UNEDITED VERSION

LINKAGE BETWEEN TRADE, DEVELOPMENT AND POVERTY REDUCTION

A Study on Short Term Impact of Trade Liberalization on Poverty in Nepal

A Report Submitted to
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CHAPTER I: INTRODUCTION

1.1 Concept of Trade and Macroeconomic Policies and Poverty Reduction

Trade policy reforms constitute a major element in macroeconomic reforms. They are not introduced in isolation; they are associated with other macroeconomic reforms and liberalization. Macroeconomic policies shape the investment climate for economic growth and promote efficiency of investment. Sound macroeconomic policies through credibility, predictability and transparency encourage investment -- giving price signals for private sector activities; removing market distorting regulations and institutions; defining the complementary roles of the state and the private sector in agricultural, manufacturing, and services sectors; and ensuring efficiency of both the government and the private sector in the production and distribution of goods and services. Evidence shows that acceleration of economic growth has taken place in countries with sound macroeconomic policies; and poverty has been better addressed in high growth condition (UNDP, 2004). It is substantiated by high and sustained economic growth in South East Asian countries, China, and of late that of Vietnam, India, and Bangladesh resulting in marked reduction in poverty. In particular, economies with trade openness have been able to enhance growth and reduce poverty faster than others. Experience has also shown that sharp drop in economic growth resulting from shocks and economic adjustments may increase the incidence of poverty, as observed in many South-East Asian countries after the financial crisis of 1997. Experience from the same crisis has also shown that countries which have adopted sound macro economic policies can recover from the crisis soon and attain catch up growth with poverty reduction.

But sound macroeconomic policies have to be supported by good institutions and governance to make growth built-in distributive so that reduction of poverty is faster and deeper. A strong relationship between growth and poverty reduction holds through the creation of employment in the process of trade and industrial expansion along with labour market conditions, public sector institutions and fiscal regime. But trade led high economic growth might initially tend to address urban poverty, and rural poverty might remain unaffected if there is no strong backward linkage between trade and rural economic activities like agriculture. The urban areas have better employment opportunities in an economic growth pattern supported by urban-based industrial and service activities. For high economic growth to reduce rural poverty in agriculture-dominated countries like Nepal, trade must lead to a transformation of the agricultural sector along with rural industrialization based on local resources.

In an export led growth pattern, rural areas have little to gain if exports are either based on imported raw material or confined to raw and semi-processed agro-products with low value added. Economic growth would help rural poverty reduction only if there is promotion of local resource-intensive or labour-intensive industries which use simple and cheap technology (UNESCAP, 2001). Such industries should have strong backward and forward linkages with other sectors and activities of the economy. Traditional capital-intensive, import substituting, trade restricting, and price distorting policies have not helped poverty reduction; rather, they have invited crisis of one type or the other. Countries which learned from those mistakes, changed economic crises into opportunities with reforms, and expedited trade and investment liberalization progressed in terms of growth and poverty reduction.

There is a great deal of empirical evidence on economic growth addressing poverty. Empirical findings suggest that economic growth raises income of the poor, although by less than proportionately[1]. This implies that there is a role of macroeconomic policies that take into account the distributional impact of economic growth. In particular policies that lower inflation, promote private sector and right-size the government, promote financial development, and create a favourable environment for external trade impact upon income of the poor directly.

The framework of macroeconomic polices is liberalization, openness, integration to global economy and internal reforms which fosters growth. But globalization and liberalization might enhance not only economic growth but also inequality. This is important for a country like Nepal which is in the process of rapid global integration and is observing increase in the incomes of the poor and the rich in a disproportionate way. The standard sets of growth stimulating policies such as trade openness, institution building, and prudent fiscal and monetary stance raise opportunity for profitable investment benefiting the poor primarily by an expansion of employment (UNDP, 2005).

Based on the theoretical underpinning of the impact of trade liberalization on poverty, (Winter 2001), the following issues have to be critically examined in order to examine the impact of trade reform on development and poverty:

(i) Price effects of the trade liberalization: changes in the production pattern as well as prices of goods consumed and produced by the poor;
(ii) Relationships between trade and employment;
(iii) Relationships between trade and inequality;
(iv) Effects on intra-household income distribution
(v) Macroeconomic impact of trade liberalization including balance of payments constraints on poverty reduction;
(vi) Structural shift in the production technology and social exclusion of poorer producers from livelihoods; and
(vii) Bargaining power in global production chains and the distribution of gains from trade

1.2 A Brief Overview of Macroeconomic Policies of Nepal

Nepal initiated economic liberalization, openness and outward orientation since mid 1980s. Till early 1980s, trade, industry, finance, and foreign exchange regimes were highly regulated with license requirements, quantitative restrictions, quotas, price administration, and high tariffs on imports. High protection to domestic industries, import substitution

[1] See Dhaneshwor Ghura et al, "Is Growth Enough? Macroeconomic Policy and Poverty Reduction", IMF Working Paper (WP 02/118).

strategy, state-led industrialization, and government monopolies were predominant in the economic policy domain.

The inward looking economic policies suppressed economic growth; created macroeconomic imbalances in terms of huge fiscal deficit, high inflation, and balance of payments deficit; and poverty remained intractable. Thus economic liberalization, outward orientation, and reforms were initiated since mid 1980s. The overall objectives of these reforms were to stabilize the economy, to reorient production structures towards the market, to create the 'correct' incentives for increased private sector involvement in economic activity, to limit state involvement in the economy and to increase openness. The reform and liberalization process expedited with the restoration of multi-party political system in 1990 and adoption of more market oriented economic policies thereafter.

The fiscal sector reforms included streamlining tax rates and slabs, minimizing exemptions and rebates, strengthening tax administration, and making tax system globally competitive so as to promote private investment and encourage foreign investment. One important aspect of the fiscal policy reform was withdrawal of price and capital subsidies like those on food, fertilizer, ground irrigation, and operations of public enterprises.

Financial liberalization and reforms also began in Nepal since mid 1980s. These included the removal of entry barriers to the private sector in banking business, interest rate deregulation, removal of portfolio restrictions, introduction of new acts and prudential regulations, restructuring of state owned banks, and privatization. Adoption of indirect instruments of monetary policy, market orientation of the government debt instruments, and reform in the capital market were some other measures introduced in the process of financial liberalization.

Key features of Nepal's liberalization and reform in the external sector included devaluation and introduction of flexibility in exchange rate determination, elimination of import license and quotas, rationalization of the tariff structure, reduction in the average level of tariffs, implementation of full convertibility of the rupee in the current account, and moving to deregulation of trade. Reform in the manufacturing sector included de-licensing, reduction of the level of protection, liberalization of foreign investments and divestment/privatization of public sector manufacturing enterprises. Nepal entered into liberal global trading regime through membership of the WTO, and is now being integrated in regional and even more liberal trading regimes under SAFTA and BIMST-EC. This has not only significantly opened up the Nepalese economy and deepened integration with the global economy, but also raised vulnerability and risks to sustained growth, livelihood and poverty reduction.

1.3 Nepal's Growth Performance in a Liberal Trade Regime

Nepal is historically a low growth country with GDP growth rates averaging less than 5 percent per annum during 1980s and 1990s. During 2001-05, the average growth rate has been less than 3 per cent owing to intensification of armed conflict. GDP growth in the post-reform period has not deviated significantly from that of the preceding decade (Table 1.1).

Table 1.1: Growth of Gross Domestic Product (at constant 1985 prices, in %)

Sectors	1976-85	1986-95	1996-2005
Agriculture	**1.9**	**2.8**	**3.4**
Non-agriculture	**12.2**	**5.6**	**4.0**
Mining	3.7	9.6	3.9
Manufacturing	10.8	12.0	3.2
Electricity, gas and water	12.4	6.5	9.8
Construction	5.3	6.0	3.4
Trade, restaurant & hotel	6.8	7.5	2.3
Transport & communication	4.2	5.8	5.8
Finance and real estate	7.3	6.7	4.2
Community & social services	3.7	4.9	5.3
GDP at factor cost	**3.7**	**4.9**	**3.7**

Source: Economic Survey, MOF (various issues).

Agriculture grew at only around 2.7 percent per annum on average during the last three decades, at the same rate as population growth. The period of stabilization and reform has seen little improvement in agriculture. Overall economic growth in the 1990s was severely constrained by the slow growth of the agricultural sector (Table 2.1). In the 1990s, agricultural growth rate (2.5 per cent) was much lower than that during the 1980s (4.6 per cent). Compared to the low growth (1.5 per cent) during the first half of the 1990s, the agricultural growth picked up (to 3.3 per cent) during the second half. The growth rate has been sustained in the recent years -- at 3.4 percent during 2001-2005. This appears to have a positive effect on broad based economic growth and rural poverty reduction.

The non-agricultural sector recorded a shift in its growth rate during early 1990s, the period when economic liberalization was expedited. This sector recorded an average growth of 8.1 per cent during 1991-95. The major contributors to such a shift were manufacturing, trade, and transport and communication sectors. The growth decelerated (to 6.0 per cent) in the second half of the 1990 with growth rates of manufacturing and trade remaining much lower than in the first half. Deregulation of industrial licensing, liberalization of foreign exchange regime, reduction in tariffs, and rationalization of domestic tax rates contributed to a higher growth in industrial and services sector during most of the 1990s. However, as macroeconomic reforms could not be supported by microeconomic reforms, the contribution of economic liberalization to trade and industry was short-lived. During the second half of the 1990s, almost all the sectors witnessed a decelerated growth. The enthusiasm brought about by rapid economic liberalization in the early 1990s could not be sustained. One of the main reasons for this was that liberalization was not backed by creation of market institutions, capacity building and efficiency enhancement.

There has been a slow change in the structure of the economy over the years. The share of agriculture in GDP declined by about one percentage point annually during the 1990s in favor of the non-agricultural sector. This was a product of changes both in volume as well as relative prices. The terms of trade also had gone in favor of the non-agricultural sector during the nineties. In the recent years, the share of agriculture in GDP has stabilized at about 39 per cent (Table 1.2). All sectors except agriculture have increased their share in the

GDP in the recent decade. The share of the manufacturing sector has grown the fastest, particularly during the nineties. This is attributed to the expansion of export-oriented industries in the 1990s, following widened export opportunities and liberalization of the economy. Service sector on the whole did not show any marked shift in its share in GDP during the 1990s and even during 2001-05.

Table 1.2: Sectoral Contribution to Gross Domestic Product (in %)

Sectors	**1975**	**1985**	**1995**	**2005**
Agriculture	61.3	51.2	41.7	39.2
Mining	0.2	0.4	0.5	0.5
Manufacturing	5.7	5.7	8.4	8.8
Electricity, gas and water	0.2	0.4	0.7	2.3
Construction	4.2	8.5	9.8	10.6
Trade, restaurant & hotel	9.0	10.3	11.3	9.9
Transport & communicatio	4.6	6.0	7.7	8.1
Finance and real estate	8.7	9.0	9.7	10.2
Community & social servic	6.1	8.6	10.1	10.4
GDP at factor cost	100.0	100.0	100.0	100.0
GDP by Major Groups				
Agriculture	61.3	51.2	41.7	39.2
Industry	10.3	15.0	19.4	22.2
Services	18.4	33.8	38.9	38.6

Source: Economic Survey, MOF (various issues).

Low productivity in agriculture, together with expanding industrial activities, led to the structural shift in GDP. The share of agriculture in GDP declined from 51 percent in 1980 to 42 percent in 1995 and further down to 39 percent in 2004. The share of manufacturing in GDP increased from 5 percent on average in the early 1980s to 9 percent in the early 1990s. The increase during the 1990s was much slower, as the share of manufacturing sector in GDP reached 9.5 percent only by 2000. The share has even declined in the recent years. As the decline in the share of agriculture in GDP was not followed by similar disengagement of a large number of labor force from agriculture (labor force engaged in agriculture which hovered around 80 percent in early 1990s came down to 66 per cent in 2001), underemployment and less than subsistence level of wage characterized the agricultural sector.

The share of the trade, restaurant and hotel sector marked up very slowly during 1980s and also in 1990s. The share went up from 10.3 percent of GDP in 1985 to 11.3 percent in 1995. But the share declined thereafter. The share of transportation and communication did not follow a definite pattern whereas the share of finance and real estate grew rather slowly. However, community and social services continued to contribute more in GDP during the last decade.

1.4 Poverty, Inequality, and Human Development Situation

Incidence of poverty is very high in Nepal with more than one-third of the population below absolute poverty line, especially in remote areas and among the excluded communities. Nepal Living Standard Survey (NLSS) 2003/04 estimated population below poverty line in 2004 at 31 per cent, a decline of 11 percentage points from 42 per cent in 1996. The decline was 9 percentage points (from 44 to 35 per cent) in rural areas and 12 percentage points (from 22 per cent to 10 per cent) in the urban areas over the period of 8 years. Although the proportion of the population below absolute poverty line have come down to 31 percent, 45 per cent of the Dalits (so-called untouchables), 44 per cent of the Hill Janajatis (indigenous people), and 41 per cent of the Muslim people are still absolutely poor.

Poverty generally is a rural phenomenon and there is high correlation between income poverty and access to assets. The poor own less land, have less access to irrigation, and have lower level of education than the non-poor. The poor also face food insecurity, especially in remote areas. Among the population below poverty line, 95 per cent live in rural areas, 67 per cent are self employed in agriculture, 71 per cent are illiterate, 54 per cent are having family size of seven or more, 51 per cent hold land less than one hectare, and 25 per cent have less than 0.2 hectares of land.

The rural urban distribution of poverty is also noteworthy. While only 10 per cent of the people are in absolute poverty in urban areas (and only 3 per cent in Kathmandu valley), rural poverty in general is 35 per cent. The change in poverty incidence is also disproportionate over survey periods. During the last 8 years, poverty in some geographical areas, social groups and development regions have increased even though there has been a significant reduction in poverty on average. Urban centered growth process should have played a key role in this regard.

There are strong indications that inequality in Nepal has widened in the recent decades with economic growth led by market forces not doing distributive justice. The inequality trends can be understood by examining the Gini coefficient that shows the concentration of income among population groups. The estimates of Gini coefficients over different household surveys reveal that there is a trend of inequality growing over years (UNDP, 2005). Besides, rural inequality appears to be slightly lower than urban inequality, but rural inequality in income distribution has increased faster compared with urban income inequality during the period 1996-2004.

There are few explicit instances in the NLSS (1995/96 and 2003/04) that clearly explain worsening inequality in Nepal. In between two surveys, the percentage of total farm holdings that operate less than 0.5 hectares of land has increased by 4.7 percentage points, from 40.1 per cent in 1995/96 to 44.8 in 2003/04. This points to three things: either the incidence of subdivision has increased, or land ownership concentration has increased, or farmland has been transformed into non-farm use. None of these factors point to lessening of inequality of assets. Moreover, an increasing proportion of agricultural households are becoming landless; according to the Population Census 2001, almost 24 percent of households in Nepal do not own cultivated land. Among the rural households, the incidence of landlessness is about 20 percent.

The changes in consumption shares of different consumption quintiles of households between 1996 and 2004 reveals starker incidence of inequality. Notwithstanding a 2.3 fold increase in average consumption in rupee term between 1996 and 2004, the consumption of the poorest 20 percent of the households increased at the pace that is roughly half the increase in consumption of the richest 20 percent of the households (91.1 per cent vis-a-vis 177.1 per cent). Taking the change in GDP deflator (47.7 per cent) as the leveler, the real consumption of the poorest 20 per cent increased by 43.4 per cent in eight years (5.4 per cent annually) as compared to 129.4 per cent (16.2 per cent annually) for the richest 20 per cent of the households. This rate of annual increment in real consumption of the richest 20 per cent is nearly thrice the similar rate of the poorest 20 per cent of the households. Further, if one is to decompose the total consumption into the share of nominal per capita consumption of the poorest 20 per cent of the households, it has absolutely fallen by 1.4 percentage points: from 7.6 per cent in 1996 to 6.2 per cent in 2004. This contrasts with the 8.4 percentage points rise in the share of nominal per capita consumption of the richest 20 per cent of the households. Thus, trends in class-wise consumption share unequivocally points to the worsening inequality.

In terms of the distribution of income, the nominal income of the poorest 20 per cent of the households has increased at the rate 98.2 per cent) which is 11.3 percentage points lower than the rate of increase (109.5 per cent) for the richest 20 per cent of the households. In terms of real income (derived by using GDP deflator), the income of the poorest one-fifth of the households increased by 50.5 per cent as compared to 61.8 per cent for the richest 20 per cent. In terms of the rate of annual increase in real income, it works out to 6.3 per cent for the poorest compared to 7.7 per cent for the richest. If one compares income statistics with that of the consumption, the class-wise consumption gap is more pronounced than the income gap. In case of the poorest 20 percent of the households the rate of consumption increased below the rate of income: 91.1 per cent verses 98.2 per cent, where as a reverse scenario occurs for the richest 20 per cent: the rate of increase in consumption (177.1 per cent) far exceeds the rate of increase in nominal income (109.5 per cent). This contradicts the premise of introductory macroeconomics which postulates that marginal propensity to consume will decline with the rise in income. The statistics, on the other hand, suggest that change in income over the period is more even than the rate of change in consumption.

Decomposition of poverty reduction into (i) economic growth and (ii) income distribution components shows that growth alone contributed to 24.1 per cent decline in poverty whereas redistribution of income exacerbated poverty by 13.2 per cent resulting in net about 11 percentage points decline in poverty from the 1996 level. Had income distribution remained neutral, the decline in poverty would have been more than 24 percentage points (CBS, 2005).

The analysis of the contributors to poverty reduction shows that income distribution in the urban areas was not a deterrent to poverty reduction, but rural income distribution was. Had income distribution not worsened in the rural areas, the decline in rural areas would have been at least 17 percentage points.

Nepal has made some progress in human development over the years. There have been improvements in education, health and other social services, particularly in the last decade. However, the level of human development in Nepal remains among the lowest in the world. This stems basically from inequity and inequality in the distribution of opportunities and resources. Development outcomes have been inequitable as reflected in gender, caste, ethnic, and geographic disparities. Poverty has remained intractable and employment opportunities have become scarce. People's needs have remained unfulfilled, institutions have become extremely weak and policies have not been pro-poor. A large section of the people continue to remain outside mainstream development (UNDP, 2004).

Using the 2001 census and other data sources, the HDI is estimated to be 0.461 (UNDP, 2004)[2]. Along with low HDI, Nepal faces the challenge of significant disparity in the level of human development within and across regions and districts. The HDI in the urban areas (0.581) surpasses the rural area (0.439) where the majority of the people reside. The HDI is lowest in the mountains (0.382) followed by the Tarai (0.457) and the Hills (0.492). Likewise the far-western and mid-western development regions lag far behind the other development regions. The human poverty in rural areas (45.3) is significantly higher than in the urban areas (25.3). The incidence of human poverty is more pronounced in the mountains followed by the Tarai and Hills. It is heavily concentrated in the far-western development region with the highest in the Mid-Western Mountain.

The Human Empowerment Index is (HEI) estimated at 0.459, indicating a low level of empowerment. Among the three dimensions, economic empowerment (0.337) is the lowest and political empowerment is the highest (0.646) with social empowerment (0.395) in between. Low level of economic empowerment level reflects low level of income, limited access to productive assets and lack of gainful employment opportunities. This also indicates that market oriented policies which Nepal has exercised for more than two decades now do not necessarily empower people economically. The current level of both economic and social empowerment remains fairly low to effectively address the overarching goal of poverty reduction on a sustained basis. The existing mismatch between socio-economic and political empowerment also clearly indicates the need for more balanced intervention in all three fronts for sustainable empowerment and poverty reduction. The higher political empowerment is a clear manifestation of rising expectations of the people.

1.5 Trade and National Plan/Poverty Reduction Strategy

Nepal has an experience of nearly 50 years of planned development efforts. In all the plans, emphasis is laid on exports. Reducing poverty was explicitly the major objective since 9th plan. The current Tenth Plan/PRSP has the sole objective of reducing poverty through broad-based growth, social sector development and rural infrastructure, targeted

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[2] The global Human Development Report 2005 however shows Nepal's HDI at 0.52 and the difference mostly arises because of the different measurements of knowledge in country and global reports.

programmes and good governance. Trade is taken as a sector contributing to high and broad-based growth. It is assumed that broad based growth would take care of poverty and trade would enhance growth. But no direct linkage between trade and poverty is worked out in the PRSP. The Tenth Plan intends to (i) making trade sector open and competitive under the active involvement of the private sector, (ii) identifying export items of comparative advantage and diversify exports - both country-wise and commodity-wise (iii) building capacity of trade promotion related institutions will be done, and (iv) linking trade with industrial promotion. The Plan expects to generate about 250 thousand jobs, to promote women entrepreneurship in food processing enterprises and create rural employment with trade sector programmes.

As there is no mention of the direct trade and poverty linkage and also no programmes to establish such a link in the PRSP, a gap is clearly seen in terms of mainstreaming trade in poverty reduction strategy. The indirect link of trade to poverty through high economic growth has a number of problems and the benefits are not automatically pro-poor. Country development strategy like PRSP need to explicitly address as to how trade would directly benefit the poor, perhaps disproportionately more than others. This is also necessary when trade liberalization has benefited only the urban sector and aggravated poverty in some sections of the society.

CHAPTER II: EXTERNAL TRADE AND POVERTY

2.1 Conceptual Framework of Trade, Growth and Poverty Linkage

Trade liberalization is a key component of conventional economic policy aimed at growth and development. Trade liberalization is regarded to have strong positive effects on resource allocation, economic growth and poverty reduction (Dollar and Kraay, 2000). Much of the empirical evidence supports the proposition that outward-looking, market-oriented policy reform stimulates trade and economic growth leading to poverty reduction. But this evidence is observed more in industrial and middle-income developing countries; but many poorer countries appear to have experienced difficulty in benefiting from these reforms (Striker and Pandolfi, 1997). Thus, there has been considerable controversy over the link between trade liberalization and poverty, with critics pointing to theoretical and empirical flaws in the existing literature and research on this area.

The link between trade and growth has been established through empirical works. But the empirical evidence of the trade-poverty linkage is new area of study and this is complicated by the debate over the definition of ‘poor’ and ‘trade openness’. One conclusion to emerge from an evaluation of this literature is that the effect of liberalization on poverty is likely to be complex. It is likely to depend on a host of factors including – the profile of the poor in a country, the structure of production and consumption, the effects of other reforms and so on. It is difficult, therefore, to conclude that trade liberalization and openness unambiguously results in a reduction of poverty. Nevertheless, there is consensus that the essential precondition for sustained poverty alleviation is rapid economic growth and trade is an engine of economic growth.

The economic theory suggests that trade liberalization results in productivity gains through increased competition, efficiency, innovation and acquisition of new technology. Trade reform is supposed to expand the set of economic opportunities by enlarging market size and increasing the effects of knowledge spillovers. All these effects together are expected to induce growth of output and consequent poverty alleviation. Thus in the medium term, trade reform has an important role in poverty alleviation through its effects on the rate and sectoral pattern of growth.

