CHAPTER VIII

CONCLUSION

Nepal and India are not merely the immediate neighbouring countries they also have long history of family, cultural, religious and social ties. The tie further strengthened and got impetus after they entered into core economic cooperation through trade, aid and investments.

During the Pre-Modern Period, Nepalese trade was mostly confined with India and Tibet. Due to the lack of industrialization and low effective demands of goods and services the composition and nature of trade was mostly dominated by the agro-based primary products. The trade between India and Tibet highly flourished via the route of Kathmandu Valley to Kuti and Kerung pass of the Himalayas and Kathmandu Valley had owed its prosperity through this trade. Most of the trade was conducted by the Kashmiri Muslims and Hindu Gosains. Nepal was highly benefited through the entrepot trade during those eras and was able to secure high trade surplus with the British India. During the ancient era, due to the lack of developed monetary system, most of the trade was characterized as barter trade. The barter of Nepalese rice with Tibetan salt was very important to note. Though the complete records of trade of that period are very difficult to obtain, various available literatures and statistics show that Nepal had been securing surplus in trade balance with British India until the first quarter of the 20th century.

After the signing of Trade Treaty of 1950 between India and Nepal, Nepal had to follow the “strict Indian tariff policy.” After the Chinese seizure of Tibet, Nepalese trade with Tibet was interrupted and India was left as an only option for Nepal to trade. The Trade Treaty of 1950 arrived at 'Common Market' between India and Nepal stipulating free trade between them, common external tariff, and free mobility of factors of production.¹ This placed an indirect barrier for Nepalese desire of diversifying trade to countries other than India. Data shows that, Nepalese dependence to India in terms of share of total trade ranged from at least from 95 percent to more than 98 percent between

¹ Though the Treaty did not mention anything about the mobility of factors of production, the mobility of labour between India and Nepal, during those days was unrestricted.
1956/57 to 1960/61. After this Treaty, Nepalese trade deficit with India started to grow heavily and the trade deficit has become a general phenomenon thereafter. The Treaty of 1950 was severely criticized in the Nepalese arena saying that it was an unequal and hegemonic Treaty which subdued Nepalese sovereignty.

However, the Treaty of 1950 was renewed in 1960 which provided Nepal freedom to choose its own external tariff structures and the structure of the payment system with the third countries. This shows that these countries moved from a higher economic integration- the 'Common market'- to lesser degree of economic integration- the Free Market.

After the signing of the Treaty of 1960, Nepalese trade with the third countries could not diversify according to their expectation. This is shown by the share of Nepalese trade with India. The data shows that the share of Nepalese trade with India increased from 96.14 percent in 1960/61 to 99.14 percent in 1961/62 and further to 99.25 in 1961/62. The share of trade with India remained more than 96 percent for all the succeeding years until 1968/69. After that the percent of share declined, even though it remained more than 92 percent.

The decade of sixties remained one of the most contentious decade for both the countries. Mostly, the issue of deflection of trade (smuggling) from Nepal to India was the most contentious issue. Nepal had adopted various trade facilitating measures in order to diversify its trade to the third countries. Due to these policies, cheaper third countries' goods flooded into Nepal and took India as the ultimate destination. Focusing the Indian market, various assembling industries and processing units were established in the Terai region of Nepal.

The two-way smuggling, however, was persistent throughout a long history. The most noticeable items involved were the agricultural goods from Nepal to India. However, after the treaty of 1960, the nature of smuggling also shifted from primary agricultural products to manufactured industrial products. Some provisions of the treaty of 1960 provided a loop hole for the business communities to involve in the lucrative entrepot trade. Various liberalized trade and investment facilitation policies adopted by the Nepalese government during the decade of 1960s further paved the way to intensify such trade between the countries. When measures to control such trade were adopted,
their movement started through informal channels transforming the situation from bad to worse. This decade remained a decade of intermittent discord and harmony in the relationship between Nepal and India.

The Treaty of 1960, which expired in 1970, could not be renewed before its expiry due to a number of unresolved contentious issues. Nepalese demand for separate treaties for trade and transit, etc. were the major stumbling blocks for its renewal on time. As the dispute intensified, there resulted a partial blockade from the date of expiry of the Treaty to till its renewal in 1971.

