

The Impact of Trade Deficit in Nepalese Economy

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Abstract

This study aims to explore more information about the economic performance of Nepal and the impact on the economy caused by foreign trade. The trade deficit impacted directly on the financial performance of the country. It affected the GDP of the nation, supply side, interest rate, price of commodities and FDI. The article has discussed the relationship with the major trading partner of Nepal and other countries. Besides this, a quantitative research method was used in this research paper. Information in this article was collected from a secondary source of data. The reliability of this study depended on the reliability of secondary data. The analysis was based on a simple statistical tool. Concerning the methodology, it is based on exploratory data analysis. The comparison has been made in this paper with primary trading partner countries India, China and other countries. This study has found the deficient export performance of Nepal, which has created the problem of rapidly increasing trade deficit. Trade deficit became one of the major causes that leads the national economy to downturn side.

Keywords: trade deficit, imports, exports, FDI

Introduction

Background

Landlocked, lacking significant resources for economic development, and hampered by deficient transportation channels, Nepal is one of the least developed countries in the world. The economy is vigorously reliant on imports of necessary materials and foreign markets for its forest and agriculture items. Nepal's trade balance in context of goods and services have been in shortfall for a long period of time. The huge deficiency has not brought about any significant assortment of average foreign liabilities, where the economy to a great extent is financed with remittances from

overseas. Actually, a huge part of the expansion in the trade deficit is clarified by the remittances. Trade deficit in Nepal is reasonably sturdy and complex to strategy malleable factors, for example, government consumptions or credit. Government consumption had a huge responsibility on the trade deficit, however at lesser portion. Trade whether it is domestic or global can be is deliberated as one of the critical significant variables to sustainable development, employment advancement and benefits of the individuals. International trade grows significant at a point where the nation is not independent in fundamentals productions also at expenditures and capital goods. There are many challenges that Nepal faces in context of foreign trade. Its major feature is that it is a land-locked country located between two large and powerful countries: India and China. Nepal imports essential elements, for example, fuel, construction materials, metals, and most customer goods and exports such items as yarn, tea, and coffee, carpets, and textiles. Nepal has a very long history of trade deficit. Nepal's trade performance over a decade persisted less satisfactory, leading to a huge trade deficit on goods and services. The country exports prominently less in contrast to the bulk of imports. While exports are diminishing imports are considerably expanding every year. Trade has been sensed globally as a substantial tool for economic growth and advanced development. In various developed countries, international trade and long-term capital stream worked as 'engine of growth' for prompt economic growth and development. In the modern age, all economies are dependent economies. All the economies import and export goods and services. A country imports those goods, which are not available in the country and exports those goods, which have an excess supply in the country. International trade has played a crucial role in the economic development of nations. The modernization of the backward countries would not be possible if there were no international trade. It promotes economic growth by improving competitive capacity, expanding the market, and providing modern technology and machinery for the industrial and agricultural sector. Therefore, it is also considered as the vehicle of economic development (Silwal 2008). Before 1951 A.D., Nepal's foreign trade was only with India and Tibet. But after 1951 A.D., Nepal's trade relation expanded with many other countries of the world like Japan, the USA, Germany, Malaysia, Singapore, Thailand, Kuwait, France, Bangladesh, Spain, etc. Nepal's foreign trade is rapidly increasing, but with the increase in the total volume of business, the trade deficit is also increasing (Kafle, 2017). Trade deficit may come up with several reasons such as low investment, inferior technology, and obstacles in movements, political instability, and uncertainty inflow of energy