External sector liberalization and outward orientation of economic policies play a catalytic role in attaining high economic growth and reducing poverty through income and employment generation. But, trade and industrial liberalization does not automatically translate into achievement in poverty reduction; backward linkage of industry and trade to local resources, labor intensity of these activities and labor market condition (wage rates, social security, safety at work, etc.) are equally important. Nevertheless, trade liberalization has become a key component of economic policy of small economies with its strong positive effects on resource allocation, economic growth and poverty reduction. As such, external sector liberalization has had a significant reduction in poverty in many East and South-East Asian countries. South Asian experience further confirms the global empirical finding that relationship between trade openness poverty emanating through growth performance (World Bank, 2004).

Much of the empirical evidence supports the proposition that outward-looking, market-oriented policy reform stimulates trade and economic growth. Trade can make economy more efficient, reduce prices to consumers, provide more employment and increase the profits of firms and thus raises the revenue base of the government (UNESCAP, 2003). But empirical work on direct poverty reduction through trade policy reform and higher trade flow show a mixed result. Trade openness that has shown in the literature to have an impact on economic growth is not observed to directly influence the income of the poor in some studies (Ghura et al, 2002; Striker and Pandolfi, 1997). It means that the poor are not able to benefit from greater trade, because their lack of access to capital and physical isolation prevent them from taking advantage of all the opportunities created.

Despite that international trade is considered vital for poverty reduction, the link between trade and poverty is, in practice, neither simple nor automatic. There are a number of channels through which trade affects poverty: (i) income and employment effects, (ii) expenditure effects arising of price changes, and (iii) effects on revenue which affect resource allocation for public goods and anti-poverty programmes (UNCTAD, 2004). Besides the direct effects, there are indirect effects of external trade to poverty reduction through economic growth. Increased investment, technology acquisition and learning, dynamic efficiency gains coming from specialization and increased capacity utilization are the major sources of growth which are directly associated with trade. When trade has a direct impact on employment and subsequently to income, consumption, human development and food security, the indirect impact comes from development of productive capacities like physical, human and social capital accumulation, structural changes, and technological progress. Besides how trade is related to poverty is affected by how trade is related to aid, debt, private capital flows and technology acquisition. Assessment of poverty implication of Nepal’s trade policies and subsequently their impact on trade flows will be done from this perspective.

Experience shows that openness and liberalization alone have limited effectiveness in diversifying exports and promoting broad based economic growth in a country like Nepal. In particular, the existence of a large non-commercialized subsistence agricultural sector and small manufacturing sector means that the supply response to trade policy reforms is likely to be limited. For this reasons, if international competitiveness is to be maintained both in domestic markets and in export markets, it is essential that strategic interventions be undertaken to build supply side capacity (UNDP, 2004).

As the world economy is becoming ever more integrated, and for that matter more globalized, countries have little leverage on this trend - isolating oneself from this trend seems very impracticable. Improvement in communication and transportation has made geographical distance more or less irrelevant. The openness to trade has created opportunities to tap foreign knowledge and technology embodied in traded goods and services which results in high economic growth rate of the country. It is observed that a country can grow fast through opening up international trade, and this is more pronounced for a small economy which has very limited size of domestic market. Thus there is no alternative other than improving competitiveness through higher productivity, reduced transaction cost and trade facilitating governance. The next challenge then is how to make trade benefit the poor. The following sections will evaluate whether Nepal's openness to trade has helped growth and poverty reduction or not.

2.2 Trend and Pattern of Nepal's External Trade after Liberalization

The Nepalese economy is now relatively open with trade of goods and services -GDP ratio at about 50 percent. Twenty-five years back, trade (goods and services) accounted for less than 30 per cent of the GDP. Nepal's meaningful international trade began since the 1960s; but it accelerated since 1980s only when exports and imports grew on average by 19 percent and 18 percent respectively. In the 1990s, external sector remained robust in general, except for a few years towards the middle of the decade. Exports grew on average by 28 percent per annum whereas imports also grew by 20 percent (Table 2.1). After 2000, imports witnessed compression, mainly because of low economic growth, depreciation of the rupee, decline in demand for third country goods for re-export purpose, and decline in demand for raw materials related to exports. During 2001-05, imports grew by 4.4 per cent whereas exports grew by even lower magnitude of 3.7 %.

Table 2.1: External Sector Indicators (Growth Rates in Per Cent)

Items/Year	1981-90	1991-2000	2001-05	1986-95	1996-05
Exports	19.0	28.0	3.7	23.0	14.1
Imports	18.0	20.0	4.4	23.7	8.0
Trade deficit	19.4	17.2	5.3	25.3	5.9
Service Exports	3.2	12.8	-1.4	17.4	-2.3
Service Imports	7.0	2.7	6.7	10.7	-0.7

Source: MOF, Economic Survey and NRB, Quarterly Economic Bulletin (various issues).

The service sector, which is also related to trade, recorded a robust growth during the early 1990s, as did the trade sector. But the same could not be maintained thereafter.

The expansion of both exports and imports increased the trade-GDP ratio from little over 20 per cent in mid 1980s to more than 40 per cent in the year 2000 (Table 2.2). Since trade grew slower than GDP after 2000, the share of external trade in GDP declined to 36 per cent in 2005.

Table 2.2: External Sector Indicators (as percent of GDP)

As per cent of GDP	1986	1990	1995	2000	2004	2005
Total Trade	22.2	22.7	37.1	41.7	38.8	36.0
Export	5.5	5.0	8.0	13.1	10.7	11.0
Import	16.7	17.7	29.1	28.6	28.1	25.0
Trade balance	-11.2	-12.0	-21.0	-15.5	-17.5	-14.0
Current a/c balance	-4.4	-7.4	-5.4	4.5	2.9	5.6
Service income	6.2	6.1	17.1	8.1	6.9	5.2
Exports/imports ratio)	33.0	28.1	27.7	45.9	37.9	44.1

Source: Economic Survey and NRB Quarterly Economic Bulletin (various issues).

Trade liberalization is supposed to improve trade deficit by enhancing exports through the correction of anti-export bias. But Nepal did not observe any improvement in trade deficit along with liberalization. As such, trade deficit went up from 11 per cent of GDP in 1985 to 21 percent in 1995. The compression of imports thereafter led to a reduction in the ratio to 16 per cent in 2000 and further down to 14 per cent in 2005.

Despite a widening trade deficit, the current account deficit improved because of service and transfer incomes, particularly from workers' remittance. The balance of payments position remained comfortable throughout the decade except for one year. This led to expanding foreign exchange reserves position of the country with a capacity to cover more than 10 months of imports of goods and services. Such a favourable external sector situation has nothing to do with trade liberalization.

Strong balance of payments and comfortable foreign exchange reserves position has a significant bearing on the promotion of investment, sustained growth and poverty reduction. First, a strong external sector ensures stability in the financial sector and the economy, and thus ensures a robust investment climate. Second, a strong reserves position is a cushion for importing essential items for ensuring food security in critical times. Third, a strong external sector also stabilizes the exchange rate thus preventing the likely price and other implications arising from volatile exchange rate. From this perspective, it can be inferred that the external sector performance of Nepal in the recent decade has helped to create sound investment climate, maintain low inflation, support food security, and promote growth. Despite political instability, the strong external sector should have in fact maintained business confidence, as evident in rising investment-GDP ratio even in a conflict situation.

There has been notable change in the structure of trade over the last two decades and a half. The share of primary goods export declined from nearly 70 percent in 1980 to 22.5 percent in 2005. In between it had further dropped to 17 percent in 1990, 16 per cent in 2000 and to 20 per cent in 2004. The share of manufacturing goods export increased from 30 percent in 1980 to 83 percent in 1990 and to 75 per cent in 2000. It slightly came down to 71 per cent in 2005 (Table 2.3).

Table 2.3: Composition of Trade (Share in Percent)

Items/Year	1980	1985	1990	1995	2000	2004	2005
Exports							
Primary Goods	69.5	56.2	17.0	12.9	16.4	19.9	22.5
Manufactured Goods	30.1	42.4	82.7	85.2	75.0	71.8	70.7
Others	0.5	1.4	0.2	1.9	8.7	8.3	6.8
Imports							
Primary Goods	16.3	18.2	21.2	16.3	21.4	21.1	18.1
Fuel and Lubricants	11.8	11.9	8.3	7.4	8.4	16.1	21.5
Capital Goods	29.2	30.4	32.2	28.9	28.9	28.0	26.4
Manufactured Goods	42.7	39.5	38.3	47.4	41.3	34.9	34.0

Source: NRB Quarterly Economic Bulletin (various issues).

The structure of imports however observed little change during these decades. The import of primary goods hovered around 20 per cent of total imports whereas the share of capital goods stood around 30 per cent. In the recent years, the share has come down to 26-28 per cent. The share of manufactured good ranged between 38-47 per cent throughout 1980s and 1990s; but the same declined to less than 35 per cent in the recent years because of a significant decline in gold imports. As such, trade liberalization led to imports of manufactured goods intended for re-exports. Gold was one such item which at some time constituted about one-third of the country's total imports.

The expectation that trade liberalization would lead to large import of capital goods and thus promote industries was refuted by the actual trade flows which shows the share of capital goods in total imports not improving over the period of twenty five years. Rather, the large share of manufacturing goods in imports reflects the slow and narrow growth of domestic manufacturing activities during this period. If manufacturing growth was rapid and if industrial deepening had taken place, marked increase in imports of capital goods would also have been evident. Really worrisome has now been the import of petroleum products which now constitutes more than 20 per cent of the total imports and is growing over years for both the price and consumption demand reasons. The price differential of petroleum products between Nepal and bordering Indian cities has raised demand for such products from across the border and thus informal export. Thus the fast rise in the consumption of petroleum products, which otherwise could be taken as a gesture of expanding economic activities, does not reflect the domestic energy need associated with the economic growth process.

2.3 Major Exports and Imports and Their Poverty Implication

The implication of structural change in trade on poverty can be examined through its effect on (i) employment, wages and profit, (ii) prices of the household consumer goods, (iii) government revenue and associated expenditure pattern, and (iv) risk and vulnerability of household livelihood (DFID, 2001). The composition of exports and imports and the nature of major traded items have a bearing on these outcomes. If export of labour intensive and high valued products is rising over time, it reveals job creation and backward linkage of the export sector with its implication on poverty reduction. Similarly if import of capital goods is increasing it signals rapid industrialization and associated job creation. Further if import of food items and basic consumer goods is growing, it implies welfare gain through access of the ordinary people to essential consumption goods. Besides, degree of export concentration reflects vulnerability of this sector to any shock and likely impact on the economy.

An analysis of exports by regrouping of SITC trade classification shows a deceleration in all groups of exports. There has been a growth of exports of primary goods by about 12 per cent during 2001-05 compared with 30 per cent during 1996-2000 (Table 2.4). Export of manufacturing goods has decelerated to 3.4 per cent during 2001-05 compared to a growth of 33 per cent during 1991-95 and 21 per cent during 1996-2000. As such manufacturing goods comprise more than 70 per cent of the total exports and create most of the job in the exports sector; and their dismal performance in the recent years speaks of the short lived effect of trade liberalization on exports and the need for diversifying export items and destinations.

Table 2.4: Periodic Average Growth Rates of Exports

Export Items	1986-90	1991-95	1996-2000	2001-05
Primary Goods	-8.8	28.0	30.3	11.7
Manufacturing Goods	31.4	32.8	21.0	3.4
Chemical &Drugs	133.3	160.2	70.3	-0.2
Others	-15.8	331.8	86.0	9.4
Total	14.4	31.6	23.5	3.7

Source: Trade Statistics, Nepal Rastra Bank, Research Department (various Issues)

Of the manufacturing exports, woolen carpet and ready-made garments are the dominant ones. There was a marked growth (27. 2 per cent) in the export of carpets during 1991-95 (Table 2.5)[3]. The growth slowed down to 5.0 per cent during 1996-2000 and declined in absolute amount (by 10 per cent) during 2001-05[4]. A highly labour intensive and value adding industry has thus shrunk and many persons employed in this industry, in whatsoever unhealthy environment, have now become unemployed.

Table 2.5: Growth Rates of Major Export Items (Periodic Averages)

Items	1991-95g	1996-2000g	2001-05g
Woolen Carpets	27.2	5.0	-9.9
Readymade Garments	29.7	22.1	-15.4
Pashmina	*NA*	*NA*	-25.9
Vegetable Ghee	*NA*	*NA*	11.1
Pulses	16.7	18.3	-6.3
Thread	*NA*	*NA*	13.6
Tooth Paste	*NA*	62.8	-10.7
Jute and Jute Goods	20.2	28.3	19.5
Textiles	*NA*	*NA*	85.1
Polyester yarn	*NA*	20.2	24.7
Zinc Sheet	*NA*	*NA*	95.7
Copper Wire Rod	*NA*	*NA*	-3.4
Hides and Skin	7.9	-15.2	4.1
Major Commodities Total	27.3	22.5	-4.3
Total Exports	27.9	25.8	0.9

Source: Nepal Rastra Bank publications
Note: g = compound growth rates.

The case of ready-made garments is also similar. This is one of the labour intensive industries employing more than 100 thousand persons. In the 1990s, this sector grew by 26 per cent in the 1990s and created many jobs for women. But the growth stood negative

[3] In volume terms the growth was slower -- during 1991-95 carpet exports grew by 20 per cent in volume terms.
[4] During 1996-2000 and 2001-05, carpet exports shrunk in volume by an average of 2.0 per cent and 11.0 per cent respectively.

during 2001-05 by 15 per cent. In volume also, garment exports grew by 18.7 per cent during 1991-95 and by 6.9 per cent during 1996-2000. But during 2001-05, exports volume declined on average by 5.0 per cent. Much of the impact is of recent years with the expiry of Agreement on Textile and Clothing (ATC). Immediate transition of labour force from this to any another industry seems to be difficult. Thus the poverty implication of shrinking garment industry is very high and damaging to the labour market.

Although major export items show significant growth in the 1990s, much of the overseas exports growth in rupee terms comes from exchange rate gain rather than from the growth in trade volume[5]. Thus there has been no significant gain from trade in US dollar terms. The per unit price[6] of carpets in dollar terms declined from about 60 dollars per sq. meter during 1991-95 to less than 55 dollars during 1996-2000. During 2001-04, that has come down to less than 47 US dollars. However, the unit price of garments improved from less than 3 dollars per piece during 1991-95 to 3.2 dollars during 1996-2000 and further to 3.3 dollars during 2001-04. The unit prices of pulses remained almost unchanged, although it increased a bit during 1996-2000. The declining unit price in dollar terms implies that the value gain in rupee terms coming from exports is solely because of exchange rate and not because of price gain in dollar terms. The depreciation of the rupee seems a major factor in raising the level of exports in rupee terms with no significant impact on volume of the trade.

Carpet and garments are two major labour intensive export items which have dominated Nepal's exports for many years. From less than 6 per cent in 1980, their share in total export rose to more than 70 percent in most of the 1990s. In the recent years, their shares have come down significantly with serious implication to the labour market. While the share of woolen carpet on total exports declined from 45.0 per cent in 1990 to 18 percent in 2000, the same has further come down to 10.0 per cent in 2005 (Table 2.6).

The share of readymade garments, which was 29 per cent in 1995, declined gradually to 25 per cent in 2000 and steeply slipped down to 10 per cent in 2005. Pashmina, another labour intensive product, emerged very fast as an export item with its share in total exports rising to more than 11 per cent in 2000 from non-existence till mid 1990s. But the exports bubble of pashmia has started disappearing very soon with market and quality problems arising in the recent years. Pashmina constitutes less than 3 per cent of exports now. The declining share of most labour intensive exports in the recent years implies a squeeze in the job opportunities in these sectors. About 300 thousand workers employed in these sectors are now facing new threats with the abolition of quota on garment export in USA since January 2005, saturation of the Nepalese carpet market and quality problem with pashmina shawls.

The conventional goods like rice, timber, and skins are no more available for exports (Table 2.6); rather rice has been imported in a large magnitude in the recent decade. The

[5] Despite declining volume of overseas exports as mentioned above, items exported to India have grown in volume as well.
[6] Unit prices are calculated from value and volume of trade figures.

differential subsidy regime for agricultural inputs in Nepal and India has led to significant price differentials and thus inflow of Indian rice in Nepal.

Table 2.6 Shares of Major Export Items in Total Exports

Items	**1980**	**1985**	**1990**	**1995**	**2000**	**2002**	**2004**	**2005**
Woolen Carpets	4.8	9.1	45.0	43.8	17.7	13.2	10.5	10.0
Readymade Garments	0.7	17.2	27.1	29.1	25.1	16.7	17.7	10.4
Pashmina	0.0	0.0	0.0	0.0	11.2	4.0	2.8	2.4
Vegetable Ghee	0.0	0.0	0.0	0.0	4.9	15.1	5.5	8.0
Pulses	7.1	4.0	4.1	2.6	1.9	2.6	1.6	1.3
Thread	0.0	0.0	0.0	0.0	2.1	1.8	3.0	3.8
Tooth Paste	0.0	0.0	0.0	1.1	4.1	3.4	2.7	2.2
Jute and Jute Goods	23.6	11.1	2.5	1.8	2.0	3.5	3.5	4.6
Textiles	0.0	0.0	0.0	0.0	0.2	1.2	3.3	5.1
Polyester yarn	0.0	0.0	0.0	1.4	1.1	2.3	2.1	3.3
Zinc Sheet	0.0	0.0	0.0	0.0	0.1	0.0	5.2	2.9
Copper Wire Rod	0.0	0.0	0.0	0.0	1.1	5.6	0.4	0.9
Rice	3.7	9.1	0.0	0.0	0.0	0.0	0.0	0.0
Hides and Skin	18.4	8.9	5.5	2.4	0.3	1.0	0.6	0.4
Timber	11.8	0.9	0.0	0.0	0.0	0.0	0.0	0.0
Major Commodities Total	70.2	60.3	84.2	82.2	71.8	70.4	58.8	55.2
Total Exports	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Economic Survey and Nepal Rastra Bank Publications

With deteriorating scenario of major exports to overseas with no new items for export, Nepal is at high risk of trade re-concentration with India. As such, despite new non-tariff trade barriers, a few items are emerging in the country's export to India. Jute goods, juice, textiles, thread, polyester yarn, plastic goods, chemicals, and metallic products like corrugated sheets, copper wire rod and aluminum sections are emerging as major exports of the country to India. But these items are mostly based on imported raw materials, are enjoying comparative advantage through tariff differences on raw materials in Nepal and India, and have very low value added. Except for jute, juice, others are highly capital intensive and create little employment opportunities to Nepalese people.

The size of Nepal's exports is very small, despite trade liberalization initiatives taken since more than two decades back (Table 2.7). The share of exports to GDP is less than 10 per cent and major export items comprises minimum share in the international market. These products are price takers and have no influence in the external market prices.

The commodity concentration of Nepalese third country trade has little changed in the recent years. With quota available for readymade garments export to USA and goodwill of Nepalese woolen carpets in the European market, these two commodities which contributed for more than 70 per cent of the exports to countries other than India in mid 1990s still comprise the same share. Besides, new challenges are cropping up in these industries as woolen carpet market has now saturated and as abolition of MFA has already started depriving Nepal of its captive US market for readymade garments. The garment industry is beginning to face a set back when end of MFA is giving wider market share for China and India in the readymade garments sector at the cost of LDCs. The shrink in garment exports will adversely affect the livelihood of more than 100 thousand workers involved in this US $ 200 million industry.

Table 2.7: Major Merchandise Export Items (Rs in Million)

Commodities	1980	1985	1990	1995	2000	2004	2005
Woolen Carpets	55	249	2331	7718	9842	5677	5833
Readymade Garments	8	471	1423	5139	13942	9550	6039
Pashmina	0	0	0	0	3544	1492	1390
Vegetable Ghee	0	0	0	0	2743	2959	4636
Pulses	82	109	213	457	1057	860	764
Thread	0	0	0	0	1169	1637	2213
Tooth Paste	0	0	0	198	2263	1479	1283
Jute and Jute Goods	272	304	160	317	1104	1883	2693
Textiles	0	0	0	0	138	1780	2997
Polyester yarn	0	0	0	251	630	1114	1896
Zinc Sheet	0	0	0	0	58	2785	1663
Copper Wire Rod	0	0	0	0	631	201	530
Rice	42	250	0	0	0	0	0
Hides and Skin	212	243	284	416	182	309	223
Timber	136	26	0	0	0	0	0
(A) Major Exports, Total	807	1652	4339	14496	39968	31726	32160
(B) Total Exports	1150	2741	5156	17639	55654	53911	58236
(A) as % of (B)	70.2	60.3	84.2	82.2	71.8	58.8	55.2

Source: Economic Survey and Nepal Rastra Bank Publications

Destination wise, Nepal's trade is re-concentrating towards India. In 2004/05, about 66 per cent of the trade was with India compared with 28 per cent in 1995. In the recent years, there has been a growth of exports of manufacturing products like vegetable ghee, toothpaste, zinc sheets, and plastic goods which have low value added and low labour intensity. Many of them have been established in Nepal to benefit from a more liberal tariff and foreign exchange regime in Nepal than that in India. Considering the vulnerability of these products to likely tariff and non-tariff shocks, there is not much to be complacent of the trade growth with India. Thus, the growth of manufacturing trade with India has very limited contribution to poverty for a number of reasons like weak backward linkage of these products to rural economy, little job creation and use of migrant workers, and little value added. Value added in key exports like vegetable ghee, plastic products and iron and steel are just 25 per cent, 38 per cent and 15 per cent respectively (CBS, 2003)[7].

[7] Derived from the manufacturing census tables. Comparison of the census input and output figures for 1991 and 2001 shows a decline in value added in these products over time.

Nepal's imports grow for a number of reasons like the economic growth related demand for investment and consumption goods, substitution for domestic goods due to cost differences, and demand for re-exports. From all these counts except for substitution of domestic goods, imports are slowing down in the recent years. The import of primary products has gone up by about 2.0 per cent during 2001-05 compared with more than 20 per cent during 1990s (Table 2.8). The import of capital goods has also decelerated to 3 per cent during 2001-05 from 26 per cent during 1991-95 and 12 per cent during 1996-2000. This signals the slow speed of manufacturing sector growth at the later stage of trade liberalization.

