

## Chapter 18

# Nepal and SAFTA: Issues, Prospects and Challenges

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### 18.1 Introduction

The Preamble to the Agreement on South Asian Free Trade Area (SAFTA) expects it to act 'as a stimulus to the strengthening of national and SAARC economic resilience, and the development of the national economies of the Contracting States by expanding investment and production opportunities, trade, and foreign exchange earnings as well as the development of economic and technological co-operation' (SAARC Secretariat 2004). Nepali policy-makers believed that joining SAFTA would help Nepal to expand its exports to countries other than India, collectively called the 'Rest of South Asia' (RSA), and thereby contribute to geographic export diversification. If Nepal's intra-regional trade during the first five years of implementation of SAFTA is any guide, this objective is far from being achieved. This is also the plight of most of the LDCs in the region, which are heavily dependent on the two largest economies of the region for their regional trade.

While the faulty Agreement resulting from the mercantilist mindset of trade negotiators in the region is partly responsible for this predicament, we argue that internal inconsistencies in Nepal's trade policy vis-à-vis SAFTA as well as the supply-side constraints are equally responsible for Nepal's inability to fully utilise SAFTA to its advantage.

This chapter discusses Nepal's trade prospects with RSA, the barriers and constraints to tapping the trade potential, and how SAFTA can be strengthened to help address them. It must be pointed out at the very outset that the analysis in this chapter is predominantly in the context of Nepal's trade relations with India. This is because India accounted for 90 per cent of Nepal's exports to South Asia, and 99 per cent of Nepal imports from South Asia in 2009. Although we note that services trade is immensely important<sup>2</sup> and the SAARC Agreement on Trade in Services<sup>3</sup> has been signed, the chapter focuses exclusively on merchandise trade.

The rest of the chapter is organised as follows. Section 18.2 provides a brief background on Nepal's trade performance. Section 18.3 discusses Nepal's trade with India, focusing on the bilateral trade treaty and the barriers faced by Nepali exports. Section 18.4 highlights the implications of SAFTA membership for trade with India. Section 18.5 discusses the trend of Nepal's trade with RSA, assesses the export potential, and sheds light on the barriers and constraints to realising that potential. Section 18.6 is devoted to Nepal's supply-side constraints. The last section summarises the discussion and provides some recommendations.

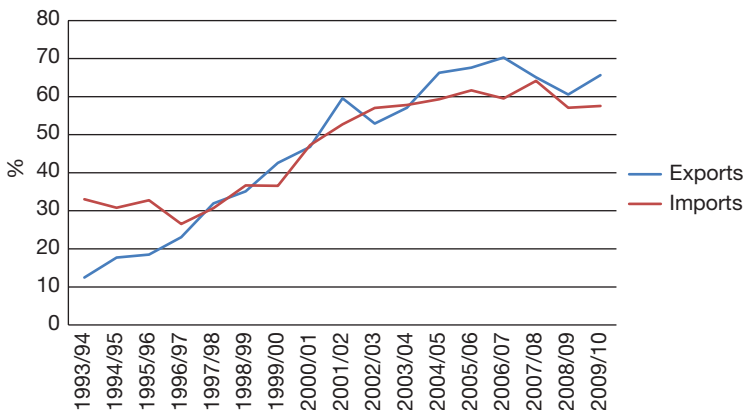
## 18.2 Nepal’s trade performance

Securing better market access conditions for its exports, achieving product-wise and destination-wise export diversification and reducing trade deficit are key motivations behind Nepal’s pursuit of negotiating trade agreements.<sup>4</sup> Nepal became a member of the World Trade Organization in 2004. Nepal has been party to various regional trade liberalisation initiatives in South Asia: it was a member of the positive-list-based SAARC Preferential Trading Arrangement (SAPTA), which was signed in 1993 and came into force in 1995, and is a member of SAFTA, which has replaced SAPTA and has been in force since July 2006. At the trans-regional level, it is a member of the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) free trade agreement (FTA), which is yet to come into operation. At the same time, Nepal has applied for the membership of the Asia Pacific Trade Agreement (APTA), also known as the Bangkok Agreement.

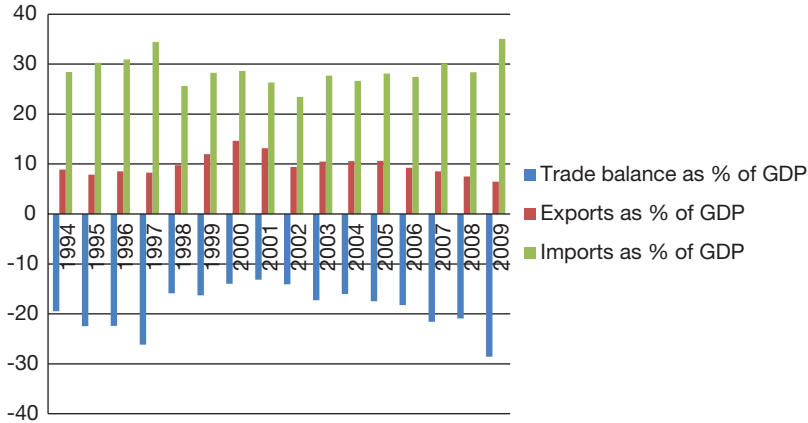
However, Nepal’s foreign trade continues to be concentrated on India, with which it has had a bilateral preferential trade agreement since 1950. Trade dependence on India has increased over time, and, more alarmingly, so has the merchandise trade deficit, which is being largely financed by remittances. From 24.5 per cent in the mid-1990s, the share of merchandise exports to India increased to an average of 64 per cent from 2007/08 to 2009/10. Likewise, the share of merchandise imports from India increased from 30 per cent to 59.6 per cent during the same period (Figure 18.1). If informal trade is taken into account, the dependence is even higher, with a study showing informal trade to be 38–103 per cent of formal trade in 2000–01 (Karmacharya et al. 2004).

In the decade 2000–09, the merchandise trade deficit as a percentage of GDP more than doubled to 28.6 per cent (Figure 18.2). The overall merchandise export–import ratio has more or less continuously fallen since 2004/05, reaching 16 per cent in 2009/10 (a slightly better 18.4 per cent with India). The trade deficit with India

**Figure 18.1 Nepal’s merchandise trade concentration with India**



Source: Nepal Rastra Bank, ‘Recent Macroeconomic Situation’, various issues

**Figure 18.2 Nepal's merchandise trade performance**

**Source:** World Bank, World Development Indicators

accounted for, on average, 58.6 per cent of Nepal's total trade deficit from 2007/08 to 2009/10.

After India, Nepal's major export destinations are the European Union (EU), the United States (US), Bangladesh and China (in 2009). Nepal's major sources of imports after India are China, the EU, Saudi Arabia and East Asian countries (in 2009).

### 18.3 Trade with India

Nepal and India have had a bilateral trade agreement for the last six decades. From Nepal's market access perspective, the Nepal–India Trade Treaty, last renewed in October 2009 for seven years, has been particularly restrictive since 2002, when a much more liberal Treaty signed in 1996 was replaced. The Treaty, which covers only goods trade, provides for, inter alia, exemption from basic customs duty and quantitative restrictions on imports of listed primary (including agricultural) goods on a reciprocal basis; access for Nepali manufacturing products, except for three items on the negative list,<sup>5</sup> to the Indian market free of customs duties; and preferential entry of goods from India to the Nepali market.<sup>6</sup> However, a number of restrictive provisions, which were introduced in the renewal of the Treaty in 2002, have diluted the duty-free provision for Nepali products:

- Stringent rules of origin (RoO) requiring Nepali exporters to fulfil the twin criteria of 30 per cent value addition and change in tariff heading at the four-digit level of the Harmonized Commodities Description and Coding System (HS)<sup>7</sup> for the products to be eligible for preferential market access.
- Tariff rate quota for four major products of export interest to Nepal with zero-duty treatment provided for in-quota items, namely vegetable ghee (100,000 tonnes), acrylic yarn (10,000 tonnes), copper products under HS Chapters 74.00 and 85.44

(10,000 tonnes) and zinc oxide (2,500 tonnes); and most favoured nation (MFN) duty for any exports above these thresholds.

- Requirement for Nepal to submit the criteria applied for RoO on an annual basis.
- Clear specification of safeguard clauses, which define ‘injury’ with a much more convenient trigger mechanism for the imposition of safeguard duty over and above normal tariff.<sup>8</sup>

That a liberal trade treaty, taking into account Nepal’s supply-side constraints, can help work wonders for the country’s export performance with its largest trading partner was demonstrated by the 1996 version of the trade treaty. The most significant provision of the treaty was duty- and quota-free access for Nepali manufacturers, without respect to the origin of raw material inputs in the production process, as long as there was some local value added in manufacturing. Exports increased by 7.6 times between 1995/96 and 2001/02, while imports grew, at a much slower rate, by 2.3 times during the same period. There was a marked shift in the composition of exports, away from primary goods to manufactured goods.<sup>9</sup>

With the revision of 2002, on the one hand, manufacture items exhibiting promising export growth were targeted with quantitative restrictions, and on the other, the onerous RoO, besides hurting existing exports, erected a barrier to emergent and potential exportable goods.<sup>10</sup> The ostensible grounds for introducing RoO – way beyond the capacity of an LDC with a weak industrial base and serious supply constraints<sup>11</sup> – were to ‘promote genuine industrialization’ in Nepal and ‘provide clarity and transparency’ to the preferential scheme (Shrestha 2003). In practice, however, RoO has been used as a means of disguised protection. Global experience shows that there is no evidence that strict RoO has helped beneficiary countries create a viable industrial base.<sup>12</sup> Indian goods, however, do not have to fulfil any RoO to gain preferential access to the Nepali market.