supply poverty, unemployment, inequality and socioeconomic unrest (Ghimire, 2010). The trade with India is growing even for basic consumptions in a huge amount whereas exports are very low comparatively. The labors here are costly that produce low quality products and majorly the government is instable and the policy is discrete. It is clear that the balance of trade is negative as the imports are higher than the exports in almost every perspective. Nepal fundamentally involves in agriculture exporting agricultural goods, handicraft goods, crude material which does not meet international standards and convey insignificant foreign exchange to its capital. The slow development in export contrasted with the vigorous development in import stays a significant distress for Nepal to gain profit in terms of trading. The overall development in export was 4.2% in the most recent decade though development in import during a similar period was 18.2 percent. India has been continuously involved majorly on the biggest export target of Nepalese products and enterprises with engrossing 66 percent of total Nepal's export. In spite of being one of the largest and powerful country, China consumed 2.8% of Nepal's complete export averagely over recent years though it tends to be rising consequently. Nations except India and China assimilated very nearly a fourth of the total export throughout the last decade. Woolen carpets, readymade garments, pashmina involved practically 50% of the all-out exports to different nations.

Research Problems

The primary purpose of the article is to sort out the impact of the trade deficit in the Nepalese economy and also to analyze the trade scenario between Nepal and India. Different recent data and figures are included to reveal the transparent body of research objectives. Hence, the research paper aimed to receive the answer to the following research questions.

- How does the trade deficit impact in Nepalese economy?
- What is the composition of Nepalese Foreign trade with its leading trading partner India, China, and other countries?

Objectives of the Study

All research has done for specific objectives and goals. Likewise, I have come up to get my article objective by analyzing and studying the books and articles that have already been published. The general objectives of the study are:

- To show the impact of the trade deficit in the Nepalese economy.

- To assess the composition of Nepalese foreign trade with its leading trading partner India, China and other countries.

Significance of the Study

- The government can improve its trade policy.
- The government can check the effect between the trade deficit and foreign direct investment.
- The government can check the effect between the trade deficit and gross domestic product.
- The government can check the effect between the trade deficit and trade volume trade deficit.
- It will help the researcher to get knowledge about the behaviour of the economy.

Literature Review

Aung (2017) study aimed to examine the positive and negative effects of the trade deficit on the economic growth of Myanmar using empirical analysis from the year 1989 to 2015. Vector Error Correction Model and Johansen co-integration test was used to examine the long-run and short-run relationship between the trade deficit and economic growth. The results reveal that there is a significant negative relationship between trade deficits and economic growth in the long-run. While in the short run, there is an insignificant negative relationship between trade deficits and economic growth.

Ahad (2017) conducted a study to examine the relationship between trade balance, financial development, exchange rate, and inflation, utilizing time-series data from 1972 to 2014 for Pakistan. Augmented Dickey-Fuller (ADF), Phillips-Perron, and breakpoint unit root tests have been applied to examine the co-integration between variables. An auto regressive distributive lag (ARDL) approach is used. The ARDL findings suggested that there is a long-run relationship between trade balance, financial development, inflation, and exchange rate. In contrast, the Error correction model (ECM) is applied to analyze the short-run relationship. In the long run, financial development, inflation, and exchange rate have a significant impact on the trade balance. Whereas in the short term, only the exchange rate and inflation have a substantial effect on the trade balance.

Hassan, et al. (2017) performed a study to investigate factors that influence trade deficit in Pakistan, India, and Bangladesh. After applying the ARDL limits testing approach on the test period from 1972 to 2013, this investigation discovers the long run connection between the trade deficit and its components in Pakistan, India, and Bangladesh. The findings confirm that the devaluation of the exchange rate decreases the exchange trade deficit in Pakistan and Bangladesh. Also, the outcomes further unveil that as economic growth extends, trade deficit shrinks altogether in Pakistan, India, and Bangladesh.

Tung (2018) looked at the impact of fiscal deficit on economic development in Vietnam; the examination has applied the Error Correction Model on the quarterly data of 2003-2016. The outcomes show there is a co- integration connection between fiscal deficit and economic development. The relationship examination has affirmed that fiscal deficit can hurt the gross output as well as private investment, net exports as well as foreign direct investment.

