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Nepal's elusive quest for export success meets LDC graduation

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Abstract

Nepal is hurtling towards graduation from the least developed country (LDC) category with a low per capita income and meagre exports. This paper analyses the implications of graduation for Nepal's exports, and suggests measures that Nepal government should take to mitigate the adverse effects. It argues that export success has eluded Nepal despite trade preferences, and graduation could make it even more elusive. The fact that the prospect of tapping the country's export potential is partly predicated on preferential tariffs implies much higher export losses than projected by standard modelling exercises. Not factoring in changes in rules of origin in preference-granting countries adds to the downward bias of existing estimates. All this underlines the urgency of building productive capacity, alleviating supply-side constraints, and strengthening factors of non-price competitiveness.

Keywords: LDC graduation, trade policy, export potential, export competitiveness, trade costs, coordination failure, policy space

JEL classification: F02, F12, F13, F14, F63, O2

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1. Introduction

Consider four key features of Nepal's economy on the external front: an extremely high dependence on remittance inflows from abroad, not just as a source of foreign exchange but also as a source of household income¹; a high share of foreign aid in the financing of government expenditure²; meagre foreign direct investment (FDI) inflows³; and an abysmally low level of exports.⁴ Nepal's graduation from the category of the least developed countries (LDCs) in 2026 will have little or no direct (adverse) impact on remittances and aid (NPC and UNDP, 2020).⁵ FDI is unlikely to be affected, or will at least not be negatively impacted.⁶ It is Nepal's export sector—more precisely, merchandise exports—where graduation's greatest, and adverse, impact will be felt. The reason is loss of LDC-specific trade preferences.

Nepal is hurtling towards graduation with a per capita gross national income (GNI) that is the lowest among the dozen LDCs on track towards graduation⁷ and with an extremely weak export base even among LDC peers, a reflection of its weak productive capacity. This paper analyses the implications of

¹ Remittances are greater than the combined foreign exchange receipts from goods and services exports, foreign aid and foreign investment (NRB, various issues). Remittances amounted to 25.72 of GDP on average during 2016/17-2018/19 (*ibid.*). A quarter of households received remittances from absentee member(s) abroad as per a nationally representative household survey in 2011/12 (calculated in Kharel (2019a)).

² Foreign aid inflows amounted to 13.6 percent of total government expenditure and 48.6 percent of total development expenditure of the government in 2017/18 (NPC and UNDP, 2020).

³ Net FDI flows as a percentage of GDP averaged 0.5 percent during 2017-2019 (World Bank's World Development Indicators).

⁴ Exports of goods and services averaged 9 percent of GDP during 2016/17-2018/19 (NRB, various issues). Exports of goods made up 34.5 of total exports on average during the same period. Goods exports never exceeded US\$1 billion before 2020/21.

⁵ Remittance inflows are orthogonal to formal LDC status. Aid from multilateral sources is linked to income status rather than LDC status, while aid from bilateral sources depends on bilateral relationship. The impact on aid is not considered to be a major challenge in NPC and UNDP (2020). Support from the Enhanced Integrated Framework, the only aid-for-trade arrangement dedicated to LDCs, may continue for up to five years after graduation, whereby graduated countries can access institutional support, analytical support and productive capacity support (WTO, 2020a). However, the loss of support thereafter, or the uncertainty over the five-year extension due to the time-bound operation of EIF, with the implementation of its current phase ending in 2024 (WTO, 2020a), will not have a significant impact on total aid for trade received by Nepal, given that receipts from EIF are very modest in size and multilateral donors (notably, the World Bank and the Asian Development Bank) are by far the biggest sources of aid for trade.

⁶ A potential positive impact on FDI turns on the thesis that graduation from the poor countries' club would elevate Nepal's standing in the eyes of rating agencies and inspire confidence in its economy among international investors (NPC and UNDP, 2020). No firm empirical evidence is provided in support of this argument, rendering it highly speculative. The stark contrast in FDI (in absolute terms or as a percentage of GDP) attracted by Nepal and fellow LDCs such as Bangladesh (which is also set to graduate in 2026) and Lao PDR (a landlocked country like Nepal but with a smaller population and GDP) suggests that LDC status *per se* is not a critical factor behind Nepal's poor record in attracting FDI. FDI data are from the World Bank's World Development Indicators.

⁷ Nepal's per capita income is also less than the graduation threshold.

graduation for Nepal's exports, with a focus on merchandise exports, and suggests measures that Nepal government should take to mitigate the adverse effects. Nepal's dependence on the Indian market under an arrangement wherein preferences are not tied to LDC status, coupled with its export structure and low utilization of preferences in key markets where LDC-specific preferences are provided, mutes the negative direct impact on its exports. However, this paper argues, the fact that the prospect of tapping the country's export potential is partly predicated on preferential tariffs implies much higher export losses than predicted by standard modelling exercises. Not factoring in changes in rules of origin in preference-granting countries adds to the downward bias of the estimates. All this underlines the urgency of tackling productive capacity and supply-side constraints and strengthening factors of non-price competitiveness.

