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Nepal – Agricultural trade policy issues

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1. Introduction

A number of structural and policy factors have determined the evolution of Nepal's trade pattern. Among the structural factors include highly subsistence agricultural economy, some diversity in production due to geography and climate, highly porous border with India, and India's protectionist trade regime until recently which induced some export oriented industries in Nepal to take advantage of the tariff differential. On the policy front, Indo-Nepal free trade agreement in primary agricultural products has been a major factor. Since about early 1990s in particular, Nepal also undertook significant policy reforms towards a liberal, market-oriented trade and economic regime. Loan conditionality from Nepal's main donors was an important factor behind these reforms. Nepal's WTO accession in 2004 and the commitments made then was also an important factor in influencing subsequent policies. Internally, trade policy making process involves two interrelated aspects: one relates to trade policy per se and the second concerns the design of the institutional framework governing trade policy formulation process. It is the second aspect that determines the inclusiveness, comprehensiveness and robustness of trade policies in the long run. Accordingly, the paper is made up of two main parts - a substantive and longer trade policy part and a shorter part on the trade policy formulation process.

The rest of the paper is structured as follows. Section 2 provides an overview of the evolution of Nepal's trade policy. It covers historical perspective, trade agreements and Nepal's current trade policy unveiled in April 2009. Section 3 discusses a number of issues on Nepal's trade policy and comments on them. Section 4 discusses the process of trade policy formulation. And section 5 concludes summarizing the main points and suggestions for further debate and analysis.

2. The evolution of trade policy

2.1 Trade policy developments through 2008

The historical development of Nepal's trade policy can be grouped into three distinct regimes: i) an essentially free trade regime in the earlier years (1923-1956); ii) a protectionist, import-substituting regime during 1956-86; and iii) an open and liberal regime since 1986, further more so from 1992 onwards.

Historically, for centuries, Nepal served as an interport for trade between the Tibet region of China and India, with no formal policy or mechanism to regulate that trade. This trade yielded considerable revenues to rulers along the trade route, especially the Kathmandu valley. It was only in 1923 when Nepal for the first time signed a trade treaty with British India, binding Nepal to import goods freely from Britain and British India. Exports to India constituted mainly agricultural, mineral and forest products such as timber, rice, ghee etc, much like now.

The next important milestone was 1935 when Nepal initiated a process of state-led industrialization, by creating an *Udyog Parishad* (Industrial Council) and establishing some industries based on the processing of local products like jute. Protecting these industries became the natural concern of industrial and trade policies.

But the seed of a protectionist trade regime was formally sown with the launching of the first development plan in 1956. As it was common then throughout most of the developing world, including India, the plan announced and implemented a series of policies and measures that have come to be known today as the classic import-substitution policies for state-led industrialization. These included, for example, the requirement of a license for export-import business, high tariffs and quotas, controls on foreign exchange transactions, and so on. Throughout the 1970s, efforts were made to promote a variety of import substitution industries, typically relatively capital intensive public manufacturing enterprises.

At the same time, and in parallel to most other developing countries, the government recognized the negative effects of this strategy on incentives for exports and so a variety of responses were made. These included, for example, incentives through favourable foreign exchange facilities, relief on import tariff for raw materials, and lower export taxes. Likewise, diversification of export destinations, notably away from India, has always been an objective of Nepal's trade policy, and several incentive measures were taken for this. For example, a dual exchange rate system was used in 1977 to provide higher incentive (of about 25 percent) for exports of traditional goods like raw jute, leathers, pulses and rice to countries other than India.

The next important milestone in the evolution of Nepal's trade policy was export promotion programme of 1983, which indeed could be said to be Nepal's first trade policy. Consistent with the export promotion and diversification policies of the Seventh Plan, this programme announced measures that were consistent with a more liberal and market-oriented trade regime that also accorded important role for the private sector. Also, some trade facilitation measures were taken to address the demand of the private sector such as de-licensing of exports, waiver of income tax on export earnings, bonded warehouse facility, simplification of customs procedures, establishment of National Export Trade Development Council etc. The major provisions of the 1983 trade policy were as follows:

1. Cash incentives in hard currency equivalent to 10 percent of f.o.b. value of export earnings for items other than leather and leather products.
2. Cash incentives in hard currency equivalent to 10 percent of f.o.b. value of export earnings for items other than leather and leather products.
3. Provision of 15 percent of export earnings in convertible currency for the import of raw materials and capital goods.
4. Lowering of custom duties on export items to 1 percent.
5. Provision of duty drawbacks for export-oriented industries.
6. Provision of pre-export loans up to Rs. 250,000 for the collection and processing of exportable goods against the letter of credit opened by importers.
7. Provision of loan for export purposes at lower than prevailing lending rate for the first month.
8. Arrangement of refinance facility from Nepal Rastra Bank to Commercial Banks to enable the latter to extend export credit, and
9. Channelling of at least 10 percent of the loan from the Nepal Industrial Development Corporation towards export oriented industries.

