running

*. *Contributions from Dr. Krishna Prasad Acharya and Mr. Prem Khanal are well recognized.*

dependency on other countries for the imports of vehicles and machinery, equipment, among others, to India.

The slow growth in export compared to the robust growth in import remains a major concern for Nepal to benefit from trade. The average growth in export was 4.2% in the last decade whereas growth in import during the same period was 18.2 percent. India continued to be the largest export destination of Nepalese goods and services with absorbing 66 percent of Nepal's export. In terms of commodities exported, textiles is the largest export to India followed by zinc sheet, polyester yarn, juice and jute products. These five commodities represented 42 percent of the total exports to India in the last fiscal year. Despite being the second largest economy and northern neighbor, China absorbed only 2.8% of Nepal's total export on average in the last three years. Tanned skin, handicraft, woolen carpet and noodles are major commodities exported to China. Countries other than India and China absorbed almost a quarter of the total export in the last one decade. Woolen carpet, readymade garments, pashmina and pulses occupied almost half of the total exports to other countries.

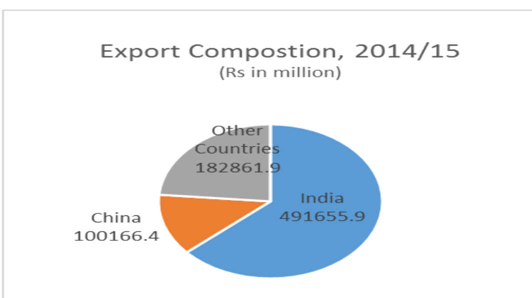
Similarly, import recorded a robust growth of over 18 percent, on average, over the last decade, also triggered and prompted by remittance supported consumption. Import from India was 64 percent of Nepal's total import. And, from China it was 12 percent. Nepal imported 24 percent from countries other than India and China. Oil and the petroleum products, imported from India accounted for 22 percent of import from India and 14 percent of total import of last year. The value of oil and petroleum products last year was Rs. 110 billion - 18 percent less than the previous year. This decline was due to a decline in price of petrol in the international market. Again, the value of oil and petroleum products import was more than the total value of goods and services Nepal exported. The other major items of import from India included are vehicles and spare parts, MS billet, and rice and paddy. Telecommunication equipment is the largest import from China followed by electrical goods, machinery parts and chemical fertilizer. With an import value of Rs. 24 billion, silver topped the list of goods imported from other countries last year. Aircraft's spare parts, crude soybean oil, polythene granules, silver and gold are other major imports from other countries.

2. Issues and Challenges

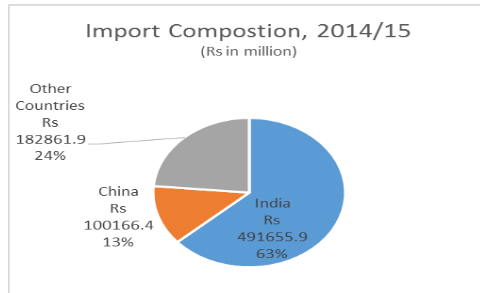
High cost of production coupled with poor access to international markets are some of the major constraints to expand Nepal's export base. In addition, Nepal's limited exportable items, such as carpet and readymade garments that used to command over two-third of total overseas export have lately lost shine. Indo-Nepal trade treaty has provided opportunities for duty-quota-free access of the majority of exportable goods to India. However, despite having strong export potentialities to some States of India, Nepal lacks the production of commodities that can compete in the Indian markets. Northern neighbor China has also offered similar arrangement, but the story is more or less same. Following are the major issues that limit export prospects.

a. **Export performance of manufactured goods is very dismal and depressing.** A steady decline in overall export has portrait a dismal indication in the foreign trade sector. The share of total export in the GDP declined to 5% in 2014-15 from 10% a decade ago, and from 15 percent one and half decade ago. Though merchandise exports, in domestic currency, grew by an average of 4.2% during the last one decade, in an US dollar terms, it was less than 1% during the same period. The main reason for the decline is the shrinking number of exportable commodities that can compete in the international market. About 85 percent of the total export used to be manufactured goods about seven years ago but the ratios shrunk to 78 percent in the last fiscal year. Growing share of agriculture products in total export basket reflects that Nepal's competitiveness in manufactured goods has weakened over the years. In addition, there is virtually no change in the types of finished products or commodities that Nepal has been exporting during the last two decades. However, trade in service has increased over the last five years.