The rest of the paper is organized as follows. Section 2 critically analyses the estimates of the impact of graduation on merchandise exports available in the literature, juxtaposing these projections with available estimates of untapped exports. Section 3 presents illustrative examples of select markets in terms of implications of graduation and the factors holding back exports to these markets. Section 4 briefly discusses the increased salience of reducing trade and logistics costs, and correcting failures in policy formulation and implementation in the context of graduation. Section 5 highlights the need for more research on and policy attention to services exports, which will not be impacted by graduation. Section 6 discusses the implications of graduation for policy space. Section 7 provides recommendations for mitigating the likely adverse impacts of graduation and shoring up Nepal's export competitiveness.

2. Estimated export losses versus untapped potential

An estimate from an *ex ante* partial equilibrium impact simulation foresees a loss in merchandise exports of 2.5 percent, lower than the 6.4 percent loss projected for 12 graduating LDCs as a group and the 14.3 percent loss forecast for Bangladesh (WTO, 2020a; 2020b). The projected loss for Nepal amounts to US\$20.14 million, compared to its baseline average export value of US\$812.8 million in 2016-2018 (*ibid.*). Almost all the estimated losses are concentrated in the European Union (EU) market, the destination for 15 percent of Nepal's merchandise exports (years 2016-2018) where exports are projected to fall by 19.13 percent (US\$20.65 million) after facing an effective tariff increase of 5.63 percentage points (WTO, 2020b).⁸

⁸ The losses in exports in the EU market are higher than total losses because of diversion of exports to other destinations (WTO, 2020b). When considering only those destinations where exports contract, the losses in the EU market account for 84.7 percent of the negative changes in exports (computed from WTO, 2020b).

This relatively low impact stems from three factors: LDC-specific trade preferences are not relevant to exports to India, which absorbs on average 56 percent of total exports⁹ and with which Nepal has a bilateral trade agreement; in several markets, the effective importance and coverage of offered LDC-specific preferences are limited¹⁰; and the utilization of available preferences is low in several markets.¹¹ The seemingly low projected impact on aggregate merchandise exports masks the likelihood of small and medium enterprises (SMEs) bearing the brunt of loss of preferences. SMEs have a significant presence among firms exporting products to the EU that are at risk of being the hardest hit—carpets and clothing.¹² The average export value per exporter in Nepal is small, and the average exports to the EU per exporter are about a quarter of the average exports to other countries per exporter.¹³ More generally, it is well established that tariffs barriers tend to matter more for SMEs (WTO, 2016, 83-84).¹⁴ The projected impact also ignores foregone potential exports that might have been realized with the aid of preferential tariffs, backed by a credible domestic programme on building productive capacity and alleviating supply-side constraints. Because it takes time for such a programme to improve export competitiveness, preferential tariffs provide a breathing space. This is an infant industry argument of sorts applied to exports. Box 1 elucidates this argument further by briefly and heuristically utilizing the heterogeneous-firms model of international trade, focusing on the extensive margin. Another reason to view the projected impact as an underestimate, even in absolute value terms, is that the underlying model abstracts from the tightening of rules of origin in destination markets in alternative preferential schemes.

⁹ The average for 2016-2018 (WTO, 2020b).

¹⁰ See Chapter IV of WTO (2018a), and WTO (2020b: 55-62).

¹¹ See Chapter IV of WTO (2018a), and WTO (2020b: 55-62).

¹² These products have been identified in WTO (2020b).

¹³ As per the author's computation based on the World Bank's Exporter Dynamics Database (<https://www.worldbank.org/en/research/brief/exporter-dynamics-database>, accessed 30 July 2021), the mean and median value of exports per exporter were, respectively, US\$660,668 and US\$96,306 during 2011-2014. The mean value of exports per exporter across EU destinations (including the UK) was 21-26 percent of that across non-EU destinations.

¹⁴ See Kharel and Dahal (2021a) for constraints on exporting faced by Nepali SMEs.

Box 1: Understanding foregone exports through the lens of heterogeneous-firms models

A key assumption of the heterogeneous-firms models of international trade—Melitz (2003), Chaney (2008) and their extensions—is that only the most productive firms export. This assumption has empirical support. The productivity cut-off (φ_x^*) determining the export decision is a function of, *inter alia*, fixed (f_x) and variable trade costs (τ):

$$\varphi_x^* = \phi(\tau, f_x, \cdot).$$

Only firms with $\varphi_x > \varphi_x^*$ export.

The models predict that a reduction in trade costs (fixed or variable) lowers the productivity cut-off for exporting: $\phi_\tau > 0$, $\phi_{f_x} > 0$.

Assume that there are firms with productivity $\varphi_x^{NONEXP} \leq \overline{\varphi^U} < \varphi_x^*$, and hence do not export.

Case I. Suppose $\tau' < \tau$ due to trade preferences in export markets such that $\varphi_{x,1}^* = \phi(\tau', f_x, \cdot) > \overline{\varphi^U}$, implying that these firms will still not export.

Case II. Suppose, in another scenario, the government intervenes to reduce the fixed cost of exporting—say, by organizing a trade fair and linking exporters with buyers abroad. Suppose this results in $f_x' < f_x$, but this is not sufficient for the non-exporters to start exporting. That is, $\varphi_{x,2}^* = \phi(\tau, f_x', \cdot) > \overline{\varphi^U}$.