Quantitative restrictions are not confined to those stipulated in the Treaty. There are cases of imports of certain products from Nepal being banned unilaterally on and off. Garlic exports are a case in point: imports of garlic from Nepal are banned from time to time with the allegation that Chinese garlic was finding its way into India, although the local certificate of origin attests to their Nepali origin.<sup>13</sup>

Application of sanitary and phytosanitary (SPS) measures and technical standards constitutes another critical impediment to Nepali exports to India. Agricultural and forest products – goods identified by the government for export promotion<sup>14</sup> – as well as manufactured goods like ready-made garments (RMG) and pharmaceuticals face these non-tariff barriers (NTBs).<sup>15</sup> There is no predictability in the way quarantine-related rules are applied (Adhikari 2008). The requirement to subject export samples to testing in India – in some cases, in New Delhi – discourages exports. India does not recognise Nepali pharmaceuticals approved by the Nepal Government’s Department of Drug Administration. A sample from the export consignment has to be taken to the central authority in New Delhi for testing and it takes anywhere between 6 and 12 months for the results to be out, by which time the medicines in the consignment waiting at the border may well have crossed the date of expiry.<sup>16</sup> This is a major reason

why Nepali pharmaceuticals, despite possessing export potential,<sup>17</sup> have not made inroads in the Indian market.<sup>18</sup>

Para-tariff barriers are another concern. A case in point is the imposition in 2009 of Special Additional Duty (SAD) on Nepali RMG, for which India has emerged as a major market after the expiry of the Agreement on Textiles and Clothing (ATC) of the WTO that saw Nepal lose a substantial market share in the United States, traditionally the largest market for its RMG exports. Furthermore, countervailing duty (CVD), levied on imports to balance the excise duty imposed on like domestic products, was imposed on the maximum retail price of RMG instead of the border price as is the standard international practice.<sup>19</sup> Besides directly hurting exports, the unpredictability associated with the imposition of such extra duties and charges, even if they are withdrawn later, has undermined investors' confidence in Nepal.

An attempt was made in the 2009 revision to the Treaty to address the problem of the lack of mutual recognition of standards and testing. Much will hinge on the implementation of India's 'best endeavours' pledge made in the Treaty to assist Nepal to increase its capacity to trade through improvements in technical standards, quarantine and testing facilities and related human resource capacities (Kharel 2010a). While the old Treaty was silent on para-tariff and non-tariff barriers – which played havoc with Nepali exports – the revised Treaty of 2009, in its Protocol to Article I, says that the two sides *shall undertake measures to reduce or eliminate* non-tariff, para-tariff and other barriers that impede promotion of bilateral trade. But this is a weak formulation and does not entail a binding commitment to categorically eliminate such barriers.<sup>20</sup>

While these market-access barriers hurt Nepal's export performance, it must be noted that supply-side constraints within Nepal (to be discussed in section 18.6) also crucially affect its export performance.

## 18.4 SAFTA membership and trade with India

SAFTA does not offer additional market access for Nepal in the Indian market. Nepal already enjoys basic customs duty-free market access to the Indian market in almost all products, subject to RoO. The RoO under SAFTA is exactly the same as in the Nepal–India Trade Treaty, which as alluded to earlier is extremely onerous for Nepali enterprises to fulfil. The RoO needs to be made simple, transparent and, for LDCs, less stringent (see, for example, Adhikari 2010a).

Preference erosion in the Indian market as India grants more and more concessions to LDCs is a challenge for Nepal. India's sensitive list for LDCs has been reduced to 480 items from the original 763 (Rahman and Rahman 2010). Moreover, the effectively applicable sensitive list for Bangladesh has 323 items (Rahman 2010a). While 157 apparel items still remain in India's sensitive list for LDCs, Bangladesh has been given duty-free access for 8 million pieces, though it has not been able to fully utilise this tariff rate quota (only 2.3 million and 3 million pieces were exported to India in 2008 (April–December) and 2009 respectively) (Rahman 2010a). Likewise, under an FTA,

Bhutan enjoys better market access conditions in the Indian market than does Nepal: duty-free access without quantitative restrictions and RoO. Similarly, under the India–Afghanistan Preferential Trade Agreement, in force since 2003, Afghanistan gets preferential market access (with the margin of preference ranging from 50 per cent to 100 per cent) to the Indian market for 38 listed items, albeit with RoO more stringent than for Nepal.

Although there are no extra benefits in terms of tariff preferences, there could be potential benefits in other areas from SAFTA for Nepal's trade with India. Compared with a bilateral agreement, a regional agreement can provide a more predictable trading environment for the smaller party. An effective dispute settlement mechanism under SAFTA which can be moved to also resolve disputes under bilateral trade treaties can help ensure better implementation of treaty provisions. The dispute settlement body under SAFTA is not independent, with the committee of experts (CoE), comprising government officials, acting as the dispute settlement body. There is no special treatment for LDCs with respect to dispute settlement. Removal of para-tariff and non-tariff barriers/measures and/or making them least trade restrictive under SAFTA may help address Nepal's concerns regarding the same in India.

On the import front, Nepal has placed on its SAFTA sensitive list 140 of 273<sup>21</sup> agricultural tariff sub-headings (covering Chapters 1, 3, 4, 6–12, 14, 15, 17 and 23 at HS 2007 six-digit level) in which it provides basic customs duty-free access to products from India and Tibet, the autonomous region of the People's Republic of China. Out of the 273 items, 173 were actually imported in 2009. These products, when imported from India, Tibet and China, are subject to a 5 per cent agricultural development fee, which has been falling since Nepal's accession to the WTO, while the MFN tariff is 10 per cent, implying that India, Tibet and China enjoy a 5 per cent duty advantage. Together with China, India accounted for 66 per cent or more of the value of imports in 143 of the 173 tariff sub-headings. RSA, which faces the MFN tariff, accounted for a paltry 0.2 per cent of the total imports of these products.

It appears logical to extend complete duty-free treatment to the same agricultural products from other South Asian countries (and also China). Consumers' choice may increase, import sources may diversify and the cost of trade diversion may reduce, while domestic competitiveness concerns are unlikely to be aggravated by the extension. It may also strengthen Nepal's negotiating position under SAFTA and enable it to secure the removal of some, if not all, products of its export interest from other South Asian partners' sensitive lists.

However, there are concerns about duty-free entry of Indian agricultural products, including subsidised ones, adversely affecting the Nepali agricultural sector. It was to secure the policy space to increase tariffs if needed to protect the agricultural sector that Nepal, when acceding to the WTO, set its bound tariffs on agricultural goods generally at a much higher level than the applied rates – for example, bound rates for cereals are 50–60 per cent.<sup>22</sup> Keeping these items on the SAFTA sensitive list, while

affording zero-duty treatment to the same products from India, suggests a lack of clarity on the part of the Government of Nepal as to the protection of the agricultural sector.

In general, Nepal should strive to accord the same treatment on trade matters to all SAARC members. This is important to reduce, if not eliminate, the cost of trade diversion and alleviate the stress on scarce capital for negotiating and implementing multiple trade agreements.

## 18.5 SAFTA: Trade with other South Asian countries

### 18.5.1 Exports

In 2009, Nepal's exports to RSA amounted to US\$66 million, or 7.5 per cent of its total exports, compared with 1.5 per cent in 2003 (Table 18.1). This represents an annual average growth rate of 38 per cent during 2003–09, significantly higher than the growth rate of exports to the world (5.2 per cent) and to India (8.7 per cent) during the same period. However, exports to RSA are highly concentrated to Bangladesh. The US\$60.8 million of exports to Bangladesh in 2009 represented 91 per cent of exports to RSA. Accounting for about 7 per cent of Nepal's total exports, Bangladesh was Nepal's third largest export partner after India and the USA in 2009. No other South Asian country was among Nepal's top 20 export partners (out of 144 countries in total), though Nepal exported to all of them in 2009. Barring Bangladesh, individual shares of RSA countries were less than 0.3 per cent.