b. **Consumption also prompted by remittance help swelling of imports**. Despite sluggish economic growth, demand in Nepal remained strong in the last one decade, due mainly to remittance earning by migrant workers. In dollar terms, the average annual growth of remittance including pension was 21 percent in the last decade. Nepal received US$ 6.63 billion worth of remittance last year, which was 11.38 percent, more than the amount that Nepal received in the previous year, and was equivalent to 31 percent of the GDP. The whopping flow of remittance in the economy propelled disposable income to grow by 13 percent annually on average in the last 10 years. However, in the absence of domestic industries capable to seize the opportunities in meeting increased demand of basic goods such as construction materials, household goods and clothing, among others, Nepal had no options but to import such items. Because of this, total import in dollar terms increased by 3.3 times in the last one decade with average annual growth of 15% percent. As the export growth in dollar terms remained almost stagnant, Nepal recorded an alarming level of trade deficit.



c. **Nepalese industrial bases have been enfolded and squeezed**. It is usually seen that when an economy starts modernizing, a normal trend seen worldwide, the share of agriculture sector to the GDP shrinks while the contribution of service and industrial sector increases and widens. However, available data show(s) that Nepal is not in foot prints that almost all the economies worldwide followed in their development history. Shrinking industrial activities is one of the disturbing features of Nepal's economy. The industrial sector that used to contribute 18 percent to the GDP a decade ago has squeezed - 15 percent in last year. The contribution of industry group to GDP stood 14.1 percent in 2010-2011 whereas the contribution of manufacturing to GDP was 6.5 % - annual average growth rate of 2.5% in the manufacturing sector in the last decade. A decreased from 10 percent to 6.5 % of the manufacturing sector's contribution to GDP indicates that industrialization in Nepal is very much sluggish. This also indicates that Nepal's industries failed to capitalize the opportunities unveiled by the remittance-fueled consumption in the domestic economy, compelling the domestic economy to depend on imports to meet increased internal demand, let alone producing goods for exports.



d. **Nepal lacks exportable production from volume, value and quantitative perspectives**. Nepal has been requesting for a duty - free as well as quota -free access of its products to various markets. However, attention has not been paid and no efforts have been made to producing high quality products to be able to compete in the international market. About 33 items - 26 in the category of goods and 7 in the category of service, have been identified as products with higher potentialities, no concrete efforts have been made to make goods and service readily available for exports. No seriousness has been shown on market research and market development. Nepal boarders with five States of India which are also the most populous region of India. With the bilateral Nepal -India Free Trade Treaty in place, Nepal is in a perfect position to tap the market of 400 million people with per capita income of US$1,340, which is almost twice of Nepal's per capita income. However, owing to the lack of policy and strategies to explore rapidly emerging business opportunities in such a huge market, Nepal hasn't been able to reap the benefits. With Indian economy advancing more and more toward shifting priority to producing products with higher profit margin from lower profit margin products, Nepal could benefit from exporting products with low-profit-margin-daily household commodities, such as readymade garments and slippers, among others. Though the size of population is small compared to Indian cities, adjoining Chinese cities where consumerism is rapidly growing, also provide good business opportunities. In addition, the European Union has given duty-free as well as quota-free access to all exportable items under its 'Everything but Arms' initiative. Adequate efforts have also not been made to benefit from Trade and Investment Framework Agreement (TIFA) Nepal signed with the United States and from BIPA agreements signed with other countries.

e. **Both trade related as well as other infrastructures remain inadequate and in poor condition**. Probably, the status of poor infrastructure is the biggest constraint that is limiting the prospects of industrialization in Nepal. Along with the lack of access to sea that adds around 15% to transit related transit cost in export compared to the countries that have access to sea, shortage of electricity, reliable road network, and access of finance have all work against to make Nepalese products competitive in the global markets. The shortage of electricity is forcing firms to operate at far less than the captive capacity. Those industries that can afford diesel power plant increases the cost of production, thereby eroding cost competitiveness. Studies have shown that the power produced by such plants using diesel as inputs are five times more expensive than the electricity. In addition, owing to lack of round-the-clock supply of power, industries utilize only about half of the productive capacity, if they opt not to have diesel generators. According to the Enterprise Survey, 2013, about 69 percent of firms identified electricity as a major constraint. The percentage of firms using a generator jumped to 50.5 percent in 2013 from 15.8 percent in 2009. Similarly, one-third of the manufacturing firms identified bad transport facility as a major constraint. In addition, the lack of adequate facilities for warehouses, handling equipment, scanning machines, and testing laboratories, have limited the prospects of export potentials.

f. **Nepal continues to struggle with poor business doing environment**. Nepal's long-running political instability has produced many ills. Industrial unrests and strikes that are often orchestrated by somehow politicalized trade unions are some of them. As a result, industrialists are often forced to talk to outsiders such as political leaders to settle unrests and strikes in their factories. Unpredictable strikes and unrests have made exporters struggling all the time to meet supply deadlines set by foreign buyers. Such activities also further add to cost of production and erode competiveness. According to Doing Business 2014, Nepal has the highest export lead time (days) in the region, as it needs 11 documents, 42 days and costs US$2,295 to export a container. Similarly, rigid labor policy that bars enterprises to adjust labor force as per the change in demand in the market. As per existing law, employees get permanent status after working for more than 240 days and after getting a permanent status, they can't be fired until they are proven engaged in criminal activities. The provision has become a recipe of disaster for order-based industries such as readymade garments and woolen rugs and season-based industry such as tourism and hotels. Enterprises are compelled to keep on paying to the laborers even during the lean seasons, something that swells cost of doing business.