The mid-1980s was a period when Nepal implemented a series of Structural Adjustment Programmes (SAPs) with the support of mainly the IMF, World Bank and ADB. The focus of the SAPs was on, inter alia, correcting incentives structures in agriculture and industry, and on relaxing what was then held as an overly restrictive trade regime. In the trade sector, various measures initiated included the following: sharply reducing maximum tariff rates (e.g. in many cases from as high as 450 percent to around 100 percent); reducing "additional duties" by 5-10 percent points; replacing quantitative import restrictions by passbook system for imports of raw materials and intermediate goods; placing more and more items under the open general license (OGL) for overseas imports; and, in 1987, introducing duty drawback for both import duties and sales tax. The process of trade liberalization was interrupted briefly in 1989 due to trade and transit impasse with India.

These reforms in the mid-1980s, along with the availability of market access under GSP schemes from developed countries, are considered to have contributed substantially to the expansion of readymade garment exports and some other products. However, there are no sound evaluation studies to substantiate these claims.

The decade of the 1990s is yet another important period in the development of Nepal's trade policies. This commenced in 1991 with the advent of democracy. In that highly liberal economic and political environment, a new and more liberal trade policy was announced in 1992 along with other economy-wide reform measures. It aimed at promoting sustainable trade to enhance the national economy by undertaking open and liberal policies, and by allowing wider participation of the private sector. It also accorded priority to new product development, trade diversification and promotion of backward linkages, reduction in trade imbalances and coordination with other sectors of the economy. The salient features of the policy were: i) minimum role for the public sector; ii) liberal and dynamic trade policies and procedures; iii) emphasis on production and exports of quality goods and services; iv) simplification of procedures; and v) development and strengthening of institutions.

Thus, in July 1993, the system of foreign exchange auction for imports of industrial raw materials was abolished and all imports were placed under the OGL system. The current account was made fully convertible in February 1993. Also introduced was duty drawback scheme for imported raw materials used for export. License requirements for exports were waived with the exception of some banned items. Similarly, income taxes on exports were also exempted by the trade policy. All exports were made free from all charges except service fees. Tariff rates were reduced sharply as well as rationalized, from numerous slabs in the 1980s to just five in 1995/96. However, the government kept changing the tariff slabs in order to optimize the revenue collection. Another simplification was the elimination of additional duties in 1993/94, but this was quickly reversed by introducing local development fees, in order to compensate revenue losses of local bodies after octroi was abolished.

Likewise, security tax was introduced to finance additional security costs during the armed insurgency period in late 1990s (now abolished). Local development fee was also reduced; the aim is to abolish them, as part of Nepal's commitments to the WTO. The government also introduced agriculture development fee of 5-10 percent, depending on the nature of the products, on all agricultural products for which customs duties are exempted (i.e. from India). The rationale was to provide some protection to Nepalese farmers from imports from India, by circumventing the provision of Nepal-India trade treaty under which all agricultural trade is free of basic customs duty (discussed below). On the other hand, export development fees were introduced to generate resources for export promotion activities. But this was abolished at a later stage as private sector protested, stating ineffective utilization of collected money.

2.2 Trade agreements

Nepal is a signatory of some trade agreements. These are Nepal-India trade treaty, SAFTA, BIMSTEC, and the WTO. The first of these is the most important agreement in terms of the volume of trade.