Exports of lentils to Bangladesh explain the dramatic increase in Nepal's exports to RSA: lentils accounted for 72 per cent of Nepal's exports to Bangladesh in 2009. Nepal exported lentils – its second largest export product – to 27 countries in 2009, with

**Table 18.1 Nepal's exports (US\$ million)**

	1994	1999	2003	2009	% Annual average growth (2003–09)
World	384.84	524.29	652.69	886.00	5.23
India	44.17	186.60	341.80	562.81	8.67
Bangladesh	0.44	18.19	6.11	60.84	46.69
Bhutan		0.36	1.37	2.52	10.71
Sri Lanka	2.44	0.04	1.19	2.09	9.82
Pakistan	0.01	0.42	0.99	1.11	1.87
Maldives				0.05	
Afghanistan				0.03	
SA	47.06	205.61	351.46	629.45	10.20
RSA	2.88	19.01	9.66	66.64	37.98
Share of SA (%)	12.23	39.22	53.85	71.04	
Share of India (%)	11.48	35.59	52.37	63.52	
Share of RSA (%)	0.75	3.63	1.48	7.52	

**Note:** SA = South Asia, RSA = Rest of South Asia

**Source:** UN Comtrade database accessed through World Integrated Trade Solution (WITS), and authors' calculations

Bangladesh being the top importer, accounting for 60 per cent of the export value. It must be noted, however, that the ban introduced in 2006 on lentils exports by India, then the leading source of lentils imports for Bangladesh,<sup>23</sup> largely explains the surge in lentils exports from Nepal to Bangladesh, which, on its part, saw domestic lentils production fall from 2004 onwards and plunge by 40 per cent between 2007 and 2008.<sup>24</sup> Nepal's total exports to Bangladesh increased by 122 per cent and 800 per cent in the two years following 2005/06.<sup>25</sup> The sustainability of lentils exports is questionable because growth in domestic production has not matched growth in exports.

### 18.5.2 Imports

Relative to exports, Nepal's imports from RSA are low, amounting to US\$14 million in 2009, implying a trade surplus of US\$42 million with RSA (Table 18.2). Imports from RSA grew at a slower rate than imports from the world (13 per cent) and India (14.3 per cent) during 2003–09. The share of RSA in Nepal's total imports thus fell from 0.6 per cent in 2003 to 0.4 per cent in 2009. In contrast to exports, imports from RSA are relatively diversified across countries. Bangladesh, Bhutan and Pakistan accounted for 38.4 per cent, 32.5 per cent and 23 per cent of imports from RSA respectively. None of the countries in RSA, however, were among the top 20 import partners (out of 141 countries in total) of Nepal in 2009.

In 2009, Nepal's overall trade balance with RSA was positive, recording trade surplus with Bangladesh, Sri Lanka and Maldives, and deficit with the rest (Table 18.3). Notably, the trade surplus with Bangladesh was nearly 84 per cent of bilateral trade. Nepal has consistently had a trade deficit with Pakistan, while no discernable trend is found for trade with others.

**Table 18.2 Nepal's imports (US\$ million)**

	1994	1999	2003	2009	% annual average growth (2003–09)
World	1,111.04	1,347.48	1,801.62	3,754.39	13.02
India	429.84	619.86	954.91	2,131.93	14.32
Bangladesh	14.67	8.97	4.85	5.40	1.78
Bhutan	2.30	0.79	0.57	4.55	41.43
Sri Lanka	0.55	1.42	1.99	0.75	-14.98
Pakistan	4.49	13.21	3.30	3.21	-0.45
Maldives				0.00	
Afghanistan	0.00		0.03	0.08	18.90
SA	451.85	644.25	965.65	2,145.93	14.23
RSA	22.01	24.39	10.74	14.00	4.50
Share of SA (%)	40.67	47.81	53.60	57.16	
Share of India (%)	38.69	46.00	53.00	56.79	
Share of RSA (%)	1.98	1.81	0.60	0.37	

SA = South Asia, RSA = Rest of South Asia

**Source:** UN Comtrade database accessed through WITS, and authors' calculations

**Table 18.3 Nepal's trade balance (US\$ million)**

	1994	1999	2003	2009
World	-726.21	-823.19	-1,148.93	-2,868.39
India	-385.67	-433.26	-613.11	-1,569.12
Bangladesh	-14.23	9.23	1.25	55.44
Bhutan	-2.30	-0.43	0.80	-2.03
Sri Lanka	1.88	-1.39	-0.80	1.33
Pakistan	-4.48	-12.78	-2.31	-2.10
Maldives				0.05
Afghanistan	0.00		-0.03	-0.05

**Source:** UN Comtrade database accessed through WITS, and authors' calculations

### 18.5.3 Trade potential

There exists large potentials for the expansion of regional trade in South Asia. As can be seen from Table 18.4, total imports of most South Asian countries have grown faster than world imports during 2005–09. One way to assess the export prospects of a country in a regional trading arrangement is to look at the complementarity index. This index provides an idea of the compatibility of the export pattern of a country with the import of another, with a high degree of complementarity being assumed to indicate more favourable prospects for a successful trade agreement (Mikic and Gilbert 2007).<sup>26</sup> Complementarity indices for 2009 show a high degree of complementarity between Nepal's exports and the imports of Maldives, Bhutan and Afghanistan (Table 18.5). Complementarity with Bhutan and the Maldives has increased over time, and was high in the 2000s too. Complementarity with respect to India takes a moderate value of 42.5 with no substantial change since 1999, while it is low (less than 33) with respect to other South Asian countries.

However, it should be noted that when the size differences in the economies is large (i.e. a match in percentage terms does not imply a match in levels), the complementarity index, which is based on shares, may be misleading. Hence, we also use a measure of trade potential – i.e., Nepal's export potential – based on levels

**Table 18.4 South Asian market size and growth**

	Imports from world, 2009 (US\$ billion)	% annual average growth in imports (2005–09)
Afghanistan	3.34	
Bangladesh	18.37	14
Bhutan	0.53	8
India	266.40	20
Maldives	0.98	10
Pakistan	31.58	8
Sri Lanka	9.43	6
World	12,650.12	6

**Source:** International Trade Centre (ITC) Trade Map

**Table 18.5 Complementarity index between Nepal's exports and its South Asian neighbours' imports**

	1999	2003	2009
Afghanistan			60.97
Bangladesh		34.50	31.41 <sup>a</sup>
Bhutan	75.40		80.73
India	41.77	38.59	42.50
Sri Lanka	36.56	27.11	32.49
Maldives	71.56	70.69	80.11 <sup>a</sup>
Pakistan		29.33	28.78

**Note:** <sup>a</sup>Figures for 2007

**Source:** WITS

of exports (of Nepal) and imports (of the partner). For each tariff sub-heading at HS six-digit level, Nepal's export potential in a South Asian country is calculated by subtracting Nepal's actual exports to that country from the minimum of Nepal's total exports and the partner's total imports. Summing the export potential in all the tariff sub-headings yields the aggregate export potential of Nepal in the partner. This measure, though based on a static concept, gives an indication of the value of additional exports that Nepal can potentially make to another country, given Nepal's existing export capacity, the existing imports of the partner country and the existing exports from Nepal to that country. We use the trade potentials at HS six-digit level calculated by the International Trade Centre (ITC)'s Trade Map for 2009 and sum them to get the aggregate trade potential (Table 18.6).

The figures in Table 18.6 show that there exists substantial potential for Nepal to increase exports to all of its South Asian neighbours; these markets remain significantly under exploited by Nepal given its existing export capacity. Export potential value ranges from US\$11.8 million to Afghanistan to US\$314 million to

**Table 18.6 Trade potential of Nepal (as an exporter) to its South Asian neighbours (importers)**

	Trade potential (TP) in 2009 (US\$ million)	Exports in 2009 from Nepal to South Asian countries (US\$ million)	Ratio of TP to actual exports from Nepal to South Asian countries
Afghanistan	11.83	0.03	394.17
Bangladesh	261.39	60.84	4.30
Bhutan	37.23	2.52	14.80
India	170.60	562.81	0.30
Maldives	65.43	0.05	1,258.35
Pakistan	314.84	1.11	283.38
Sri Lanka	269.04	2.09	128.91

**Sources:** TP: aggregated on the basis of tariff sub-heading-wise trade potentials calculated by ITC Trade Map

Exports value: UN Comtrade database /ITC Trade Map

Pakistan. Even with India, which already absorbs 63.5 per cent of Nepal's exports, an export potential of US\$170 million exists. In the RSA group, following Pakistan in terms of size of trade potential are Sri Lanka, Bangladesh, Maldives, Bhutan and Afghanistan. Trade potential exceeds existing exports by factors ranging from 4.3 (Bangladesh) to 1,258 (Maldives). With India, however, trade potential is 30 per cent of current exports—which is not surprising given the already high concentration of exports in that market.

#### 18.5.4 Market access conditions in RSA: tariff barriers

This section looks at the tariff barriers faced by Nepal in the top four markets in RSA (Bangladesh, Pakistan, Sri Lanka and Bhutan) and the coverage by the sensitive lists maintained by these countries of items of export interest to Nepal.

##### *Bangladesh*

Nepal exported products in 19 sub-headings (HS six-digit) to Bangladesh in 2009, with lentils accounting for 72 per cent of total export value. Six of the sub-headings, representing over 97 per cent of the value of Nepal's exports to Bangladesh, are on Bangladesh's sensitive list. In 2008, they attracted tariffs of 0 (in two sub-headings), 7, 10, 12 and/or 25 per cent (in two sub-headings) (Table 18.7). Lentils, which is on the sensitive list, gets zero-tariff access but they are bound at 200 per cent in the WTO schedule of concessions, leaving open the possibility of the tariff being increased to a prohibitive level. Three sub-headings are unbound. Tariff rates in six of the 13 sub-headings not on the sensitive list were already 0 or 5 per cent in 2007. Tariffs in the remaining seven sub-headings were 12 or 23.75 per cent in 2007; they must be reduced to 0–5 per cent by 2016 if they have not been already. The SAFTA Agreement encourages LDC members to reduce tariffs, from the third year onwards, in equal annual instalments, not less than 10 per cent annually. MFN tariffs on items outside the sensitive list are 0 per cent (2 sub-headings), 7 per cent (5), 12 (3) and 25 (3) in 2008.