g. **Nepal's quarantine certificates are not recognized by the importers.** Nepal has a huge potential of exporting agro-products to China and India. But both the countries do not recognize quarantine certificates issued by Nepal's laboratories because they do not meet international standard. As a result, agricultural products, such as fresh vegetables and seasonal fruits have been barred from entering into the neighboring markets just because Nepalese exporters are unable to submit quarantine certificates acceptable to both the countries.

h. **Export incentives are not giving much incentives to exports.** In 2011, the government introduced cash incentive scheme to promote exports. As per the scheme, traders exporting goods to countries other than India are entitled to receive up to 2% of the value of the products as an incentive. Also, those goods with at least 30 per cent domestic value addition qualify for export cash incentive. However, exporters exporting goods to India are not qualified for such incentives, although it accounts for two-thirds of total exports.

3. Recommendations

Promoting export oriented industries have long been a top priority of successive governments and the over the period governments have brought many policies aimed at enhancing exports. However, most of the policies failed to achieve set targets due mainly to lack of basic industrial infrastructures and business friendly environment. The following are the some of the critical recommendations to promote exports of Nepal.

a. **Immediate improvement of basic industrial infrastructures becomes very urgent.** The most crucial constraint for industrialization in Nepal is lack of basic infrastructures, such as adequate electricity and road access, among others. The shortcomings have greatly eroded competiveness of Nepalese products in the domestic market, let alone in the international market. In the wake of strong internal demand and rapid price rise of Chinese goods, experts believe that Nepalese industries would have supplied a sizable chunk of domestic demand of household goods, such as basic readymade garments and textiles, slippers and shoes and basic utensils had there been enough electricity to power industrial activities and road access to connect market places for finished goods and raw materials. So, foremost attention has to be paid in generating additional electricity and expanding road network, critical factors to boost trade.

b. **There is a greater need for creating conducive environment to ease doing business in Nepal.** Industrial unrests and rigid labor laws are some of the biggest obstacles to industrialization in Nepal. All three major actors that deal with industrial relations, the government, trade unions and the industrialists have unanimity that there is a need to revise the present labor law and they have been negotiating for years to reform the law. However, despite lengthy talks, no agreement or consensus has reached at. It is high time that the government put extra efforts to bringing all parties on the same page and put serious efforts to bring a flexible as well as business friendly labor law that helps to promote contract-based businesses, such as supply of readymade garments also by providing some sort of social protection to laborers.

c. **Cash incentives being offered to exporters needs to be revisited.** South Asian experiences show that cash incentives can play a very critical role in promoting export by making it competitive. However, the scheme has so far failed to bring any positive contribution in promoting export. Trade experts believe that exclusion of India form the list of the countries eligible for the incentive is the main reason for the gloomy outcomes. Inclusion of India in the list that commands a share of 65 percent in Nepal's foreign trade is a must aspects that Nepal needs to consider immediately. Traders' complains about the inadequate level of incentives compared to incentives provided in other South Asian countries also need to be considered to make Nepalese products competitive.

d. **There is need for establishment of a quarantine lab to be accredited internationally to issue certificates meeting global standards.** In order to capitalize the growing opportunities of agricultural exports such as vegetables, fruits and meat products, particularly to neighboring Indian cities, there is a need to pay an urgent attention in building quarantine labs of international quality in major trading points especially in the trading points of bordering with both India and China. Adhering the guidelines of Codex Alimentarius Commission, a globally recognized body that formulates international food standard, guidelines and codes of practice must be ensured.

e. **Reforms are needed to smoothen cumbersome reimbursement procedures to get duties paid back that traders pay while importing raw materials**. The recently unveiled Trade Policy, 2015 provisioned that the export-oriented industries can get tax refund facilities paid on purchases of raw materials either locally or imported. However, the provision so far has received little response form the exporters as they, based on their past experiences, see lengthy as well as cumbersome official procedures that traders will have to go through to get the refund.

4. Conclusion

Poor infrastructure and the poor business doing environment fueled by lengthening political instability are amongst the major reasons for deindustrialization in Nepal. As a result, domestic industries have not been able to capitalize the opportunity unveiled by robust growth in domestic demand and Indo-Nepal free trade accord that open accesses to 400 million consumers in bordering India.. Hopes are high that the promulgation of a new constitution will mark the end of a decade-long political upheavals. However, it is high time that the government pay urgent attention in improving basic infrastructure, such as electricity and road access.

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