Case III. Now, suppose the reduction in tariffs ($\tau' < \tau$) is complemented by a reduction in fixed costs of exporting ($f_x' < f_x$) such that $\varphi_{x,3}^* = \phi(\tau', f_x', \cdot) \leq \overline{\varphi^U}$. In this scenario, the hitherto non-exporters start exporting. To link the exercise to the Nepali context, it could be that many firms in Nepal have been unable to break into export markets despite getting tariff preferences because there has not been a sufficient reduction in fixed costs of exporting that, combined with the zero tariffs, would enable these firms to export. Prior to its graduation from the LDC category, Nepal is in Case I, which does not generate export entry. Upon graduation, Case I is ruled out and Case II is possible but it does not generate export entry. Case III generates export entry, but graduation rules out Case III. Hence, exports that would have been generated by the entry of firms into export markets are foregone due to graduation.

Case IV. Reductions in trade cost are not the only way to enable firms to start exporting. Note that we have implicitly assumed that the productivity of firms remains constant. If, instead of a reduction in fixed costs, a sufficient improvement in firm productivity accompanied the initial reduction in variable trade costs (tariffs), one would expect the hitherto non-exporting firms to start exporting, with $\varphi_x^{NONEXP'} \geq \varphi_{x,1}^* = \phi(\tau', f_x, \cdot)$, although $\varphi_x^{NONEXP'} < \varphi_x^*$. Relating this to the Nepali context, it could be that many firms in Nepal are not exporting despite facing zero tariffs because they are not productive enough to meet the standards and technical regulations (non-tariff measures) in destination markets in a cost-effective manner. Therefore, enabling these firms to meet the non-tariff measures—say, through the establishment by the government of internationally accredited laboratories, or simply informing the firms of the standards in destination markets and the options and ways to meet them—would translate into a rise in their productivity, making it possible for them to utilize the available trade preferences and hence export. Prior to its graduation from the LDC category, Nepal is in Case I, which rules out export entry. Graduation rules out Case IV, which would have generated export entry. In the absence of tariff preferences, a rise in productivity alone

is not enough to generate export entry, since $\varphi_x^{NONEXP'} < \varphi_x^*$. Hence, exports that would have been generated by the entry of firms into export markets are foregone due to graduation.

Source: Author.

With merchandise exports just 7 percent of imports and services exports also less than imports¹⁵, the growing trade deficit, financed by remittances sent home by Nepali youth toiling on foreign shores, is seen in public discourse as a symbol of the economy's failure to generate output and employment adequately. Reducing trade deficit has become a national obsession, a manifestation of which is the National Action Plan for Trade Deficit Minimization, introduced in 2019 (GoN, 2019a). Both export promotion and import substitution actions have been proposed in the Action Plan.

That Nepal is exporting only a small fraction of its total export potential has been shown by several studies. A recent estimate, obtained from the estimation of a gravity model of international trade, puts Nepal's untapped merchandise export potential or "missing" exports at US\$9.2 billion, 12 times its actual merchandise exports (World Bank, 2021). Realizing this export potential would yield an estimated 220,000 new jobs (*ibid.*). Note that the gravity equation specification that yielded this estimate of export potential included bilateral tariffs as an explanatory variable. Plausible factors behind the difference between potential and actual exports are non-tariff measures (notably, sanitary and phytosanitary (SPS) measures and technical barriers to trade in destination markets) and weak domestic productive capacity and severe supply-side constraints¹⁶, which would also capture the inadequate capacity to navigate non-tariff measures.

Even without poring over the large body of work documenting and analysing Nepal's weak capacity to export¹⁷, one gets powerful pointers to this aspect from a few facts about market access conditions: Nepal ranked first in the foreign market access pillar of the Enabling Trade Index for 2016¹⁸; in its five major markets in 2017 it faced an applied weighted average tariff of 0.2 percent for all exports, 0 percent for agricultural exports and 0.3 percent for non-agricultural exports¹⁹; it has not been able to fully utilize preferences, especially in Switzerland, China, Japan and South Korea²⁰; it faces a preference

¹⁵ Calculated for 2016/17-2018/19 from NRB, various issues.

¹⁶ For a discussion of factors constraining Nepal's exports, see Kharel and Dahal (2021a); Adhikari and Kharel (2014); ADB (2019); Arenas (2016); Narain and Varela (2017); ITC (2017); and GoN (2010, 2016).

¹⁷ See previous footnote

¹⁸ World Economic Forum and the Global Alliance for Trade Facilitation (2016).

¹⁹ WTO (2020c).

²⁰ WTO (2018a).

margin in tariffs of 39.9 percentage points in agriculture exports and 10.2 percentage points in non-agriculture exports to India, and a margin of 10.5 percentage points in non-agriculture exports to China²¹; preferential tariff treatment was on offer for 293 of the 335 tariff lines in which China imported from Nepal in 2018, with a preference margin of 13.91 percentage points.²²

That non-tariff measures in foreign markets and weak export capacity are driving a wedge between potential and actual exports does not discount the help preferential tariffs can provide in exploiting or building the foundations for harnessing the export potential whilst the requisite export capacity is developed. Higher tariffs can cause the least productive exporting firms to stop exporting and existing exporting firms (especially the less productive among them) to reduce exports, while deterring firms that might otherwise have entered the export market from doing so.²³ Consequently, the economy will lose out on learning-by-exporting effects whereby exporting improves technical efficiency.²⁴

Nepal's export strategy for 2016-2020 does not consider tariffs as a significant market access barrier for key Nepali products and acknowledges the role of LDC preferences in bringing about this situation (GoN, 2016). The World Bank study that estimated the export potential also acknowledges that in the presence of trade preferences accorded to Nepal, tariffs in major markets are not a major barrier (World Bank, 2021). If the prospect of tapping the export potential is partly predicated on preferential tariffs, the loss of trade preferences owing to Nepal's graduation from the LDC group would result in much higher export losses than projected in WTO (2020a, 2020b) and NPC and UNDP (2020). These losses arise from yet-to-be realized exports being foregone.