It is pertinent to look also at whether products in which Nepal has comparative advantage are on the sensitive list of Bangladesh or not (Table 18.8). In 2009, Nepal had revealed comparative advantage (RCA) globally, as measured the RCA index,<sup>27</sup> in 478 sub-headings at HS six-digit level. In 154 of these sub-headings, Bangladesh's global imports exceeded Nepal's global exports, implying there is a potential additional market in Bangladesh for these products from Nepal, provided Nepal can increase its export supply.<sup>28</sup> Of these 154 items, 62 (40 per cent) are on Bangladesh's sensitive list (which has a total of 1,166 items for the LDC-specific sensitive list), while the rest are outside it. These items represent a market in Bangladesh of US\$1.3 billion, over and above what Nepal exports to the world.<sup>29</sup> Items outside the sensitive list also represent a substantial market of US\$323 million.

This suggests that while Bangladesh's sensitive list appears to be a barrier, other factors, such as para-tariff barriers<sup>30</sup> and NTBs, transit-related problems and Nepal's own supply-side constraints, should also be taken into account while addressing the issue of sub-optimal utilisation of trade potential.

**Table 18.7 Market access conditions in the RSA: tariff barriers faced by Nepal**

Market	No. of items sensitive list (SL)	No. of items exported by Nepal	No. of exported items on SL and their percentage of export value	No. of exported items entering duty-free	Applied tariff on exported items on SL	Applied tariff on exported items outside SL
Bangladesh	1,166	19	6 (97.6)	2 [2008]	0%, 7%, 10%, 12%, 25% (2 sub-headings) [2008]	0%, 5% (6 sub-headings) 12%, 23.75% (7 sub-headings) [2007]
Pakistan	1,169	17	5 (48.5)	0 [2010]	10% (1 sub-heading), 25% (4 sub-headings) [2010]	Required to have reduced it to 0–5% by July 2009
Sri Lanka	1,065	6	2 (14)	0 [2009]	28% (1 sub-heading), 28% and a specific duty of LKR 5/kg (1 sub-heading) [2009]	Required to have reduced it to 0–5% by July 2009
Bhutan	150	51	1 (0)	0 [2007]	50% [2007]	19%, 28.5% or 35% (45 sub-headings) 9.5% (2 sub-headings) 0% (2 sub-headings) [2007]

**Note:** See text for further explanation

**Source:** Tariff data from ITC Trade Map, Trade Analysis and Information System (TRAINS) and UN Comtrade database (accessed through WITS); rest, authors' calculation

**Table 18.8 Coverage by RSA sensitive lists of items of Nepal's comparative advantage**

Market	No. of items in which Nepal has RCA>1 and partner's global imports>Nepal's global exports	No. of items in column 2 that are on sensitive list (SL)	Indicative market value in partner for items in column 3 (US\$ million)	Indicative market value in partner for items in column 2 but not on SL (US\$ million)
Bangladesh	154	62	1,300	323
Pakistan	205	60	327.8	1,000
Sri Lanka	181	54	431	163.7
Bhutan	24	4	1	20.8

**Note:** Indicative market value is calculated as the sum of the difference between partner's global imports and Nepal's global exports of the items in question

**Source:** Authors' calculation based on UN Comtrade data accessed through WITS

### *Pakistan*

Nepal exported products in 17 sub-headings (HS six-digit) to Pakistan in 2009, with HS 6214.20 (shawls, scarves, mufflers, mantillas, veils and the like (excluding knitted/crocheted), of wool/fine animal hair) accounting for 46 per cent of total export value. Five of the sub-headings, including the top export item, representing 48.5 per cent of the value of Nepal's exports to Pakistan, are on Pakistan's sensitive list. In 2010, they attracted tariffs of 10 (one sub-heading) or 25 per cent (in four sub-headings). The SAFTA Agreement requires non-LDC members to reduce tariffs to 0–5 per cent on products imported from LDC members within three years of the date of entry into force of the Agreement, that is, by July 2009.<sup>31</sup> MFN tariffs on the 12 sub-headings not on the sensitive list were 0 per cent (2 sub-headings), 5 per cent (4), 10 per cent (4), 15 per cent (1) and 25 per cent (1) in 2008 or 2010.

In 205 of the 478 sub-headings in which Nepal had RCA in 2009, Pakistan's global imports exceeded Nepal's global exports, implying there is a potential additional market in Pakistan for these products from Nepal, provided Nepal can increase its export supply. Some 60 (29 per cent) of these items are on Pakistan's sensitive list (which has a total of 1,169 items for LDCs). These items represent a market in Pakistan of US\$327.8 million, over and above what Nepal exports to the world. The remaining items, those outside the sensitive list, represent an even greater market of US\$1 billion. Tariffs on these items for Nepal were due to have been reduced to 0–5 per cent by July 2009.

As in the case of Bangladesh, while Pakistan's sensitive list may be a barrier, other factors may also be at work. One of the serious issues, as noted by Adhikari (2010a), is the transit problems faced by Nepal while using Indian territory to access Pakistan.<sup>32</sup>

### *Sri Lanka*

Nepal exported products in just six sub-headings (HS six-digit) to Sri Lanka in 2009, with lentils accounting for 85.6 per cent of total export value. Two of the sub-headings

are on the sensitive list, representing 14 per cent of the value of Nepal's exports to Sri Lanka. In 2009, they faced tariff peaks (28 per cent), with one also facing a specific duty of 5 Sri Lankan rupees (LKR) per kg.

It is not clear what is the actual tariff rate for lentils, the top export item (85.6 per cent of exports), since Sri Lanka has five tariff lines within HS 0713.40, with the applied rate in 2009 ranging from 2 to 22.4 per cent for LDCs, and the trade data being available at the six-digit level only. MFN tariffs on the three other sub-headings not on the sensitive list were 15 per cent in 2009. As a non-LDC, Sri Lanka was required to reduce tariffs on items outside the sensitive list for LDC members to 0–5 per cent by July 2009.<sup>33</sup>

In 181 of the 478 sub-headings in which Nepal had RCA in 2009, Sri Lanka's global imports exceeded Nepal's global exports, implying there is a potential additional market in Sri Lanka for these products from Nepal, provided Nepal can increase its export supply. Fifty-four (30 per cent) of these items are on Sri Lanka's sensitive list (which has 1,065 items in total). These items represent a market in Sri Lanka worth US\$431 million, over and above what Nepal exports to the world. The remaining items, those outside the sensitive list, represent a market of US\$164 million. Tariffs on these items for Nepal were due to have been reduced to 0–5 per cent by July 2009.

### *Bhutan*

Nepal exported products in 51 sub-headings (HS six-digit) to Bhutan in 2009, the highest among RSA export partners. Export value is less concentrated in a few products than with respect to Bangladesh, Pakistan and Sri Lanka.

Only one (HS 9403,50: wooden furniture) of the 51 exported items is on the sensitive list. It faces a prohibitive tariff of 50 per cent and the export value is negligible. As for the remaining 50 sub-headings which are not on the sensitive list, in 2007, 45 faced tariffs of 19, 28.5 or 35 per cent; two faced 9.5 per cent and two entered duty-free (the tariff rate on one item is not known). These must be reduced to 0–5 per cent by 2016 if they have not been already. The SAFTA Agreement encourages LDC members to reduce tariffs, from the third year onwards, in equal annual instalments, not less than 10 per cent annually.

In 24 of the 478 sub-headings in which Nepal had RCA in 2009, Bhutan's global imports exceeded Nepal's global exports, implying there is a potential additional market in Bhutan for these products from Nepal, provided Nepal can increase its export supply. Only four of these items are on Bhutan's sensitive list (which has a total of 150 items). These items represent a market in Bhutan of US\$1 million, over and above what Nepal exports to the world. The remaining items, those outside the sensitive list, represent a much greater market worth US\$20.8 million.

This suggests that Bhutan's sensitive list is in general not a major barrier for Nepal to expand its exports to that country. Nepal would, however, want the reduction of tariffs on items not on the sensitive list to take place at a speedy rate.

From the foregoing analysis, we observe that, overall, the sensitive lists of RSA countries contain items of export interest to Nepal, including those in which Nepal has RCA (for which a substantial market exists). As for items outside the sensitive

lists, which also represent a significant market, it is of interest how fast the tariffs on them will be reduced to 0–5 per cent. In addition, para-tariffs and NTBs, transit-related problems and domestic supply-side constraints must be taken into account.