Table 2.8 Periodic Average Growth Rates of Imports (%)

Imports by Major Groups	**1986-90**	**1991-95**	**1996-2000**	**2001-05**
Primary	23.8	22.8	17.9	1.7
Manufacturing	18.5	34.7	12.2	0.8
Fuel & lubricants	11.6	27.8	15.1	25.9
Capital Goods	21.1	25.9	11.8	2.8
Total Imports	18.9	28.4	12.0	4.4

Source: Economic Survey and Nepal Rastra Bank Publications

An analysis of imports by major commodities shows the import of key raw materials related to export items stagnating and even declining in the recent years. Imports of raw wool, textile and thread, which are directly linked to export potential, increased the fastest in the late 1990s when exports were also picking up. The same declined significantly during 2001-05 because of shrunk exports market (Table 2.9). Imports intended for informal re-exports like gold and silver, betel nut, umbrella and raw silk grew the fastest in the 1990s. But as such prospect dissipated, and as their domestic market is limited, their import declined significantly in the recent years. Recently, with the growing prospect of metal related exports to India, the import of iron and steel related raw materials have gone up significantly.

Table 2.9 Periodic Growth Rates of Major Imports (in %)

Items	**1990-95g**	**1996-2000**	**2001-05**
Raw Wool	9.2	11.4	0.7
Copper Wire Rods & Sheets	18.3	52.4	21.5
Polythene Granules	30.7	19.0	9.6
Chemical Fertilizer	1.3	17.3	26.1
Textiles	35.1	23.5	-5.6
Threads	25.5	57.7	-15.5
Transport Vehicles & Parts	32.8	11.5	6.8
Electrical Goods	26.5	-1.0	2.5
Telecom Equip. Parts	66.3	-1.4	16.0
Petroleum Products	26.7	15.4	27.0
Computer Parts	NA	-5.6	26.4
Machinery & Parts	19.3	17.9	0.1

Table 2.9 Periodic Growth Rates of Major Imports (contd..)

Gold and Silver	71.6*	4.8	-28.3
Betel nut, Umbrella, Raw Silk	74.7	59.8	-7.5
Crude Palm Oil	NA	51.7	40.3
Rice	69.4	201.3	9.3
Chemicals	18.3	66.3	18.4
Cold rolled Sheet Incoil	NA	NA	287.0
M.S. Billet and Wire Rod	-28.7	-1.7	20.7
Major Imports	35.7	12.1	4.1
Other Imports	20.3	13.2	4.9
Total Imports	28.3	12.0	4.4

Source: Economic Survey and Nepal Rastra Bank Publications

Note: g= compound growth rate; * implies growth for 1994-95 only.

A review of the composition of imports during the last two decades or so reveals a more or less static share so far as the import of primary goods and machinery and transport equipments are concerned (Table 2.10). The share of manufactured goods has declined in the recent years because of a significant reduction in gold imports. The rising share of fuel and lubricants in the recent years is due to surging global oil prices.

Table 2.10 Share of Major Items in Total Imports (in %)

Major Imports	1990	1995	1997	1999	2001	2003	2005
Raw Wool	5.5	2.5	3.1	2.3	1.6	1.3	1.2
Copper Wire Rod & Sheets	0.9	0.6	0.5	0.6	3.6	0.7	1.0
Polythene Granules	1.0	1.1	0.9	1.3	1.7	2.3	1.5
Chemical Fertilizer	7.3	2.2	2.0	2.4	0.7	0.8	0.4
Textiles	2.7	3.5	2.6	4.1	6.3	5.0	2.6
Threads	2.8	2.6	1.5	1.6	4.7	2.1	1.5
Transport Vehicles & Parts	4.1	4.9	3.3	5.2	6.0	4.5	5.2
Electrical Goods	4.5	4.1	2.5	3.3	1.7	2.0	1.7
Telecom Equip. Parts	0.6	2.3	1.4	1.5	1.1	1.9	1.4
Petroleum Products	7.2	6.8	6.7	9.3	9.1	15.4	20.3
Computer Parts	0.0	2.1	0.5	0.5	1.6	1.1	0.9
Machinery & Parts	6.5	4.5	5.1	5.9	4.9	3.6	4.2
Gold and Silver	0.0	21.0	33.6	10.1	5.5	0.3	0.2
Betel nut, Umbrella, Raw Silk	0.3	1.3	0.8	1.4	1.4	0.7	0.7
Crude Palm Oil	0.0	0.0	0.0	1.3	1.5	4.1	1.6
Rice	0.2	0.7	0.4	2.2	0.4	0.6	0.3
Chemicals	0.5	0.4	1.1	1.9	1.6	1.5	2.5
Cold rolled Sheet In coil	0.0	0.0	0.0	0.0	0.7	1.1	3.1
M.S. Billet and Wire Rod	1.5	0.2	0.0	0.0	5.1	6.5	6.3
Major Imports	45.8	60.6	65.8	55.1	59.0	55.4	56.7
Other Imports	54.2	39.4	34.2	44.9	41.0	44.6	43.3
Total Imports	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Economic Survey and Nepal Rastra Bank Publications

Trade liberalization is supposed to support commercialization of agriculture by expanding domestic and by creating export market for the produces, smoothing the supply of inputs and bringing excess labour from agriculture to non-agricultural sector. While Nepal's imports were highly regulated, the import of chemical fertilizers was constrained due to government monopoly in this sector and high price subsidy provided to its use. With trade liberalization, such import was expected to rise along with other agricultural machinery and tools. But the import of such items did not grow after liberalization, as the share of such items in total imports have declined from more than 7 per cent in 1990 to less than 1 per cent in 2005 (Table 2.11). The share of raw materials for manufacturing other than carpet and garments has also declined after mid 1990s. The only rise is seen in the import of transport and communications equipments and petroleum products which create less employment than other sectors. Thus from industrial expansion and employment perspective, imports do not seem to have contributed significantly.

Table 2.11 Share of Major Imports Classified by Uses (%)

Items	1990	1995	2000	2002	2004	2005
Agricultural Produces	1.9	2.1	3.8	1.6	1.7	1.5
Agricultural Inputs	7.3	2.7	3.5	2.9	1.8	0.9
Raw Materials for Garment & Carpet	11.0	8.5	12.6	8.1	8.1	5.3
Transport & Communication Equip.	5.5	7.9	7.7	7.6	8.3	7.3
Petroleum Products	7.2	6.8	7.6	13.3	15.0	20.3
Construction Materials	6.0	5.4	3.4	4.8	3.7	2.6
Raw Material for Vegetable Ghee	1.6	1.5	2.8	6.8	5.6	2.4
Raw Materials for Other Industries	0.3	24.3	3.3	2.9	4.0	4.0
Goods Intended to Re-export	6.5	4.5	9.1	3.5	1.8	1.8
Machinery & Parts	0.4	1.1	5.7	3.7	4.2	4.2
Raw Material for Iron and Steel	2.5	1.1	4.1	8.2	9.7	9.2
Consumer Goods	5.1	4.6	4.4	4.8	3.6	4.4
Major Items Total	55.3	70.6	68.0	68.1	67.5	64.0

Source: Economic Survey and Nepal Rastra Bank Publications and Researcher's Recalculations

Imports are meant for ensuring smooth supply of basic consumer goods, industrial raw material and other capital goods along with providing revenue to the government to undertake pro-poor programmes. There has been a rise in the import of primary goods particularly food items from India in the recent years at a low price which has helped price to remain low. But the welfare gains arising from cheap imports should be analyzed against the resulting poor agricultural performance in Nepal[8].

There had been a surge in the imports of rice from India in the recent past with its price dampening effect in the domestic market. As such the price index of rice went up by just 1.0 per cent per annum during 2000-05 against 9.6 per cent per annum during 1996-2000. The low food prices have had positive impact on food security and helped the food deficit

[8] See UNDP, 2004 for the implication of cheap food import from India.

households to have access to food items. But food surplus households, farm income was adversely affected by low food prices and their demand for non-food items was adversely affected (detail discussion is done in Chapter V).

2.4 Assessment of a few 'Shining' and 'Fading' Export Products

Studies have shown that Nepal has comparative advantage in the global market in a number of products (WB, 2004). They include labour intensive, natural resource and bio-diversity related, indigenous skill related and a few new technology related products. Nepal has the potential to become competitive in many manufacturing and agricultural goods, as their exports have been growing over years and as their market share is very low. The task then is to provide investment and trade friendly environment for the industrial and trading communities. But linking trade with poverty reduction needs reorienting production structure and developing linkage with rural resources.

In addition, Nepal's exports are also subject to high degree of volatility. A recent IMF paper on the export sector calculated the degree of volatility in the growth of apparel exports and found Nepal to have a much higher level of volatility compared with other South Asian countries (UNDP, 2004). Again, this volatility is likely to reflect the narrow concentration in export markets, which makes Nepal vulnerable to demand changes as well as import policy changes. This feature of the export sector is however the result of the failure of domestic policies to diversify and alter production structure in the export sector. Evidence from successful developing country exporters shows that this type of diversification does not take place 'automatically' as a result of trade policy reform. An effective and strategic industrial policy is essential to alter production structures that will have positive effects on employment.

Nepal has made a progress in the export of some agro produces like tea, coffee, vegetable seeds, off-season vegetable, herbs, non-timber products, and dairy products. But they do not significantly figure out in the major trade items so far. While some other products have almost collapsed on account of factors discussed above; they are pashmina shawl, dried ginger, and some other agro products (Table 2.12). Quality related issues, regulations, and standards are imposing a threat to most of the fading items.

Table 2.12: Some Rapidly Growing and Declining Export Goods (% growth)

Items	Period: 2001-05
Handicrafts	35.3
Herbs	12.3
Pashmina	-19.0
Jute Goods	19.1
Dried Ginger	-4.1
Paper products	8.2
Textiles	110.2*
Tea	167.3*

Source: Nepal Rastra Bank, * for the years 2004-2005 only, ** for 2002-05 only.

Nepal has entered into liberal global trading regime through WTO and has integrated in even more liberal regional trading regimes under SAFTA and BIMSTEC. This has widened export opportunities. But the country's export competitiveness is hindered by several factors ranging from cost of production to transit cost and market access. There are other supply side capacity constraints as well. Small scale of production, backward technology, unskilled and less productive labour and lack of innovation and entrepreneurship are some of them.

2.5 Workers' Remittance, Household Consumption, and Trade

In a country where unemployment and underemployment is high, where merchandise trade is in huge deficit (14 per cent of GDP in 2005), and where opportunities for transfer incomes are limited, external employment works to compensate for all of them. Temporary movement of natural persons as workers has become a growing phenomenon due to labour shortage in countries with high economic growth and/or low population growth. Nepalese labour market has surplus labour emanating from labour growth rate of 3 per cent against job creation to about 1 per cent of the work force. This low labour absorption in the domestic labour market and armed violence leading to threat to the youth to join rebellion group have pushed Nepalese to external labour markets.

In the recent years, more than 100 thousand workers per annum migrate for work abroad. Of them the largest number goes to India followed by Saudi Arabia, Malaysia and Qatar. About half of the migrants in 2003/04 were from the hilly region followed by 44 per cent from Tarai region and 6 per cent from the mountain region (CBS, 2004). Labour, military service, and professional job are the types of work Nepalese are engaged abroad. From these services, Nepal now gets annually more than $1.2 billion (Rs 86.5 billion in 2005) worth of foreign exchange (Table 2.13).

Table 2.13 Remittance Inflows from Migrant Workers

	Remittance Amt. (Rs million)				**Growth Rates (%)**		
Items/Year	**1990**	**1995**	**2000**	**2005**	**1996-2000**	**2001-2005**	**1996-2004**
Workers' Service Income[9]	2552	26430	9919	8614	-17.8	1.1	-8.3
Workers Remittance	1748	5064	36818	65416	48.7	12.5	30.6
Gurkha Army Pension			5941	12496	-	18.4	18.4*
Total Remittance Inflow	4300	31494	52678	86526	10.8	9.9	10.3
As % of GDP	4.8	14.4	13.9	16.4	-	-	-

Source: Quarterly Economic Bulletin (various issues), Nepal Rastra Bank.
* Average of 2001-2005 only.

[9] In the 1990s, there was a large import of gold; and as financing of such import was not from the banking system, it was assumed that gold import was financed by workers' remittance. So gold import equivalent amount used to be recorded under service income as short-term workers' remittance. That is why service income seems to be significantly increased in the middle of the 1990s. In the recent years, gold import has declined and remittance has been better recorded under transfer heads resulting to a decline in service income accounts.

In the recent years remittances are growing by more than 10 per cent per annum[10]. The short term service income, long term transfer income and Gurkha pension together accounted for about 16 per cent of the GDP in the recent years. There has not only been an increase of remittance inflow, its coverage has also widened. Compared to 23.4 per cent of the households in 1997, 31.9 per cent of the households were receiving remittances in 2004.

Of the total household income, remittance accounted for 11 per cent in 2004 compared to 6 per cent in 1997. However, of the households receiving remittance, the latter accounted for 35.4 per cent of their income compared with 26.6 per cent in 1997. The average amount of remittance received increase from Rs 15 thousand in 1997 to Rs 35 thousand in 2004, an increase of 128 per cent in eight years.

There are indications that the remittance income is utilized in financing consumption, school education of the children, health care, and housing and to some extent on capital formation. A Nepal Rastra Bank survey (NRB, 2002) shows that 27 per cent of the remittance receivers spent their income solely on household expenditure, 23 per cent on procuring land along with household expenditure and another 24 per cent on housing and household expenditure. Thus nearly three-fourth of the remittance is used in consumption and housing. This must have had raised the living standard of the households receiving remittances.

A survey of the household response on adequacy of consumption (CBS, 2004) shows that in 2004 less than one-third of the responding households had ‘less than adequate’ food consumption compared with more than 50 per cent households in 1996. Similarly, households responding ‘less than adequate’ clothing, schooling, and health care expenses also declined to 36 per cent, 21 per cent, and 28 per cent respectively in 2004 compared with 58 per cent, 45 per cent and 59 per cent respectively in 1996. The increase in the consumption of goods and services in the rural areas is attributed to the flow of remittance in these households.

There is a trade implication of increased consumption demand. When the economy is growing by less than 3 per cent on average, the rise in imports is substantiated by the consumption demand triggered by remittances. It has twin effects on poverty—first, there has been dampening effect of imports on prices, therefore keeping inflation low and indirectly supporting the poor; and second, availability of essential items has been assured because of affordability and accessibility. Thus income from external work and open trade regime together has helped consumption poverty to improve and bring many people up from below poverty line.

On the whole, remittances have become the second largest and widest source of income after agriculture; it has become the second largest employer after agriculture again; and it is now the largest earner of foreign exchange. After agriculture, there is no significant

[10] The estimated remittance in the balance of payment statistics of the Nepal Rastra Bank however does not cover all the inflow, as a large chunk of the inflow is from informal sources.

source of income which could explain the decline in poverty over the last eight years (1996-2004) as indicated by the living standard survey. Besides, remittance has emerged as a trade-financing source and helped the economy growing, albeit at a modest rate, even at the time of intense conflict.

2.6 Exchange Rate, Trade and Poverty

Exchange rate is a key instrument of trade policy reforms. Market oriented exchange rate is seen as a necessary condition for trade liberalization. Exchange rate adjustment can work for poverty reduction by creating a conducive environment for investment, promoting exports and providing protection to domestic economic activities which have a bearing on economic growth and employment. Additionally, in an open and small economy like that of Nepal, exchange rate policy has a bearing on inflation as well. And the adverse impact of inflation on poverty is well established by empirical studies. Thus a credible poverty reduction strategy has to maintain macroeconomic stability through prudent exchange rate management. Nepal has been opting for a fixed exchange rate regime with India and a flexible one with the rest of the world with a view to attaining the above-mentioned objectives.

Nepal's Exchange rate regime has had a significant bearing on the direction of trade, on international competitiveness, and after all, on the volume of trade as well. The exchange rate of Nepalese rupee against Indian currency remains unchanged for the last 12 years whereas the exchange rate against convertible currencies has under gone large depreciation in this period. This has made significant differential movements in relative real exchange rate as well. The asymmetrical movement of the nominal and real exchange rates of NRe vis-à-vis the Indian rupee and the US dollar has had a serious implication in the direction and structure of Nepal's foreign trade. The real appreciation of NRe against the Indian rupee as compared to real depreciation against the US dollar has resulted in higher imports from India resulting in re-concentration of trade. Although exports to India also increased due to removal of non-tariff and non-price barriers, the same has been constrained after India reintroduced non-tariff barriers on Nepalese exports.

Overvalued exchange rates create anti-export bias; suppress the external market for goods and services, and thus constrain growth and employment. But when traded goods and services sectors are not elastic to exchange rate devaluation, and if imports comprise of essential consumer goods, devaluation might have adverse impact on the poor through price changes. Regardless of this, Nepal introduced flexibility in exchange rate determination in early 1993 when currency convertibility was introduced. Convertibility of the NRe at current account on the market determined exchange rate had a marked contribution to trade expansion. Exports in general then grew significantly and created new jobs in the formal sector. But, in the absence of improvement in productivity and quality control, the gain from currency convertibility was short lived.

Optimal real exchange rate is critical for maintaining export competitiveness. But as most of Nepal’s third country exports are governed by factors other than exchange rate, the effect of exchange rate movement on trade performance cannot be objectively assessed.

Exports to India are also determined more by non-price factors such as quantitative restrictions, para- tariff and non-tariff barriers like sanitary and phyto-sanitary norms, and infrastructural bottlenecks, exchange rate seems to be not very instrumental in trade promotion without other simultaneous actions.

One important channel through which exchange rate affects poverty is inflation. Empirical studies have found a significant relationship between improvement in the well being of the poor and lower inflation (Cashin et al, 2001). Cross-country empirical estimation show income share of the poorest quintile to be inversely related to inflation and thus inflation to worsen income inequality (Romer and Romer, 1998). Inflation not only directly hits the poor most (as their income does not necessarily go up- due to nominal wage rigidity- in line with the price they pay for their consumption goods) but it also deteriorates the trade competitiveness and thus erodes economic growth potential. Even the investment climate is disturbed with high inflation. And in open economies, as the following section will explain, movement in exchange rate has a significant role in inflation.

The purchasing power parity theory says that in an open economy, domestic prices are determined by foreign prices and the exchange rate. In the Nepalese context, this seems to be a very extreme condition and the existence of non-traded goods, imperfect arbitrage in goods, services and capital following certain restriction on their free movement, and some structural variables have some effect on prices. However, exchange rate has also been instrumental to inflation. Empirical studies show that discrete devaluations of more than 15 percent also cause rate of inflation to shoot up by more than 7 percentage points[11]. This manifests the sensitivity of prices with exchange rate movement. Empirical estimation with nominal effective exchange rate as one of the explanatory variables in Inflation equation shows prices to increase by about 3 percent for a 10 per cent depreciation of the currency (see Acharya et al, 2003, Khatiwada, 2005).

During the last decade exchange rate of NRe against US dollar depreciated by 4 per cent annually on average but that against Indian currency remained fixed at the 1993 level. As India is the major trading partner of the country, the fixed exchange rate regime with India has helped to maintain inflation low in most of the recent decade. As the previous chapter mentions, inflation has not been a major factor contributing to poverty and thus there is no direct effect of exchange rate on poverty emanating from inflation. But low inflation has helped to prevent price rise of essential items, deterioration of real wage situation, and maintain real exchange rate at optimal level, therefore indirectly contributing to poverty reduction through income, consumption and trade channels.

Historical evidence shows macroeconomic stability critical for averting economic crisis and attaining sustained growth inevitable for poverty reduction. Macroeconomic crises are found associated with increase in income poverty and inequality (World Bank, 2001). Misaligned exchange rate in an economy with liberal capital account transaction can invite financial and economic crisis with consequential impact on poverty. This has been evident from the Asian financial crisis of the later 1990s. However, Nepal survived the

[11] See Khatiwada (1994), Acharya et al (2003).

crisis and did not have to suffer from the spillover this of this crisis as many Asian countries did. Experience from the same crisis has also shown that countries which have sound macro economic policies can recover from the crisis soon and attain catch up growth with poverty reduction.

Credible exchange rate policy is crucial not only for creating conducive investment climate and but also for preventing financial crisis. Traditional capital-intensive, import substituting, trade restricting, and price distorting policies led by misaligned exchange rate have not helped poverty reduction, rather they have invited crisis of one type or the other. Countries, which learned from those mistakes, changed economic crises into opportunities with reforms and liberalization and progressed in terms of growth and poverty reduction. Nepal did take this opportunity with liberal and market oriented exchange rate policy. Although macroeconomic stability characterized by low inflation, strong balance of payments, build-up of foreign exchange reserves, monetary restraints, and low interest rate was attained throughout the recent decade (1996-2004), the same could not be translated into high economic growth and significant reduction in poverty from the growth channel. In later half of the 1990s, exports became insensitive to exchange rate and non-price factors determined the size and structure of trade. The direction of trade was somehow affected by the exchange rate policy. This however does not have direct link to poverty except for making cheaper imports from India meant for the low- income group of people.

2.7 Overall Effects of External Sector Reform on Employment and Poverty

Given the high incidence of rural poverty in Nepal, any analysis of the effects of trade liberalization on poverty in Nepal must focus on income generation and employment creation for the rural people, particularly in the agricultural and small and medium enterprises. Given the heterogeneity of the rural poor in Nepal, trade reform is likely to have a differential impact on various groups among the poor. This makes it difficult to isolate the effect of trade liberalization from the effects of other policy changes in a systematic manner. Extensive trade policy reform has been undertaken in Nepal since 1990. However, the predicted dynamic benefits of trade liberalization for agricultural growth and rural poverty have not materialized. As such, the historically poor performance of agriculture over decades has been the outcome of serious technical and institutional constraints such as low levels of investment, low technology use and patterns of land ownership, and low levels of commercialization. It can however be argued that trade reform was little successful to promote agriculture in Nepal by providing improved incentives and signals (see Chapter V).

Even if trade liberalization had resulted in improved price incentives for agriculture, the supply response of this sector has been constrained by its very low levels of commercialization. The marketable surplus in paddy is around 27 percent and for lentil around 42 percent. For cereal crops such as rice, sales by the top 20 percent (in income terms) of farmers account for around 90 percent of total sales[12]. The ability of subsistence farmers in remote regions to respond to price changes therefore is largely absent. There

[12] See Agricultural Sector Performance Review 2002, AsDB, Manila.

has been little diversification of the agriculture sector following the introduction of market- oriented reform. The weak supply response to improved incentives for crop diversification is largely due to the low levels of commercialization associated with high levels of subsistence farming and weak, fragmented markets for marketable surplus.

During the last eight years (1996-2004), nominal per capita household income increased by an average of 9 per cent per annum whereas nominal per capita consumption went up by 11 per cent (Table 2.14). Most of the growth in per capita income comes from the non-agricultural sector and non-wage employment. This indicates that non-agricultural sector activities facilitated by liberal industrial and trade policies have had impact on income and employment.