WTO (2020b) estimates a loss of 11.4-13.4 percent in exports to Japan and Canada on account of graduation. This amounts to about US\$1.4 million worth of sales in each destination because the baseline exports in 2016-2018 were only US\$10 million to US\$12 million each. Export losses might have been much higher in absolute terms if the export potential (US\$150 million to US\$700 million), as estimated in World Bank (2021), had been tapped to a significant degree, as the percentage change in exports would be applied to a significantly larger base. This argument is not readily amenable to mathematical model-based theorization and ex ante quantification. Yet, it must inform the export

²¹ WTO (2018a).

²² WTO's Tariff Analysis Online, <https://tao.wto.org>

²³ Heuristically, this argument relates to new-new trade theory models (Melitz, 2003; Chaney, 2008; and their extensions) and their numerous empirical applications.

²⁴ See Atkin et al. (2017) for a randomized control trial-based demonstration of learning-by-exporting effects. Although exposure to exporting in their experiment is not a function of tariffs, they argue, plausibly, that other positive shocks that expose a firm to exporting may yield similar results.

component of the post-graduation transition strategy that Nepal government will prepare. At a minimum, it underlines the urgency of tackling productive capacity and supply-side constraints and strengthening factors of non-price competitiveness, and at the same time highlights the importance of expeditiously seeking and obtaining alternative preferential tariff schemes (e.g., the EU's Generalized System of Preferences (GSP)+ scheme in place of the Everything but Arms (EBA) scheme).

Achieving Nepal's product and market diversification goal, as in Commerce Policy 2015 (GoN, 2015), will be all the more challenging. World Bank (2021) shows Nepal's unrealized export potential is spread across products and destinations, both developed and developing economies. Nepal under-exports to China by over US\$2.2 billion, the largest value of "missing" exports by destination (*ibid.*). This is followed by India (US\$1.2 billion), the United States (US\$800 million), and Japan (US\$700 million). Others in the top 15 include EU countries, South Korea, Indonesia, Russia, Australia, Canada and Bangladesh, each representing missing exports of at least about US\$150 million (*ibid.*). With the loss of LDC-specific trade preferences, the relative value of the existing duty-free access to the Indian market, which is not tied to LDC status, will increase. As a result, dependence on India as an export market may increase, or reducing this dependence may become more difficult. Non-tariff measures and supply-side constraints both are impeding exports to India (Kharel, 2021).

3. Illustrations from select markets

Exports to the EU are low relative to potential despite an almost cent percent coverage of existing or potential exports by the EBA duty-free scheme and despite a high preference utilization rate of 92 percent (WTO, 2018a). This suggests there are other factors detracting from Nepali exporters' competitiveness there. In a sense, if one were to adopt a non-conventional definition of utilization rate—actual exports as a percentage of potential exports—and if zero tariffs are expected to help tap that potential, then (effective) utilization would be much lower.²⁵ Severe gaps in the national quality infrastructure—comprising standardization, testing, inspection and certification—constitute formidable barriers (e.g., see ITC, 2017; ADB, 2019; Kharel and Singh, 2020) to entering the EU (as well as other attractive markets) and, upon entering, tapping a niche market for, say, organic products or catering to the demands of ethical consumerism. Exports that do materialize fetch relatively low prices on average, a feature of Nepal's exports in general (Arenas, 2016; World Bank, 2021) that calls for an up-to-the-mark national quality infrastructure. There are a few individual firm-level success stories in

²⁵ A comparison of top four destinations in the EU in terms of export potential identified in World Bank (2021)—Germany, France, Italy and Spain—with actual exports to these countries available from the Department of Customs, Government of Nepal, for the year 2018/19 suggests only 10 percent of the potential is being exported.

getting products certified and securing premium prices, but scaling up exports by the very same firms and replicating the success across more firms have proven a tall order (see Sharma, 2021). The rules of origin under the EU's preferential market access schemes for non-LDCs (GSP and GSP+) are more stringent than those under EBA. This is also true of the United Kingdom's Enhanced Framework, a GSP+ like scheme. ITC and UN-OHRLS (2021), using a partial equilibrium model, predicts that about 95 percent of the losses in exports to the EU would be reversed if Nepali exports were subject to GSP+ preferences rather than GSP preferences following graduation. However, the study does not account for changes in rules of origin. This illustrates another challenge to Nepali products' competitiveness in EU and UK markets, mainly for non-agricultural products (e.g., apparel, for which the requirement will shift from single-stage transformation to double-stage processing in order to get duty-free access under GSP+/Enhanced Framework). Notably, however, handknotted woollen carpets, another key export product in the EU, will not see a change in rules of origin in order to qualify for duty-free access. For agricultural and forest-based products (e.g., tea), which are wholly produced in Nepal, rules of origin do not change or become more restrictive. Rules of origin will also tighten when moving to alternative preferential schemes offered by several other countries (WTO, 2020a).