### 18.5.5 Nepal's tariff structure

As Nepal itself has the longest sensitive list in SAFTA (1,257 for LDCs and 1,295 for non-LDCs), it should be prepared to prune its own while asking the same of others. Nearly 48 per cent of Nepal's global imports are covered by the sensitive list. In the case of imports from South Asia, the sensitive list coverage is even higher (57 per cent). Some 68 per cent of total imports under sensitive list are from South Asia. Imports from South Asia under the sensitive list amounted to US\$1.2 billion in 2009. The coverage by the sensitive list of imports from individual countries varies, however (Table 18.9): it is in the range of 8–16 per cent for Afghanistan, Bhutan, Maldives and Sri Lanka, while it is 60 per cent for India and 75 per cent for Bangladesh. It must be noted that the huge coverage of imports by the sensitive list is driven by imports of petroleum products under Chapter 27 from India, amounting to US\$558.3 million, which alone make up 46 per cent of sensitive list imports from India and about 15 per cent of total imports (inside and outside the sensitive list).<sup>34</sup>

As noted in section 18.4, the presence of 140 agricultural products on Nepal's sensitive list is redundant in the light of the fact that basic customs duty-free access is provided to such products from India (and Tibet and China), which also happens to be a predominant supplier of the same. In 2009, Nepal actually imported 97 of the 140 products amounting to US\$80.2 million, with India accounting for 85 per cent and China 8 per cent of the supplies. India and China accounted for 66 per cent or more of imports in 86 of the 97 products. This illustrates the need to rationalise the sensitive list.

Application of objective criteria, backed by stakeholder consultation, should guide the process of pruning the sensitive list. Kharel (2010b) used four criteria for initial consideration of items to be removed from the sensitive list:<sup>35</sup> first, at least one South Asian country has RCA greater than unity in the product consistently for

**Table 18.9 Import coverage by Nepal's sensitive list, 2009**

Imports from	Imports of items under SL (US\$1000)	Percentage of imports covered by SL	Total items imported (HS six-digit)	Total imported items that are on SL
Afghanistan	7.47	9.30	10	5
Bangladesh	4,032.06	74.70	118	80
Bhutan	502.87	11.05	9	6
India	1,216,650.76	60.25	3,783	913
Pakistan	1,421.56	44.23	68	30
Sri Lanka	116.75	15.53	40	23
Maldives	0.08	8.37	2	1
South Asia	1,222,731.54	56.98		

**Source:** Authors' calculation based on UN Comtrade data accessed through WITS

three years; second, South Asia supplies at least two-thirds of Nepal's imports of the product consistently for three years; third, there exists trade potential (Nepal as an importer) for at least one South Asian country consistently for three years; and fourth, Nepal already provides duty-free access to the product if imported from India.<sup>36</sup> The criteria try to ensure that trade is created and trade diversion minimised as a result of sensitive list reduction. Since an important motive for keeping items on the sensitive list for Nepal is revenue (trade taxes on imports made up 21.7 per cent of total tax revenue in 2009/10), the study also assessed the importance of the shortlisted items for revenue purpose. Combining the secondary data analysis with limited stakeholder consultation to assess the potential impact of tariff liberalisation on the domestic sectors, the study identified 129 items for consideration for removal from the sensitive list, while recommending that measures, including provision of state support, be taken to enhance the domestic supply capacity in the sectors concerned.

Apart from providing basic customs duty-free access to listed agricultural products from India, Nepal also provides preferential tariff treatment, albeit marginal, to other goods from India, as per the bilateral trade treaty. In 2010/11, the tariff concession consisted of a 7 per cent rebate on *ad valorem* customs duty for goods attracting *ad valorem* tariff of up to 30 per cent and a 5 per cent rebate for goods attracting *ad valorem* tariff of more than 30 per cent. Besides this general rebate, tariff concessions are provided also to some specific products imported from India.<sup>37</sup> Nepal should consider extending the same preferential treatment to all SAFTA members, subject to RoO as agreed under SAFTA, including for India.

Table 18.10 provides a summary comparison between Nepal's MFN applied duty rates and preferential duty rates for SAFTA members for the year 2010 based on the WTO's Tariff Analysis Online database. Considering only *ad valorem* duties due to data constraints, in 2010, Nepal's simple average preferential duty for SAFTA members (LDCs and non-LDCs) is 10.79 per cent, or 1.39 percentage points lower than its simple average MFN applied duty.<sup>38</sup> This absolute difference is slightly lower than when the average is taken over non-duty-free tariff lines only. A total of 135 tariff lines are duty-free on an MFN basis (by definition, also applicable to SAFTA members). Available data indicate that there are no duty-free tariff lines exclusively for SAFTA members under SAFTA. Tariff dispersion is lower for SAFTA preferential rates than for MFN applied rates. The minimum and maximum duties are the same for both duty types.

The SAFTA rate is lower than the MFN rate in about 44 per cent of *ad valorem* dutiable tariff lines; the absolute difference of the simple average rates in these 2,173 tariff lines is 3.29 percentage points, which is higher than when the comparison covers all tariff lines. Tariff dispersion is also much lower for SAFTA rates that are lower than MFN rates. Also, the maximum SAFTA rate on the 2,173 tariff lines where the MFN duty is higher than the SAFTA duty is 24 per cent, as opposed to 80 per cent for MFN duty. A total of 117 out of these tariff lines for SAFTA members have tariff peaks, defined as duties equal to or greater than 15 per cent. Since the MFN rate is higher than the SAFTA rate in these tariff lines, by implication these are outside Nepal's sensitive lists

**Table 18.10 Summary comparison between Nepal's MFN applied duty rates and preferential duty rates for SAFTA members, 2010**

Duties	Number of tariff lines (HS 2007)	Simple average Duty1	Simple average Duty2	Absolute difference (Duty2 – Duty 1)	Standard deviation of Duty1	Standard deviation of Duty2	Min. Duty1	Max. Duty1	Min. Duty2	Max. Duty2	
All TL excl. NA	5,127	12.18	10.79	-1.39	8.6	7.36	5	80	5	80	
Duty1, Duty2	4,992	12.51	11.08	-1.43	8.48	7.24	5	80	5	80	
<i>Ad valorem</i> dutiable											
Duty1 = Duty2	2,819	11.92	11.92	0	9.09	9.09	5	80	5	80	
Duty1 > Duty2	2,173	13.29	10	-3.29	7.54	3.35	10	80	5	24	
Duty1, Duty2 are duty-free	135	0	0	0							
Duty1 is NA	41										
Duty2 is NA	41										
<b>Preferential duty only for LDCs</b>											
Duties	Number of tariff lines (HS 2007)	Simple average Duty1	Simple average Duty3	Absolute difference (Duty3 – Duty 1)	Standard deviation of Duty1	Standard deviation of Duty3	Min. Duty1	Max. Duty1	Min. Duty3	Max. Duty3	
Duty 1 > Duty 3	37	18.51	11.14	-7.37	5.31	1.65	10	30	8	12	

TL = Tariff line (national, beyond HS six-digit level where applicable).

Duty1 = MFN applied duty rates

Duty2 = Preferential duty rates for all SAFTA members (LDCs and non-LDCs)

Duty3 = Preferential duty rates for LDCs only

NA = Not available

Source: WTO's Tariff Analysis Online

for both LDCs and non-LDCs. Nepal has until 2016 to phase in its tariff liberalisation programme under SAFTA. The SAFTA duties on these tariff lines will have to fall into the range of 0–5 per cent by 2016.

There are 37 tariff lines in which preferential duty is granted to LDCs only. In these tariff lines, the margin of preference for LDCs in terms of simple average duty is 7.37 percentage points. The minimum and maximum rates for LDCs in these tariff lines are 8 per cent and 12 per cent, respectively, as opposed to the MFN rates of 10 per cent and 30 per cent. The SAFTA duties for LDCs on these tariff lines will have to fall into the range of 0–5 per cent by 2016.

In 2,819 tariff lines the MFN rates are equal to the SAFTA rates. Table 18.10 shows that the simple average duty on these tariff lines is 11.92 per cent, with a standard deviation of 9.09. Of these, 1,327 tariff lines attract 5 per cent duty, while 1,131 tariff lines face tariff peaks.

Now, analysing *ad valorem* duties on HS 2007 six-digit tariff sub-headings (not national tariff lines) available at the WTO's Tariff Analysis Online database for the year 2010, we find that some 1,078 tariff sub-headings on the sensitive list for non-LDCs are subject to tariff peaks, thus indicating considerable scope for further tariff liberalisation by Nepal under SAFTA.

### 18.5.6 Non-tariff and para-tariff barriers

Perhaps because exports to RSA are limited, the issue of NTBs and para-tariff barriers in these countries has not come prominently to public attention in Nepal. However, going by the experiences of other countries in the region, such barriers are a serious restriction on trade.<sup>39</sup> The majority of NTBs relate to SPS, technical barriers to trade (TBT) and other related measures (Asian Development Bank (ADB) and United Nations Conference on Trade and Development (UNCTAD) 2008).

The current institutional mechanism under SAFTA to deal with NTBs and para-tariff barriers is fairly weak. Under the existing rules, the member states notify the SAARC Secretariat of the non-tariff and para-tariff measures they face on their exports on an annual basis. The notified measures are reviewed by the CoE, established under Article 10, in its regular meetings to examine their compatibility with relevant WTO provisions. The CoE recommends the elimination or implementation of the measure in the least trade-restrictive manner in order to facilitate intra-SAARC trade. A majority of notifications and complaints are being dealt through bilateral negotiations (Rahman 2010b). The CoE acts as the dispute settlement body (DSB) under SAFTA, but its role in settling disputes related to NTBs and para-tariff barriers has not been satisfactory.