Table 2.14: Household Income, Consumption, and Employment Over Two Survey Years

Indicators	**1995/96**	**2003/04**	**Avg. Growth**
Nominal PC Income (Rs)-- Poorest 20%	2020	4003	8.9
-- Richest 20%	19325	40486	9.7
Share in Total Income -- Poorest 20%	5.3	5.3	0.0
-- Richest 20%	50.3	53.4	0.8
Nominal PC Consumption (Rs)- Poorest 20%	2571	4913	8.4
- Richest 20%	15243	42236	13.6
Share in Total Consumption-- Poorest 20%	7.6	6.2	-2.5
-- Richest 20%	44.9	53.3	2.2
Sources of Income (%)-- Farm income	61.0	48.0	-3.0
--Non farm income	22.0	28.0	3.1
-- Others	16.0	24.0	5.2
Of which: Remittance	6.0	11.0	7.9
Wage Employment, in %	21.7	17.0	-3.0
Agriculture	12.2	6.8	-7.0
Non Agriculture	9.5	10.2	0.9
Non-Wage (Self) Employment, in %	78.4	73.6	-0.8
Agriculture	70.7	64.3	-1.2
Non Agriculture	7.7	9.3	2.4
Extended Economic activity	NA	9.4	
Wage Rates (Rs) -- Agriculture	40	75	8.2
-- Non-Agriculture	74	133	7.6

Source: NLSS I, 1996 and NLSS II, 2004, CBS.

The living standard survey shows that there was not much improvement in wage and non-wage employment in agriculture and non-agriculture. That the share of the lowest income (consumption) quintile in total income (consumption) deteriorated during 1996-2004 while that of the highest income (consumption) quintile increased significantly (Table 2.14) implies that the income so generated was more unequally distributed. There was a 8 per cent per annum rise in nominal wage during 1996-2004 which was not sufficient to increase the share of low income group in total income.

Overall, there was a reduction in poverty during 1996-2004, but the reduction took place while the GDP growth rate was less than 4 per cent on average amidst population growth rate of 2.25 per cent and growing income inequality. The mystery is being unfolded with the link of this achievement with remittances but that alone cannot explain all the achievements made in poverty reduction. Underlying growth in the informal sectors of the economy which is not properly covered by the national accounting system and role of micro-finance institutions, local bodies, and non government organizations are to be perceived equally important in this regard.

In the manufacturing sector, Nepal's competitiveness appears low. It has very high unit labor costs (labor costs for producing one unit of commodity) by international standards because, although wage rates are low, so is labor productivity. Lack of dynamism in the labor market is shown by the fact that annual percentage change in labor costs was by far the lowest at 0.5% compared to an average of 6.2% for eight Asian economies.[13] Manufacturing efficiency is also low: average productivity level (productivity measured as a percentage of the most efficient benchmark) is 53% compared to mean level of 60-70% found in other developing countries.

There appears to have been no improvement in the competitiveness of the economy in the last 20 years. Economy-wide and firm-level estimates of total factor productivity (growth in productivity of all factors taken together) suggest no change since 1970. The acceleration of manufacturing output growth from 2% to 8% per annum after 1987/88 seems to have come from factor accumulation. Indeed, total factor productivity growth was negative over the period. This has implications for raising income levels: unless productivity of or, alternatively, returns to various factors - especially labor - increases, prospect of sustainable increases in incomes are weak. Possible causes for continued low efficiency could be factors such as lack of technology transfer, lack of business support services, and lack of FDI which is a key conduit for new techniques and management practices.

Finally, price level is one channel through which trade and openness affects poverty. Global experience shows that countries which have opted for more open and liberal trading regime have attained lower inflation than others. In Nepal also, the rate of inflation came down along with opening trade regime. An empirical analysis of inflation with trade openness shows a significant negative relationship—one percentage point rise in trade openness (measured by trade/GDP ratio) reduces price by 0.32 per cent[14]. Thus, overall, there have been some positive implications of trade liberalization on the prices front whereas little impact is observed in the real sectors of the economy[15].

[13] Nepal, India, China, Indonesia, Thailand, Sri Lanka, Malaysia and Philippines. Source: UNIDO 2001; ILO 2001.

[14] The estimation period was 1985-2005. The coefficient was statistically significant at 5 per cent level and R2 was 0.26.

[15] Regression of real GDP against trade openness showed insignificant relationship for the period 1975-2005.

CHAPTER III: FISCAL REFORMS, TRADE COMPETITIVENESS AND POVERTY

3. 1 Fiscal Implication of Trade Liberalization and Poverty

The implication of trade liberalization on poverty through the private sector channels of growth, employment, and prices was discussed in the previous Chapters. This Chapter dwells on the fiscal channel through which trade liberalization impinges upon poverty and development outcomes. There are at least six trade-to-poverty links: the extent of prices change and its effect on the poor; links via factor markets (especially employment and wages); changes in government revenue and expenditure; changes in risk and vulnerability; effects on economic growth; and adjustment strains. In a country where role of the state in economic development and poverty reduction is prominent, revenue implication of trade policy reform is critical, as this determines the capacity of the state to spend on anti poverty programmes.

Trade reform could have not only income but also distributive effects in the short term and some segments of the society might suffer loses while others are gaining. This calls for devising safety nets and enhancing the capacity of the poor to compete in the market place. Public policy and spending plays a critical role in this area. As the poor or near poor have fewer assets to protect them during economic hard times created by trade regime change, they are less able to absorb adjustment costs than other segment of the society. This justifies public policies and actions looking more carefully at the effects of trade liberalization on the poor.

Trade reform can affect government revenue; but the effects are observed less adverse than imagined. As trade liberalization leads to increased volume of trade and as reduction in tariff enhances compliances and raises collection rates, the reduction in revenue from lower tariff rats are often more than offset by higher volume of trade and better compliance. In a country like Nepal where revenue collection faces leakages in terms of under invoicing of imports, smuggling through the open border, understating the volume of imports and misquoting the imported items –all related to high tariff, reduction in tariff reduces the incentives for revenue evasion. When the tariff rates are comparable or lower than the smuggling costs, there is less incentive for illegal imports. All these compensate for the loss incurred in terms of lowering tariff and associated taxes. The subsequent sections will show that revenue collection in Nepal has gone up significantly along with tariff reduction.

Even if tariff reduction leads to a reduced revenue collection, there is no straightforward conclusion that the poor will suffer. There are two choices for the government to prevent poverty and development suffer from trade related tax reforms— it can either introduce new domestic taxes to compensate for the shortfall in revenue emanating from lowered tariff rates, or it can restructure allocation of public expenditure to protect the poor from such a revenue shortfall, if any. Nepal's case is a strong pointer toward this direction. The introduction of Value Added Tax (VAT) in later 1990s was a compensatory measure to reduced tariff rates whereas public expenditure reforms leading to the formulation and implementation of Medium Term Expenditure Framework (MTEF) was a devise to protect the poor from any revenue shortfall arising of external and domestic shocks, including trade reforms. A credible fiscal framework is essential not only to protect the poor from any risk associated with trade reforms and shocks, but also to promoting infrastructure for reducing transaction costs, enhancing competitiveness, and eliminating trade distorting activities like subsidies and transfers to inefficient public enterprises.

The full benefits from trade liberalization can be realized fully if the country has certain domestic policy prerequisites. It includes, among others, policies that enable building supply side capacity and competitiveness, encourage export diversification, promote both domestic and foreign investment and ensure stable macroeconomic policies and institutional and infrastructural supports. From the perspectives of poverty reduction, it is necessary to carefully selecting a sequence and pace of liberalization that distributes the benefits of trade-driven economic growth across various income groups; forming human, social and physical capital of the poor; and ensuring mobility of factors of production. A credible fiscal policy can be instrumental in creating safety nets for the losers from trade regime change, in building capacity for the poor who can never compete in the market place, and in redistributing income and resources for equitable growth and development. Fiscal sector instruments like expenditure, revenue, taxation, borrowing and public enterprise management play a key role in reshaping the impact of trade reform on poverty reduction and development.

3.2 Nepal's Fiscal Scenario: Size and Growth Trends

Public finance is supposed to influence either the distribution of income or the efficiency of the economy. A prudent fiscal policy would try to attain both. Private sector is said to be unable to achieve an efficient economy because of the public goods, externalities, competition failures, asymmetric information and missing markets. Addressing these issues calls for public intervention with appropriate instruments. In order to spend money, government must tax business. Trade tax thus comes into picture and trade liberalization impinges on public spending by reducing the revenue collection of the country. But most taxes have a cost in terms of inducing inefficiency in the economy; and reduction in taxes may raise efficiency of the economy thereby benefiting the whole economy.

On the expenditure side, income redistribution and poverty reduction takes place through three instruments—direct or personal subsidy, price subsidy, and direct public spending on public services like health, education, social security, and infrastructure. The following sections deal on the size and trend of public spending, its financing sources, and major contributors to revenue financing.

Nepal's size of public spending is constrained by resource availability and capacity to spend. The resource envelop for public spending is revenue, foreign aid and domestic borrowing. Revenue is largely international trade based; more than 40 per cent of the revenue is trade (imports) based. Thus revenue implication of trade policy reform is significant. Besides, Nepal's entry in WTO and subsequent investment requirements related to WTO has high chance of crowding out resource availability to anti poverty programmes. Thus both revenue and expenditure implication of trade policy reform has implication for public spending on development works and poverty reduction activities.

The size of public spending has remained low in Nepal. As a proportion of GDP, it remained at less than 20 percent throughout 1980s and 1990s. It has been around 19 per cent of the GDP in the recent years (2001-05). However, revenue to GDP ratio observed an improvement in the 1990s compared with that in the 1980s. From 9.0 percent of the GDP in the 1980s, revenue ratio went up to 10.7 per cent on average during the 1990s. It further improved during 2001-2005; the ratio stood at 12 percent, on average (Table 3.1).

Table 3.1: Fiscal Sector Indicators as per cent of GDP

Budget Heads/ Year	1981-90	1991-2000	2001-05	1986-95	1996-2005
Total Expenditure	18.6	18.1	18.9	18.3	18.6
Development Exp	12.6	10.5	7.4	12.2	8.4
Revenue	9.0	10.7	12.4	9.6	12.0
Budgetary Deficit	-7.2	-6.3	-4.7	-7.4	-5.1
Foreign Aid	6.8	5.8	4.0	6.9	4.6

Source: Economic Survey, MOF (various issues)

One noteworthy aspect of fiscal indicators in Nepal has been a move towards greater fiscal stability supported by rising revenue–GDP ratio, declining budgetary deficit as a proportion to GDP, and stabilizing shares of internal and external debts to GDP. Implementation of PRSP, formulation of Medium Term Expenditure Framework (MTEF), and other fiscal reform have significantly streamlined budgetary allocations and reduced unproductive transfers and subsidies. This has paved way for more resource allocation to the social sector and rural infrastructure. In the situation of resource marginal short falls, the basic social, anti poverty, and targeted programmes for inclusive development are not affected, as most of them fall under priority one and budget cut is applied to lesser priority projects. However, if resource shortfalls are high, say more than 15 per cent, even such projects are at risk[16].

Low resource availability has suppressed the level of public spending in Nepal. The “20/20 compact” initiated by the United Nations suggests that the size of public spending should be 25 per cent of the GNP. In Nepal it has always been less than 20 per cent. The small size of public spending in relation to GDP continues as a result of low growth of revenue associated with slower trade flows. The need for macroeconomic stability has compressed the size and growth of public expenditure. In the 1980s, the growth rate of government expenditure was more than 19 per cent per annum which decelerated to 13 per cent per annum in the 1990s (Table 3.2). In the recent years (2001-04), the growth has further decelerated to less than 9 per cent per annum. As such, high expenditure growth had resulted in an unsustainably high budgetary deficit growth of 32 per cent per annum in the 1980s. Then, this period had witnessed the fastest widening of deficit in the last

[16] The proportion of P1 projects for which funding is guaranteed is more than 85 per cent (including the current expenditure). So if there is revenue shortfall of more than 15 per cent, fund for even P1 projects are to be slashed down.

three decades resulting in economic instability in mid 1980s. This along with higher monetary expansion had led to high inflation and a serious balance of payment crisis in the first half of the 1980.

Table 3.2: Fiscal Sector Indicators (in Growth Rates)

Avg. Growth Rates	1981-90	1991-2000	2001-05	1986-95	1996-2005
Total Expenditure	19.2	13.0	9.0	16.8	10.1
Regular	19.1	18.5	12.5*	21.4	12.4
Development	19.4	9.8	0.2*	14.3	5.2
Revenue	17.6	16.7	10.4	20.4	11.3
Foreign Grant	11.4	18.7	17.1	24.1	12.8
Budgetary Deficit	31.9	8.6	3.3	13.7	7.6

Source: Economic Survey, MOF (various issues)

* Growth of regular and development budget for the period 2001-05 corresponds to recurrent and capital expenditures respectively.

The restructuring of the fiscal sector in Nepal was initiated with the adoption of economic stabilization and trade liberalization programme in 1985. As trade liberalization could have destabilizing effect on the economy, fiscal profligacy was to be contained to put aggregate demand under control. This was implemented through the structural and enhanced structural adjustment programmes in late 1980s and early 1990s. Following the introduction of stabilization and adjustment policies, the 1990s witnessed a slower growth of government expenditure, mainly due to lower growth of development expenditure. As the government remained cognizant of the implication of huge budget deficit, the same was attained through compressed development spending. The low budgetary deficit followed by monetary slow down helped, in the recent years, in maintaining macroeconomic stability even with fairly liberalized trade regime--a cornerstone in the promotion of private sector investment and poverty reduction through high and sustained economic growth.

3.3 Public Enterprises Management, Privatization and Trade Liberalization

The government has made large investments in public enterprises, some of them related to trade and industry, in the form of share capital, loan, operating/transport subsidy, and capital subsidy. Despite this investment, it receives very low returns from public enterprises. Taking into account the liberal trade regime adopted, fiscal austerity required, and budgetary burden in financing public enterprises to be contained, the government has started privatizing, merging, consolidating, and even liquidating public enterprises. Steps have also been taken to make public enterprises run on a cost recovery basis.

A number of trade related public enterprises are closed, privatized, or liquidated in the process of trade and industrial liberalization. There is obviously a trade off between welfare and fiscal discipline of the government in this process. The closure of Rice Exporting Companies, Jute Development Corporation, Handicrafts Emporium, etc; bifurcation of Agricultural Inputs Corporation into two and involving private sector in the supply of agricultural inputs; elimination of price subsidy in the supply of food and fertilizer, and withdrawal of minimum support price for agricultural produces have implication for the growth of agriculture and poverty reduction.

3.4 Impact of Trade Liberalization on Revenue Trend and Structure

Trade liberalisation affects poverty indirectly via its impact on trade taxes, if tax revenue has been mostly allocated for pro-poor programmes. In the very early stages of trade liberalization, revenue collected from trade taxes may in fact rise as a country moves from quantitative restrictions to fairly high-level tariffs. Subsequently, however, revenue from tariffs might fall as the average level of tariffs fall, if compensatory domestic tax measures are not introduced or if the measures so introduced do not cover the loss incurred in tariff reduction. This fall in revenue is seen as constraining government expenditure on poverty reduction. However, this link is not indisputable, but it must certainly be borne in mind when analyzing the effects of openness on poverty (Winters, 2000).

One positive contribution of trade liberalization on revenue collection is through the expansion of manufacturing sector. The growth of the manufacturing sector widens domestic tax base and this can more than compensate the loss incurred by opting for low tariff regime. However, higher revenue collection can be translated into poverty reduction only with very much pro-poor allocation of government budget and expansion of the social protection measures.

Taxes comprise the major portion of government revenue and are often seen as the domain of the riches. However, taxes do affect the poor; and actually the poor usually pay a larger proportion of their income to state exchequer as payers of sales taxes/VAT and user-charges as users of public services which require funding from tax revenue[17]. But as the impact and incidence of the tax may fall differently upon different groups of the society, caution is needed in identifying who bears the tax burden. The evaluation of tax incidence on poverty is, however, a daunting task; as indirect business taxes can be passed on to the consumers or workers as higher prices or lower wages, and direct business tax can be avoided. This is even more complicated in countries like Nepal with a large informal sector, corruption, and non-compliance with the tax system.

As different types of taxes have differential incidence on the poor, one has to look into the political, economic and management principles of taxation from a pro-poor perspective. There is a need to develop a framework for tax analysis, based on these principles and focusing on transparency and equity. A more progressive and equity based tax system would be the one which depends more on direct tax (like personal income tax) than on indirect tax (like VAT) which has a fairly wider coverage of goods and services which the poor also consume.

The structure and growth of revenue has a significant bearing on poverty reduction. First, the progressive structure of the tax system has redistributional effect whereby the tax collected from the rich could be transferred to the poor through higher social sector

[17]Chuck Sheketoff and Joel Friedman, Tax and Poverty Work in International Budget Project, http://www.internationalbudget.org/cdrom/sessions/4revenue.htm.

allocation and introduction of targeted programmes. Second, higher rate of revenue collection allows for higher spending of the government which works for high economic growth and poverty reduction. As such revenue measures work as powerful fiscal instrument for economic growth and income redistribution. And third, a sound fiscal system backed by strong revenue performance ensures fiscal stability and thus helps maintain macroeconomic stability—a critical pre-condition for sustained high economic growth and poverty reduction. Nepal's revenue performance in the context of trade liberalization and poverty reduction should be viewed from this perspective.

Growth of government revenue, which had accelerated from 16 per cent in early 1980s to 19 percent in later 1980s and later to 22 per cent in early 1990s, deteriorated in the second half of the 1990s. Compared with a growth of 21.7 per cent during 1991-95, revenue growth decelerated to 11.8 per cent during 1996-2000 and further down to 10.4 per cent during 2001-05 (Table 3.4).

Table 3.4: Growth of Revenue by Its Sources (in %)

Description \ Year	**1981-85**	**1986-90**	**1991-95**	**1996-2000**	**2001-05**
Tax Revenue	15.9	18.5	22.2	11.1	10.4
Direct	17.8	21.1	22.9	18.4	7.8
Indirect	15.6	18.0	22.1	9.0	11.4
Non Tax Revenue	19.0	24.1	20.5	15.2	10.1
Total Revenue	16.1	19.1	21.7	11.8	10.4

Source: Economic Survey 2005 (various issues), MOF.

It can be observed that the slowdown in revenue growth in the later part of the 1990s and during 2001-05 is due to lower contribution of tax revenue. In fact, tax revenue went up on average by 11.1 per cent only during 1996-2000, lower than the growth rate of nominal GDP[18]. This reflects the deterioration in the buoyancy of the tax system in the later 1990s. During 2001-05, despite low growth of the revenue, the tax system has become more buoyant-- the growth of tax revenue (10.4 per cent) has been higher than that of gross domestic product (7.0 per cent). In the recent years, higher compliance has resulted in higher (13.5 per cent) growth on VAT collection, leading to improved buoyancy of the tax system.

A pro-poor tax structure would call for a growing share of direct taxes in the revenue structure, exemption of basic consumption goods and services from sales/value added tax, horizontal and vertical equity in tax rates, and a good tax compliance. In Nepal, the share of indirect tax in total revenue slightly dropped from 67 per cent in 1985 to 64 percent in 1995 (Table 3.5). It was only towards 2000 that the share came down to 56 per cent. It has again gone up to 59 per cent in 2004. The share of direct tax could increase from 13 per cent in 1985 to 16 percent in 1995. Since the year 2000, it marked an improvement, but still direct tax accounts for less than 20 per cent of the tax revenue.

[18] Nominal GDP grew by 11.75 per cent during 1996-2000.

Table 3.5: Composition of Government Revenue (in %)

Items \ FY	1980	1985	1990	1995	2000	2004	2005
Tax Revenue	**82.3**	**80.5**	**78.4**	**79.9**	**77.3**	**77.3**	**77.2**
Indirect Tax	69.8	67.2	63.7	64.5	56.4	59.3	59.7
Customs	32.7	27.2	28.9	28.6	25.2	25.0	22.4
Sales Tax /VAT	21.5	21.6	17.2	24.6	23.0	23.3	26.9
Excise	11.6	12.3	11.5	6.7	7.3	10.0	9.2
Direct Tax	12.4	13.3	14.7	15.5	20.9	18.0	17.5
Land and Registration	7.0	5.4	4.8	3.8	2.4	2.7	2.6
Income Tax	5.4	7.9	9.9	10.7	16.3	15.2	14.9
Other direct tax	0.0	0.0	0.0	0.9	2.2	0.0	0.0
Non Tax Revenue	**17.7**	**19.5**	**21.6**	**20.1**	**22.7**	**22.7**	**22.8**
Interest and Dividend	5.0	3.0	5.5	7.7	9.5	6.9	8.6
Principal Repayment	0.0	0.0	0.0	4.9	5.1	3.0	1.8
Public Utilities & Forest	7.7	6.4	4.3	3.4	3.7	3.2	2.6
Miscellaneous	5.1	10.1	11.8	4.0	4.4	9.6	9.8
Total Revenue	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Economic Survey 2005, MOF

The introduction of value added tax has had some positive effects on revenue collection in the recent years whereas reduction in tariff rates have had positive signal for private sector investment. But effective implementation of VAT continues to remain a challenge, the regressive nature of this tax limits the expansion of its base, and recent increase in the rate has entailed more regressive impact. Furthermore, as the structure of taxation has gone little change-with direct tax accounting for not more than 20 per cent of the total tax revenue, the distributive effect of the tax system in the economy has been minimal. Tax avoidance and tax leakage at collection point are other issues which are depriving the government of its potential resources which, if adequately mobilized, could be allocated for poverty reduction programmes.

Despite several measures to widen domestic tax base, international trade still accounts for nearly 50 per cent of the total revenue and more than 60 per cent of the tax revenue (Table 3.6).

Table 3.6 Contribution of International Trade on Revenue (Rs in million)

Trade Related Taxes	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
Customs	10764.8	12479.0	12492.6	14236.4	15554.2	15701.5
Excise on Imports	48.5	73.1	166.3	183.5	1286.6	1084.0
VAT on Imports	6119.9	7303.0	7354.9	8629.2	8874.7	12270.2
Income Tax on Trade*	2077.1	2204.2	3054.8	2226.3	2332.1	2553.1
Total Trade Related Tax	21010.3	24060.3	25070.6	27278.4	30051.6	33613.7
Trade Tax/ Total Tax Rev.(%)	63.4	61.9	63.7	64.1	62.4	62.1
Trade Tax/ Total Revenue (%)	49.0	49.2	49.7	48.5	48.2	47.9

Source: Nepal Rastra Bank publications

* It is assumed that 75 per cent of the private business income taxes come from trade-generated income.

So far, the negative impact of tariff reduction in the process of trade liberalization has been more than offset by higher revenue base created high more imports, wider income tax base, introduction of VAT and upward revision of the VAT rate, and administrative measures to enhance compliance. But when it come to elimination of trade related duties and charges, reduction in some tariff lines as commitment to WTO and SAFTA and saturation of income tax base expansion, the revenue implication would be serious and global and regional trade negotiations call for serious attention to revenue compensating provisions.