Nepal signed its first Trade and Transit Treaty with India in 1950. The treaty was renewed in 1960, 1971, 1978 (when trade treaty was de-linked from transit treaty), 1991, 1996, 2002 and 2009. The treaty provides reciprocal duty free and without any quantitative restrictions market access for 16 agriculture and primary products, including paddy, wheat, maize, rice, pulses and flour. With regard to manufacturing products, it grants duty free and quota free access to the Indian market for all articles manufactured in Nepal which qualify the rules of origin criteria. It also exempts application of export restriction on case by case basis. In fact, the 1996 treaty bestowed practically duty free market access for almost all products produced in Nepal. However, the revised treaty of 2002 introduced several new restrictions: i) a more stringent rules of origin (minimum 30 percent domestic value addition); ii) tariff rate quota (TRQ) on Nepal's exports of vegetable ghee, acrylic yarn, copper, and zinc oxide; and iii) invocation of safeguard measures if the imports cause or threaten to cause injury to the domestic industry or a significant segment of it (GoI 2009).

Nepal as a LDC is also entitled for special and differential treatments enshrined in WTO agreements. Nepal's WTO bound tariff on agriculture products is 41.4 percent on average and has committed to phase out other duty and charges (ODCs) by 2012. Nepal does not provide any export subsidy to the agricultural products and the domestic support to the agriculture sector is very low.[1]

2.3 Trade policy 2009

The GoN enacted Trade Policy 2009 (GoN 2009, NNTP09 in short) taking into account a number of developments and objectives. These included the following: i) the need for developing products of comparative and competitive advantages; ii) strengthening linkages of the export sector with the domestic economy; iii) improving inter-sector policy coordination; iv) facilitating trade and developing trade-related infrastructures and services; v) improving the supply side capability in order to take advantage of the membership of the WTO and other regional trade agreements. The main focus of the previous trade policies was on the reduction of market distortions, deregulation and institutional development. In contrast, the new trade policy recognizes that export

[1] Detailed accounts on Nepal's positions on domestic support measures, market access and export subsidies in the context of the WTO Agreement on Agriculture are found in the following three papers: Awasthi and Adhikary (2004), Pant et al. (2004), and Tiwari et al. (2004).

development is essential to sustained broad-based economic growth and poverty reduction in light of the small domestic markets and thus is heavily concentrated on the "supply side" and is oriented towards export "development" and not just "promotion". Although the policy recognizes the need to establish increased linkages of export sector with other sectors of the domestic economy, it does not intend to promote explicitly the import competing sectors.

The main objectives of the NNTP09 are: i) to create conducive environment to promote and enable enterprises to compete at international level through simplification of procedures, trade facilitation, institutional and policy reforms and infrastructure development; ii) to reduce trade deficits through the promotion of high value added exports; iii) to promote competitiveness in the trade of goods and services and create employment opportunities; and iv) to establish linkages between domestic and international trade.

The salient features of the trade policy include the following: i) lead role assigned to the private sector for export promotion, limiting the role of the state as a guide, facilitator and regulator; ii) reducing transaction costs through the development of infrastructures and trade facilitation measures; iii) undertake legal and regulatory reforms so as to enhance competitiveness at both the regional and global level; iv) enhance linkages between the export sector and other sectors of the economy; v) harmonize other sectoral policies with trade policy; vi) provide necessary incentives for export-oriented industries, including through simplified import procedure for raw materials, export trading houses, exemption of custom duties and domestic taxes, and product development fund; vii) establish export processing zones and special economic zones; viii) develop required skills and technology for export development; ix) ensure intellectual property rights and formulate policies for trade in services; x) identify products of comparative advantages and also export promotion programmes for these products; xi) institute participatory institutional mechanisms for trade policy formulation, evaluation and implementation.

The NNTP09 was also a significant departure from the previous trade policies in that the policy formulation process provided opportunity to stakeholders to view their opinions on the draft policy document and the process was relatively participatory (discussed below). One important issue and a big question mark for the success of the trade policy is the support expected from other government agencies, especially for agriculture because so many of the identified priority products are agricultural. This is also an issue of policy consistency or mainstreaming and is discussed in detail in the next chapter. One weakness of the NNTP09 is that it does not provide indicative resource requirements for its programmes, and this will raise questions from sceptical analysts. Likewise, it also lacks an in-built monitoring and evaluation system which is so essential given the dynamism of international trade and trade policies.

2.4 Trade policy instruments and tariff structure

The key trade policy measures taken so far can be summarized as folows:

1. Eliminated quantitative restrictions on imports and import licensing.
2. Reduced import tariff rates, including tariff peaks.
3. Zero tariffs for information technology products.
4. Reduced the number of tariff slabs to six.
5. Made fully convertible current account of balance of payments (now market determined).
6. Limited export duties only to selected natural resource products.
7. Undertook reforms to introduce export incentives and neutralize anti-export bias with instruments like duty drawback and bonded warehouse system.
8. Simplified export and import procedures.
9. Took steps to attract FDI, permitting 100 percent foreign ownership in most sectors, with the exception of sectors with strategic importance.