Popescu (2016) finds out the connection between budget deficit and macroeconomic factors, for example, economic growth, trade deficit, and interest rates. The point of this paper was to test the legitimacy of the Keynesian view on account of the Slovak Republic by experimentally investigating the presence of a long-run relationship and the heading of causality between the budget and current account shortages utilizing a VAR model and Granger causality test for values extending from 1999Q1 to 2014Q2. The paper uses regression analysis to investigate the effect of budget deficit on economic growth.

Ibrahim (2016) empirically appraises the basic parameters of trade deficiency in Egypt for the period of 1970-2014 by utilizing dynamic ordinary least squares (DOLS) approach of Stock and Watson. The estimation results show that all factors have a positive relationship among the trade deficit in Egypt and incomes, relative domestic costs to foreign costs, and International reserves. But then there is a negative and significant connection between the trade deficit and exchange rate.

Moushumi (2016) tried to find out “the relationship between trade deficit, FDI, and economic growth of Bangladesh.” Her findings present that “trade deficit is better for economic growth” as it enhances the GDP and increases jobs in the long term. But the report did not include the variables which make a positive impact on GDP and employment in the long run.

Shawa and Shen (2013) studied the causes of the trade deficit and found the main reason for the trade deficit of Tanzania. They used the Phillip-Peron (P.P.) unit root tests and augmented Dickey-Fuller (ADF) to identify the relationship between variables. Actual GDP, real exchange rate, relative GNI, and import weighted index variables were used. The overall result shows that all variables have a unit root at levels.

Duasa (2007) investigated the long-run and short-run relationships between trade balance, income, money supply, and RERs of Malaysia. Using the ARDL co-integration approach, he found a positive yet statistically insignificant connection between the trade balance and exchange rate. The money supply had a negative and domestic income had a positive impact on the trade balance.

Mubeen and Ahmad (2016) conducted a study using Gini Hirschman Index (GHI) to gauge the level of export diversification by using time series data from 1980-2015. This examination applies Auto Regressive Distributive Lag way to deal with long-run relationships in fundamental variables. The discoveries of this investigation demonstrate that geographic concentration of exports improves product concentration in exports and lessens export diversification, while world income, exchange rate, and foreign direct investment play a significant role in promoting export diversification. Then again, trade openness also has benefits to export concentration.

Ghani (2011) examined the impact of trade liberalization on the merchandise trade balance for a sample of developing countries that have adopted trade liberalization policies. The impact is differentiated according to the destinations and origins of the exports and imports, whether they are developing or industrial countries. This is important as one of the arguments for protection is based on the assumption of asymmetry in the elasticities of products traded between developing and industrial countries, and this asymmetry leads to disparity in economic growth. The paper shows that the impact on the merchandise trade balance differs between the two groups of trading partners; there is weak evidence that the trade balance worsens (increase in deficit) for trade with developing countries, but the trade balance improves (increase in surplus) for trade with industrial countries.

Limitations of the Study

The focus of this study is to assess the trade performance of Nepal. However, the study has some limitations, which are as follows:

- This study includes only merchandise trade in Nepal.
- The findings of this study cannot be generalized to all developing countries because of their diverse characteristics.
- The reliability of this study depends on the reliability of secondary data.

Research Methods and Materials

The study is descriptive in nature. It is based on secondary data. Since the study is based on secondary sources, data have been collected from the various publications of the Ministry of Finance and Annual Reports and survey study of Nepal Rastra Bank. Based on the problem, issues, and objectives, detailed information has been collected to describe and analyze the research objectives. The research is based on quantitative data. The description of the situation of the Nepalese foreign trade and trade performance is all in quantitative data. Simple statistical tools: percentages have been used to analyze the data. Concerning the methodology, it is based on exploratory data analysis. The comparison has been made in this research paper with major trading partner countries India, China and other countries.