3.4 Fiscal Policy and Trade Competitiveness

Fiscal policy affects trade competitiveness through various channels: (i) taxes on inputs and outputs, (ii) taxes on income from trade proceeds, (iii) price subsidies on products, (iv) influencing general prices and inflation, (v) creation of infrastructure, and (vi) investment on education, skill, technology, and research.

Nepal's trade competitiveness has been eroded with high production cost, low labour productivity, high transaction costs, distortionary tax system (at times), and lack of access to appropriate technology. Reform in the fiscal sector has been intended to address some of these issues. Currently, tax system is much simplified—there are few tax slabs, there is not much discretionary power in tax assessment, voluntary tax assessment and returns are in place, and maximum tax rates have been brought down. Duty drawback system has been simplified; and export duty and charges have been almost abolished. However, tax administration is still clumsy, tax hassles at the local level continue, and hidden costs exist in trade facilitation.

Market-orientation of agricultural produces is low in Nepal as only about 13 per cent of total agricultural produces is sold at the market and 54 per cent households do not sell anything at all (see also Chapter V). Crop diversification is low, as cereal crops, meant mainly for self-consumption, account for 80 per cent of gross cropped area and 57 per cent of total production. Access to markets is difficult, as nearly 55 per cent of rural households are more than one hour away from a market, of which 21 per cent are more than 3 hours away from the market center. About 40 per cent of the rural households are more than two hours away from a paved road, and 20 per cent households have to walk more than two hours even to get a dirt road. Such infrastructural difficulties mean than these are often isolated and thin markets, subject to local price swings and without adequate storage capacities. Even in areas where market demand is available, scarcity of market infrastructure such as collection centers, storage facilities and organized market places limit opportunities for commercialization. Information about the demand for and the prices of agricultural commodities at different markets is also not available to the farmers. Monopsony in agricultural produces' market costs a lot to the farmers as they are forced to sell their products at very low prices.

The government has also developed market infrastructures in 33 locations in urban as well as rural areas. These markets are either urban wholesale markets or collection centers to feed larger urban markets. But a number of problems are encountered in optimally utilizing these developed market facilities. Market and price related information on crops is currently available only in selected markets through the joint efforts of the government and the private sector organizations.

There is substantial informal trade between Nepal and India. Estimates vary but indicate that it could be up to 50 per cent of the formal trade (Karmacharya, 2003). This has seriously eroded the competitiveness of domestic trade and industry as the minimum level of protection provided to industries and level playing field created trade have been distorted with duty unpaid items capturing the market. With respect to dynamics, informal trade is driven by a variety of factors including (i) high tariff rates (on selected items); (ii) differences in production cost structures (reflecting differences in geo-technical aspects of production); (ii) differences in input prices, typically due to differences in subsidy regimes; and (iii) high transactions costs of formal trade, especially financing and bureaucratic formalities of border crossings. Given the implication of informal trade, government has a crucial role to play in terms of tariff rationalization, enforcement of border regulation, creating infrastructure for private players and developing institutions like Competition Commission, enacting competition law and enforcing them.

Indian farmers benefit from a host of central and state government subsidies on inputs like fertilizer, seeds, pesticides, power for irrigation, and agro-processing equipment and services. It is estimated that up to a quarter of the production cost may be offset by subsidies. There are also substantial interventions in output markets, with market prices for 24 major commodities being heavily influenced by (fixed) procurement prices of the State Trading Corporations. Thus both ways they are protected whereas in Nepal there is hardly any subsidy on these items.

Indian and Nepalese markets, both for inputs and outputs, are linked which means that the benefit of Indian subsidies and price supports can in principle be enjoyed on both sides. Still, Nepalese producers face an uneven playing field for two reasons. First, some of the input subsidies are on non-tradable inputs (like power and irrigation water); hence these subsidies cannot be “availed” by Nepalese farmers. Second, price differentials suggest that cross-border input markets are less integrated than output markets. Hence, Nepalese producers typically face higher prices for the subsidized inputs but lower prices for output (since output markets are more competitively linked). Therefore, their net margin gets squeezed from both sides.

However, this does not automatically lead to subsidizing farmers in Nepal to protect their competitiveness against Indian one. As such, the issue of which group a subsidy should be given to and who benefits from it is also not clear. A majority of the Nepalese farmers are subsistence producers who do not enter the market at all (and hence are unaffected by the price distortions Indian policies generate). There is also evidence to suggest that many of these are poor farmers who are net buyers of food grain who may in fact be benefiting from lower food prices. If subsidies (or other support policies) are targeted at the crops whose markets (or profit margin) have been affected by Indian policies then it would basically lead to expanded domestic production of those crops for which large surpluses exist in the sub-continental markets. Therefore, given their likely low prices, provision of public support in this form will not lead to significant income gains.

From the point of view of maximizing agricultural incomes, the appropriate strategy for Nepalese producers will be to focus on developing their comparative advantages vis-à-vis these sets of prices (rather than independent estimations of technical efficiency, which ignore the political economy of the market place). This will have the built-in advantage of guiding production into higher net-return areas than into mass-market commodities whose prices are likely to remain low under pressure from Indian surpluses. Government intervention is essential here to facilitate the private sector in making appropriate investments so that it can shift into activities where it enjoys comparative advantage.

The above analysis indicates that Nepal has to make fiscal interventions in the agriculture sector within the domestic limits imposed by the revenue crunch and external constraints set in the rules under WTO. The budgetary side of trade capacity building is equally important, as public investment in trade related infrastructure, trade facilitation measures and trade-governing institutions (see Chapter six) is very important. Thus trade related aid bears much significance in this respect and the concept of 'aid for trade' needs materialization with global and regional initiatives.

CHAPTER IV: MONETARY AND FINANCIAL POLICIES, TRADE PROMOTION, AND POVERTY

4.1 Liberalization of the Financial Sector, Investment Climate, and Trade

Trade and finance are interrelated in many ways—finance providing payment facilitation for trade, extending credit and payment guarantees for financing trade, and offering capital for the production of goods and services intended for exports. Similarly trade supports financial system through creating business for banks and supplying savings to banks. In Nepal, nearly two-fifth of the bank credit goes for financing trade and consumption of imports related items; and most of non-fund based income of the financial system comes from trade related service provided to the trading companies. This in turn creates jobs and income opportunities to both the sectors. The impact of these opportunities depends on who gets the job and whose income increases. The previous chapters have amply highlighted that larger chunk of this benefit has gone to higher income group, as the distribution of income has deteriorated over years during the period of trade liberalization.

During the last decade, there has been a rapid growth of the financial services. As a result, the share of finance and real estate in GDP has gone up from 8.7 per cent in 1975 to 10 percent in 2000 and further to 10.2 per cent in 2005. Empirical relationship between trade and finance is strong. A regression of financial sector value added against value added in the trading sector (trade, restaurant and hotel) shows that each 10 per cent growth in value added in trade, restaurant and hotel sector contributes to 3.35 per cent growth in the financial sector value added[19]. The relationship between financial sector and manufacturing is weak as evident from the analysis.

The purpose of financial liberalization is promoting the growth of the real sector through the development of financial markets. Interest rate liberalisation is seen as essential for rationing out low yielding investment and increasing saving. Increased competition is seen as helping to lower financial intermediation costs. Increased savings and an increase in the quality of investment are seen as promoting economic growth through the promotion of trade and industry. Against this background, financial reforms were undertaken.

Following reforms and liberalization in the financial sector, there has been massive expansion of financial institutions, deposit mobilization, and credit flow of the banks. The number of financial institutions now stand at more than 200 compared to less than a dozen

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[19] The empirical relationship is as follows: $\ln FIN = 17.25 + 0.335 \ln TRH$ period: 1976-2005

$$\underset{(0.2)}{17.25} \quad \underset{(2.7)^*}{0.335}$$

$$R^2=0.993 \quad DW=1.95, \ \rho=0.997$$

where lnFIN=log of value added in financial sector, lnTRH=log of value added in trade, restaurant and hotel sector, ρ is autocorrelation coefficient; figures in the parentheses are t ratios and * means significant at 5 per cent level.

two decades back. The size of bank deposits rose 31 fold in 20 years whereas outstanding bank credit also went up by 33 fold. With new instruments and competition, although limited, trade financing now enjoys better terms.

Commercial banks' credit to the private sector has risen from 8.7 percent of GDP in 1985 to 31 percent in 2000 and further to 43 per cent in 2005. However, analysis of sectoral credit of commercial banks shows that there has not been an increase of credit to the agricultural sector. Of the total credit extended by commercial banks, only 3 percent went to agriculture in 2005. Nevertheless, there has been a positive shift of banking sector credit toward the exports related manufacturing sector. The share of manufacturing sector credit had increased from 18.8 percent of total credit in 1985 to 45 percent in 2000; but the share again declined to 37 per cent in 2005. The latest shift has partly come out of the growing share of bank credit on consumer loan. Such loan which was non-existent a few years before now accounts for nearly 3 per cent of the outstanding loan. The share of commercial sector loan declined from 44 percent in 1985 to 27 percent in 2005. Current slowdown in the trading sector has created problems in the financial sector as well. Bank financing of the consumer loan in the areas like hire purchase of automobiles, consumer durables, housing, and real estate has not contributed much in terms of domestic production and employment generation and then to the growth and poverty reduction in the country.

International trade at times destabilizes the financial system and creates financial crisis through imbalances in the external sector, particularly the current account and balance of payments deficit. Trade liberalization is often associated with huge trade deficit which if not covered by service and transfer inflows result in loss of foreign exchange reserves. In an inflexible exchange regime, this might invite financial crisis as observed in South East Asia during later 1970s. It is conceived that when average income rises during periods of economic growth, the poor become better off. But during economic downturns triggered by financial crises, they not only become worse off but that they suffer disproportionately to the non-poor. This is because financial crises are expected to deepen poverty and worsen income inequality in a number of ways including (i) weaker economic activity, (ii) relative price changes, and (iii) fiscal retrenchment**.** A financial crisis can cause workers' earnings to fall as jobs are lost in the formal sector, demand for services provided by the informal sector declines, and working hours and real wages are cut. When formal sector workers who have lost their jobs enter the informal sector, they put additional pressure on informal labor markets.

A financial crisis typically involves a large currency depreciation, which changes relative prices. For example, the price of tradable items rises relative to non-tradable ones, causing earnings of those employed in the non-traded goods sector to fall. At the same time, increased export demand boosts employment and earnings in the sectors producing the exports. The currency depreciation may also affect consumer prices, and the higher cost of imported food hurts poor individuals and households that spend much of their income on food. Governments often respond to crises by tightening the monetary and fiscal stances, often leading to cuts in public outlays on social programs, transfers to households, and wages and salaries (Baldacci, et al 2002).

It is observed that financial crises deepen poverty and income inequality. A fall in GDP per capita in the wake of a financial crisis is associated with deterioration in income distribution and an increase in poverty. As a crisis causes a country's average income to decline, growing income inequality results from a more-than-proportional fall in the income share of the lowest income quintiles of the population and an increase in the income share of the richest one-fifth. Households in the lowest and second lowest quintiles are most likely to have incomes below the poverty line; thus, a fall in their incomes is more closely associated with an increase in poverty than is a decline in the incomes of higher-income quintile households. But the main losers are not the poorest (lowest income quintile), who might be finding income in informal sector activities, but those in the second income quintile. Cutbacks in government spending on education, health care, and social security programs—the main ways tighter fiscal policy affects the poor—are associated with falling incomes for the poorest groups. Poverty seems to be particularly sensitive to a decrease in government spending on health care after a financial crisis (Baldacci et al, 2002).

Trade liberalization has oriented economic activities in the urban areas. Manufacturing, finance, transport, and communication services associated with trade expansion have an urban bias. Whereas agriculture, which could be benefited from trade liberalization, has remained detached with formal sector opportunities. One consequence of this situation is that there has been a reverse flow of financial resources from rural to urban areas. This is mainly the contribution of the deposits collected by the state-controlled commercial banks in the rural areas that are used for financing business and industrial activities in the urban areas. Also the Agricultural Development Bank, which was allowed to mobilize deposits in the urban areas to extend credit in the rural areas, has failed in its objective because of its own inclination towards urban business rather than rural financing. The joint-venture banks opened with foreign participation have been hesitant to extend services by opening bank branches in rural areas. The financial reform, which encourages banks to consolidate their network, has further squeezed the access of rural areas in formal sector finance.

There have also been other recent policy reforms which are likely to worsen this urban bias of the financial sector. Firstly, the priority sector credit program is being phased-out very soon, thereby depriving agriculture, small industries and basic services from institutional credit. The priority sector program required all commercial banks to target 10 per cent of loans to priority sectors such as agriculture and rural industry. The phasing out of this program is also likely to deprive rural development banks and micro finance institutions of captive source of fund coming from the commercial banks in the form of meeting priority sector lending requirement.

Secondly, no subsidies and transfers are now available for providing micro financial services to the rural poor. As micro finance institutions have a social cost component in their overall operations, even market based interest rates often do not suffice to cover the cost. In such a situation, it is hard to ensure institutional credit facility to the remote rural areas and the hard- core poor of the society.

4.2 Monetary Policy, Financial Services, and Trade Competitiveness

Monetary policy and financial services help to enhance trade competitiveness through (i) making available low cost fund to finance business and industries, (ii) offering efficient service and charging competitive service fees, and (iii) providing innovative financial instruments and trade related information to the business community. Nepal's international trade is often non-competitive due to high cost of borrowing, high charges and less efficient services. The inefficiency of the financial system is manifested in the spread between deposit and lending rates of the banks. With financial sector liberalization, it was expected that growing competition would reduce the interest spread and service charges of the banks. However, the spread widened over time and currently the spread stands at more than 5 per cent on average, while it is as high as 8 per cent for some banks[20].

Nepal's banking service has been not only highly profit oriented but also big business oriented with emphasis on wholesale lending with urban bias, to the neglect of rural economy and small and medium enterprises. This has prevented the commercialization of the rural economy and linkage of the small rural business with the urban trading activities. Undisclosed information tell that Nepal's bank credit is concentrated among a few business houses and a single house absorbs nearly 5 per cent of the entire credit of the banking system. Among the more than 4 million households, very few are lucky to enjoy such facility. Such financial concentration has neither helped to expand trade and industry nor ensured access of the poor to formal credit thereby helping poverty reduction.

Trade competitiveness is affected by inflation which is associated with the performance of monetary policy. Although monetary policy in Nepal has little control over inflation, it nevertheless can exacerbate inflationary situation. Monetary policy that aims to restrain inflation and minimize output fluctuations is the most likely to permanently improve conditions for growth and poverty reduction. Nepal's case in terms of inflation has improved over years. The average inflation rate was in double digit during 1980s; it came down to single digit in the 1990s. In the recent years, the average inflation (measured by CPI) stands at less than 5 per cent. The price for non-food items and services has gone up by an average of 4.9 per cent during 2001-05 compared with 7.3 per cent during 1991-95. The slow growth of prices have prevented Nepalese rupee from appreciating significantly and thus helped maintain real exchange rate at a competitive level. This is particularly true with respect to Indian currency. Although sensitivity of trade flows with exchange rate is very low in Nepal (Khatiwada, 1999), it nevertheless implies that Nepal's weak exports performance has more to do with structural factors rather than price factors.

Monetary policy has a few key roles to play in order to promote trade competitiveness in terms of maintaining external sector stability and then helping exchange rate to remain at optimal level. Open market operations of the central banks could be taken to offset the likely adverse effects on domestic liquidity emerging from the interventions in the

[20] The spread is measured by difference between maximum lending rate of the banks to industry and maximum interest offered on one-year fixed deposit.

foreign exchange market made to defend or to correct the exchange rate level. An accommodative monetary policy would then provide room for foreign exchange operation consistent with competitive exchange rate level. Nepal's case is very much supportive from this perspective.

4.3 Micro Credit, SMEs and Trade Promotion

There are a wide variety of agro-enterprises in Nepal, active in the following sub-sectors: (i) processing of cereals like rice and wheat; (ii) animal products like milk, cheese, ghee, meat and meat products; (iii) confectionary items such as sugar, honey, candies and biscuits; (iv) production of poultry feed; and (v) other activities. Agro-enterprises are important to Nepal’s economy, accounting for 50 per cent of value-added by the manufacturing sector and over 4 percent of Nepal’s GDP.

Small and medium enterprises, and particularly agro-enterprises, have an important role to play in commercialization of agriculture and in creating rural employment. At present, over 80 per cent of the agro-enterprises in the small, medium and large category (i.e., excluding the micro category) are privately owned and largely rely on finance from family and friends. The performance of agro-enterprises continues to held back by important constraints like (i) lack of credit to acquire inventories, upgrade and expand facilities, and invest in market and product development; (ii) lack of skilled labor; (iii) difficulty in getting appropriate equipment, and more crucially, spare parts; (iv) difficulty in getting basic inputs like land (suitably re-classified for industrial use) clean water, reliable electricity supply, and all-weather road access; and (v) insufficient information on prices and marketing opportunities.

The living standard surveys done in 1995/96 and in 2003/04 show that borrowing households (from both the formal and informal financial system) have increased from 61 per cent in 1996 to 69 per cent in 2004. Of the borrowing households, only 15 per cent borrowed from the banking system in 2004 compared with 16 per cent in 1996. This implies that households having access to bank credit have very marginally gone up from less than 10 per cent in 1996 to 10.4 percent in 2004. Moneylenders and relatives account for more than 80 percent of the borrowing. The poor have to resort more to such source. Only 8.3 per cent of the poorest consumption quintile had access to bank credit in 2004, almost the same as in 1996; whereas 26.8 per cent of the richest consumption quintile has access to such credit in 2004 compared with 21.8 per cent in 1996.

The collateral based lending practice of the banks has been a factor denying access of the SMEs in bank credit. In 2004, 28 per cent of the bank loan went free of collateral compared with less than 12 per cent in 1996, a remarkable transformation in eight years. But that is yet to encompass most of the poor. Beside, the lower the consumption group of households, the higher has been the proportion of borrowing for consumption. In 2004, 58 per cent of the borrowing of the poorest consumption quintile went on consumption compared with 62 per cent in 1996. This implies that these households have to meet their basic consumption needs by incurring debt. This raises a fundamental question as to whether the improvement in consumption financed by indebtedness sustains the well-being of the poor households or not. As such, rural indebtedness has been one of the reasons for growing landlessness, migration and even emigration in search of work abroad.

On the whole, liberal monetary policy -- working through interest rate liberalization, deregulation of portfolio restrictions, removal of credit ceilings, and withdrawal of other regulations – has been able to have easy credit expansion to trade and industry. But bank financing was confined to limited urban-based business activities and credit expansion concentrated in a few business houses. There was a large misuse of the easy credit, as evidenced by the non-performing assets of the two large banks rising to 60 per cent level in 2004. Such credit was not able to promote growth by enhancing the productivity of investment, nor was it supportive to income generation and creation of jobs for the poor. The liberalization of interest rates in 1989 left no room for subsidized credit to targeted sectors or groups of people. The priority sector credit programme, which included agriculture, cottage and small industries and basic service sectors, continued to be in place as the mandated lending requirements of the banks. But the requirement that at least 12 per cent of bank credit should flow towards these priority sectors was often not met. Banks took it as an imposed programme and after a lot of opposition, it is now being phased out. This is likely to deprive the rural households from the bank credit in the absence of alternative formal institutions. While bank financing is still confined to a few business houses, the vast majority of the households remain deprived of any type of formal institutional credit[21] (UNDP, 2004). Besides, the lending practice remains highly collateral based, thus undermining the access of the small business sector and the poor in bank credit.

Nepalese economy is characterized by the command of a few business houses in trade, industry, and business. More than 140 companies or firms are run by 8 business houses with an average of nearly 20 firms per each group. Those who own industry have also trading firms for exports and imports, and now they operate banks and finance companies for catering their own financial needs. They are also the ones who have been able to collaborate with the foreigners and many joint venture investments revolve around these business houses. So much so that privatized public enterprises also go in their hand and in the absence of anti-monopoly act, privatization of public enterprises results in transfer of state monopoly into private monopoly. They are the ones who have been able to enjoy most of the commercial bank credit. It is estimated that about 25 business houses have borrowed annually more than Rs 15 billion from the banking system with credit liability outstanding at nearly Rs. 12 billion. This comprises nearly 20 per cent of the outstanding bank credit to the private sector.

4.4 WTO Membership, Financial Reforms and Its implication on Poverty

It is well known that Trade liberalization measures push other sectors also to be liberalized and lead towards global economic integration. Nepal's membership to WTO, SAFTA and BIMST-EC can be viewed from this perspective. But entering global and regional trading

[21] Undisclosed Nepal Rastra Bank sources indicate that 200 big business houses enjoy more than 80 per cent of the banking sector’s credit. Even disclosed information reveals half a dozen large business house holding nearly 20 per cent of the commercial bank s’ outstanding credit.

regime demands a number of adjustments and reforms which impact upon well-being, livelihood, and poverty. As a member of WTO, Nepal has to open up service sector, including financial services, by the end of 2009**.** This calls for permission to foreign banks to open bank branches in Nepal, along with allowing the operation of insurance and professional services also. The ensuing competition has urged the government to take initiatives to restructure the domestic financial system in terms of consolidating branches, retrenching of employees, withdrawing from mandated priority sector lending, consolidating loan portfolio, privatizing public sector institutions and liquidating unviable ones. These measures have serious implications for rural economy and access of the poor to institutional credit. In the absence of alternative financial institutions, the restructuring is creating a new financing gap in the rural area.

There are a number of provisions under WTO which impinge upon the financial sector. Right from national treatment to entry opportunities and ownership, these WTO based rules call for rapid reform and restructuring of the financial sector. The restructuring costs are, however, very high. The consolidated non-performing of the public sector banks about Rs 40 billion-more than half the revenue the government collects in a year. Without recapitalizing these banks along with eliminating bad loans, it is difficult to privatize them. Thus the fiscal cost associated with financial reform is huge; and global financial integration associated with trade liberalization calls larger public actions at a time when traditional sources of revenue are squeezing. It is also to be understood that without financial stability, sustained external sector liberalization is not possible.

Overall, expansion of international trade and financial services are interlinked; a deeper financial sector is both a cause and effect of enlarged trade flows. Empirical analysis shows that for each 10 percent growth in value added in the trade sector, value added in the financial services goes up by 3.3 per cent[22]. This is because of trade concentration of financial services. But, as explained earlier, trade competitiveness is enhanced with efficient financial services; and a deeper financial sector would strengthen supply side of international trade. Interdependent expansion of both of these sectors would enhance growth and thus create a comfortable environment for poverty reduction.

[22] A regression of vale added in financial sector as a function of value added in trade, restaurant and hotel sector shows elasticity at 0.33 with R2 as high as 0.99 and the elasticity coefficient significant at 1 per cent level (period 1976-2005).