Nepal's tariff structure shows slightly higher level of unweighted average of MFN tariff rates for agricultural products than that for the non-agriculture sector, implying higher level of nominal protection to agriculture than to manufacturing (Table 1). Within agriculture, average MFN tariff is high for beverage and tobacco, coffee and tea whereas for cereals it is less than 15 percent (WTO 2008). The government also imposes agriculture development fee of 5-10 percent, depending on the nature of the product, on all agricultural products for which customs duties are exempted. The rationale for this fee is to provide some protection to the Nepalese farmers from the Indian imports by circumventing the zero customs duty provision in the Nepal-India trade treaty. Nepal does not have significant NTBs other than quarantine and product composition standards.

2.5 Assessment of policy developments and impact

An assessment of the effectiveness of Nepal's past trade policies needs to be made taking into consideration several factors. First, Nepal embarked into organized economic development very recently in a relative sense. Second, Nepal lacked and continues to lack basic productive capacities and infrastructures to generate surplus for trade or to respond to new trading opportunities. Third, being surrounded from three sides by India with a highly porous border, while also an opportunity, is also a major constraint in terms of not being able to influence incentives and pursue independent trade policies. Fourth, Nepal's own market is very small for industrial expansion and realization of economies of scale, and so export markets are essential. Trade performance is determined by these and other factors, and it is difficult and risky to relate policy changes to aggregate trade outcomes like export growth. What would be more useful is policy evaluations that use more proximate impact indicators (outcomes, effects etc). Unfortunately, it proved very hard to find good analyses that have assessed the impact of policies.

TABLE 1:
MFN tariff rates, 2007 (*ad valorem*, percent)

MFN tariff banks	Agricultural products	Non-agricultural products
Duty free	0	0
0<=5	9.8	30.0
5<=10	60.5	28.0
10<=15	19.1	27.1
15<=25	1.8	11.5
25<=50	7.3	2.6
50<=100	1.4	0.7
> 100	0	0
Simple average	14.0	12.4

Source: WTO (2008)

During 1985/86-1987/88, Nepal's GDP growth rate exceeded 4 percent and productivity of cash crops rose. However, agricultural production and exports remained vulnerable to the vagaries of weather. Although this continues to be debated, it is generally held that reforms under the Structural Adjustment Programme (SAP) contributed positively to growth and development. Industrial production rose by about 70 percent during the SAP period. Despite deteriorating terms of trade, the programme contributed to the expansion of non-traditional exports such as carpet and garments and increased income from tourism and as a result the balance of payments position improved steadily. Policy reforms in agriculture under the SAP included the abolition of compulsory procurement at concessional prices and withdrawal of fertilizer subsidies. It is held that the former enhanced production incentives and the latter increased supplies of fertilizers, in large part because leakages to India were reversed. At the same time, liberalization of investment and import licensing procedures reduced the cost of doing business and improved incentives to generate productive employment, e.g. in carpet and garment sectors. Likewise, these measures provided incentives for private investment in small scale industry. Importing raw materials was made much easier and many administrative hassles reduced. Despite these positive impacts, income distribution did not improve.

During the recent past, export growth fell from an annual average of 6.9 percent during 1995-1999 to less than 1 percent during 2000-2006. Services exports recorded negative growth during this period because of sharp declines in transport and tourism services due to conflict (Table 2). The decline in exports was more pronounced in the case of exports to overseas countries[2] and in woollen carpets,

[2] The share of overseas countries (countries other than India) in total exports declined from 40 percent in 2000-01 to 31 percent in 2006-07.

readymade garments, *pashmina*, handicrafts, vegetable ghee, jute products, textiles and chemicals.[3] There was much less success on the goal of diversification. Exports remained concentrated to India as regards destination, and limited to 3-4 products only (mainly ready-made garments, *pashmina* and carpets). As a result, Nepal's share in global exports declined from 0.017 percent during 1995-99 to 0.008 percent in 2007.

Moreover, the economy continued to suffer from the longstanding structural weakness on the supply side, with exports not much linked to domestic economy through raw materials. Stiff competition from Indian exports to Nepal was another major constraint to industrial growth. Taking into account the dismal state of industrialization, income distribution, poverty and trade balance, strong voices were also raised on the desirability of a liberal trade regime in the long run (Panday 1999).