However, Nepal became successful, to some extent, in diversifying its trade after the Treaty of 1971. The share of trade with India reduced to 66.96 percent in 1975/76 and further reduced to 57.37 percent in 1977/78. Both the exports to and imports from India increased substantially compared to previous years. Similarly the exports to countries other than India increased to 292.1 million NRS in 1975/76 from 5.37 million NRS in 1970/71 and the imports from the third countries increased to 754.6 million NRS in 1975/76 from 82.327 million NRS in 1970/71. The exports to India increased to 1185.8 million NRS in 1975/76 from 400.645 million NRS in 1970/71. Similarly imports from India increased to 1227.1 million NRS from 616.754 million NRS during the same period. This shows that despite the decrease in the share of trade with India, the trade volume with India increased tremendously. As this increase in the trade volume with both India and the countries other than India was not due to the productive capacity of the country, the increase in the trade volume provides some insight into the deflection of trade. Goods imported from India were deflected to third countries and similarly goods imported from third countries were deflected to Indian market developing Nepal as a centre of entrepot trade.

However the long waited demand of Nepal for separate Treaties of Trade and Transit fulfilled in 1978. In 1978 two separate treaties on “Trade” and “Transit”, and an “Agreement for Cooperation to Control Unauthorized Trade” on border was signed in New Delhi on 17 March 1978. This treaty was viewed as an improvement over all other earlier Treaties in this respect. The Agreement for Cooperation to Control Unauthorized Trade aimed at discouraging the two-way deflection of goods.
This Treaty succeeded to diversify Nepalese trade to countries other than India reducing its dependence with India. This can be seen by the share of trade. After signing of the Treaty, share of Nepalese trade with India declined substantially throughout each succeeding years. It declined to 49.83 percent in 1979/80 from 53.37 in 1978/79. Ultimately the share of Nepalese trade with India declined to 22.47 percent in 1989/90- the most contentious year in the entire history of Indo-Nepal relation. However, the extent of trade deficit with both India and countries other than India continued to increase substantially.

The year 1990, which restored democracy, became a remarkable year in the history of Nepal. The hostility between the two countries ended and again they tied their hand of cooperation through concluding the Treaty of Trade, the Treaty of Transit and the Agreement of Cooperation to Control Unauthorised Trade on 6th December 1991. The “Treaty of Trade”, the “Treaty of Transit” and the “Agreement on the Cooperation to Control Unauthorized Trade” came into force from the same date to remain in force for a period of five years, seven years and five years respectively. All these Treaties and Agreements retained the same Articles of the former Treaty of 1978 without any alterations. However, the Treaty got some changes in the Protocols only.

According to the Protocol with reference to Article V of the Treaty of Trade of 1991 the provision of value added, for the application of preferential treatment, was lowered down from at least 50 per cent (as stipulated in the 1978 Treaty) to at least 40 percent of the ex-factory price, barring some exceptional cases.

However, later, on 16th February 1993, the Protocol with reference to the Article V of the Trade Treaty of 1991 was replaced by a new Protocol which provided Nepal access to the Indian market free of basic and auxiliary customs duty and quantitative restrictions for all articles manufactured in Nepal which contain not less than 50 percent of the Nepalese labour content, Nepalese material content and the Indian material content in place of previous provision of 80 percent. This Article again lowered down the tariff concessions to the extent of 50 per cent from 55 per cent of the MFN rate of import duty, in the case of other manufactured articles which were not eligible for the preferential treatment, provided that the value added in such articles is at least 40 percent of the ex-factory price.
After the signing of the Trade Treaty of 1991, the share of Nepalese trade with India ranged from around 25 percent to around 30 percent, till the other Treaty was not signed in 1996. Despite double increase in Nepalese exports in 1991/92 compared to in 1990/91 the total trade deficit increased to 18233.5 million NRS in 1991/92 from 15839 million NRS in 1990/91. This increase in trade deficit in 1991/92 is largely attributed to the increase in trade deficit with India due to increase in imports and decrease in exports in that year. The total trade deficit reached up to 70916.9 million NRS in 1996/97 out of which India accounted for 27 percent and other countries for the rest of 73 percent. In this way, growing nature of Nepalese trade deficit further got its impetus during the validity period of the Treaty of 1991.