Results and Discussion

Impact of Trade Deficit on National Income

National income is the sum of the current account and national expenditure. The difference between national income and investment results in current account. A trade deficit occurs as the increasing consuming power of goods and services. The limited resources in many developing countries as Nepal could not fulfil increasing demand and needs of people, so the country has to import the required goods and services from other countries. Mathematically, one of the renowned economists Keynesian, proved with a formula that more import certainly creates a deficit that influences national output. According to him, National Income Accounts Identity = $G + C + I + (EX - IM)$. Where Y stands for total national output, G is equal to government consumption, C is for private consumptions I is equal to Investment expenditure, EX stands for exports, and I.M. equal import. If G, C, I and EX increases, then Y (total output) gets accelerated, but if (I.M.) import exceeds, then there is a negative influence on national output. Furthermore, if imports increased more than export, it is trade deficit (IM-EX).

Impact of Trade Deficit on Gross Domestic Product (GDP)

Deficit impacts on the income of the country and GDP are said as the way of measuring the wealth of the nation's economy. Gross Domestic Product (GDP) is one of the major components of the trade balance. Trade surplus helps to raise it, but deficit leads to reduces it. Valentino Piana said, "If this impact is strong enough, it gives rise to the traditional Keynesian multiplier effect with consumption moving in the same direction" Income deficit for a country is derived when a nation paid a comparatively higher amount for wages, rental, interest and profit to other countries than it gets from other countries. The adverse effect on GDP rises because of exceeding imports demands rather than exports earning. The extreme growth of trade deficit in the nation leads to decrease demands of overall domestic goods and services. As a result, it leads to lower income for domestic producers, lower demands that impact on GDP by the multiplier effect. Besides this, trade deficit occurred in a country if GDP growth is faster than its trading partners because imports are elastic to GDP and their growth rate is more than proportionally.

Impact of Trade Deficit on Supply Side

Trade liberalization is one of the main causes of trade deficit, and it has impacts on supply-side which means the effect on the stock of the productive capital and the structure of production. The production capacity of the nation is based on investment. So, the effect of the trade deficit on the investment leads to an effect on the productive capacity of the country in the future. On the other hand, growth in import efficiency can help the nation by creating competing industries and investment in exportable goods because of improved incentives. Some studies also pointed out that a typical liberalization package brings an impact on investment, from decreased aggregate demand to high-interest rate and increase competition in the market from cheap imports. Besides this, devaluation in the currency is the cause of the trade deficit. It creates impact on the supply side, particularly on national net capital flow as the fact that investor does not want to invest in the country where a country has instability economic situation and is facing deficit which causes a rise in capital flight. So, this brings loss in financial account surplus.

Impact of Trade Deficit on Interest Rate

Deficit decreases net external claims—interest rate increases as the deficit increases. When a country faces higher debt, it directly impacts on interest rate because the capital provider demands a higher rate of interest for new loans. Another reason behind the increasing interest rate is because of the decreasing value of the national

currency. Loans and interest are closely related to each other. The prolonged-lasting trade deficit in the nation leads to foreign debt on which the governments have to pay interest. Sustainable deficit happened if the country highly depends on the import from other countries and comparatively lower exports than imports in the same year. As a result, the currency crisis can happen if market agents judge this debt as unsustainable.

Impact of Trade Deficit on Price of Commodities

General prices of goods and services are affected by the trade deficit. Trade deficit naturally followed when imports are exceeding in a higher ratio which causes inflation. It is also called cost-push factor that occurred when there is the persistence of high prices despite low growth. Shortage of products creates higher demands and demands invites import and exceeding import rates in the country presence trade deficit. Usually, inflation and purchasing power are indirectly related to each other. When the ratio of purchasing power is falling, then the inflation rate is increasing and when the ratio of purchasing power increases then inflation decreases.