There are various studies available for review on the impact of trade liberalization on growth, poverty etc. Interestingly, some researchers have used economy-wide models (the CGEs) to answer these questions (Cockburn 2001, Sapkota 2002 and Sapkota and Cockburn 2008). The findings are qualitatively similar. Briefly, they find that trade liberalization reallocates resources away from non-trade services towards export-oriented manufacturing, mining and hotel/restaurant sectors. As a result, output in industry and hotel and restaurant increases and agriculture sector declines, with the impact on paddy coming out highest. Impact on consumer prices is very small. Overall, the size of the impact is very small. The message that comes out is that trade liberalization has little impact on aggregate welfare at the national level but there are winners and losers, with smaller income gains for the poorest groups than for the richer households. The negative impact on poverty is higher for the Tarai, followed by hills and mountains and least in urban areas.

There is hardly any other study to review. Industry-specific or partial equilibrium studies would have been more useful. For example, there are export industries such as *vanaspati ghee*, copper and acrylic that have grown taking advantage of tariff differentials on raw materials between India and Nepal. These industries contribute to revenue and some jobs but, being fully based on imported raw materials, very little to the real economy through backward linkages. So one question often asked is what is the net contribution of these industries to poverty, versus, say, other export products that are based on local resources, such as tea and ginger? Sadly, these questions have not been subjected to rigorous analyses. This has hindered policy making, for example to decide where the government should channel its support and incentives, as well as capital in negotiating trade agreements. Also

[3] The share of woollen carpets, readymade garments, pashmina, handicrafts, vegetable ghee, jute products, textiles and chemicals in total exports declined from 75 percent in 2000/01 to 32 percent in 2006/07.

TABLE 2:
Nepal's trade performance

Indicators	1995-1999	2000/2004	2005/2006	2006/2007
Export growth at current prices (percent)	6.89	0.35	0.10	9.00
Growth of merchandise exports	11.12	6.61	0.67	10.54
Growth of services exports	4.85	-4.29	-8.03	6.81
Import growth at current prices (percent)	4.53	6.51	13.23	14.00
Growth of merchandise exports	5.82	6.16	6.18	14.97
Growth of services exports	-5.74	13.77	13.14	8.65
Exports as a percent of GDP	24.30	18.33	14.73	13.44
Merchandise exports	9.27	11.43	9.32	8.38
Services exports	14.89	6.67	4.48	4.11
Imports as a percent of GDP	35.55	30.08	32.98	33.32
Merchandise imports	29.91	26.00	23.12	24.07
Services imports	5.06	4.12	5.41	5.34
Export share of world market (percent)	0.017	0.013	0.009	0.008
Import share of world market (percent)	0.025	0.021	0.021	0.021

Source: Government statistics.

lacking is studies and debate on the net impact of the Indo-Nepal trade agreement on agriculture and poverty in Nepal, which would have provided tips to the government on how best to strengthen the positive effects and respond to the negative ones. There is thus a large research agenda to be initiated.

3. Selected issues on agricultural trade policies

Based on the above review of policies and taking into account observations from stakeholder consultations, the following four issues related to Nepal's agricultural trade polices are selected here for some further discussion.

Issues on Nepal-India trade

The provision in the Nepal-India trade treaty of duty free market access for agricultural and primary products on a reciprocal basis, coupled with the porous border, has created *de facto* free trade for both products and inputs, through both formal and informal channels. This has constrained Nepal to pursue independent trade policy in the sense of maintaining relative prices different from that in India, or in providing protection to selected products and sub-sectors. This was one important reason why Nepal abandoned its farm price support programme in the 1980s and later withdrew price subsidies on fertilizers. Furthermore, the Nepalese agriculture faces intense competition from the Indian imports as the Indian agriculture (and agro-industry) is more advanced in terms technology and economies of scale, and also benefits considerably from subsidies.