### 18.5.7 Transit problems

Nepal completely depends on transit passage through India as well as Indian sea ports for its surface and sea-borne trade with the rest of the world.<sup>40</sup> Even if Nepal were to use the sea ports in Bangladesh, transit passage through India would still be unavoidable for trade with and through Bangladesh.

The political relationship with India has had an important bearing on the transit facility, an extreme case being the blockade imposed by India on Nepal in 1989–90. Even in normal times, it faces numerous transit-related problems, resolving which is critical for increased trade integration with RSA as well as the rest of the world. A host of transit restrictions is in place, causing delays, raising the landed prices of imports and eroding export competitiveness. The restrictions operate at two levels: transit to access Indian sea ports, and transit through Indian territory to access Bangladeshi markets and sea ports.<sup>41</sup>

Cumbersome transit processes, including procedural controls, citing the possibility of trade deflection, are in place. It is customary for Indian authorities to issue unilateral notifications on transit and customs matters, adding to the unpredictability stemming from the bilateral Transit Treaty's lack of unconditional automaticity in renewal. Hassles in the form of multiple checking agencies mar the entire transit process. Actual documentary requirements are higher than those specified in the treaty.

Although the transit treaty requires duty insurance (to hedge the risk of trade deflection and the resulting loss of customs duties for India) only for goods deemed sensitive by the Indian government, the list of such goods is not made public to Nepali traders. The monopoly of the Kolkata-based office of the Indian National Insurance Company Limited on issuing duty insurance policy means a high premium rate (Kaphley 2007). While insurance policy needs to cover only Indian customs duty if the goods are transported by rail, goods transported in private-owned vehicles by road have to be insured to the difference between the market value and the cost, insurance and freight (CIF) value (Kaphley 2007). The premium amount is also artificially raised due to the fixation of the market value by Indian customs at an unreasonably high level, at 200–250 per cent of CIF value (*ibid.*).

Transit through India is subject not only to central government regulations and formalities but also those that are in force in the states. Although the Indian road freight market is generally competitive, Nepal has not been able to benefit from it fully due to the enforcement of minimum freight tariffs for the transportation of Nepali cargo in three Indian states bordering Nepal, namely, Uttar Pradesh, Bihar and West Bengal (Chakra Infrastructure Consultants (CIC) 2001). Nepali cargoes are subject to state-level taxes as well as bribes (Nepal 2006).

Administrative rigmarole, gross inefficiency and congestion – resulting in delays, higher turnaround time, detention and demurrage – define Kolkata and Haldia ports, the gateway ports for Nepal's third country trade. In addition, Nepali importers have to pay penalty charges not only for the delayed portion of the cargo but also on the entire cargo, particularly in the case of bulk cargo, when such cargo is transported in partial shipments. Demurrage is charged even if goods are not cleared due to conditions beyond the control of the importer such as labour strikes (Nepal 2006).

The operationalisation of an inland container depot (dry port) at Nepal's main border point (Birgunj), which is connected by a rail link to Kolkata port through a bilateral rail services agreement signed in May 2004, was expected to reduce

transit costs from 12–15 per cent of CIF to 8–10 per cent and the journey time between Kolkata and Birgunj from ten days to three days (CIC 2001). However, the full benefits are yet to be realised as, among other problems, through bills of lading (BoL) are still not provided (Rajkarnikar 2010). The most important advantage of issuing and receiving BoL at a dry port is that they reduce customs and clearance activities at sea ports to a minimum, with only the transport activities of transit being emphasised (CIC 2001). If all documents are in order, cargoes have to spend three to five days at the port, which could be reduced if BoL are issued and received at the dry port (*ibid.*). Other problems include: non-availability of round-the-clock customs, only the movement of a few types of wagons being allowed, idling of costly reach stackers, non-integration of customs procedures, and deficiency in the infrastructure design of the dry port. Rough estimates suggest that the dry port is underutilised, operating at only 25 per cent of its normal capacity (NITDB 2008a).

Nepal has long sought alternative ports in India, as Kolkata and Haldiya are not only congested and inefficient but also cannot accept mother vessels, necessitating costly transshipment in other ports. Using Jawaharlal Nehru Port (JNP) in Mumbai, for instance, is estimated to reduce transit cost by US\$400 per 20-foot container by, *inter alia*, avoiding transshipment, thereby improving the competitiveness of Nepal's West-bound exports (CIC 2001). India agreed in principle in 1995 to allow Nepal to use JNP and Kandla port on the western coast of India for its third country trade. The pledge was not implemented. Later, another study<sup>42</sup> recommended using Visakhapatnam Port located on the eastern coast of India in the state of Andhra Pradesh as an alternative to Kolkata port, as the port has spare capacity and draft conditions permitting berthing of mother vessels of up to 100,000 deadweight tonnage and is also much more efficient than Kolkata port in handling containers. In August 2009, India agreed to allow Nepal to use Visakhapatnam Port. However, India has put forth the condition of a double-seal<sup>43</sup> system on Nepali cargoes for Nepal to use Visakhapatnam Port, which is not the standard international practice and could complicate transit.<sup>44</sup>

Chittagong and Mongla ports in Bangladesh are potential alternative ports for Nepal. While Chittagong is said to be among the least-productive container ports in the world (Simon 2009), Mongla offers a viable option for carrying out at least part of Nepal's third country trade more efficiently. Although a transit agreement between Bangladesh and Nepal signed in 1976 and a protocol to it give Nepal transit facility to access overseas markets through Bangladeshi territory and sea ports, lack of co-operation with India in providing a railway transit facility to Nepal for third country trade via Bangladesh has prevented Nepal from utilising that option. Mongla port is an under-utilised port (with 80 per cent spare capacity) with a much lower cost of holding of goods than Kolkata port thanks to shorter turnaround time, and lower detention and demurrage. Moreover, the Government of Bangladesh had announced a 50 per cent discount on port charges for Nepali trade handled through Mongla port and the notification could be extended if and when Nepal is able to trade through that port (NITDB/GoN 2008a). Further, Bangladesh has a huge trade deficit with India with the result that cargo trains carrying exports from India to Bangladesh

through a major route<sup>45</sup> return with empty wagons (*ibid.*). Utilisation of these empty wagons for Nepal's imports from Bangladesh and third countries can potentially take place at competitive railway tariffs (*ibid.*).

In a positive development, the Joint Communiqué issued by the governments of Bangladesh and India at the end of the visit to India by Bangladesh's Prime Minister on 10–13 January 2010 included an agreement to grant railway transit facility to Nepal through the Rohanpur–Singhabad point for its trade with and through Bangladesh. Simple transit procedures and issuance of BoL are necessary to maximise the gains from this agreement for Nepal.

A 1997 agreement between Nepal and India already allows Nepal road transit via a single route for trade with and through Bangladesh (the 54-km Kakarbhitta (Nepal)–Phulbari (India)–Banglabandh (Bangladesh) route). It is estimated that routing trade through this route from Kathmandu to Mongla port will result in time savings of up to 94 hours and cost savings of about US\$35 per tonnes compared with the existing corridor involving Kolkata port (Rahmatullah 2010). But a host of transit problems stymies cargo movement through this route (see Kharel 2009 and Nepal 2006). Cargo movement is allowed only at specified times in daylight hours on weekdays. Trucks carrying cargo-in-transit must move in convoys of a maximum of 20–25 trucks. A security escort is mandatory and provided only when there is a convoy of 25 trucks. There is no permanent customs office at the Fulbari border post in India. Poor implementation of a one-time lock system is combined with the poor state of infrastructure on the Indian side of the border. Indian insurance companies enjoy monopoly power, goods have to be transshipped at the Bangladesh–India border, and there is no provision of BoL by shipping lines. The involvement of third-party (Indian) customs is an additional burden. Besides the problems vis-à-vis India, Bangladesh's policy of not allowing foreign trucks to operate in its territory causes delays at the border, as cargoes have to be transshipped from Nepali trucks into Bangladeshi trucks.

Although, as argued by Faye et al. (2004: 45), 'there is a legal basis for rights of landlocked transit as outlined in Article 125 (1) of the United Nations Convention on the Law of the Sea' (United Nations 1982), this does not mean much as, 'in practice, this right of access must be agreed upon with the transit neighbour (Article 125 (2) and (3)) and is determined by the relationship between the countries.' Moreover, Article V of the General Agreement on Tariffs and Trade (GATT) also provides similar rights, but this has not been invoked so far probably due to conflicting interpretations of the provision (Adhikari 2010a). Discussions on this issue took place in the Doha Round of trade negotiations under the broad rubric of trade facilitation.

In order to remedy this persistent problem of transit, Kharel (2009) makes a case for a regional transit arrangement in South Asia that simplifies and harmonises rules, regulations and procedures for goods and vehicles in transit across countries – backed by investments in infrastructures (including roads, railways and sea ports), and communications systems, and the establishment and improvement of regional transport corridors. Such an arrangement will benefit not just Nepal and the two

other landlocked countries of the region (Afghanistan and Bhutan) but also the non-landlocked ones (*ibid.*). It will also help to create a level playing field for relatively weaker countries in the region. As lowering trade costs this way facilitates trade with the rest of the world as well as with neighbours, they do not give rise to welfare-enhancing trade diversions that can arise from preferential tariff reduction (Hoekman and Wilson 2010).