Table 1

National Consumer Price Index

Groups/Subgroups	Weight %	2015/16	2016/17	2017/18	Percentage change	
					2016/17	2017/18
Food & Beverage	43.91	110.9	113.0	116.1	1.9	2.7
Cereal Grains	11.33	109.2	111.1	113.8	1.7	2.5
Legume varieties	1.84	132.7	125.4	95.2	-5.5	-24.0
Vegetables	5.52	110.3	107.5	119.7	-2.5	11.4
Meat & Fish	6.75	109.8	112.4	114.9	2.4	2.2
Milk Products & Eggs	5.24	110.0	114.0	121.9	3.6	7.0
Ghee & Oil	2.95	119.5	112.3	115.1	-6.0	2.4
Fruits	2.08	106.5	110.6	114.7	3.8	3.8
Sugar & sweets	1.74	107.5	123.2	122.3	14.8	-0.7
Spices	1.21	113.5	119.9	114.0	5.7	-4.9
Soft drinks	1.24	104.7	108.5	111.7	3.6	3.0

Hard drinks	0.68	112.9	126.1	135.8	11.8	7.6
Tobacco products	0.41	107.6	111.6	117.5	3.7	5.4
Restaurant food	2.92	109.3	117.1	122.8	7.1	4.9
Non-food & services	56.09	109.2	116.3	122.4	6.5	5.3
Clothing & footwear	7.19	114.2	124.7	132.1	9.2	5.9
Housing & utilities	20.30	112.7	122.0	130.3	8.2	6.8
Furnishing & household equipment	4.30	106.3	112.9	117.2	6.3	3.7
Health	3.47	102.6	105.3	107.7	2.7	2.2
Transport	5.34	102.0	100.9	102.9	-1.1	1.9
Communication	2.82	105.1	104.9	105.4	-0.2	0.5
Recreation & culture	2.46	104.3	107.5	111.9	3.1	4.1
Education	7.41	110.1	120.9	130.6	9.8	8.0
Miscellaneous goods & services	2.81	104.5	113.8	118.1	9.0	3.7
Overall index	100.00	109.9	114.8	119.6	4.5	4.2

Note. NRB, Annual report 2017/18

The annual average consumer price inflation in FY2017/18 remained at 4.2 percent as compared to the inflation at 4.5 percent in FY2016/17. In FY2017/18, the prices of food and beverages group rose by 2.7 percent while the prices of non-food and services group witnessed a rise of 5.3 percent. In the previous year, the prices of food and non-food items had risen by 1.9 percent and 6.5 percent respectively. Overall consumer inflation in the review year somewhat softened in comparison to the inflation in the previous year mainly due to reduction in the prices of pulses and legumes by 24.0 percent, spices by 4.9 percent, and sugar and sugar products by 0.7 percent. In the previous year, prices of pulses and legumes declined by 5.5 percent while prices of spices rose by 5.7 percent and prices of sugar and sugar products recorded the rise of 14.8 percent. In the review year, under the non-food and services group, increase in prices was observed in education at 8.0 percent, in furnishing and household at 6.8 percent, in clothing and footwear at 5.9 percent, in miscellaneous goods and services at

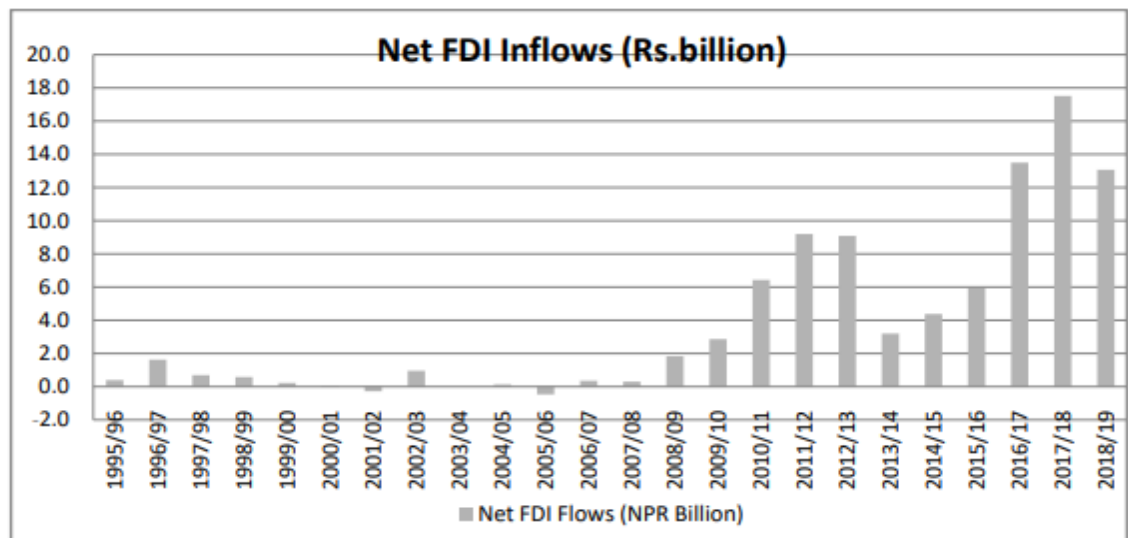
3.7 percent, and in transportation at 1.9 percent. There is some reason why the price is increasing in goods and services. It is because of structural factors- supply-side rigidities and adverse development such as increasing price in petroleum products that raised transportation cost and the other reason is the situation of national currency depreciation against major convertible currencies, affect the price of imported goods and domestic cost of productions through imported inputs and raw materials.