In view of this, there is some debate in Nepal on how best to create some policy space for trade and pricing policies for addressing the needs of the agricultural sector. Three options are often discussed: i) matching India on the provision of supports and incentives; ii) introducing para tariffs or non-tariff measures such that the playing field is levelled; and iii) renegotiating with India on the coverage of the products that enjoy reciprocal free market access. These are not easy options. On the first, given Nepal's fiscal situation and administrative weaknesses, it is very difficult for Nepal to match the support provided by India. As regards the second option, while the Nepal-India trade treaty does not prevent Nepal from introducing some para tariffs like agriculture development fee on imports from India (as now), Nepal has made a commitment at the WTO not to use such measures beyond 2012. The third option is somewhat promising if Nepal could renegotiate with India to exclude from the *reciprocal* duty free list at least some major farm products like paddy, wheat, maize, millets and their products. However, not much concrete is happening on any of these issues, neither from the government side nor in terms of studies and discussions. Neither does the 2009 trade policy have anything to say on these issues, being fully quiet by design on the issues facing importables.

Other bilateral and regional trade agreements

Other than the India-Nepal treaty, SAFTA is the most prominent agreement. Being also a regional cooperation initiative among neighbours, Nepal participates actively in the SAFTA negotiations and deliberations. But so far the SAFTA has not been of any significance for trade. Indeed, Nepal has not yet exported any goods under the provision of the SAFTA. The reason is simple - India is essentially the main market for Nepal in South Asia, and the market access provisions in the Indo-Nepal treaty are far superior to those under the SAFTA.

So an often raised question is why is SAFTA so prominent in the region? One reason is the importance given to the political process itself through the SAARC and its potentials for regional cooperation in a variety of areas. But for Nepal, SAFTA also has some trade significance – it is also seen as something like a strategic trade agreement which is there as a fallback agreement in case there are problems with the Nepal-India treaty and it stops to function.

The pros and cons of various trade agreements is a topic that attracts some attention from time to time. Thus, for example, in the case of the Nepal-India treaty, the question asked is net gains to Nepal, considering a) the constraints imposed on Nepal in pursuing independent trade policy for its agriculture and industry (the "negatives") and b) the free access to the Indian market on the one hand and the stability in food prices in Nepal due to the treaty, on the other (the "positives").

Although written from the standpoint of WTO compatibility of the Indo-Nepal trade treaty, and not an economic analysis, one study gets into the issue of alternatives to this treaty in case it is not found WTO compatible (Nepal 2004). The fifth option considered in that paper was terminating the treaty and trading with India under SAFTA, as the middle way between the Nepal-India treaty and a MFN regime with India. As SAFTA also provides preferential treatment to LDCs in the region (and importantly on a non-reciprocal basis), the study noted that a SAFTA that is sufficiently rich in non-reciprocal preferences might come closer to the current Indo-Nepal treaty on the preferences (and at the same time also WTO-compatible). Being non-reciprocal, such a trade relationship also gives Nepal some policy space for trade, pricing and protection policies. That was an interesting analysis because it looked into several options. Unfortunately, these ideas have not been subjected to economic analyses which would have provided estimates on relative gains and losses for Nepal of those options.

Next to SAFTA, BIMSTEC also attracts some attention in Nepal. Although there is also a trade component in it (there is a Trade Negotiating Committee), BIMSTEC is seen less as a trade agreement and more as a regional cooperation agreement, as its full name also indicates. It looks like it will be several years before the trade component of the BIMSTEC takes some shape for any commentary and analysis. But for Nepal, given the situation with SAFTA itself, it will be long time before BIMSTEC starts to become valuable as an agreement for market access.

Other than these, Nepal as a LDC is a beneficiary of the EU's *Everything but Arms* deal. An increasing number of developed countries and advanced developing countries are granting free market access to the LDCs (the "duty-free quota-free" or DFQF scheme). This is expected to expand further if the Doha Round agreement is concluded. This means that market access is unlikely to be an issue for Nepal, in contrast to other challenges such as generating surpluses for exports and meeting technical and quality standards.

Fixed exchange rate regime with India

Although Nepal adopted in the 1990s market-determined exchange rate regime for most currencies, it maintains fixed exchange rate to the Indian rupees. The pros and cons of this regime has also been a topic of some debate, the key ones being the impact on Nepal's trade competitiveness and inflation/instability in Nepal. As regards the former, the concern is that through changes in the real exchange rate, Nepal's competitive edge on exports to India, as well as in the domestic market itself, could be eroded over time. For example, during 2000-09, the wholesale price index rose by 76 percent in Nepal and 51 percent in India, thus eroding Nepal's competitive edge. Likewise, Indian productivity in agriculture and industry is also rising faster than in Nepal, again favouring India's competitive edge that cannot be corrected by changes in the exchange rate. For this reason, many analysts hold that a review of the pegged exchange rate system with India is necessary.