Some of Nepal's key exports (notably, apparels) to the US—which absorbed 12 percent of Nepali merchandise exports during 2016-2018 (WTO, 2020b)—are not eligible for duty-free access under the US' LDC-specific GSP scheme or generic GSP scheme. Under Nepal Trade Preference Programme (NTPP), the US is providing duty-free access to an additional 77 products from Nepal until 31 December 2025. This is beyond the standard GSP and an LDC-specific scheme within it. While apparel items like cotton shirts and trousers are excluded from NTPP, it includes some products of export interest to Nepal such as shawls. Just under 50 percent of exports eligible for NTPP utilize the preferences, while about 70 percent of exports eligible for GSP utilize the preferences.²⁶ Non-tariff constraints (much of them domestic) holding back Nepal's exports in general also stymie exports of products eligible for Nepal-specific tariff treatment (which had an export value of just US\$6.4 million in 2019).²⁷ The 77 products appear to be highly "related" to Nepal's overall export basket as well as exports to the US prior to the introduction of the Nepal-specific preferences.²⁸ Going by the "product space" literature set off by Hidalgo et al. (2007), who showed that "countries tend to move to goods

²⁶ Based on Dahal (2021) and data shared by Alabhya Dahal.

²⁷ The export figure is based on the dataset underlying Dahal (2021), shared by Alabhya Dahal.

²⁸ I refer to the concept of relatedness between products used in Hausmann and Klinger (2007) and Hidalgo et al. (2007), where the proximity between any two products is calculated as the probability of the products being co-exported, based on observed exports across products and countries. Intuitively, a high degree of proximity implies a greater ease of adapting the skills and capital, among other factors, used in the production of one product to the production of another. Kharel (2019b) finds that the impact of proximity on export propensity also holds at the product-destination level.

close to those they are currently specialized in" (p 482), we would expect Nepal to export in significant amounts many of these 77 products that have been accorded zero-duty treatment. That it has not been able to is another pointer to non-tariff trade costs and other constraints on export competitiveness. Just a quarter of Nepal's exports to the US are covered by GSP or NTTP²⁹, which is a reminder about the limited coverage of preferential treatment schemes of the US relevant to Nepal. However, about two thirds of Nepal's exports, including a top handknotted woollen carpet item, to the US are subject to most-favoured nation (MFN) zero duty (WTO, 2018a)—a fact that re-emphasizes the need to improve Nepal's export competitiveness through other means.

Nepal's utilization of LDC-specific tariff preferences afforded by China is low, at 46.8 percent (WTO, 2018a). The window for utilizing preferential access to the Chinese market is short, what with the impending graduation, unless Nepal negotiates a bilateral preferential trade agreement with China. Challenges to meeting SPS requirements are a key constraint on tapping the potential of agriculture exports to China. Identified by Nepal government as having high potential for exporting to China, certain citrus fruits (e.g., oranges—HS 08051000) are eligible for duty-free entry into China under the scheme, with a preference margin of 11 percentage points.³⁰ However, exports are nil due to, among other factors, a lack of facilities for "cold treatment" and delays in the implementation of a phytosanitary protocol³¹, a prerequisite for gaining entry into China. This again highlights the need to upgrade the national quality infrastructure. Poor conditions of the highway linking two major commercial trading points on the Nepal-China border to the rest of Nepal, poor border infrastructure, and the absence of a Chinese bank's branch in Nepal are other barriers to expanding exports to China (Kharel, 2019c).

On the other hand, high tariffs and para tariffs (often higher than tariffs) are the biggest barrier to exporting to Bangladesh, a neighbouring country with a significant potential market, notably for Nepal's agricultural products (SAWTEE, 2019). Negotiations on a reciprocal preferential trade agreement with Bangladesh, a fellow LDC set to graduate alongside Nepal, have been slow. Nepal's latitude to offer concessions is constrained by a provision in the Nepal-India trade treaty that requires Nepal to extend to India any concessions it offers to another country (Kharel, 2021). This also has implications for negotiating trade agreements with other countries, which Nepal may have to pursue

²⁹ Based on the dataset underlying Dahal (2021), shared by Alabhya Dahal.

³⁰ WTO's Tariff Analysis Online, <https://tao.wto.org>

³¹ See <https://www.abhiyandaily.com/newscategory-detail/379676>. Also based on discussions at a workshop at the Ministry of Industry, Commerce and Supplies, Government of Nepal on 10 February 2021.

to remain competitive and as it seeks out newer markets (at the product-destination level) post graduation.