Impact on Foreign Direct Investment

Foreign Direct Investment is becoming popular, especially in developing countries, and it becomes an essential source for them. The reason for being famous in developing countries like Nepal is because of having plenty of resources, and these countries suffer a lack of sufficient finance, technology and competitive management. FDI is the one who can introduce technology, competitive practice, knowledge and skills in the recipient economy of the country. An inflow of Foreign Direct Investment (FDI) can push to higher imports rate if the financial transaction is incredibly intensive and autonomous and also because of revaluation of currency leads to trade deficit (Piana 2006).

Figure 1

FDI Flows to Nepal



Note. NRB Study report 2018/19

This figure describes the FDI inflows to Nepal from abroad countries. Net FDI inflows to Nepal in the 1990s and 2000s were merger. The early 2010s showed some sign of an increase in FDI inflows on the background of institutional reforms and the government's efforts in attracting foreign investment. FDI inflows have been steady in recent years that represent a clear break from earlier decades. Net FDI inflows to Nepal increased by 29.69 percent to reach Rs. 17.51 billion in FY 2017/18 whereas it declined by 25.38% percent in FY 2018/19 to reach Rs. 13.07 billion. The recent trend of FDI realization shows that there is a considerable gap between approved FDI and actual FDI inflows in Nepal. For FY 2018/19, total approved FDI was Rs. 24.99 billion while actual inflows were Rs. 13.07 billion. Trade deficit brings adverse effect in the nation. It destroys jobs, decreasing salary and wages and hurting competitiveness. As a result, those who have lower income have to face struggling life because of cutting wages and destroying jobs. The people who have lower income and do not have a job could not save for the future, and it reduces national savings because national saving is the saving of people of the nation.

Composition of Nepalese Foreign Trade

Before 1951 A.D., Nepal's foreign trade was limited only with India and Tibet. The business with India formed 95 percent, and the remaining business was with Tibet. The trade with overseas countries was almost nil. The primary reasons behind the concentration of Nepalese trade with India were: Nepal bordering by India, open border with India, and similarities in language, culture, religion, tradition, etc. But nowadays, Nepal's trade relation is with many overseas countries besides India and China. But India is still a major trading partner of Nepal. In the fiscal year 1974/75, Nepal's 82.2 percentage trade was with India and the trade with other countries was only 17.8 percent. In the fiscal year 1984/85, the trade with India was reduced to 52.4 percent. In the fiscal year 1990/91, the trade with India was 52.5 percent (Pant 1964). Nepal's trade dependency with India was declining until the fiscal year 1996/97. But in the later years, the share of trade with India has increased rapidly.