As the Treaty of Trade 1991 expired on 5 December 1996, it was renewed on 6 December merely revising the Protocol with reference to Article V of the foregoing Treaty of 1991. The Treaty of Trade 1996 was a breakthrough in the history of Indo-Nepal trade, which for the first time provided, access to the Indian market free of customs duties and quantitative restrictions for all articles manufactured in Nepal on the basis of the Certificate of Origin issued by the agency designated by Government of Nepal in the prescribed format for each consignment of articles exported from Nepal to India excluding those which do not fulfill the conditions required by the Certificate of Origin and set aside in the negative list of articles. The requirement of at least 50 percent of Nepalese labour content, Nepalese material content and the Indian material content for preferential entry of Nepalese manufactured into India was completely wiped out. Whereas, MFN status was granted to those articles which did not fulfill the conditions required by the Certificate of Origin and placed in the negative list.

Immediately after the signing of Trade Treaty of 1996, the share of Nepalese trade with India started to swing up. The share of trade with India which was 25.89 percent in 1996/97 increased to 31.18 percent in 1997/98 and increased further thereafter and reached up to 55.86 in 2002/03. Both import from and export to India increased in each succeeding years. However, the import- export ratio, on an average, remained more than double throughout the validity period of the Trade Treaty.

The Trade Treaty of 1996 which was scheduled to expire on 5th December 2001 could not get renewed before its expiry due to some contentions between the countries.
The major point of contention was the surge in Nepalese exports to India of Nepalese products like acrylic yarn, Zinc oxide, vegetable ghee, steel pipes and copper winding wires. However, the existing Treaty was extended for three months from 6th December 2001 to 5th March 2001 and renewed with effect from 6th March 2002 for a period of further five years.

The Treaty of 2002 imposed quantitative restrictions for four Nepalese products, viz., Acrylic Yarn (10,000 MT per year), Copper Wire (7500 MT per year), Vegetable Ghee (100000 MT per year) and Zinc Oxide (2500 MT per year). It abrogated the provision of no requirement of value addition for the Nepalese manufactures (stipulated by the former Treaty) and reintroduced the provision of value addition of at least 25 percent up to 5th March 2003 and at least 30 percent thereafter, of the ex-factory price.

Even after signing the Trade Treaty of 2002, the share of Nepalese trade continued to increase in each year, and both exports to and import from India increased but the ratio of imports over exports remained more than double for all the years.

Though the history of cooperation through aid and investment is comparatively very recent, yet it has played a significant role to strengthen the relationship between these countries. The history of Indian aid to Nepal though started since the British period, got momentum with the fall of Rana oligarchy regime in general and with the establishment of Nepalese diplomatic relationship with Republic of China in 1 August 1955 and Nepalese agreement with China for the construction of road from Tibet to Kathmandu in particular. Indian aid to Nepal has been remained a significant aspect of cooperation. India tried to speed up the development process of Nepal through assisting in numerous infrastructure building projects. The assistance for the development of transportation system, communication, water resources and human resources are most appreciable and notable assistance provided by India.

Even though, Indian economic aid to Nepal seemed apparently altruistic, in real sense it is a strategic investment to deter the Chinese and other Western influence in Nepal. Besides this, the great economic interest behind India’s aid to Nepal is the immense hydropower potentiality of perpetual Nepalese river system. India could be benefited by the Nepalese river system from exploiting them for the generation of hydroelectricity as well as for the development of its agricultural system through
increased irrigation facilities. However, it cannot be ignored that Indian aid for the development of infrastructure—a prerequisite for the development of economy—has produced large economies of scale in the production and distributional aspect of the country. Enhancement in transportation, communication and other modern facilities lowered the cost of transportation and thereby increased the economies of scale that is needed for the sustainable development of the country. Moreover, since few decades, India has been providing grants to Nepal. These grants are not liable to pay and also have contributed largely to the balance of payments of Nepal.