CHAPER V: EFFECTS OF TRADE LIBERALIZATION ON AGRICULTURE, MANUFACTURING, AND LABOUR MARKET

5.1 Trade and Agriculture

The effects of trade reform on development and poverty in an agriculture-dominated country like Nepal largely depends on intersectoral changes in the economy as well as intra-sectoral changes, particularly within agriculture. In general, liberalization is expected to exert positive effects on agricultural growth, and via faster agricultural growth, on rural poverty. Agriculture is seen as a disadvantaged sector under protection which through suppressed prices promotes the interests of the import-substitutionist urban sector. When trade is not liberalized, it is argued that agricultural prices are depressed; as the inter-sectoral terms of trade are maintained in favor of the urban sector. Trade policy reform is supposed to revert this and provide improved incentives for agricultural production through price signal.

Agricultural output prices are expected to rise at the border following trade liberalization; thus rural incomes and agricultural output are expected to increase. Given that agriculture typically has strong spillover effects on non-farm activities (like demand for manufactured goods, construction, and transport), the effects of agricultural growth on the overall effective demand are seen to be widespread. Output growth is also seen as being positively influenced by improved access to inputs and new technologies following trade policy reform.

High agricultural prices is however a double-edged sword which can cut both sides of the agricultural households. In a country where food sufficiency is reported by less than 40 per cent of the lowest consumption quintile of households and 60 per cent of the second lowest consumption quintile of households, and where food surplus is reported by little over 2 per cent only, prices might adversely affect food security situation of the household who have to buy food.

Empirical studies indicate that higher agricultural produce prices may not always have a positive effect on larger farmers. Farmers may not be responsive to price change; this is especially true when commercialization of the agricultural sector is limited, and output effects will be limited. Even when agriculture is commercialized, whether or not farmers increase output in response to higher prices will depend partly on what happens to input prices. If input prices rise more than output prices, the positive output effects will not be forthcoming. Besides, even if a small group of farmers respond to price rises by expanding output and aggregate output increases, poor farmers may be left out of this process (if they are engaged in subsistence farming with little surplus) and the positive effect on rural poverty will be small. The net effects of liberalization on poverty will depend on whether the rural poor are largely net sellers or buyers of agricultural produce, especially food. If the majority of the poor are net buyers of food, a rise in food prices could lead to increased poverty.

Trade policy reform is also predicted to induce a switch from subsistence agriculture to cash crops and increased incomes for the poor (Winters, 2000). There could however be other effects which counteract this. If cash crop prices are subject to fluctuations, farmers may not be willing to bear the increased risk and uncertainty, and output of cash crops may not increase. Switching to cash enterprises has also been shown to be disadvantageous to women, who are more likely to remain with subsistence production and whose incomes fall relatively to that of men.

Most of the agricultural produces in Nepal are non-marketed. Only half of Nepali agricultural households sell any agricultural produce in the market compared to nearly all households in Bangladesh selling some of their produce (Bhasker Sharma, 2005). Such low levels of commercialization and productivity of agriculture stand in sharp contrast with the country's significant potential, arising from its inherently favorable agro-climatic conditions and regional diversity. Domestic policies affecting agriculture that restricted trade and distorted prices until a few years ago, competition from Indian producers who are supported by large subsidies, and the poor state of Nepal's infrastructure are the key factors behind the country's low labor productivity and lack of market development.

Trade liberalization affects protection of agriculture through tariff reduction in agricultural produces in the process of creating freer global or regional trading regime. In principle, Nepal's entry into WTO, SAFTA, and BIMST-EC calls for tariff reduction to a certain level. In practice, however, the requirement is minimum, as applied tariff rates are much lower than the binding rates. The unweighted average of the final bound level of tariff in agriculture products under WTO is 42 percent. Around 80 percent of the bound tariffs are concentrated in the range of 30 to 50 percent, with 90 percent of the tariff lines being at least 30 percent. There is no tariff rate quota and no products under special safeguards. Nepal has made commitments to phase out all other duties and charges than customs duties by 2012. MFN tariffs on agricultural produces average at about 13.0 percent. The tariffs on agricultural produces in Nepal have been kept low due to (i) Nepal-India preferential trade relationship which entails tariff free flow of primary commodities, (ii) porous open border with India which provides room for illegal trade if customs duties are high, and (iii) welfare concern regarding prices and availability of food items ensuring domestic food security.

Nepal has been able to keep binding tariff rates high enough and there have been significant gaps in the bound rate and applied rate of duty. The un-weighted average of the applied tariff at 13.0 percent with maximum rate of 40 percent as compared with the binding average rate of 42 per cent implies that Nepal is not pressed hard to reduce tariff just being a member of WTO; rather she has flexibility to raise tariffs up to the bound level in case of import surge injuring domestic farms.

Another element in the process of trade reform and integration, which affects agriculture, is loss of protection in terms of elimination of transfers and subsidies. Nepal withdrew price subsidy on chemical fertilizer, capital subsidy to shallow tube-well, and interest subsidy to bank credit as an attempt to enhance inputs supplies by relieving traders from subsidy constrained supply system, rationalize public spending, and promote private sector to participate in the agricultural inputs market. Overall, due to resource constraints, Nepal is not providing any trade and production distorting supports to the farmers. However, if the level of protection to agriculture following entry into WTO is unlikely to change, the implication of IPR related norms is likely to affect it.

Trade liberalization is supposed to support commercialization of agriculture by expanding domestic and by creating export market for the produces, smoothing the supply of inputs and bringing excess labour from agriculture to non-agricultural sector. While Nepal's imports were highly regulated, the import of chemical fertilizers was constrained due to government monopoly in this sector and high price subsidy provided to its use. With trade liberalization, such import was expected to rise along with other agricultural machinery and tools. But the import of such items did not grow after liberalization, as the share of such items in total imports have declined from more than 7 per cent in 1990 to less than 1 per cent in 2005 (Table 5.1). On the other hand, raw materials for manufacturing of agro-based products constitute a fairly large size; e.g. that for carpet, garment, vegetable ghee, jute, etc. is mostly imported[23]. Thus from backward linkage perspective of manufacturing sector with agriculture, agriculture does not seem to have contributed significantly.

Table 5.1: Share of Major Inputs on Total Imports (%)

Items	1990	1995	2000	2002	2004	2005
Agricultural Inputs	7.3	2.7	3.5	2.9	1.8	0.9
Raw Materials for Garment & Carpet	11.0	8.5	12.6	8.1	8.1	5.3
Transport & Communication Equip.	5.5	7.9	7.7	7.6	8.3	7.3
Construction Materials	6.0	5.4	3.4	4.8	3.7	2.6
Raw Material for Vegetable Ghee	1.6	1.5	2.8	6.8	5.6	2.4
Machinery & Parts	0.4	1.1	5.7	3.7	4.2	4.2

Source: Compiled from Economic Survey and Nepal Rastra Bank Publications

Trade liberalization has not transferred technology to agriculture, as evidenced by the limited use of modern agricultural inputs and mechanization technology. The agricultural system in Nepal still depends on indigenous technology. Most farmers use conventional agricultural tools; and mechanization of agriculture is at a very low stage. Only 0.6 percent of the farmers in Nepal own tractors or power tillers, 0.9 percent use threshers, and 2.7 percent own a pumping set (CBS, 2004).

Withdrawal of fertilizer subsidies led to a substantial rise in the price of fertilizers. Since the subsidy withdrawal in 1998, the price of sulphate fertilizers has increased by more than 50 per cent, the price of urea has almost doubled, and that of potash rose by 50 per cent. The price of phosphate fertilizer also went up by about 12 per cent. This happened at a time when prices of food grains, mainly rice, dropped down (see Table 5.2). Such a hike in the prices of most fertilizers has led to a considerable increase in the costs of

[23] The recent decline in the share of imported raw materials of some manufacturing products is mainly due to weaker export prospect of these items.

production, contraction in the uses of fertilizers in non-commercial crops, and use of low quality cheap fertilizer illegally imported from India. Understandably, small farmers are the hardest hit as a result of the price hikes in fertilizers.

It is possible that liberalization leads to a fall in agricultural prices, due to the entry of cheap imports. The poor would benefit from this via consumption effects. For surplus producers, however, the effects would be different. Competition with imports, a fall in prices and reduced farm income increases poverty among rural producers. Again, the net effect would depend on what happened to other variables such as input prices and non-farm employment. On the whole, there has been a rise in the import of primary goods particularly food items from India in the recent years at a low price which has helped price to remain low. But the welfare gains arising from cheap imports should be analyzed against the resulting poor agricultural performance in Nepal[24].

There was a significant drop in paddy prices during 2000-05 because of huge imports of input-subsidized paddy from India. The import was as high as 7 per cent of imports from India. As a result, the drop in paddy prices was as high as 25 per cent in some years and the annual average drop in 5 years was 4.5 per cent (Table 5.2). Although this had positive impact on the consumer's price index, as food price index went up by 2.6 per cent per annum only and kept inflation low, the depressed income level of the households adversely affected their effective demand. The low food prices have had positive impact on food security and helped the food deficit households to have access to food items. But food surplus households, farm income was adversely affected by low food prices and their demand for non-food items was adversely affected.

Table 5.2: Local Market Retail Price Of Paddy (Selected Districts)

Districts/ Crop	**1999/00**	**2000/01**	**2001/02**	**2002/03**	**2003/04**
Banke					
Coarse Rice	18.48	13.73	11.11	13.41	14.17
Medium Rice	17.13	22.57	16.39	15.50	16.93
Chitwan					
Coarse Rice	16.56	14.55	13.23	14.11	13.82
Medium Rice	21.10	20.05	16.88	18.85	19.63
Morang					
Coarse Rice	17.03	13.49	13.21	14.57	14.65
Medium Rice	22.11	17.95	16.67	17.08	19.02

Source: Ministry of Agriculture and Cooperatives, cited in Bhasker Sharma (2005)

There had been a 'surge' in the imports of rice from India in the recent past with its price dampening effect in the domestic market. But 'injury' from the 'surge' has become difficult to establish for a number of reasons like special trade treaty between India and Nepal, no domestic production shocks from the surge, and a large component of the imports having taken place in informal way.

[24] See UNDP, 2004 for the implication of cheap food import from India.

The growth of the Nepalese economy is determined largely by the growth of its agricultural sector. However, agricultural growth over the past two decades has barely kept pace with population growth. Agriculture in Nepal is characterized by low rates of productivity, very low levels of technology absorption and low levels of commercialization. Given the high and increasing concentration of poverty in rural areas, improving agricultural growth is essential for poverty reduction.

Agricultural growth even in the post-reform period 1990-2001 continues to be poor. Agricultural gross domestic product (AGDP) growth was slower in the 1990s than in the 1980s. With an average annual growth rate of 2.7 percent, agricultural growth was the lowest among all the major components of GDP. There is however some difference between the two sub-periods 1990-1995 and 1996-2001, with growth rates being 1.75 and 2.94 per cent respectively. Recent satisfactory performance of agriculture (3 per cent during 2002-05) is the outcome of better weather condition (Table 5.3).

Table 5.3: Growth of Agriculture, Population and Economy

Items	1971-81	1981-1991	1991-2001	2002-05
Population growth	2.66	2.10	2.24	2.24
Real GDP Growth	3.11	5.06	4.64	2.84
Real AGDP Growth	0.76	3.74	2.72	3.05
Real NAGDP Growth	7.32	6.87	6.64	2.71

Source: UNDP (2004) and Economic Survey, MOF (various issues).

Some studies (ANZDEC, 2002) have shown an improvement in agricultural performance in the second half of the 1990s. This improvement is attributed to policy changes. But this is questioned on two counts. First, the improvement in performance is fairly marginal and does not denote a fundamental shift in the agricultural growth performance trend. And second, it is difficult to attribute this to policy shifts without controlling for other factors such as weather. Given that key structural features and constraints of the agricultural sector have persisted over time, the precise mechanisms and channels by which these policy changes have influenced performance are also unclear (UNDP, 2004).

Trade liberalization is supposed to change the structure of agricultural production. But it is not yet clearly observed in Nepal. Crop production is the most commonly undertaken agricultural activity and accounts for around 61 percent of agricultural GDP. Food grains dominate crop production, accounting for 34 percent of agricultural GDP. Industrial (cash) crops account for 7 per cent of the agricultural GDP[25]. Fruits and vegetables account for 22 per cent of the agricultural GDP and this is one of the very fast thriving crop now.

There has been some change in the cropping pattern. The living standards survey shows that the number of households engaged in cash crop farming has grown over years (Table 5.4). Particularly, green vegetable, potato, lentil, sugarcane, and tea cultivation and cropping has gone up significantly in the last decade. But much of this change has come from changing domestic consumption pattern and industrial demand for raw materials.

[25] The weightage is based on the production level of 1995. So it does not truly reflect the current share.

Table 5.4: Pattern of Households Engagement in Cropping (in %)

Crops	**1996**	**2004**
Rice	76.0	76.1
Wheat	66.4	62.6
Summer Vegetable	35.6	60.8
Winter Vegetable	NA	62.7
Potato	35.5	50.0
Mustard	40.2	37.6
Lentil	NA	32.1
Tea*	2.0	15.0
Sugercane*	42.0	59.0

Source: economic Survey, MOF various issues.
* ‘000 hectares

The changing cropping pattern is reflected in the growth rate of various crops. There has been a faster growth of commercial (cash) crops like sugarcane (6.1 per cent), potato (6.6 per cent), and vegetables (4.9 per cent) during 1991-05 (Table 5.5). Milk production has also gone up during 1996-05 whereas the production of tea has doubled in 5 years (2001-05). Some of these items have strong export potential, while others are emerging as import substitutes. On the whole, cash crops outperformed cereals for much of the 1990s, with an annual average growth rate of around 5 percent. Diversification of crop production away from food grains and into cash crops has been minimal over the last decade.

Table 5.5: Major Agricultural Production (Compound Growth Rates in %)

Major Crops	**1986-90**	**1991-95**	**1996-2000**	**2001-05**	**1991-05**
Paddy	4.6	-2.9	6.6	1.3	1.7
Maize	7.9	1.2	2.6	3.5	2.4
Wheat	9.9	1.3	5.3	4.0	3.6
Sugarcane	19.3	8.7	7.0	2.5	6.1
Oil Seeds	3.1	0.8	3.8	3.0	2.5
Tobacco	3.1	-1.0	-10.5	-4.6	-5.4
Jute	-13.5	-6.6	6.0	3.1	0.8
Potato	9.8	4.6	7.1	8.0	6.6
Pulses	2.2	4.4	3.3	2.7	3.5
Fruits	6.2	4.1	-4.6	4.1	1.2
Vegetables	6.0	4.8	3.5	6.5	4.9
Milk	2.9	1.1	3.9	3.1	2.7
Meat	2.7	1.9	3.5	2.6	2.7

Source: Economic Survey, MOF various issues

Agricultural production in Nepal is mainly for domestic consumption, with agricultural exports accounting for only 3.4 percent of agricultural GDP during the 1990s. Agricultural imports accounted for around 7.5 percent of total imports during this period.

India is Nepal's main trading partner for agricultural commodities. Agricultural export to India accounts for around 75 percent of total agricultural exports. Very recently, export of green vegetable to Bangladesh, Japan, and Middle East has picked up; but the size is small. Agricultural import from India accounts for around 55 percent of total agricultural imports (ANZDEC, 2002) and much of the agro-industries still depend on imported raw materials.

There has been a shift in the labour force engaged in agriculture. In 2001, 66 percent of the economically active population was engaged in agriculture compared to 81 per cent in 1991 (CBS, 2003). The share of employment in manufacturing has gone up during this period (Table 5.6). The continuing predominance of the agriculture sector in the livelihoods indicates the importance of a broad based agricultural growth for poverty reduction.

Table 5.6: Labour Force Participation in Major Sectors (in %)

Sectors	**1981**	**1991**	**2001**
Agriculture, forestry & fishery	91.1	81.2	66.0
Non-agriculture	8.9	18.8	34.0
Manufacturing	*0.5*	*2.0*	*8.8*
Trade and services	*1.6*	*3.5*	*9.9*
Social and community service	*4.6*	*10.3*	*8.3*
Other sectors	*2.2*	*3.0*	*7.0**

Source: CBS (1995), and CBS (2003).
* Of the 7 per cent, 3 per cent is occupied by construction alone.

The Agricultural Perspective Plan (APP) introduced in 1997 was intended to accelerate the agricultural growth rate sufficiently to obtain strong multiplier effects on growth and employment, in both the agricultural and non-agricultural sectors. This growth would occur through technological change to be achieved through investment in research and extension. The APP aimed for a broad-based participatory growth across regions and income classes and emphasized sub-sectors particularly important to women. The strategic thrusts identified to achieve the APP objectives were, among others, (i) a technology-based green revolution in agriculture which becomes the initial engine of accelerated growth; (ii) accelerated agricultural growth which creates a demand-pull for the production of high-value commodities in agriculture, as well as for non-agricultural commodities, with consequent large multiplier effects on other sectors of the economy; and (iii) broadly based high employment growth, which then becomes the mechanism for achieving societal objectives.

What then has been the overall effect of these policies on agricultural growth? In general terms, the APP and other reforms have failed to have a significantly positive impact on agricultural production. The overall objective of raising the growth of per capita agricultural GDP to 3 percent has not been reached. As such, there has been just 0.5 per cent growth in per capita agricultural GDP during the last decade or so. Whilst the analysis has indicated that the agricultural sector has not responded favorably to recent policy reforms, there are a few positive signals: agricultural production and exports increased in the second half of the 1990s, high-value crops showed a strong performance, and new export items emerged in the trade flows, although these still account for a tiny fraction of total exports. Strong performance in these areas is encouraging, and has helped poverty reduction in some pockets of the country; but it is yet to emerge as the basis of a sustained, broad-based agricultural growth and poverty reduction.

5.2 Trade Liberalization and Manufacturing Sector

Trade liberalization can support manufacturing sector by, among others, (i) reducing the tariff applied on raw materials and machinery, (ii) encouraging foreign investment in manufacturing, (iii) facilitating technology transfer, and (iv) creating a competitive environment by elimination of distorting measures like subsidies, transfers, and differential tax rates. Expanded external market through trade liberalization helps domestic and foreign investment in export-oriented industries. At the same time, trade liberalization could reduce the degree of protection enjoyed by domestic industries, and therefore, make non-competitive domestic firms to close down. This implies structural shift in manufacturing industries in course of trade reforms.

Manufacturing output grew rates sharply in the early 1990s immediately after trade policy reform began. Such output growth which averaged around 5 percent per annum during the 1980s, rose to 14 percent during 1991-1995. However, this growth decelerated sharply thereafter and averaged at 7.6 percent during 1996-2000. In the subsequent years (2001-05), manufacturing output stagnated as the average growth was just 0.1 per cent. The same trend is seen in investment growth rates. Annual average rate of growth of investment, which was negative during 1985-1990, rose to 15.9 percent during 1991-1995, but decelerated to 5.9 percent during 1996-2000 and further to **3.1** per cent during 2001-05 (Table 5.7). The fall in manufacturing output and investment growth rates also reflects the effects of increased import competition (Khan, 2000). As discussed earlier infant industry development during the closed economy period was weak. Removal of trade barriers therefore meant that import-competing sectors of manufacturing were not competitive vis-à-vis imports, thus resulting in a contraction in growth rates.

Table 5.7: Output and Investment Growth in Manufacturing Sector (Annual Avg)

Year	Output Growth	Investment
1986-1990	5.2	-1.4
1990-1995	14.0	15.9
1996-2000	7.6	5.9
2001-2005	0.1	**3.1**
1986-1995	9.6	7.4
1996-2005	3.5	**4.5**

Source: Economic Survey 2004/05, MOF and Central Bureau of Statistics.

Empirical analysis shows some positive effect of trade liberalization on manufacturing sector. Regressing value added in manufacturing sector against value added in trade sector and openness, it is observed that each 1 per cent growth in value added in the trade sector is associated with 1.02 per cent rise in value added in manufacturing sector; and each one percentage point increase in trade openness results in the growth of manufacturing by 0.02 per cent[26].

Overall, Nepal's manufacturing sector shows some improvement in the post-liberalization period with a marked growth in the early 1990s. But as the growth could not be sustained thereafter, the sector seems to be vulnerable to external market condition and competition from abroad. Its volatile performance reflects its narrow commodity composition, dependence on a few export markets and inability to compete with imports.

The poverty implications of this manufacturing performance would partly depend on the growth of employment and wages in this sector. The Population Census show an increase in the proportion of the total labor force employment in manufacturing from around 2 percent of the labor force in 1991 to 8.8 percent in 2001. But manufacturing census[27], which covers only organized sector establishments does not substantiate this. There has in fact been a decline in the employment in this sector during 1991-2002 by 15 per cent (Table 5.8). Also employment elasticity of manufacturing output declined from 3.1 in the 1980s to 1.5 in the 1990s.

Table 5.8: Indicators of Manufacturing Industries (Rs in Million)

Indicators	**1992**	**2002**	**% Changes (1992-2002)**
No of Establishments*	4271	3213	-24.8
No of Persons Engaged*	223463	191853	-14.1
No of Employees*	213653	181943	-14.8
Wages, Salaries & Perks	3348.5	6389.7	90.8
Gross Addition to Fixed Assets	2373.7	3104.9	30.8
Gross Fixed Assets at End of Year	20067.1	40371.4	101.2
Total Input	19347.5	62206.5	221.5
Total Output	32997.4	94811.1	187.3
Value Added	13649.9	32604.6	138.9
Wages and Salaries as % of Output	10.1	6.7	-33.6
Output as % of Input	170.6	152.4	-10.6
Capital Productivity*	68.0	80.8	18.7
Employees Productivity**	**6108.4**	**16994.6**	**178.2**

* value added in rupees as per cent of gross fixed assets
** value added in nominal '000 rupees terms per employee.

[26] The estimated period is 1976 through 2005, the coefficients are statistically significant at 5 per cent level and the explanatory power of the estimated equation was 0.99.
[27] Census of Manufacturing Establishments—1991, 1997 and 2002, CBS.

There was a decline in the number of workers employed per fixed capital investment (number of additional workers per Rs one thousand of additional fixed capital of the manufacturing establishments declined by 0.2 per cent during 1997-2002). The backward linkage of manufacturing output deteriorated during this period (the share of domestic raw materials to total raw materials used by the manufacturing establishments declined from 54 per cent in 1997 to 34 per cent in 2002). And, there was no substantial rise in manufacturing sector wage rates and no significant diversification of the products. All these indicate little poverty impact of manufacturing sector triggered by trade reform.

Analysis of the manufacturing census data shows that there has been a decline in the number of manufacturing establishments by 25 per cent during 1992-2002. Number of persons engaged in manufacturing also declined by 14 per cent and wage employees by 15 per cent. Output increased by nearly 3 folds but wage bill less than doubled. Output per unit of input declined by 10 per cent and wages and salaries as per cent of output declined by one-third. All this manifests not an encouraging picture of the manufacturing sector during 1992 –2002 when trade liberalization had got momentum.