On the other side of the argument, also held strongly by many analysts in Nepal, is the worry that a flexible exchange rate regime with India will invite unbearable instability and uncertainty in the Nepalese economy, inflation being one of them. While this debates takes place from time to time, not much analyses on this topic is found in the literature. But then there is also an argument that points a compromise which is that the pegged or free exchange rate regime could be attempted gradually, implementing the changes step by step, and carefully monitoring the outcomes and responding to the negatives.

Food security

The link between trade policy and food security is a hotly debated subject all over the world. Trade policy impacts on food security through a number of channels, notably by influencing domestic food prices relative to those at the border. For political economy reason, most developing countries cannot afford to keep domestic food prices substantially higher than those at the border. Where trade policy has been used actively is for stabilizing domestic prices around some level. Economists typically do not favour using trade policies to protect a sub-sector or products so as to artificially maintain higher levels of self-sufficiency in view of the resource costs and other reasons.

Section 2.3 of the next chapter on mainstreaming briefly reviews food security policy of the government. It also notes that in many other countries, e.g. India, trade policy instruments like tariffs, quotas and export bans are used actively to regulate the import and export of food products with a view to maintaining price stability. Nepal's situation is different and does not seem to have this option in view of the porous border with India. Any attempt to regulate that trade, e.g. with some para tariff or other regulations, will only result into increased informal trade. This trade is substantive in general, and for several farm products as large as formally recorded trade (Karmacharya 2010).

Nepal's main food insecurity problem is lack of effective demand on the part of low-income households and not food availability in the markets (Pandey 2009, which is a study on trade policy and food security). Indeed, given the above constraint imposed by porous border, increased cereals production in Nepal, especially in the Tarai, does not necessarily lead to more consumption by food insecure households. In the 1960s and 1970s, Nepal used to export cereals to

India when also food insecurity was rampant in the hills and mountains. The food security chapter of the TYIP07 acknowledges this problematic when it states that at the aggregate level the country appears to be self sufficient in food production but then 55 of the 75 districts of Nepal are food deficit. This chapter does not say anything on the role of trade policy in food security issue and most of its 14 bullet points on strategies and 31 on policies and working policies are about production, marketing and safety nets.

There is some debate in Nepal on the extent to which the government should push cereals production in the Tarai and hills, e.g. through more research, irrigation, fertilizer subsidies. The alternative is to aggressively push cash crops and other high value products. If food insecurity is seen mainly as an issue of economic access, then it should not really matter what is grown, and the choice is obviously towards non-cereals and livestock which yield higher returns. The proponents of this view also argue that as long as there is effective demand, the porous border with India, and the Nepal-India trade treaty, will ensure enough food supplies in the Nepalese markets. In this view, the trade treaty and the porous border are the sources of price stability and assured supplies rather than a threat to Nepal's food security. There is also a counterview often heard in Nepal which is that food security is a matter of strategic importance and so Nepal should strive to maintain a certain level of self-sufficiency in foods, especially cereals, irrespective of the economics of food production. In this view, too much dependency on India, as well as in global markets, is fraught with risks as food supplies could be easily disrupted by political tensions with India, changes in the Nepal-India treaty and the global food crisis like that in 2007-08.

4. Trade policy formulation process

The process followed for the formulation of a trade policy matters greatly for its quality and so the process is receiving a great deal of attention in recent years. The best practice calls for an inclusive process based on stakeholder consultations. In Nepal, trade policy formulation is initiated by the MoCS. For this study, an attempt was made to understand the process for the previous two trade policies also (1983 and 1992). This was very difficult because hardly any record could be found in the MoCS, and so the only way out was to piece together a picture of the process through interviews with government officers and private stakeholders who participated in those exercises. Most of those involved were either retired or transferred, and were not in a position to fully recall how things were done. They were requested to recall, in particular, the process followed itself and the alternative policies/views considered and discussed before settling on the final document.

One official claimed that a committee was formed for trade policy in 1983 including private sector members, but this statement could not be verified from the private sector respondents. But both the officials and private respondents agreed that a committee with representation from both sides was formed for the 1992 policy formulation. Again there was no written record of any kind. One of the complaints from the private sector was that they were not really consulted on policy matters. They further felt that there is a strong "elite group bias" in the process, meaning that consultations, in an effective sense, get limited to a small elite from the private sector.