Growing markets in West Asia, Central Asia and Southeast Asia—and even in China—remain under-researched from Nepal's export perspective. It is essential to explore opportunities in new, non-traditional markets in the fast-growing developing world also in view of an increased possibility of non-trade issues like governance and human rights conditioning access to developed-country markets in the wake of sharpening geopolitical rivalries. Governance, human rights and the like are issues around which the US-led West differentiates itself from China and Russia. True, most people cherish good governance and respect of human rights, and Nepal has ratified all but two³² of the 27 conventions required for being eligible for the GSP+ scheme of the EU and the Enhanced Framework scheme of the UK through which a significant part of the preferential market access provided by their LDC-specific schemes can be retained after the three-year post-graduation extension to LDC-specific preferences expires in 2029.³³ But the catch is non-trade issues are open to interpretation, more so in these geopolitically charged times. Nepal, which is smack in the heart of the theatre of great power rivalry, would do well to factor this into its traditional motivation for trade diversification.

4. Trade costs and coordination failures

Graduation means increased salience of four factors pertaining to transport, logistics, trade facilitation and transit that contribute to making landlocked Nepal a high-cost economy and erode its export competitiveness³⁴: (i) high cost of moving and storing goods within the country, a result of deficient infrastructure and transport cartels compounding topographic difficulties, and suboptimal provisioning of warehousing services; (ii) inadequacies and inefficiencies in border infrastructure and customs clearance; (iii) time-consuming and costly trade processes in Nepal; and (iv) inadequacies and inefficiencies in the existing transit arrangement. A related concern is the neglect of airfreight in policies, strategies and projects pertaining to trade competitiveness, underappreciating the fact that

³² Based on <https://gsphub.eu/country-info/Nepal> (accessed 30 July 2021).

³³ The EU is revising the GSP+ regime for the period 2024-2034, and the proposed revision includes an additional five conventions that countries seeking market access under GSP+ have to ratify (<https://trade.ec.europa.eu/doclib/press/index.cfm?id=2303>, accessed 24.02.2022). Nepal is yet to sign and ratify one of the additional conventions.

³⁴ See, for example, ITC (2017) and Dahal (2019). These factors were also based on information and insights from consultations with policymakers and private sector representatives in meetings organized by the Ministry of Industry, Commerce and Supplies in Kathmandu on 24 December 2020, 8 January 2021, 20 January 2021, 25 January 2021, 3 February 2021, 10 February 2021, 18 February 2021 and 21 July 2021, and discussions with producers, importers, exporters, customs officials, dry port operators and local government officials, among others, during visits to Jhapa, Biratnagar, Birgunj, Bhairahawa and Krishnanagar from 27 February to 6 March 2021.

about three fourths of Nepal's exports to countries other than India are airfreighted (Kharel and Dahal, 2021b). This neglect militates against the prospect of increasing exports of high-value goods targeting niche markets so as to beat the cost of a difficult terrain and landlockedness, as well as to divorce export competitiveness from trade preferences.

Graduation also means Nepal government must place a premium on rectifying a lack of coherence among policies, strategies and laws that bear on international trade (e.g., concessions provided by one act repealed by another; half-hearted implementation of a duty-drawback scheme for exporters), and ineffective inter-agency coordination on trade matters, partly a result of non-functioning coordination bodies (e.g., Board of Trade unable to even hold regular meetings as mandated in Commerce Policy 2015) (Kharel and Dahal, 2021b). Nepal Trade Integration Strategy (NTIS) 2016-2020 had strengthening interagency coordination as one of its objectives (GoN, 2016), motivated by its assessment that weak coordination was one of the reasons behind the poor implementation of its predecessor, NTIS 2010. That problem continued to hamstring NTIS 2016-2020, as reflected in, *inter alia*, export targets not being met by a huge margin (Kharel and Dahal, 2021b).

5. Giving services exports their due

Given the likely negative impact on goods exports, it is natural to wonder how services exports will fare. Services exports, which averaged 64 percent of total exports in 2017/18 and 2018/19 (NRB, various issues), will not be impacted because no meaningful preferential market access scheme linked to LDC status is in place. The LDC Waiver under the World Trade Organization (WTO), which allows countries to provide preferential market access to LDC services and service suppliers, has not yet resulted in economically meaningful preferences for LDCs, with the majority of measures announced by developed and developing countries only reflecting the applied MFN regime (WTO, 2020a). Supply-side constraints and weak productive capacity are widely believed to be the biggest barrier facing services exports from LDCs, including Nepal (WTO, 2020a; NPC and UNDP, 2020). Moreover, services exports, barring tourism, have received minimal effective policy attention in Nepal. Until the central bank started publishing balance-of-payments data as per the International Monetary Fund's Balance of Payments Manual Sixth Edition in fiscal year 2020/21, all that researchers knew from official services data was that travel (mostly tourism) and "other" category were the top sources of service exports, generating 40.4 percent and 47.8 percent of total services exports, respectively, in 2018/19 (NRB, various issues). The "other" category remained a black box for years, although it was widely believed to include ICT and business services. From the new BoP format, we know that in the first 11 months of 2018/19, "other business services" made up 19.5 percent of total services exports, followed

by "telecommunications, computer and information services" at 10 percent, transport at 8 percent and construction at 5.3 percent.