Table 2

Foreign Trade composition of Nepal

Description	2016/17	% in Total	2017/18	% in Total	2018/19	% in Total
Exports						

India	41,500,844	56.8	46,661,564	57.4	62,731,665	64.6
China	2,129,967	2.8	2,765,562	3.4	2,575,846	2.7
Others	29,494,541	4.4	31,898,252	39.2	31,801,302	32.7
Total	73,125,351	100.0	81,325,378	100.0	97,108,813	100.0
Imports						
India	646,019,017	65.5	812,551,461	65.3	917,947,260	64.7
China	135,423,882	13.5	164,324,870	13.2	214,797,841	15.1
Other	204,508,427	21.0	268,313,917	21.5	285,814,330	20.2
Total	985,951,326	100.0	1,245,190,247	100.0	1,418,559,431	
Trade Deficit						
India	604,518,173		765,889,897		855,215,595	
China	133,293,916		161,559,307		212,221,995	
Other	175,013,886		236,415,665		254,013,028	
Total	912,825,975		1,163,864,869		1,321,450,618	

Note. Nepal Foreign Trade Statistics 2018/19

Table 2 shows the composition of the Nepalese foreign trade since the fiscal year 2016/17 to 2018/19. From the table, it is clear that Nepal's major trade partner is India. Nepal's more than 60 percent of the total trade is with India. It shows that Nepal has not been very prosperous in the field of country-wise trade diversification. Although the share of trade with India for the last three fiscal years is declining and share with China and other countries is increasing. Other countries include the USA, Germany, Japan, UK, France, Italy, Spain, Switzerland, Belgium, etc. Besides India and China, Nepalese products are exported to the USA, Germany, Japan, Bangladesh, the UK, France, Italy, Spain, Switzerland, Belgium, etc. Similarly, besides India and China, Nepal imports from Singapore, U.K., UAE, Malaysia, Kuwait, etc. Nepal has also not been successful in the commodity-wise trade diversification. Nepal's more than 90 percent foreign exchange earnings from commodity exports that come from merely seven commodities: readymade garment, carpet, pulses, handicrafts, leather, medicinal

herbs, and paper products. In recent years, the export of these products is also declining.

Conclusion

Nepal, a landlocked country with the highest mountains, is bordered by the two most prominent South Asian countries India and China and rich in natural resources, has had impacted on its economic performance since it becomes liberalized in 1980. India is a major trading partner of Nepal and half of the total percentages of trade is done with India because of easy access to importing and exporting goods and services to India. The article has discussed the impacts of the trade deficit on GDP of the nation, price of the commodities, supply side, Foreign Direct, Investment. The trade deficit is one of the major causes that leads the national economy to downturn side. Nepal has been suffering imbalance figure in import and export factors. The national's import ratio leads by seven times to its export. So, in order to maintain the balancing figure between these two factors, the government has to increase the export ratio by seven times. Because of low export performance, Nepal is facing the problem of rapidly increasing trade deficit. Nepal is also unable to diversify its trade in terms of countries and commodities. The major causes of Nepal's increasing trade deficit are landlocked, low export and high import, low-quality goods, improper trade policy, higher cost of production, lack of publicity and advertisement, low production, slow industrial development, lack of trade diversification, etc. Until and unless, Nepal increases its trade competitiveness adopting different policies, it cannot reduce its ever-increasing trade deficit. Nepal should also improve its trade structure in terms of commodities and destination. Reform in political instability is one of the effective ways to minimize trade deficit. The country is facing domestic war, revolution, and as a result, the government could not focus on creating effective economic welfare policy and development. Stable political situation leads store cover in both public and private investments. Political stability needs to be followed by structural reforms that could solve the enduring source of fragility, including financial sector consolidation, public financial management reforms, investments in climate improvements and a strategy to mention the smooth erosions of Nepal's external competitiveness. Political uncertainty hampered the industrial activity, which leads the increment in imports percentage of goods to fulfil domestic needs and demands. Political stability in a country helps to minimize huge importing percentage to Nepal, which control the deficit. Besides this,

the budget announcement in the sector of agriculture and the needed technology could be an effective way to increase the national export ratio.

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