## 18.6 Supply-side constraints

Nepal faces severe supply-side constraints, overcoming which is critical for exploiting existing market access opportunities and improving its export performance. An important supply-side constraint (poor transit facility) was discussed in section 18.5.7. This section discusses other supply-side problems.

ADB et al. (2009) identified a number of critical constraints to Nepal's growth which are causing low social returns to investment and/or low private appropriability of returns to investment: (a) limited and low-quality infrastructure (namely, electricity and transport networks and irrigation); (b) weak governance (political instability and corruption), poor industrial relations climate and labour market rigidities; and (c) market failures (information and learning externalities and co-ordination failures) indicated by domestic manufacturing being low in technology quality and not growing, and exports being low in volume and in technology quality. These factors also adversely affect Nepal's export competitiveness.

The major binding competitiveness-related supply-side constraints are inadequate infrastructure for efficient production and transportation of goods; lack of human capital endowed with the education and skills to process exportables; limited access to credit due to conventional/conservative banking practices that rely more on collateral than on the feasibility of business ventures; limited use of technology in the production processes which impedes the prospects of what is known as 'moving up the value-chain ladder'; and the virtual absence of trade facilitation measures which causes delays in the shipment of goods.<sup>46</sup>

These features are also reflected in Nepal's ranking in the Global Competitiveness Report (GCR) published by the World Economic Forum, which bases its analysis on 12 different indicators of competitiveness. Table 18.11 shows that in terms of various competitiveness rankings, Nepal falls below other South Asian countries, in terms of infrastructure, ease of access to loans and technological readiness, although it has a better indicator than Pakistan in the case of health and primary education.

Nepal continues to produce and export 'poor country goods'<sup>47</sup> and its efforts at enhancing its competitiveness and achieving export diversification have not produced satisfactory results, nor are they targeted at moving up the value-chain ladder. In terms of research and development (R&D), as measured by industrial value addition, the business sophistication index, innovation index and technological readiness index, Nepal ranks much lower than its South Asian neighbours (Table 18.12).

**Table 18.11 Select competitiveness rankings and indices, 2010–11**

Country/ economy	Infrastructure		Health and primary education		Ease of access to loans		Technological readiness	
	Rank	Index	Rank	Index	Rank	Index	Rank	Index
	<i>n</i> = 139	(1–7)	<i>n</i> = 139	(1–7)	<i>n</i> = 139	(1–7)	<i>n</i> = 139	(1–7)
Switzerland (Overall, top)	6	6.1	7	6.6	22	3.7	7	5.6
Bangladesh	133	2.1	106	5	79	2.6	126	2.7
India	86	3.5	104	5.2	39	3.3	86	3.3
Nepal	139	1.8	109	4.8	88	2.5	134	2.5
Pakistan	110	2.8	123	4.3	40	3.3	109	2.9
Sri Lanka	70	3.8	35	6.2	38	3.3	84	3.4
Chad (Overall, bottom)	137	1.8	138	2.9	115	2.1	13	2.3

**Source:** World Economic Forum's Global Competitiveness Report 2010–11

Like many other indicators of trade competitiveness, Nepal's trade facilitation indicators are poor. The trading-across-borders indicators published by the World Bank's Doing Business Report, which is one way of measuring trade facilitation indicators, show that Nepal ranks 164th among 183 countries and is ahead of only Afghanistan in South Asia in overall ranking (Table 18.13).<sup>48</sup> Nepal's performance is worse than the South Asian average (and obviously the Organisation for Economic Co-operation and Development (OECD) average by a large margin) in all the indicators.

Similarly, the Logistics Performance Index (LPI) – a composite index of various logistics and trade facilitation indicators – ranks Nepal one of the lowest, i.e., 147 out of the 155 countries surveyed in 2010 (Table 18.14). Nepal's ranking, compared

**Table 18.12 Productive capacity, sophistication, innovation and technological readiness in South Asia, 2010–11, *n* = 139**

Country	Industrial value addition	Business sophistication index		Innovation index		Technological readiness index	
	(% of GDP) 2007	Rank	Score	Rank	Score	Rank	Score
Bangladesh	29	105	3.4	119	2.6	126	2.7
India	29	44	4.3	39	3.6	86	3.3
Nepal	17	132	3	137	2.3	134	2.5
Pakistan	27	79	3.7	75	3	109	2.9
Sri Lanka	30	39	4.4	40	3.6	84	3.4

**Source:** World Economic Forum's Global Competitiveness Report 2010–11

**Table 18.13 Trading across borders indicators for South Asian countries, 2011**

Indicators	South Asian LDCs					South Asian developing countries			South Asia (average)	OECD (average)
	AF	BD	BT	MV	NP	IN	PK	SL		
Doing business – trading across borders (rank out of 183)	183	112	161	138	164	100	81	72		
No. of documents required for exports	12	6	8	8	9	8	9	8	8.5	4.4
No. of days required for exports	74	25	38	21	41	17	21	21	32.3	10.9
Cost to export (US\$ per container)	3,865	985	1,210	1,550	1,960	1,055	611	715	1,511.60	1,058.70
No. of documents required for imports	11	8	11	9	10	9	8	6	9	4.9
No. of days required for imports	77	31	38	22	35	20	18	19	32.5	11.4
Cost to import (US\$ per container)	3,830	1,390	2,665	1,526	2,095	1,025	680	745	1,744.50	1,106.30

**Note:** AF = Afghanistan; BD = Bangladesh; BT = Bhutan; MV = Maldives; NP = Nepal; IN = India; PK = Pakistan; SL = Sri Lanka.

**Source:** World Bank, Doing Business Report 2011

**Table 18.14 LPI of South Asian countries, 2010**

Indicators	South Asian LDCs					South Asian DCs		
	AF	BD	BT	MV	NP	IN	PK	SL
Overall LPI	143	79	128	125	147	47	110	137
Customs	104	90	118	98	130	52	135	143
Infrastructure	139	72	141	111	143	47	120	138
International shipments	141	61	120	125	143	46	66	117
Logistics competence	141	96	127	117	143	40	120	142
Tracking and tracing	128	92	105	121	140	52	93	142
Timeliness	146	70	122	133	139	56	110	125

**Source:** World Bank's Logistics Performance Indicators 2010

with 2009, has not only slipped by 17 positions, but also been surpassed even by Afghanistan.

Nepal faces severe supply-side constraints on all major fronts, which means that it will not be in a position to fully utilise whatever limited market access opportunity it is granted under SAFTA. The preference erosion that Nepal is facing in the India market, as discussed in section 18.4, is likely to further exacerbate the problem.

The Government of Nepal has been unable to offer meaningful export incentives. Although the budget speech for the fiscal year (FY) 2010/11 offered a cash incentive of 2–4 per cent for exporters depending on the level of value addition, the incentive has not been operationalised so far. Further, as the government explicitly mentioned that such a facility would be provided to only convertible currency-denominated exports, the incentive excludes exports to India as they are denominated in the Indian currency. Although this was apparently done with a view to diversifying Nepal's exports to other destinations than India (both within and outside the region), only a third of exports being eligible for such facility means that most exporters would be deprived of enjoying the benefit, if and when the scheme comes into operation.

## 18.7 Conclusion

Notwithstanding the coming into force of SAFTA, Nepal's trade with South Asia remains concentrated on India. Trade with RSA is negligible in relation to Nepal's total trade. A substantial export potential exists with RSA, but a combination of market access barriers and supply-side constraints hinders the realisation of this potential. Overall, the sensitive lists of RSA countries contain items of export interest to Nepal, including those in which Nepal has RCA and for which a substantial market exists. As for items outside the sensitive lists, which also represent a significant market, it is of interest how fast the tariffs on them will be reduced to 0–5 per cent. Meaningful pruning of sensitive lists by RSA countries will help Nepal gain from SAFTA.

As Nepal itself has the longest sensitive list in SAFTA, it should be prepared to prune its own while asking the same of others. Application of objective criteria, backed by stakeholder consultation, should inform the process of pruning the sensitive list. The RoO under SAFTA needs to be made simple, transparent and, for LDCs, less stringent. A single criterion of 20 per cent value addition – backed up with a credible deadline for increasing the same (say, in ten years) to ensure enhanced domestic supply capacity – would be helpful for Nepal to expand exports to South Asian countries (Adhikari 2010a). As tariff barriers come down, the importance of NTBs and para-tariff barriers increases.

Implementation of the provision of the SAFTA Agreement for the removal of para-tariff and non-tariff barriers/measures and/or making them least trade restrictive is essential to effectively gain from tariff reduction. A regional mutual recognition agreement on SPS measures and technical standards and eventually a harmonisation of such measures and standards under SAFTA could be an effective way to deal with NTBs. As a least developed country with low capacity to upgrade its standards, however, Nepal needs financial, technical and capacity-building assistance to benefit from such an agreement. Because Nepal is close to eliminating all para-tariff barriers, it can take the lead in pushing for the elimination of such barriers in intra-regional trade. Nepal's major interest in SAFTA effectively dealing with NTBs and para-tariff barriers is that such barriers that Nepal itself faces in its largest export partner, India, could be addressed in the process. Implementation of trade facilitation measures, as provisioned in Article 8 of SAFTA, will also hold significance for Nepal–India trade.