Both Commerce Policy 2015 (GoN, 2015) and Nepal Trade Integration Strategy 2016-2020 (GoN, 2016) recognize Nepal's services export potential, and the latter prioritizes skilled and semi-skilled professionals; information technology and business process outsourcing, and tourism (including leisure, business, education and medical). Yet, the government's focus, in practice, is on goods exports and tourism in terms of planning, resource allocation, research and data collection. And it is also goods exports and tourism that have monopolized the attention of the trade research community. There is an acute dearth of surveys of service exporters. There is scant information on the characteristics of firms exporting "other business services" and "telecommunications, computer and information services", their products, their experiences, their plans and the challenges they face. The activities of Trade and Export Promotion Centre, under the Ministry of Industry, Commerce and Supplies, remain overwhelmingly concentrated on goods trade, although Commerce Policy provides for turning it into an autonomous body that also works substantially on service export promotion (GoN, 2015). Service exports do not feature prominently in the National Action Plan for Trade Deficit Minimization 2019 (GoN, 2019a), which lists both export promotion and import substitution actions. According priority to collecting and disseminating data on services trade and encouraging research on services trade—including on its relationship with goods trade—are the basic steps needed for understanding the services trade sector. These should be accompanied by subsector-specific services export development and promotion strategies to tap Nepal's services export potential.

6. Reduced policy space

Loss of preferential market access will also be accompanied by loss of flexibilities in the application of World Trade Organization (WTO) rules, impinging on Nepal's policy space to industrialize and support the export sector. Nepal has an export cash subsidy programme that covers select products, agricultural and non-agricultural (GoN, 2019b). Agricultural products, as defined by the WTO, made up about 26 percent of the country's total goods exports in 2016-2018 (WTO, 2020b). As per Nepal's commitments during its accession to the WTO, Nepal bound export subsidies at the then prevailing level, i.e., zero. Although the total budget allocated to export subsidies (for all eligible products, agricultural and non-agricultural) is low³⁵, graduation from the LDC group could mean increased scrutiny of the provision of export subsidy to agricultural products.

³⁵ The WTO's Trade Policy Review of Nepal points out that given the allocation of US\$ 5.4 million as export subsidy, the "impact of the subsidy would be insignificant" (WTO, 2018b).

As for subsidies for non-agricultural exports, Nepal as an LDC is allowed to provide them but stands to lose this policy space upon graduation. Here, the proposal submitted by the LDC Group to allow graduated LDCs with a GNI per capita below US\$1,000 (constant 1990 dollars) to provide non-agricultural export subsidies (WTO, 2020a) is of high relevance to Nepal. The GNI per capita of Nepal in 2019 was US\$443 (constant 1990 dollars).³⁶ While there is a strong possibility that this proposal will be approved by the WTO, Nepal must revise its export subsidy programme to make it effective in increasing exports and engendering product and market diversification (see Kharel and Dahal, 2021a, 2021b; Narain and Varela, 2017 for suggestions), given evidence that a few, large and established exporters are cornering most of the subsidy budget disbursed on a first-come-first-served basis, and the scheme has not led to increased exports by existing exporters receiving the subsidy (Defever et al., 2017; Kharel and Dahal, 2021a). It must also explore options other than export subsidy to help exporters of agricultural products meet the fixed cost of discovering new markets, a basic rationale for such a subsidy.

Nepal government is developing special economic zones (SEZs) as a means of achieving industrialization and export growth. A raft of financial concessions, incentives and facilities have been offered to firms located in SEZs, and firms selling to firms located in SEZs. Most of these support measures are contingent on exporting and are export subsidies under WTO rules. The foregoing discussion of the implications of graduation for the export cash-subsidy scheme also holds for them.

After graduating from the LDC category, Nepal government is likely to come under increased pressure to open up its trade and investment regime further. At the WTO, Nepal may not be exempt from making tariff liberalization commitments. At the regional level, under the Agreement on South Asian Free Trade Area (SAFTA), Nepal may be called upon to make wider, sharper and faster cuts to tariffs, even as the national revenue advisory body expresses concerns about domestic industry being hurt and the government losing revenue due to tariff liberalization effected under SAFTA thus far (Nepal Revenue Advisory Committee, 2021). Besides, proponents of liberalization, including multilateral lending agencies, are likely to argue that with trade preferences gone, reducing tariffs, liberalizing services trade further and opening almost all of the few sectors that are on the negative list of the country's foreign investment law become doubly critical to shoring up export competitiveness as well as the overall competitiveness of the economy. While some of such measures can help enhance

³⁶ GDP per capita calculations for all WTO members using the methodology in G/SCM/38, Note by the Secretariat, G/SCM/W/585.

competitiveness and boost exports—for example, reducing tariffs on raw materials and intermediate goods used in export-oriented production, or instituting an effective duty-drawback system for exporters—Nepal government needs to carefully weigh the probable implications of across-the-board liberalization for revenue and the space for infant industry protection and development of national capabilities.³⁷ It must be sure of a tight link between the absence of certain liberalization measures and poor competitiveness. For example, is the protection afforded to accounting services, legal services and retail trade, and the formal restrictions on foreign investment in these subsectors, really a binding constraint on export competitiveness, industrialization or, more broadly, economic growth? Nepal needs an industrial development strategy that takes to heart the fact that the "jury is still out on whether the East Asian miracle happened with the helping hand of an active industrial policy, featuring protectionism and other forms of state interventionism, or despite it" (Kharel, 2020: 5).