As, aid cannot be a perpetual source of earning foreign currencies, the foreign investment has occupied one of the most important factors for the earnings of foreign currencies, augmenting infrastructural development, increasing productive capacities and thereby enhancing the global competitiveness of a country, and improving the balance of payments of that country. Liberalized investment policy helps to increase the volume of foreign investment. Nepal has been earning foreign currencies from foreign investment since years. Along with this, it also has helped to alleviate poverty significantly by generating employment for the poor unskilled labour.

The history of Indian investment in Nepal dates back to Rana period when the Biratnagar Jute Mills was set up with Indian collaboration for the first time. During the Rana period, a number of individual Indian investors and groups were successful to exploit the cheap labour and raw materials by investing in Nepal. The trend of Indian investment continued till the Panchayati System and got its impetus after the restoration of democracy in 1990 in Nepal. The basic nature of the Indian investment is that it is highly attracted towards the high yielding cheap projects like garments, hotel & restaurant and services sectors. Indian investment was attracted to garment industries especially in the late 1970s. Among all investor countries, Indian foreign investment is the highest in terms of invested amount, employment generation and also in terms of numbers. Indian investment has contributed significantly to the balance of payments of Nepal.

Foreign investment has both benefits and drawbacks. It generates employment, contributes to government revenue, brings modern technology to the country, increases the human and social welfare through the mobilization of the unutilized resources,
contributes for the economic growth, and improves the balance of payments through capital inflow, increase in the exports and substitution in the imports. But the drawbacks are that it demands high level of subsidies in the form of exemption of custom duties, and other taxes. The foreign investors also demand tax holidays and complete autonomy from the government. Not only this, these highly capital deepening projects destroy the traditional method of production making them incompetent in the market and makes the society consumerist. In manufacturing sector they can generate employment for mass unskilled labour but in service sector they need very trained and skillful manpower. So the service sector cannot provide expected employment for the rural poor people. They are motivated only by maximizing their own welfare maximizing their profits. Therefore, the government has to make a proper cost- benefit analysis before providing permission to any foreign investment. To accept foreign investment unconditionally in the name of showing a government’s efficiency is short sighted.

Peoples’ migration and remittance are worldwide phenomenon. These days, remittance has become an important source of earning foreign currency for the developing countries. On the one hand it assists to improve the balance of payments by supplying scarce foreign currencies in the country and on the other helps for the alleviation of poverty of the individual recipient households.

The phenomenon of Nepalese migrating to India for better life and opportunities is a general phenomenon. For most of the poor Nepalese, India has been becoming a destination of earning money through getting employment. Though, they earn very less compared to the people migrating to third countries for job, the remittance they transfer to Nepal is yet significant.

Still there are challenges for the government of the receiving country. Most of the remittances come from informal channel of transfer making the estimation unrealistic. Hundii is one of the major challenges in this field. This also helps to flourish an underground network that diverts the precious foreign currencies to the hands of smugglers and other criminals. The practice of using informal channels can be discouraged by providing cheap and reliable banking facilities.

It is frequently observed that, people working abroad are being cheated by their employer and also discriminated by the government of that country. All the workers
migrated abroad from the South Asia are facing common problem of cheating and discriminating there. Therefore, it is strongly recommended to all the South Asian countries to make a common policy for the security of the migrated people for employment abroad.

The amount of remittance is directly related to the nature of job, country of destination and the skills of the workers. Therefore, the Nepalese government must facilitate such programmes which increase the skill of the manpower.

In a situation of no hope of competing with the developed countries in the manufacturing and services, the developing countries have some advantages from remittance coming from the former. This has become one of the major weighted items in the balance of payments which is helpful to reduce the current account deficit of the developing countries. Thus, it has become imperative to the workers supplier countries to make an efficient management of migration and remittance.

Tourism sector has been becoming an important sector of earning foreign currencies, generating employment, increasing trade and improving balance of payments. Nepal has been formulating various policies and plans for the development of this sector. Due to the richness in natural beauties, cultural heritage, and due hospitality Nepal has been developed as a dreamland for visitors of other places. The Nepali culture is guided by the principle of Atithi Devo Bhava that is “Guests are God.” In this context there are ample opportunities to develop this sector as a sector of comparative advantage. The importance of the sector cannot be ignored in the situation of decreasing performance of exporting trade and commercial activities– the area in which Nepal is very incompetent and inefficient.