The discussion of trade reform, employment and poverty in the literature has been confined largely to the manufacturing sector and has focused on the proposition that liberalization leads to reduced wage inequality in developing countries due to an expansion of employment for unskilled and low skilled workers in export sectors. Whether reduced wage inequality leads to a fall in poverty would however depend on whether incomes for unskilled workers rose above the poverty line. Further, there is the possibility that the most intensively used labor in export sectors may be relatively skilled by developing country standards. If the relatively skilled are underrepresented among the poor (as is likely to be the case) a fall in poverty is unlikely. In Nepal the growth of manufacturing sector is accompanied by informalization of the production process by sub contracting, outsourcing and using home based workers. The informalization of the labour market has led to wage differences across sectors, pockets of the economy and establishments. The informal labour market has remained highly exploitative and wage discriminations persist (see next section).

Foreign trade, industrial and foreign investment policies are interlinked. When one third of the global trade is concentrated among multinational companies, the complementarities between trade and investment can be amply understood. Along with larger international trade volumes, flows of foreign investment have been growing in recent years, partly as a result of the increasingly close integration of national economies, driven by worldwide competitive pressures, economic liberalization, and the opening up of new areas to investment. In addition, foreign investment, especially FDI has become the principal source of external capital in a number of countries, which are now more receptive to FDI as evidenced by changes in their investment policies.

Nepal encourages foreign investment as joint venture operations with Nepalese investors or as 100 per cent foreign owned enterprises. The broad areas opened for foreign investment include manufacturing industries, energy based industries, tourism industries, mineral resource based industries, agro-based industries and service industries.

Enactment of the Foreign Investment and Technology Transfer Act (FITA) 1991, introduction of Foreign Investment and One Window Policy and also new policies relating to trade, transportation, communication and electricity have created a congenial environment in attracting foreign investors to Nepal.

With the liberal economic policy changes put in place, foreign investors are attracted to participate in joint venture investments particularly in the field of banking, hydropower development and tourism. As a result, within the span of 15 years, the number of industries approved for joint venture investments have increased by almost 10 folds. The total fixed investment cost of these industries stood at US $ 1025 million with the total project cost of US $ 1227 million. The foreign investment accounts for 22.7 percent of the total project cost amounting to US $ 353 million[28]. These industries under FDI are estimated to generate employment opportunities to about 94 thousand people and this is nearly nine times the level of employment opportunities received by 10.6 thousand people 15 years back. Recently multinational companies have been entering the country in the areas of hydropower, telecommunication, insurance and banking.

As a major trading partner and close neighbour, India has remained as the largest investor in Nepal with 287 (32.4 percent) of industrial joint ventures having foreign capital investment of Rs.9.5 billion (38.0 percent of total foreign investment). In terms of amount of foreign investment USA comes second (16.0 percent) after India, followed by China (10.5 percent), Norway (4.2 percent) and Japan (3.7 percent). Also by type of collaboration, out of the total industrial ventures, 87 percent are financial and the rest 13 per cent are on technology transfer, management, patent, and trademark agreement.

Foreign investment is said to be helping developing countries to grow and to enhance human development (HDR, 1999). But studies show no automatic link among FDI, economic growth and human development. With huge FDI, Asian countries like China, Korea and Malaysia have benefited immensely in terms of not only economic growth but also human development. But countries like India and Vietnam have met the same with tiny size of FDI and countries like Indonesia, Russia and Romania have not performed well despite sizable FDI inflows.

Empirical findings reveal a numbers of benefits derived from foreign investment. First, FDI is the principal sources for external capital. It provides financing for balance of payments. An inflow of FDI provides balance of payments financing if it is not used for capital formation. Privatization of national enterprises/industries and involvement of foreign participants are some of the examples of inflow of foreign capital. Second, FDI provides access to new technology. Technology owners are more willing to make technology available to a partner if they can retain some degree of management control. Additionally, it provides management techniques. FDI brings in new knowledge and entrepreneurial skills, which are among the important benefits of international exchanges of goods and services. These help to employ domestic resources more efficiently and adjust the mix of products to obtain more value added per unit.

[28] These figures correspond to April 2004.

Third, FDI provides access to marketing expertise and market links is also facilitated through these capital inflows. Many foreign investors come to the host countries with established marketing networks and have more experience in international markets. FDI can also provide marketing links to a foreign partner as the local partner may be able to provide access to the local and possibly the regional market. Fourth, most importantly FDI, is thought to stimulate economic growth. Through its mobilization of domestic resource, FDI provides additional economic activity and generates employment. In the case of well-developed markets, FDI can also accelerate economic transformation and restructuring the economy. FDI played a considerable role as a source of capital as well as a supplier of technology and managerial skill in East Asia, especially in Hong Kong, Republic of Korea, Taipei, and China.

Studies covering most of the Asian developing countries have found out that foreign investment has contributed to economic growth both by augmenting resources available for capital formation and by increasing the efficiency of investment. However, in addition to foreign capital, export performance, growth of labour force and the domestic savings rate have also made a positive contribution to the growth of the Asian region. Foreign private investment and export performance have been found more importance than aid supporting the North's prescription of self-reliant approaches for the developing countries. Also growth of labour force and domestic savings rate has been more important than either foreign capital or exports. These findings have serious policy implications; the most important is that if a country wishes to achieve rapid economic growth, maximum efforts will have to be directed towards increasing the productivity of the labour force and towards mobilizing domestic resources. These tasks may involve difficult choices and tough policy measures. But there is no escaping the implication that reliance on foreign capital does not necessarily offer the solution for high and rapid growth; however, countries should continue to accept foreign capital in those areas where domestic resources do not provide an adequate substitute.

The impact of foreign capital on the economic growth of developing countries as well as the relative significance of the various types of foreign capital vis-à-vis trade is controversial. Despite the benefits and opportunities offered, there are a number of disadvantages. First, there is a possibility that foreign investment may "crowd out" domestic private enterprise and also reduce pressure to foster such an enterprise because of the presence of competitive foreign enterprises. Second, if financial and trade distortions exist in an economy, foreign investment, particularly, FDI can take from the country more than it contributes. Third, foreign investment also has found its downside risks. In the long run foreign investment may de-capitalize the recipient economy as the annual repatriation of profits, dividends, royalties and fees increase over time. Fourth, Although foreign investment has played significant role in some of the countries, it is not the only ingredient for their economic development.

For Nepal, it is too early to make any assessment of FDI in economic growth. This is because the proportion of FDI in total investment of the country is very low; official figures show the proportion at less than 2 per cent. Further, it is declining in the recent years because of the deteriorated investment climate. Withdrawal of FDI has also been observed in some services sectors. Compared to what our neighboring countries have benefited from FDI, Nepal is yet to be benefited from such capital inflows.

The impact of FDI on poverty and development could be judged on two grounds; (i) whether FDI has been instrumental to generate broad based high economic growth or not, and (ii) whether this has created gainful employment opportunities and wider revenue base of the government to support social sector development programmes or not. Gainful and dignified job is the most effective means of social security and poverty reduction. In this context, relating foreign investment to poverty reduction needs examination of the issues like employment intensity of investment, safety at work, job security, level and growth of wages, and other incentives like medical, maternity, and old age pensions. We have to see that these prerequisites are met while providing employment with foreign investment.

In a democratic country, citizens have the right to survive, grow, develop and actualize their potentials. For this, the state should be able either to create adequate job opportunities or provide social security support for needy citizens. In this context, creation of gainful job opportunities should be major reason behind inviting foreign investment. But what we should also realize that one of the major reasons behind FDI flows to Nepal is the unorganized labour market with excess supply of labour force and this force willing to work at a wage which is not enough even to meet the poverty threshold level of consumption. Without plugging the loopholes for exploitative labour relation, creation of job opportunities alone is not going to promote labour welfare. In a nutshell, no automatic positive linkage seems to have evolved between FDI and development in Nepal.

5.3 Labour Market Implications

One core area whereby trade liberalization impacts upon poverty and development outcomes is through labour front. The process of trade led industrial expansion creates job opportunities out side the agriculture sector; and through the backward linkage, it also generates off-farm employment in the agriculture sector. This makes a structural shift in the employment pattern along with affecting the wage level.

As discussed earlier, there has been a marginal change in the occupation (employment) pattern in Nepal over years. But agriculture still accounts for nearly two-thirds of the employment and industry and service are together contributing just one-third of the job opportunities. Underemployment is a major problem with only 52 per cent of the workers working for more than 40 hours a week (CBS, 2004). More than 90 per cent of the labour market is informal and the process of informalization is growing due to issues related to trade unionism and rigidity of the labour law.

Despite unemployment and underemployment situation, there has been some improvement in the wage rates in the recent years. Most of such a rise has come because of the out-migration of the youth population for work. Also the strong growth performance of the Indian economy and subsequent rise in the wage rates in India has discouraged Indian workers to come to Nepal for informal sector job, and trend has now reversed with Nepalese labour going to India as agricultural workers.

In nominal terms, wages of all types of workers went up during the last two decades (Table 5.9). The rise was higher during 1990s. The differential wage rates for male and female continued during this period but the trend was towards convergence inh the formal sector, a good sign of improving wage discrimination. However, the same in the informal sector was reverse.

Table 5.9: Trend of Wage Rates by Types of Employment (Average Growth in %)

	1981-85	1986-90	1991-95	1996-2000	2001-05
Carpenter					
1.Skilled	12.66	13.29	13.47	9.54	4.09
2.Semi-Skilled	12.75	12.33	13.44	7.71	3.95
Masoon					
1.Skilled	12.01	13.85	13.01	9.45	3.98
2.Semi-Skilled	12.41	13.09	12.74	7.59	4.16
Industrial Labour					
2.Skilled	7.46	9.99	14.88	19.61	4.75
4.Un-Skilled	7.76	11.82	17.73	10.55	7.16
Agricultural Labour					
1.Male	13.02	14.00	11.06	9.15	5.14
2.Female	14.71	15.90	8.65	5.41	8.54
Ordinary Labour					
1.Male		9.58	15.27	9.06	4.21
2.Female		8.15	14.64	9.65	4.28
Memorandum:					
Inflation	9.7	11.6	11.3	7.9	3.7
Food	9.4	12.5	11.5	8.3	2.3
Non Food	10.4	10.0	10.9	7.3	5.0

Source: Nepal Rastra Bank

There was marginal rise in real wage rates during the last decade or so. Real wage of carpenters, masons, and agricultural went up during 1981-2005 by 2 per cent or less (Table 5.10). The only sector where real wage went up by more than 2 per cent was the industrial sector. In many years, the real wage growth was negative. Low level of wage followed by marginal rise in its level in real terms reflects poor income condition of even the employed class and thus no significant improvement on living condition.

In the last three decades, the environment for FDI and trade has been changed dramatically. The major contributory factors have been the reduction of technological and policy related barriers to the movement of goods, services, capital, professional and skilled workers, and firms. Many local industries have now become transnational corporations. The consequence is that margins of competitive advantage have become thinner; a small shift in costs somewhere can seriously affect the competitiveness of a country. This is mostly reflected in the increased pressure in the labour market.

Table 5.10: Trend of Real Wage Rates by Types of Employment (Avg. Growth in %)

	1981-85	1986-90	1991-95	1996-2000	2001-05	1981-05
Carpenter: Skilled	2.96	1.67	2.20	1.67	0.39	1.78
Semi-Skilled	3.06	0.71	2.18	-0.15	0.25	1.21
Mason: Skilled	2.32	2.23	1.74	1.58	0.28	1.63
Semi-Skilled	2.72	1.47	1.47	-0.28	0.46	1.17
Ind. Labour: Skilled	-2.23	-1.63	3.62	11.75	1.05	2.51
Un-Skilled	-1.93	0.20	6.46	2.68	3.46	2.17
Agri. Labour: Male	3.32	2.38	-0.20	1.29	1.44	1.65
Female	5.02	4.28	-2.62	-2.46	4.84	1.81
Ord'ry Labour: Male	NA	NA	4.01	1.19	0.51	1.90
Female	NA	NA	3.38	1.78	0.58	1.91

Source: Nepal Rastra Bank

In the industrial countries, as cheaper imports have substituted local production, unemployment is growing. This is attributed developing countries' comparative advantage in unskilled labour whereby production could take place with very low wages and poor labour standard. Developing countries have then their own concern as to why labour movement has not been liberalized the way capital is liberalized and oppose the inclusion of labour standard as a clause under WTO arrangement. Now a fundamental issue has been raised: are human right and labour standard a luxury good or does respecting them help development (Leicht, 1998)? Many people see human rights' dimension of certain labour standard, as some labour standards reflect basic human rights that every country may have to adhere.

Globalization has encouraged the entry of multinational companies as a sole proprietorship or joint venture in industrial activities with low employment intensity, not even one-fifth of that in organized domestic industries. In the process of privatization and downsizing, the government has laid off thousands of employees. Following the structural adjustment programme, wages in the public sector were frozen for long in order to avoid wage increase in the private sector and ensure competitiveness of domestic industries. Thus workers share in national income has deteriorated and poverty intensified.

Globalization may exert both positive and negative effects on the labor market. The positive effects are achieved through expanded employment opportunities and improved productivity of labour through infusion of foreign capital and technology in the industrial activities. However, as labour also tends to be more mobile with the process of globalization, those having low skills than others face a threat of losing job. Besides, substitution of domestic products by cheaper imports makes many domestic industries and labour redundant. In particular, the indigenous cottage and small industrial products face a severe threat from the exposure of the economy and often vanish, displacing many people from their indigenous occupation.

Nepalese labor market is characterized by higher growth of labor supply in relation to demand, growing unemployment and underemployment, discrimination against women labour, exploitation of child labour, bonded labour system, very low wage rates (even deteriorating in real terms), high proportion of labour in unorganized sector and in self employment, lack of education and skill of most of the labours, and poor social security provisions for wage-workers. The labour force is increasing by 300 thousand each year whereas the estimated number for additional employment is 150 thousand only. Although the unemployment rate is about 5 percent, unemployment is as high as 47 percent. Of the work force, 78 percent are self-employed and only 22 percent are wage-workers. For female, the proportion of self-employment is even higher (86 percent). As most of the workers are in the unorganized sector and self-employed, the impact of globalization and foreign investment in the labour market has so far been limited.

Nevertheless, the process of globalization has had the following effects in the Nepalese labour market. First, globalization has encouraged the entry of multinational companies as a sole proprietorship or joint venture in industrial activities. But the employment intensity of foreign capital is observed very low-- one employment per Rs 500 thousand, as compared with Rs 90 thousand in organized domestic industries. The capital-intensive nature of foreign capital has created limited employment opportunities. Some ventures with foreign capital have been able to generate one employment for as much as Rs 3 million of fixed capital investment where a cottage industry can generate one employment for not more than Rs 10 thousand.

Second, the process of globalization has suddenly dismantled high level of protection provided for a long time to the domestic industries and eroded their competitiveness in the domestic market. As a result many import substituting industries and particularly the cottage and small industries have become redundant and many people involved in these areas have lost their job. The so-called technological shift has also made unskilled Nepalese labour force redundant and encouraged the use of foreign labour.

Third, as a means to enhance foreign investment, privatization has been opted for as a major policy instrument. So far about 18 industries have been privatized affecting job of about 4 thousand workers. In the process of privatization, about 1200 workers were laid off in the first two-phases of privatization covering 8 enterprises. The lay-off in the third phase is estimated to be even higher as 1000 employees of a single jute factory were laid-off in terms of privatization. There also have been a number of labour unrests before and after privatization.

Fourth, the strategy to adopt outward oriented economic policies has led to downsizing the public sector. The government has also laid-off more than 4 thousand civil servants. Besides, the golden hand-shake policy introduced to downsize the personnel strength of public enterprises also made hundreds of employee to quit job for no betterment. Besides, following structural adjustment programme, wages in the public sector were frozen for long in order to avoid wage increase in the private sector and ensure competitiveness of domestic industries so that the benefit of devaluation could be fully reaped. As a result, real wages in the public as well as private sector deteriorated during the last decade. In fact, industrial and business activities intend to compete in the market by suppressing labour wages rather than by promoting productivity through innovation.

Fifth, The multinational companies are also found to be exploiting the labour by hiring labour on contract, sub-contract, on daily wages basis or on temporary basis, by employing foreign labours, by not adopting liberal wage policy and by undertaking production itself on contract basis. There are growing cases of *bogus contract* in the Nepalese labour market. Foreign labourers are also encouraged because they are hired on contract; it is easy to fire them; and there is no risk of unionization and labour unrest.

Sixth, the process of globalization has posed a pressure on the existing labour laws and militancy of trade unions. Foreign investors, even in the disguise of multilateral institutions, are insisting the authorities for introducing greater flexibility in labour laws and ensuring the right to 'hire and fire' to the investors themselves. This is likely to undermine the creative role that trade unions can play for the growth of the enterprise along with protecting their own interest.

Nepal’s labour law and labour policy have evolved in line with the norm of the constitution which allows workers to unionize. There are also provisions which protect the labour against random dismissal from the job. The investors have been advocating that they should be given the freedom to hire or fire any employee. Growingly, concerns are also expressed against the right of the labour for unionization. The investors view that labour law and policies are biased against the promoters of industries and strongly in favour of labour. They cite this as one of the reasons for low foreign capital inflow in the country. The financial institutions have been blaming trade unions for the poor performance of the institutions. Thus, pressure is mounting for more liberal labour laws ensuring the right of the employer to lay off labour at its discretion.

But as there are no scientific ways to determine wages, as wages are tied up with productivity, as the working conditions are not secured and hygienic, and as there is no social security provision, it is risky to introduce more flexibility in the labour laws so as to woo the investors. Initiatives taken for fixing minimum wage in the formal and even in some informal sectors like agriculture is definitely a safeguard in this regard.

FDI has a significant bearing on labour market, industrial relation, trade union activities, and the process of unionization as well which has implications for human right. There are growing pressures for the introduction of labour laws, which would be to the advantage of the employers, and such pressure is often succumbed by the governments. The practice of hire and fire has begun from the financial institutions where joint venture financial institutions have been able to suppress union. This has been followed by some manufacturing industries by hiring foreign labour and using Nepalese workers as casual labour. The need then is to balance the interest of the employers with the job security and productivity-based compensation to the employees.

CHAPTER VI: INFRASTRUCTURE, STATE OF INSTITUTIONS AND TRADE CAPACITY BUILDING

6.1 Trade Related Infrastructure Policies and Programmes

Along with liberalization, deregulation, and privatization, declining costs of transport and communication have been a contributory factor for rapid globalization of financial flows and increasing foreign investment. Worldwide, the communication cost has come down drastically. From as high as 60 US dollars a minute 50 years ago, the long distance telephone call costs not more than 50 cents per minute now. In the last fifty years, the sea freight charge has come down to half whereas air service charge has been reduced to one quarter. Improvement in communication and transportation has made geographical distance more or less irrelevant. Access to information has been amazingly eased with the revolution in electronic media, particularly, the internet, email, and round the clock radio and television programs. However, this has not so far ensured equal opportunity to all, among countries and within a country. The absence of infrastructure such as transport and communication, particularly information and communication technology, is yet to reduce transaction cost, facilitate market information, and ensure factor mobility in Nepal. Besides, globally speaking, existing facilities have not fully integrated factors market; for labour, one of the major factors of production, still remains immobile. In fact labour markets remain highly segmented and show no indication of integration on account of stringent immigration policies, language, culture and other barriers to the international movement of labour. At this time of tough competition in the products market, low cost production strategy has then prompted movement of capital from capital surplus to labour surplus countries. Movement of such capital is also contingent upon infrastructure facility, among others.

Nepal began developing trade infrastructure like construction of road, expanding customs area facility, constructions of dry ports for facilitating multimodel transport system, and building capacity to regulation and standards related areas. Accordingly, 3 dry ports have been constructed in the country adjoining Indian border, one of them linked to Indian railways and the rest linked to Indian highways network leading to Kolkata -- the major port used by Nepal for third country trade. However, due to other logistic and regulatory issues, the benefit coming from these ports has been less than expected.

Infrastructure at the customs point is poor—parking, warehouse, transport facility, and cargo handling are all problematic. This has raised transaction cost and eroded export competitiveness or made imported goods expensive. To address this problem, transfer of 5 major customs points at Indian border to more spacious areas is being considered. But the process has been very slow and problem has begun right with land acquisition.

Connectivity has been a major problem in domestic and international trade expansion. Poor road connectivity impedes the backward linkage of industrial activities while it has also encouraged industrial and trade concentration. Rural-urban and regional distribution of trade benefits is thus highly unequal[29]. Similarly, as water supply, electricity and telecommunication facilities are centered at the urban areas, nearly half of the industrial establishments in located in the 58 municipalities and the rest in the villages adjoining to the municipalities in the eastern and central development region which have better connectivity with external market. The trickles down effects of industrial activities are also then highly concentrated.

6.2 Trade Facilitation, Customs Reform, and Trade Governance

A 3-year "Customs Reform and Modernization Programme'' is in implementation from FY 2003/04 to make Nepalese Customs more competent, transparent, client-oriented and modern as of other international modern Customs Administration for giving support to trade flows. The main objectives of the programme are to facilitate trade, increase the discipline of customs officials, reform in valuation system, direct to the customs administration towards modernization, increasing of transparency, integrity and specialization in customs administration, reform the identification and classification process of commodities and to control the illegal trade through the public awareness programme.

The major aspects of customs reform and modernization include (i) reform in valuation system, (ii) customs simplification and harmonization of customs procedure, (iii) mechanization, (iv) implementation of selectivity, (v) development of physical facilities, (vi) enhancing integrity in customs staff, (vii) reforming the passengers' clearance system, and (viii) training to customs staff. Expeditious implementation of the plan is necessary to facilitate trade and reduce transaction cost.

There is a need to implementing a number of trade facilitation activities geared towards the better supply chain management including (a) adopting a subregional, or regional approach in introduction or multimodal transport system, leading towards the integration of transport system at the international level (b) forming a common understanding and approach in developing physical infrastructures at port, development of roadways, rail/road, and ICDs for bringing synergies in transport efficiency (c) developing a common customs procedures (d) encouraging private sector collaboration in infrastructure development (e) harmonization of customs transit documents and procedures among trading partner countries and (f) developing adequate physical infrastructures at land customs stations.

[29] Of the total industrial establishments, 47 per cent are in the central development region and 26 per cent in the eastern development region which are better connected with Indian road and rail network.

Addressing newly emerging trade barriers is equally important to promote trade. No doubt, there has been a significant reduction in conventional trade barriers as (i) traditional trade protection measures eliminated throughout the 1990s and so far, (ii) tariff and para-tariff barriers have been broadly reduced, made transparent, and predictable, (iii) conventional non tariff barriers are minimized, quantitative restrictions are eliminated, and quota and long negative list have been minimized, and (iv) tariffication has been exercised to reduce non- tariff barriers to trade.