7. Way forward

Nepal government should make international trade a central component of the strategy for a smooth transition it prepares. Alleviation of supply-side constraints and building of trade-related productive capacity should get top priority. The successor to the Nepal Trade Integration Strategy 2016-2020 should speak directly to the issue of responding to the trade-related challenges of graduation. It should be made part and parcel of the overall transition strategy. Special thrust should be placed on developing the national quality infrastructure, and helping exporters discover markets and in branding and marketing, making use of the opportunities presented by e-commerce. It should feature a strategy to utilize trade preferences available until graduation and, in the case of the EBA in the EU market and the GSP-LDC in the UK market, until 2029, as well as the Nepal-specific trade preference programme of the US which expires in 2025-end. A Nepal-specific ascertainment of the reasons for low rates of preference utilization in several destination markets is in order. The trade integration strategy should address the factors thus identified. A survey of and in-depth consultations with firms, including SMEs, exporting to the EU should be conducted before preparing a trade adjustment programme to help them overcome the competitiveness challenges unleashed by graduation. The government should study, and if deemed appropriate ratify, the additional international conventions whose ratification is required to be eligible for the GSP+ scheme of the EU and the Enhanced Framework scheme of the UK.

³⁷ See Kharel (2020) for a discussion on industrialization, input duties and revenue concerns in Nepal.

An action plan to help Nepali firms meet the more stringent rules of origin in the EU and the UK markets under the GSP+ and Enhanced Framework schemes requiring double transformation in apparels should be rolled out in consultation with the domestic industry, exploring ways to integrate the export-oriented apparel sector with the domestic textiles industry, while also seeking a time-limited derogation from the rules. Effectively implementing a Logistics Policy that the government is finalizing, backed by a timebound action plan and a robust coordination and monitoring mechanism, is essential to slash logistics time and cost. Nepal government should also formulate an industrial development strategy to situate its trade strategy in. A strategy to attract FDI in export-oriented ventures should complement the export strategy.

Effective implementation of the trade strategy that addresses the graduation challenge hinges overwhelmingly on an effective coordination and monitoring mechanism, which has eluded trade strategies so far. Operationalizing the Board of Trade, which has been unable to even meet regularly as mandated, is critical for reining in coordination and monitoring failures. It should be supported by a dedicated secretariat equipped with adequate human and financial resources. This is also true of other trade-related coordination bodies such as the National Trade and Transport Facilitation Committee. The effectiveness of such bodies depends critically upon "discipline in terms of the meetings having clear agendas, setting targets and conducting diligent follow-ups, along with accountability of all participants" (Kharel and Dahal, 2021b).

Nepal government should conduct or commission studies on opportunities and market access issues in new or non-traditional markets, including China and in the rest of developing Asia, and pursue trade negotiations, where needed. It must prioritize revising the bilateral trade treaty with India to, *inter alia*, remove the provision that constrains Nepal's ability to exchange trade concessions with other countries. Products with high export potential which are already being exported and will continue to enjoy trade preferences post graduation under, say, the GSP, or which attract MFN zero tariff, should be identified for export capacity development and promotion. Building the capacity of policymakers in formulating and executing trade policy and strategy, and negotiating trade agreements should be complemented by reducing the frequency of transfers of personnel, especially in the Ministry of Industry, Commerce and Supplies (MoICS). The research and analysis capabilities of the Trade and Export Promotion Centre (TEPC) should be enhanced so that it can provide substantive inputs to MoICS. The government must encourage data collection and research on services trade, in which a strengthened TEPC can take the lead.

Economic diplomacy must be effectively set in motion in pursuit of continued non-reciprocal preferential market access through alternative arrangements in existing preference-granting markets, whether they are currently LDC-specific or Nepal-specific. In the WTO, Nepal should join forces with likeminded countries, including soon-to-be LDC graduates, in seeking the preservation of a range of special and differential treatment provisions for a certain period of time. Nepal's transition strategy should clearly spell out the support measures it needs from development partners and the wider international community. The Committee for Development Policy under the United Nations monitors a graduated country's development progress and the implementation of its transition strategy for three consecutive years after graduation, followed by two triennial reviews. Nepal should utilize this opportunity to effectively communicate the challenges it faces upon graduation, and the support it needs. The LDC Group in 2020 called for an extension of all support measures benefitting LDCs for a period of 12 after their graduation³⁸ and in 2021 called for an extension of LDC-specific trade preferences for a period of 6-9 years after graduation.³⁹ Nepali stakeholders must embrace the imperative of having a clear strategy on utilizing the extension, if granted, and implementing the strategy effectively. Otherwise, 6-12 years will pass in no time, just as the last one decade or so has seen two trade integration strategies without a significant improvement in export performance.

As a signal it is serious about shoring up the export competitiveness of Nepali firms, even before it finalizes the transition strategy, Nepal government should start plucking low-hanging fruits such as reducing the cost of inputs for exporters through an effective duty-drawback scheme, operationalizing the two special economic zones (in Bhairahawa and Simara) by providing the facilities promised, and enabling exporters to receive payments online. These are no brilliant or novel measures; they have been tried and tested across the world. If these cannot be delivered expeditiously, it is doubtful more difficult tasks such as building export-related productive capacity will be accomplished.

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³⁸ Trade related challenges of the least developed countries and way forward: A draft for MC decision, 17 November 2020, WT/GC/W/807.

³⁹ A smooth transition package in favour of members graduating from the LDC category, 18 October 2021, WT/GC/W/829.

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