Despite of formulation of various policies and plans to attract tourists from different places of the world, the increase in the tourism is not according to the expectation. The large factor for this can be attributed to unwanted situation that has been developing in the country. Hijacking of one of the plane of Indian Airlines, escalation of Maoist insurgency and the infamous Royal massacre put the destination in the condition of turmoil. Moreover, the frequent and unprecedented general strike, political instability and lack of efficient state affairs, added oil in the burning fire. Despite all such
difficulties, the number of tourists and their length of stay did not decrease much significantly. This proves how important is the destination for tourism.

Besides security problem, tourists are facing some other infrastructural problems in Nepal. Facilities to them are not appropriate. For example, most of the good quality hotels and guesthouses are located in city areas. Lack of trained guide and good transportation system is long felt problem in this areas. Similarly, lack of cheap package tours and imposition of high charge in the accession to Mt. Everest in comparison to the Chinese Government, there is high possibility of diversion of tourist inflow towards that way. On the other hand it is strongly felt that most of the tourist comes to Nepal to save their income rather than to make expenditures. Low paid hotels and low paid markets have been becoming their important places to save money. Therefore, the policy is to made to attract high quality tourists rather than low quality tourists. Higher quality tourists are attracted only if they are provided a good infrastructures and well-off facilities. Indian tourists for the purpose of pilgrimage are not much advantageous for the purpose of earning income. But the business groups and individual are going there for their business purposes to change black money into white money through casino activities. Therefore, the government should take proper initiatives to control such kind of activities with the help of Indian government. Only few individuals from the business sector are benefited from such activities but neither government benefits. No substantial employments and no substantial income are generated from such activities.

Regarding to the overall balance of payments of Nepal with India, despite significant net earnings from transfers and services, the current account and thereby the overall balance of payments remained adverse in most of the years which compelled the country to purchase Indian currencies at the cost of the convertible currencies. In some years the trade deficit with India remained more than 10 percent of GDP and reached up to 16 percent of GDP in 1990/91. Nepalese trade deficit with India is found to be the foremost source for the current account deficit of Nepal with India.

Due to the policy of non-dissemination taken by Nepalese authority which is emanated mostly from some ‘Psychological Fear’, it is very hard to find, from direct Nepalese source, bilateral data of Nepalese balance of payments with India separately. However, the International Monetary Fund (IMF) provides the Nepal- India bilateral
balance of payments data in its publication of Country Report in dollars terms, which are needed to convert in NRS term for making comparison easier with all others data which are published in the Nepalese currency. Nevertheless, due to the change in exchange rate of NRS vis-à-vis US $, sometimes it has been experienced that even if the earnings in dollar terms remained constant for any two years or more, earnings in terms of NRS for those years increased or decreased according to the fluctuation in exchange rate. For example, for two consecutive years 1999/00 and 2000/01, Nepalese net earnings from services and income account remained the same to the extent of 46 million dollar. However, when they are converted to Nepalese currency multiplying both by corresponding exchange rates for those years, the net earnings from services and income increased from 3270.32 million NRS in 1999/00 to 3447.65 million NRS in 2000/01—an increase by 5.42 percent contrary to no increase in terms of dollar. Similarly, in 1994/95 and 1995/96, total of net earnings remained constant to the extent of 208 million US $. However, when converted these earnings in NRS, the net earning increased, contrary to no change in earnings in dollar term, from 10793.12 million NRS to 11791.94 million NRS—an increase by 9.25 percent. On these grounds it can be observed that as a result of decrease in exchange rate, there always remains a possibility of increase in earnings in terms of NRS even if the earnings in terms of dollar remains unchanged. In this way, there remains a high influence of exchange rate in the earnings or payments, which sometimes may lead to produce a misleading result. To avoid all sorts of such confusions it is advisable to maintain the balance of payments accounts in any of strong monetary units like US dollar or Euro.

Along with the difficulties of getting adequate data, the discrepancy in data in IMF’s sources further made the analysis difficult.