But technical barriers to trade (TBT) and sanitary and phyto-sanitary measures (SPS) have emerged as new trade barriers. In particular, technical regulation, standard, and conformity assessment related barriers are blocking free flow of trade across countries.

The TBT and SPS Agreements under WTO framework seek to ensure that governments pursuing non-trade-related policy objectives through use of regulations and standards do so with least disruptive effects on trade. But the spirit does not exist in trade practice. Domestic technical regulations (technical requirements, testing, certification, labeling, etc.) have become much more important channels through which trade is now blocked—a protection in new guise. The WTO agreements do include provisions that regulations be based on international norms & scientific principles to assess risk cited in disputed cases. Still regulations, standards, codes, processes, and practices (like GMP) at forefront of policy discussions. There are serious implications of new trade barriers as they (i) produce serious distortions in commercial markets, (ii) restrain trade & limit market entry through environmental, health, or safety mandates, not necessarily based on international norms, and (iii) often discriminate in context of WTO disciplines, including commitments made by WTO members on TBT or SPS agreements. To sum up, technical regulations imposed on trade in goods & agricultural products are affecting (i) trade patterns by protecting inefficient domestic firms, (ii) ability of producers to enter new export markets, (iii) consumer costs, and (iv) trade policy choices & success or failure of liberalization efforts of developing countries.

A marked rise in number of trade disputes over standards brought to the WTO in recent years, centred mostly on trade in agricultural products and obligations under Agreement on SPS. Standards and technical regulations impose costs that could restrain competition. Compliance to standards and norms involves various costs--(i) one-time costs of product re-design and building an administrative system, (ii) recurrent costs of maintaining quality control and testing and certification, and (iii) indirect cost such as reformulating the ingredients of a product, meeting precise technical regulations, verifying that regulations are met (conformity assessment). Resource constrained countries like Nepal have problems to meet these costs.

Initiatives to resolve these trade barriers are noteworthy. First, there is an increased call for harmonization of standards and negotiation of Mutual Recognition Agreements (MRAs) covering product testing and certification systems. Second, there has been a rapid rise in the regional and bilateral trade agreements addressing technical barriers. And third, mutual recognition of testing, certification and harmonization of standards arise among important policy tools in global, regional or bilateral trade talks.

Despite those initiatives, least developed countries like Nepal are faced with numerous problems. Technical issues are impinging upon future direction of trade policy debate, especially with respect to the interests of developing countries. In disputes over agricultural standards, developing countries have special difficulties & higher costs in demonstrating compliance with import regulations. The costs of implementation of requirements under TBT and SPS Agreement by developing countries are extremely high relative to development budgets and aid. Developing countries lag behind in their capacities for effective certification and accreditation of testing facilities, leading to difficulty to develop adequate standards and reach mutual recognition agreements (MRAs). Technology intensive testing and certification needed in areas of health and safety. But lack of infrastructure poses clear problem. Developed countries may not trust in inspection procedures in developing countries, making conformity assessment a costly task. Developing nations face continued constraints in diffusing best practice information on standards & resources necessary for adoption of appropriate process and production methods. GSP schemes offered in exports could be beneficial only if technical barriers are removed. But stringent RoO as contained in GSP has resulted in low utilization rates. Countries offering GSP schemes are unilateral in nature; can be reversed at the will of the GSP providing country; these schemes need to make binding at the WTO level to ensure certainty & predictability of LDC exports. Nepal is currently facing many of such problems and not benefiting from the Special and Differential Treatment provisioned in the global trade rules.

Special and Differential Treatment to LDCs is mentioned in WTO agreement, but it is not sincerely observed. Similarly technical assistance as proposed is not necessarily binding. Integrated Framework (IF) to support trade in developing countries is a welcome step but lacks sufficient resources to enhance hardware related capacity building. Technology intensive testing & certification systems often needed to assure final products meet high standards, especially in areas of health and safety.

There are WTO ad other compliance related tasks for Nepal. As preparatory tasks, Nepal has to establish single contact point for information (enquiry points) (NBSM designated), identification of responsibility authority, publication of information on standards, technical regulations, & conformity, amend Nepal Standards Act and Regulations, upgrade existing testing and calibration facilities, completion of review and adjustment of technical regulations and procedures in line with WTO, establish procedure for conformity assessment, accreditation, and full implementation of TBT, by 1 Jan 2007. These require human and financial resources. Without external support, they are unlikely to be achieved.

Besides, irrespective of WTO norms, Nepal faces problems like (i) very stringent Rules of Origin (RoO); value added requirements; and trade through specified trading corporation imposed by India after 2002 Trade Treaty, (ii) quarantine procedures for all agro products time taking, expensive and very bureaucratic (leaf tea, ginger, cardamom, broom- grass, green vegetables, etc. exported to India enormously face such problem), (iii) export barriers in terms of entry points, trade routes, and mode of transport, (iv) standards often far higher than required by the standard setting institutions like Codex Alimentarious Commission and the European Union (EU) (eg, honey export to EU impeded by EU rules), and (v) difficulty to fulfil such criteria given its existing technical, human & financial capabilities and resources.

Thus it is essential that he Doha Development Round does in fact have development at the core of its agenda & that clauses relating to S&DT in the various WTO Agreements in favor of developing countries are actually implemented. GSP schemes need to make binding at the WTO level to ensure certainty & predictability of LDC exports. Preference erosion due to reduced industrial tariffs under various GSP schemes need to be compensated by other means including technical issues. Harmonization of GSP rules of origin, which now differ from one GSP scheme to another, to be made an important step toward making market access commercially meaningful.

6.3 Regional Cooperation in Trade Promotion

In 20 years of initiative to forge regional cooperation for peace and development in South Asia in the form of South Asian Association for Regional Cooperation (SAARC), various steps have been taken to promote regional trade. Convinced that the preferential trading arrangement among SAARC countries will act as a stimulus to the strengthening of national and regional economic resilience, along with promoting investment, technological cooperation, and production opportunities, trade, and foreign exchange earnings, South Asia Free Trade Area (SAFTA) has been agreed during SAARC summit held in Islamabad in January 2004. The “Islamabad Declaration” aims to launch the South Asia Free Trade Area

(SAFTA) on January 1, 2006. Implementation of this decision could usher in profound economic and political changes in the region.

The geographical imperatives compel countries to forge alliance in trade among neighboring countries. According to the "gravity" model of international trade, distance heavily influences the destination of trade; as most international trade occurs within a radius of 3000 km. But interregional trade within South Asia is just 5 per cent of the trade SAARC countries do. Most exports from South Asia go to the world's rich countries—in particular the United States. South Asia deviates from the model not because it is inherently defiant but because of intense hostility between two major economies of this region.

Trade has also had a relatively low share in the region's gross domestic product because South Asian governments followed an import-substitution strategy of development for decades. This strategy was abandoned since 1980s, and more so since early 1990s, in favor of openness. Consequently, the region's trade-to-GDP ratio has increased in recent years but intraregional trade still accounts for less than 5 percent of the total. A properly designed SAFTA should help increase intraregional trade and improve living standards.

Regional trading arrangements (RTA) tend to be most successful when participating countries have already opened their economies to the world. The various rounds of South Asia Preferential Trading Arrangement (SAPTA)—a predecessor of SAFTA—did not produce meaningful consequences partly because of the highly protective trade regimes most countries had in place. Now that South Asian trade is more open, the proposed SAFTA is more likely to be successful. SAPTA implementation was also made difficult by the abiding hostility between two major economies of South Asia. It is questioned whether the SAARC member countries have the technical capacity and political will to implement SAFTA as proposed in the Islamabad Declaration on SAFTA. It is suggested that rather than concentrating on immediately developing an all-encompassing free trade area, it may be prudent to focus on some sectors in which intraregional trade could develop rapidly and bring economic benefits to most countries.

Nepal has joined another regional cooperation initiative known as BIMST-EC. The BIMST-EC FTA is established with the objective to strengthen and enhance economic, trade and investment cooperation, progressively liberalize and promote trade in goods and services, create a transparent, liberal and facilitative investment regime and explore new areas and develop appropriate measures for closer cooperation among the members. With the signing of the framework agreement of BIMST-EC FTA, members agreed to enter into negotiations for eliminating the tariffs and non-tariff barriers in substantially all goods. However, the agreement provides a provision of maintaining negative list for liberalization and also of liberalizing trade under 'fast' and 'normal' tracks. However, materialization of such cooperation requires effective differential treatment to LDCs like Nepal, supporting development of in-country trade infrastructure, and creating an inter-country physical trade links along with other policy measures.

CHAPTER VII: SUMMARY, CONCLUSION AND RECOMMENDATIONS

7.1 Summary and Conclusions

Countries with trade openness have been able to enhance growth and reduce poverty faster than others. A strong relationship between growth and poverty reduction holds through the creation of employment in the process of trade and industrial expansion along with labour market conditions, public sector institutions and fiscal regime.

The following issues have to be critically examined in order to assess the impact of trade reform on poverty, among others: (i) price effects of the trade liberalization: changes in the production pattern as well as prices of goods consumed and produced by the poor; (ii) relationships between trade and employment; and between trade and inequality; and (iii) structural shift in production technology leading to social exclusion of poor from livelihoods.

There has been some change in the structure of the economy over the period of trade and other macroeconomic reforms. The share of agriculture in GDP declined by about one percentage point annually during the 1990s in favor of the non-agricultural sector. The share of manufacturing in GDP increased from less than 6.0 percent in mid1980s to 9 percent in 2005.

There was a reduction in poverty during the last decade (1996-2004) by more than one percentage point a year. But inequality widened with economic growth led by market forces not doing distributive justice. Besides, rural inequality appeared to be slightly lower than urban inequality, but rural inequality in income distribution increased faster compared with urban income inequality.

The Nepalese economy is now relatively open with trade of goods and services -GDP ratio at about 50 percent. In the 1990s, exports grew on average by 28 percent per annum whereas imports also grew by 20 percent. After 2000, trade witnessed a compression, and thus during 2001-05, imports grew by 4.4 per cent whereas exports grew by even lesser magnitude of 3.7 per cent.

There has been notable change in the structure of trade over the last two decades and a half. The share of primary goods export declined from nearly 70 percent in 1980 to 22.5 percent in 2005. The structure of imports however observed little change during these decades, except for virtual no import of goods subject to smuggling out.

Although major export items show significant growth in the 1990s, much of the overseas exports growth in rupee terms comes from exchange rate gain rather than from the growth in trade volume. Recent decline in the export of woolen carpet and ready-made garments has squeezed the labour market. With deteriorating scenario of major exports to overseas with no new items for export, Nepal is at high risk of trade re-concentration with India.

Remittance has become the second largest and widest source of income after agriculture; it has become the second largest employer after agriculture again; and it is now the largest earner of foreign exchange. This has emerged as a trade-financing source and helped the economy growing, albeit at a modest rate, even at the time of intense conflict.

Exchange rate, as a key element of trade liberalization, can help poverty reduction by creating a conducive environment for investment, promoting exports and providing protection to domestic economic activities which have a bearing on economic growth and employment.

Exchange rate has been instrumental to inflation in Nepal. Empirical studies show that discrete devaluations of more than 15 percent also cause rate of inflation to shoot up by more than 7 percentage points. This manifests the sensitivity of prices with exchange rate movement and then the poverty implication of high inflation.

Overall, marked reduction in poverty took place in Nepal while the GDP growth rate was less than 4 per cent on average amidst population growth rate of 2.25 per cent and growing income inequality. The mystery is being unfolded with the link of this achievement with remittances but that alone cannot explain all the achievements made in poverty reduction.

Trade reform can affect government revenue but the effects are observed less adverse than imagined. Even if tariff reduction leads to a reduced revenue collection, there is no straightforward conclusion that the poor will suffer. A credible fiscal framework can not only protect the poor from any risk associated with trade reforms and shocks, but also promote infrastructure for reducing transaction costs, enhancing competitiveness, and eliminating trade distorting activities like subsidies and transfers to inefficient public enterprises.

Nepal's size of public spending is constrained by resource availability and capacity to spend. Revenue is largely international trade based; nearly 50 per cent of the revenue is trade (imports) based. Thus revenue implication of trade policy reform is significant.

The introduction of value added tax has had some positive effects on revenue collection in the recent years whereas reduction in tariff rates have had positive signal for private sector investment. But effective implementation of VAT continues to remain a challenge, the regressive nature of this tax limits the expansion of its base, and recent increase in the rate has entailed more regressive impact.

Nepal's trade competitiveness has been eroded with high production cost, low labour productivity, high transaction costs, distortionary tax system (at times), and lack of access to appropriate technology. Reform in the fiscal sector has been intended to address some of these issues.

Nepal has to make fiscal interventions in the agriculture sector within the domestic limits imposed by the revenue crunch and external constraints set in the rules under WTO. The budgetary side of trade capacity building is equally important, as public investment in trade related infrastructure, trade facilitation measures and trade-governing institutions is very important.

Trade and finance are interrelated in many ways—finance providing payment facilitation for trade, extending credit and payment guarantees for financing trade, and offering capital for the production of goods and services intended for exports. Similarly trade supports financial system through creating business for banks and supplying savings to banks.

Following reforms and liberalization in the financial sector, there has been massive expansion of financial institutions, deposit mobilization, and credit flow of the banks. The size of bank deposits and credit rose by more than 30 folds in 20 years. With new instruments and competition, trade financing now enjoys better terms.

Liberal monetary policy -- working through interest rate liberalization, deregulation of portfolio restrictions, removal of credit ceilings, and withdrawal of other regulations – has been able to have easy credit expansion to trade and industry. But bank financing was confined to limited urban-based business activities and credit expansion concentrated in a few business houses. There was a large misuse of the easy credit, as evidenced by the non-performing assets of the two large banks rising to 60 per cent level in 2004.

There are a number of provisions under WTO which impinge upon the financial sector. Right from national treatment to entry opportunities and ownership, these WTO based rules call for rapid reform and restructuring of the financial sector. The restructuring costs are, however, very high. The trade competitiveness and poverty outcome of financial sector deepening is yet to be observed.

The effects of trade reform on development and poverty in an agriculture-dominated country like Nepal largely depends on inter-sectoral changes in the economy as well as intra-sectoral changes, particularly within agriculture. In general, liberalization is expected to exert positive effects on agricultural growth, and via faster agricultural growth, on rural poverty.

Agricultural output prices are expected to rise at the border following trade liberalization; thus rural incomes and agricultural output are expected to increase. High agricultural prices is however a double-edged sword which can cut both sides of the agricultural households.

Trade policy reform is also predicted to induce a switch from subsistence agriculture to cash crops and increased incomes for the poor. But, most of the agricultural produces in Nepal are non-marketed. Trade liberalization has not transferred technology to agriculture, as evidenced by the limited use of modern agricultural inputs and mechanization technology.

Agricultural growth even in the post-reform period 1990-2001 continues to be poor. Agricultural gross domestic product growth was slower in the 1990s than in the 1980s. With an average annual growth rate of 2.7 percent, agricultural growth was the lowest among all the major components of GDP.

There has been some change in the cropping pattern. Particularly, green vegetable, potato, lentil, sugarcane, and tea cultivation and cropping has gone up significantly in the last decade. But this does not hold much strength in terms of livelihood and poverty reduction.

Manufacturing output grew rates sharply in the early 1990s immediately after trade policy reform began. Such output growth accelerated to 14 percent during 1991-1995 from 5 per cent during 1980s. However, this growth decelerated sharply thereafter and averaged at 7.6 percent during 1996-2000 and stagnated during 2001-05.

Despite unemployment and underemployment situation, there has been some improvement in the wage rates in the recent years. In nominal terms, wages of all types of workers went up during the last two decades. The rise was higher during 1990s. But there was marginal rise in real wage rates during this period. Real wage of carpenters, masons, and agricultural went up during 1981-2005 by 2 per cent or less while the real wage of industrial workers went up by more than 2 per cent on average.

Along with liberalization, deregulation, and privatization, declining costs of transport and communication have been a contributory factor for rapid globalization of financial flows and increasing foreign investment. But the absence of infrastructure such as transport and communication, particularly information and communication technology, is yet to reduce transaction cost, facilitate market information, and ensure factor mobility in Nepal.

Technical barriers to trade (TBT) and sanitary and phyto-sanitary measures (SPS) have emerged as new trade barriers. In particular, technical regulation, standard, and conformity assessment related barriers are blocking free flow of trade across countries. Addressing newly emerging trade barriers is equally important to promote trade.

Special and Differential Treatment to LDCs is mentioned in WTO agreement, but it is not sincerely observed. Similarly technical assistance as proposed is not necessarily binding. Integrated Framework (IF) to support trade in developing countries is a welcome step but lacks sufficient resources to enhance hardware related capacity building. Technology intensive testing & certification systems often needed to assure final products meet high standards, especially in areas of health and safety.

Nepal faces problems like (i) very stringent Rules of Origin (RoO); value added requirements; and trade through specified trading corporation, (ii) time taking, expensive and very bureaucratic quarantine procedures for agro products (iii) export barriers in terms of entry points, trade routes, and mode of transport, (iv) far higher standards than required by the standard setting institutions and (v) difficulty to fulfil such criteria given the country's existing technical, human & financial capabilities and resources.

7.2 Key Recommendations

- There is no mention of the direct trade and poverty linkage and also no programmes to establish such a link in the PRSP; thus, a gap is clearly seen in terms of mainstreaming trade in poverty reduction strategy. The indirect link of trade to poverty through high economic growth has a number of problems and the benefits are not automatically pro-poor. Country development strategy like PRSP need to explicitly address as to how trade would directly benefit the poor, perhaps disproportionately more than others.
- Trade reform have not only income but also distributive effects in the short term and some segments of the society suffer loses while others are gaining. The growing income inequality amidst reduction in poverty in Nepal indicates that policies have not been pro-poor. This calls for reorienting policies, devising safety nets, and enhancing the capacity of the poor to compete in the market place. Public policy and spending plays a critical role in this area.
- Trade liberalization affects poverty indirectly via its impact on trade taxes, when tax revenue remains mostly allocated for pro-poor programmes. Presently, revenue collection in Nepal has been rising because of imports growth, introduction of VAT and widening of the scope of income tax. As the country moves on further duty reduction along with elimination of other duties and charges (ODCs) and export service charges as per WTO commitments, revenue might fall if compensatory domestic tax measures are not introduced or if the measures so introduced do not cover the loss incurred in tariff reduction. Thus extra efforts in the front of domestic taxation are required.
- Although trade liberalization is meant to improve incentives for agriculture, the poor supply response to changed incentives in Nepal is primarily a result of the low levels of commercialization of agriculture and its weak and fragmented markets. As the rural poor in Nepal are largely untouched by changes in trade policy, linking export opportunities with agriculture and rural economic activities is a must if trade is to address rural poverty.
- Increased openness has had some negative effects on agriculture. In particular, the fall in food prices has been a major constraint on the cereal sub-sector and has deterred important investments in agriculture. Support to agriculture by means of infrastructure like irrigation, power and road is called for, if direct subsidy to key activities, highly essential to safeguard the livelihood of the farmers, could not be extended due to resources constraints.
- Manufacturing export growth which was rapid in the period immediately after trade liberalization, has fallen sharply in recent years due to structural weaknesses within the sector. Structural weaknesses are a largely due to the absence of an effective industrial policy aimed at increased competitiveness and industrial upgrading. The contraction of manufacturing is likely to have negative effects on employment and poverty. There is a need to strongly link trade policy with long-

term industrial perspective plan and make trade and industry to support each other.

- If international trade competitiveness is to be maintained, it is essential that strategic interventions be undertaken to build supply side capacity and capabilities. Mobilization of FDI should be considered as an effort in this direction.
- It is necessary to diversify export products and export markets and also to increase competitiveness of existing exports. Trade liberalization and the reduction of tariffs alone will not ensure this, and more strategic interventionist industrial policy is required. A host of measures such as targeting potential export sectors, preferential credit and tax incentives needs to be devised. 'Aid for trade' has to be mobilized.
- Trade promotes income and consumption of the poor if it is linked to their resources. But Nepal's export trade is not strongly linked to domestic and particularly rural resource base; thus restructuring of trade sector is needed to make it work for meaningful poverty reduction.
- Openness alone has limited effectiveness in promoting broad based economic growth in a country like Nepal. In particular, the existence of a large non-commercialized subsistence agricultural sector means that the supply response to trade policy reforms is likely to be limited. Thus strategic public interventions are needed to make trade work for the poor.
- For preferential market access provided to LDCs to be commercially meaningful, rules of origin should not constrain their capacity. Nepal should be lobbying among LDCs for relaxing them. Moreover, harmonization of GSP rules of origin, which currently differ from one GSP scheme to another, would be an important step toward making market access commercially meaningful.
- Ongoing negotiations under the Doha Development Round Work Plan could provide LDCs with a window of opportunity toward obtaining greater market access. There is a need to ensure that the Doha Development Round does in fact have development at the core of its agenda and that clauses relating to special and differential treatment in the various WTO Agreements in favour of developing countries are actually implemented. Global zero-tariff and quota-free access for exports from the LDCs could be an important initiative. But equally important would be non-tariff barriers including SPS and TBT.
- Special and Differential Treatment to LDCs is mentioned in WTO agreement, technical assistance not necessarily binding. IF is a welcome step but lacks sufficient resources to enhance hardware related capacity building. Technology intensive testing & certification systems often needed to assure final products meet high standards, especially in areas of health and safety. There is a need that financial and technical support be mobilized to enhance capacity in this area.
- Preference erosion due to reduced industrial tariffs under various GSP schemes enjoyed by LDCs needs to be compensated by other means including technical issues. Harmonization of GSP rules of origin, which currently differ from one GSP scheme to another, would be an important step toward making market access commercially meaningful.

- Nepal needs to harmonize her trade liberalization with those of India in order to avoid deflection and diversion of trade flow (without economic gain). Trade policy reform in Nepal must be analyzed in the context of the open border with India and the political economy of the relationship between the two nations.
- Nepal's economic realities compel normal trade concentration towards India. Besides, Nepal and India compete in the international market for products like garment, carpet, handicrafts, and agro-processed goods like tea and sugar. Thus maintaining export competitiveness vis-a-vis is highly important. The current exchange rate regime and the level of peg with Indian currency are subject to constant review to ensure that the exchange rate does not trigger loss of trade competitiveness.
- Markets across India and Nepal and between different regions in Nepal are "connected" rather than integrated for the reason that: (i) significant price differentials exist, both across the border and across internal regions of Nepal; (ii) demand in Indian border states appears to have insignificant effect on cropping pattern and input use by Nepalese farmers and weak effect on sales by them; and (iii) localized gluts and price crashes occur. The main issue is difference between the two countries regarding subsidy regimes and government support for agriculture which has made Nepalese farm produces uncompetitive with Indian produces. This has to be assessed in light of the policy options available including the readjustment in the exchange rate if fiscal constraints are so binding.

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