Transit-related problems, which add to trade costs, constrain Nepal's trade with RSA, particularly Bangladesh, Bhutan and Pakistan (and also the rest of the world). A regional transit arrangement, backed by investments in transit transport infrastructure, leading to an effective, efficient, integrated and harmonised transit transport system, will be appropriate to address many of the transit-related problems faced by Nepal.

There is an acute need for an independent dispute settlement body, including an independent appellate body where parties to a dispute can appeal panel reports. The implementation mechanism to ensure compliance with dispute settlement body decisions must be strengthened.

## Notes

- 1 This chapter was written and finalised by the authors in 2011 when they were working respectively as the Chief Executive Director and Research Coordinator with South Asia Watch on Trade, Economics and Environment (SAWTEE).
- 2 Services exports and imports accounted for, on average, 42.7 per cent and 18 per cent of total exports and imports of Nepal, respectively, from 2007/08 to 2009/10.
- 3 At the Sixteenth SAARC Summit held Thimpu in April 2010.
- 4 See Nepal's Trade Policy, 1992 and Trade Policy, 2009, which has replaced the former. They are available, respectively, at: [www.nepalchamber.org](http://www.nepalchamber.org) (accessed 3 May 2011) and [www.mocs.gov.np](http://www.mocs.gov.np) (accessed 3 May 2011).
- 5 The items on the negative list are: alcoholic liquors/beverages and their concentrates except industrial spirits; perfumes and cosmetics with non-Nepali/non-Indian brand names; and cigarettes and tobacco.

- 6 Protocol to Article VI states that Nepal, 'with a view to continuing preferences given to Indian exports, will waive additional customs duty on all Indian exports during the validity of the Treaty'. The concession rate has varied over the years.
- 7 Change in tariff heading at the four-digit level entails substantial processing, indicating that goods have undergone transformation from one tariff heading into another. An example relating to the iron and steel sector would be that goods get transformed from stainless steel ingots (HS Chapter 72.18) to flat-rolled products of stainless steel (HS Chapter 72.19).
- 8 See Adhikari (2010a) for further details.
- 9 See Kharel (2008 and 2010a) for details of the impact of the liberal provision.
- 10 See Adhikari (2010a) and Kharel (2008 and 2010a) for analysis of the impact of the restrictive provisions.
- 11 Agrawal (2008), for example, suggests that the steep value addition requirement is not achievable even for Indian industries.
- 12 See WTO (2005).
- 13 See *Republika*, (2010).
- 14 See Government of Nepal (GoN) (2010).
- 15 For example, based on our discussion with Mr Uday Raj Pandey, President, Garment Association of Nepal, we found that India imposes NTBs, such as the requirement to certify that ready-made garments (RMG)s being exported to India are free of certain chemical substances (such as azo) and the requirement to obtain a certificate from a laboratory in New Delhi to certify that certain products contain less than 51 per cent nylon in order to qualify for lower level of countervailing duty (CVD).
- 16 Umesh Lal Shrestha, President of the Nepal Association of Pharmaceutical Producers and Managing Director, Quest Pharmaceuticals Pvt Ltd, in an interview to *Karobar* national business daily ('Nepali pharmaceuticals are of good quality yet low-priced', 8 February 2011, p 12).
- 17 Ibid.
- 18 In 2009, Nepal exported pharmaceutical products (HS Chapter 30) worth US\$1.6 million to India. This was 85 per cent of Nepal's total pharmaceutical product exports for the year.
- 19 See Sharma, (2009).
- 20 See Kharel (2010a) for further details.
- 21 There are 274 such tariff lines as per Customs Tariff Schedule published by Department of Customs, Government of Nepal for 2009/10. But one tariff line is at the eight-digit level (HS 170.111.90), which was ignored for this analysis based on six-digit tariff lines. A few more products were added to the list in the October 2009 revision to the trade treaty with India, which are not considered here.
- 22 See Nepal's schedule of concession available on the WTO website.
- 23 In 2006, India accounted for 35 per cent of Bangladesh's imports of lentils in value terms and 29 per cent in quantity terms (authors' calculation based on UN Comtrade data).
- 24 FAOSTAT, <http://faostat.fao.org> 9 accessed 10 March 2010.
- 25 This is based on data of Trade and Export Promotion Centre, Government of Nepal.
- 26 The index is calculated as the sum of the absolute value of the difference between the import category shares and the export shares of the countries under study, divided by two, and is converted to percentage form (Mikic and Gilbert 2007). The index takes a value between 0 and 100, with a higher percentage indicating a higher level of complementarity, and vice versa.
- 27 A concept developed by Balassa (1965), the revealed comparative advantage (RCA) index, is calculated as the ratio of the share of a country's total exports of a commodity in its total exports to the share of world exports of the same commodity in total world exports (Mikic and Gilbert 2007). An RCA index greater than unity indicates that the country has a revealed comparative advantage in the commodity of interest.
- 28 A major limitation of the RCA index should be noted: it is affected by trade-distorting policies, whether in the exporting country or in other countries. Also, due to data constraints, we computed RCA indices for just one year, although ideally RCA indices over, say, a three-year period would provide a more definite picture. The results should, therefore, be taken as indicative.

- 29 The existing value of exports to Bangladesh was not considered here, unlike in the trade potential index. This is the same for other countries considered.
- 30 This is particularly important because Bangladesh imposes several para-tariff barriers, which appear legal because they represent other duties and charges (ODCs) within the meaning of the General Agreement on Tariffs and Trade (GATT) as noted in the forms of infrastructure development surcharge (IDSC), supplementary duty (SD) and regulatory duty (RD), which add up to the protective effect of trade taxes (WTO 2006). Even the value-added tax (VAT), which is supposed to be a trade-neutral tax, has been applied in a discriminatory manner, as a 15 per cent VAT is imposed on imported items whereas the same product is exempted from VAT when it is produced domestically (World Bank 2006: 21). While tariff barriers in Bangladesh have steadily declined between 1991/92 and 2004/05, para-tariff barriers have actually increased by more than three times during the corresponding period, with the protection of agricultural products rising more rapidly in the recent period. For example, in 1991/92, the simple average weighted tariff was 17.64 per cent and para-tariffs were 2.98 per cent; these figures were 16.39 per cent and 10.23 per cent respectively in the year 2004/05 (World Bank 2006). Although the latest figures are not available, Bangladesh's schedule of concession submitted to the WTO shows that it charges 2.5 per cent licence fees for all imports (see Bangladesh's schedule on the WTO website). Similarly, five-tier SD rates of 20 per cent, 60 per cent, 100 per cent, 250 per cent and 350 per cent are being applied by Bangladesh as of fiscal year (FY) 2008–2009 and revenue from SD on imports was BDT 23 billion in FY 2008–2009, which was one-fourth of the total customs duty collected during the year (Ministry of Finance (MoF) and Government of Bangladesh (GoB) 2010). This indicates that para-tariff barriers are still high in Bangladesh.
- 31 Complete data are not available to verify if this has happened.
- 32 Exporting to Pakistan via the Indian land route is extremely difficult because of transit-related problems. Attempts by the Nepali private sector to utilise the spare capacity of Pakistan International Airlines cargo at a discounted price so as to export to Pakistan to overcome these problems are yet to bear fruit.
- 33 Complete data are not available to verify if this has happened.
- 34 These items are on the sensitive list mainly for revenue purposes.
- 35 Trade data used in Kharel (2010b) were mirror statistics as no direct data were available at UN Comtrade database for the chosen period of 2005–2007.
- 36 The last criterion was applied on a standalone basis.
- 37 A 50 per cent tariff rebate is accorded on cotton vest, cotton underwear, cotton brassier and cotton panty (as per Finance Act 2010/11).
- 38 The tariff lines are at the national level (i.e. beyond HS six-digit level where applicable).
- 39 SAFTA member states notified non-tariff and para-tariff measures they faced in other member states and responded to notifications related to them at the Fourth SAFTA Sub-Group Meeting of the committee of experts (CoE) held in Kathmandu in October 2009. See Rahman (2010b).
- 40 Transit trade through China, which borders Nepal to the north, is restricted by the Himalayas, inadequate transport links as well as the distance to the nearest sea port in China.
- 41 Transit through India is also a problem for Nepal's overland trade with Bhutan and Pakistan. Here, we focus on transit through India to Bangladesh.
- 42 See NITDB (2008).
- 43 Freight forwarders seal the cargo in transit in order to allay the fear of leakage. Not satisfied with this, Indian authorities want to put a second seal to be double sure. This adds to the cost of trading, not least because it adds one more layer of bureaucratic hassle for traders.
- 44 See Shrestha (2011).
- 45 Via the Singhabad–Rohanpur interchange point, the nearest operative point to two major economic hubs of Nepal through which some 87 per cent of Nepal's foreign trade passes.
- 46 See, for example, Raihan et al. (2007); Adhikari and Weeratunge (2007).
- 47 According to Hausmann et al. (2005), 'poor country goods', as the name suggests, are low-value goods produced by poor countries, with low technology and skill components.
- 48 It should be noted that for a landlocked country, the documents, time and cost to import and export are a function not only of domestic factors but also the situation in the transit country and the transit facility.

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