It has been long felt that, due to the lack in the efficiency and seriousness of the working personnel in the collection of data for the compilation of balance of payments, most of the entries of the balance of payments are subject to question. The lack of frequent survey for its estimation, high figure of miscellaneous capital item net, zero or nil entry in the item of foreign direct investment etc are some lacunas of the compilation of balance of payments in Nepal. On the other hand, due to the unlimited convertibility facility of Indian currency vis-à-vis Nepalese currency and acceptance of Indian currency
in general mass throughout the country, most of the people do not deem necessary to exchange Indian currency for the Nepalese currency. In the situation that all the circulation of Indian currency does not enter into the banking channel and all the remittance does not remit from the formal (banking) channel, the figures of the balance of payments with India could be subjected to question.

However, Nepalese balance of payments with India could be improved by the effective management of Indian currency in Nepal. If efforts were made to canalize all the circulation of Indian currency in banking system and the remittances were made through formal channel, Nepalese balance of payments with India would improve. Moreover, to reduce the cost for transportation of Indian currency, negotiation with Indian authority has to be made to legalise the 500 and 1000 denomination of Indian currency notes in the country. The reserves of Indian currency can be increased if an agreement is reached between India and Nepal to transact in both Indian currency and dollar whichever becomes convenient. If the payment for the purchase of petroleum products from India be allowed to be made in dollar, the reserve of Indian currency in Nepal would be significant.

The empirical results suggest that Nepalese exports to India would improve with the fall in Nepalese price and with the increase in Indian prices. All the other variables used for the estimation show dual role in the sense that they encourage both imports from and exports to India at the same time. So they cannot be appropriate variables to improve Nepalese trade deficit.

However, the results suggested by the monetary approach to balance of payments shows that Nepalese balance of payments with India depends positively with the growth rate of current Nepalese GDP and with the growth rate of the expected cross rate differential. However, it is inversely depended with the growth rate of expected ratio of the Indian to Nepalese interest rate structure, growth rate of current ratio of Indian price structure to Nepalese price structure, growth rate of current NFAS and growth rate of current NDA.

Expected increase of Nepalese interest rate in the bank deposit relative to the Indian interest rate attracts Indian capital to Nepal, and consequently improves Nepalese reserves of inconvertible currency. On the similar ground, the expected increase in the
value of US$ in India relative to its value in Nepal (that is cross rates) improves the reserves of Indian currency of Nepalese authority through the diversion of US$.

The result further suggests to decrease the current ratio of Indian consumer price index to Nepalese consumer price index in order to improve the reserves on Indian currency of Nepalese monetary authority. If the ratio is decreased by the reduction in the price structure of India, the demand for Indian currency in Nepal will decline as the Nepalese total expenditure for imports from India will be lessened. This will ultimately lead to an improvement in the overall balance of payments with India. On the contrary, if the ratio is decreased by increase in Nepalese price, the domestic money demand will increase and hence it will tend to appreciate. To keep the exchange rate constant, Nepalese authority will sell Nepalese currency and buy the Indian currencies from the market. This will lead to an improvement in the level of reserves of inconvertible currencies of the Nepalese authority. Though it seems to be contrary to the traditional balance of payments approaches, yet it is equally valid. Current growth in Nepalese GDP cause to increase in the domestic money demand leading to its appreciation. However, as the exchange rate is to be kept fixed, the reserves of inconvertible currency of the Nepalese monetary authority increases. The current growth rate of NFAS$ and the NDA has adverse effect in the Nepalese balance of payments with India. As the inflow of NFAS$ is exogenously determined, Nepalese authority can never have real control over it. However, the Nepalese authority can have control over the NDA.

The proper management of Indian currency through banking channel, increment in the relative interest rate and GDP, reduction in the cross rates, price ratio, NFAS$ and NDA would be the key factors of improving the balance of payments with India. However, some of the variables are exogenously determined, so the government might not have full control over them. And some of the policies like increase in Nepalese price for the decrease of the ratio of Indian to Nepalese price may adversely affect the welfare of the people. Therefore, though the findings of the study are theoretically tenable, yet in practical field much would depend on the goals and priorities of the government.