In contrast, being a recent work, much more information is available on the process followed for the 2009 trade policy. The formal process followed was as follows:

1. Within the MoCS in particular, the need for a new trade policy was felt for some time, and accordingly a decision was made in 2007 to move ahead; the MoCS requested the UNDP funded project, *Enhancing Nepal's Trade Related Capacity* (ENTReC), to assist in the process.
2. The ENTReC project provided in January 2008 a consultant, a former secretary of the MoF, to prepare the draft trade policy.
3. In the mean time, the GoN formed in August 2008 a five-member technical task force under the chairmanship of the joint secretary of the MoCS, and comprising of members from other GoN agencies and private sector. The task force's responsibility was to finalize the draft prepared by the consultant.
4. The consultant's draft policy was discussed in September and December 2009 with stakeholders comprising about 30-40 people from the private and public sectors. The records of these stakeholders meetings were *not* available for review.
5. In the mean time, the MoCS also requested for written comments on the draft from relevant public agencies and private sector (mainly FNCCI and NCCCNI).
6. None of the government agencies, other than the MoF, forwarded written comments. The MoF comments were limited to revenue and expenditure sides (e.g. seed subsidies, various incentives), and not on development issues. The views were incorporated following intense discussion.
7. Likewise, the FNCCI was the only private sector providing comments and suggestions. The comments were of general nature and lacked specificity. But the FNCCI was an active participant in the meetings.
8. Having incorporated the comments, the MoCS finalized the draft and forwarded in February 2009 to the cabinet of ministers for approval which approved the trade policy on 11 February 2009.

The above shows that there was a process of consultation followed, notably requests for written comments from relevant Ministries and private sector and the two stakeholder meetings. However, the quality of consultation was poor in both cases. On the former, most ministries and private sector agencies did not submit any comment, and those that sent something, the comments did not appear to be substantive. On the latter, hardly anything is known of the quality of the stakeholder consultations. Moreover, the process was not inclusive enough as several other stakeholders such as the CSOs, farmers association and cooperatives did not participate in the process. Even if some of them attended the two consultations, it must have been very difficult for them to provide substantive comments in such a short period of time, especially so when alternative positions and analyses were not provided to stimulate discussions.

It is sad that despite the growing popularity in Nepal of the process of stakeholder consultations, what was followed for the trade policy was highly inadequate. The main risk is that as alternative views were not solicited, debated and processed, the final policy document stands the risk of being either undermined (e.g. by other ministries) or revised and reversed when a new government – especially with a different political viewpoint on trade and development issues - takes over. In part, the weaknesses of the 2009 trade policy, discussed in more detail in the next two chapters, can be linked to the process of consultations followed.

5. Conclusions

The liberal trade policy regime adopted since the 1980's has focused primarily on addressing the bias against exports, reducing distortions in domestic markets and procedural and institutional reforms. The 1992 trade policy also continued on the same thrust. However, liberal trade policy, in an environment where the choice of policy instruments and pace of liberalization are constrained by both formal and informal trade relations with India, could not produce the desired results in terms of export growth and its diversification, agricultural development, industrialization and poverty reduction. At the same time, there were binding constraints on the supply side, as well as poor and underdeveloped infrastructures and, in the recent past, security and law and order problems.

The new NNTP09 takes into account the need for developing products of comparative and competitive advantages, establishing increased linkages between the export sector and domestic economy, improving inter-sector policy coordination, facilitating trade and developing trade related infrastructures and services, improving supply side capabilities and the exploitation of dynamism in international trade relations brought about by Nepal's membership of the WTO and RTAs. It also recognizes that export development is essential to sustained broad-based economic growth and poverty reduction in light of the small domestic market. Although the policy recognizes the need to establish increased linkages of the export sector with other sectors of the economy, it did not support explicitly the import competing sectors. The policy formulation process included stakeholder consultation but the process was not effective enough.

In conclusion, the following issues are considered to remain germane for trade policy.

1. The kind of trade relation with India on agriculture products.
2. The need for tariff rationalization for primary agriculture products *vis-à-vis* processed agriculture products and other industrial products.
3. The need for support measures in agricultural products, in particular the products identified by the 2009 trade policy for thrust areas.
4. The role of exchange rate regime in promoting agricultural exports.
5. The role of international trade in ensuring food security.

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