

Trade Policy and Trade Development in Nepal via Terms of Trade: A Testing of Hypotheses.

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Abstract: Trade policy of a country comprises several instruments, such as, tariff/quota and devaluation, etc. Here, in this paper only the effects of tariff/quota and devaluation are taken into account on terms of trade of a country. Tariff and quota improve the terms of trade whereby imports increase and exports decrease, resulting into deficit in BOT. On the other hand, devaluation reduces the terms of trade creating more exports and small imports. It creates surplus in the balance of payments. Thus, two hypotheses can be formulated first, imposition of tariff and quota, generally, improves the terms of trade, resulting into deficit in balance of trade. Second, devaluation reduces terms of trade, resulting into more exports and less imports, creating a surplus in BOT of a country. An attempt has been made to test these two hypotheses in case of Nepal's foreign trade/BOT. Result has been that these two hypotheses are not proved in case of Nepal's terms of trade and BOT position.

Keywords: Tariff, Quota, Devaluation, Terms of Trade, Balance of Trade.

Trade policy through its instruments like tariffs/quantitative restrictions and devaluation affects the terms of trade of a country, influencing foreign trade of a country.

Objective:

- (i) To examine the effects of trade policy instruments like tariff and quota on foreign trade/balance of trade of Nepal through terms of trade of a country.

Hypotheses:

- (i) Imposition of tariff/quota on a country improves the terms of trade resulting into surplus in balance of trade of a country like Nepal.
- (ii) Devaluation deteriorates the terms of trade which encourages exports and reduces imports, resulting into surplus in balance of trade.

Methodology:

The study is based on secondary data collected from Economic Survey of Nepal and Nepal Rastra Bank Quarterly Economic Bulletin, various issues. Terms of trade are estimated by the formula as $\text{export value/import value} \times 100$ (base year). The comparative analysis has been made.

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Tariff/Quota and Terms of Trade:

When a country imposes tariff on imports its willingness to import declines and for a given quantity of exports the importers require a larger quantity of imports, provided the supply of the particular foreign good is inelastic, this means an improvement in terms of trade. When terms of trade improve the imports are encouraged and exports are discouraged resulting into deficit in balance of payments on current account. It would be relevant to test this hypothesis in case of Nepal's foreign trade. Similar is the case with quota imposition.

Devaluation and Terms of Trade:

Devaluation is a component of trade policy. Trade policy through devaluation affects the terms of trade, influencing the position of balance of payments on current account of a country. Devaluation reduces the value of the home currency unit expressed in terms of the currency of the foreign country. After the foreign currency value of the home currency has been lessened due to devaluation, it is but natural to think that the terms of trade of the currency devaluating country will decline because the prices of countries exports fall in terms of the foreign currency, while the prices of imports increase in terms of the home currency. This will lead to increase in exports and fall in imports, resulting into improvement in countries balance of payments (BOP) on current account. Here, it would be relevant to examine the impact of decreasing terms of trade of Nepal on its balance of payment on current account.

This is not a bare fact. In fact, the effects of devaluation on a country's balance of payments (BOP) depend upon the elasticity of demand for and supply of imports and exports of a country. Devaluation will tend to improve the terms of trade creating the impact on balance of payments of a country, provided the sum of the demand elasticity for country's imports and exports is greater.

On the other hand, Frank B. Graham and others are of the view that the terms of trade are likely to remain constant as a country typically transact at world prices which are beyond its control. Contrary to it, the new classical economists are of the view that currency devaluation deteriorates the terms of trade, while currency appreciation improves them. It can be attributed to this fact that most countries specialize in the exports of a few commodities which have relatively inelastic foreign demand whereas these countries import a number of commodities from different countries. As a result, the supply of their imports is relatively elastic. Mrs. Joan Robinson is of the view that one country plays a more dominant role in the world supply of those goods which it exports than it plays in the world market for those goods which it imports. C P Kindleberger is of the view that it is particularly true for larger developing countries.

The impact of trade policy through terms of trade on Nepal's, foreign trade/balance of trade has been examined taking into account the figures of table 1 and table 2.

Table-1

| Terms of Trade in Nepal (Base Year 1990-91) | | | |
|---|------------------|------------------|----------------|
| Year | Value of Exports | Value of Imports | Terms of Trade |
| 1991-92 | 13706.5 | 31940 | 42.91 |
| 1992-93 | 17266.5 | 39205.6 | 44.04 |
| 1993-94 | 19293.4 | 51570.8 | 37.41 |
| 1994-95 | 17639.2 | 63679.5 | 27.70 |
| 1995-96 | 19881.1 | 74454.5 | 26.70 |
| 1996-97 | 22636.5 | 93553.4 | 24.20 |
| 1997-98 | 27513.5 | 89002 | 30.91 |
| 1998-99 | 35676.3 | 87525.3 | 40.76 |
| 1999-00 | 49822.7 | 108504.9 | 45.92 |
| 2000-01 | 55654.1 | 115687.2 | 48.11 |
| 2001-02 | 46944.8 | 107388.9 | 43.71 |
| 2002-03 | 49930.6 | 124352.1 | 40.15 |
| 2003-04 | 53910.7 | 136277.1 | 39.56 |
| 2004-05 | 58705.7 | 149473.6 | 39.27 |
| 2005-06 | 60234.1 | 173780.3 | 34.66 |
| 2006-07 | 59383.1 | 194694.6 | 30.50 |
| 2007-08 | 59266.5 | 221937.8 | 26.70 |
| 2008-09 | 67697.5 | 284469.6 | 23.80 |
| 2009-10 | 60824 | 374335.2 | 16.25 |
| 2010-11 | 64338.5 | 396175.5 | 16.24 |
| 2011-12 | 74261 | 461667.7 | 16.09 |
| 2012-13 | 76917.1 | 556740.2 | 13.82 |
| 2013-14 | 91991.4 | 714365.9 | 12.88 |
| 2014-15 | 85319.1 | 774684.1 | 11.01 |
| 2015-16 | 70117.2 | 773599.1 | 9.06 |
| 2016-17 | 73049.1 | 990133.2 | 7.38 |
| 2107-18 | 81633.3 | 1242826.8 | 6.57 |

Source: (i) Data collected from Nepal Rastra Bank Quarterly Economic Bulletin.
(ii) Terms of Trade are calculated.

The table-1 indicates that in Nepal the terms of trade, in general, have been falling and show falling and fluctuating trends. It is clear from the table that in 1991-92 the terms of trade of Nepal amounted to 42.1 with base year 1990-91=100. It declined to 24.2 in 1996-97, and showing an increasing trend became 48.11 in 2000-01. It again declined to 43.71 in 2001-02 and became 6.57 in 2016-17, showing a declining trend. On the whole, it can be observed from the table that Nepal's terms of trade have been deteriorating compared to base year.

Table-2

| Nepal's Foreign Trade (In Million Rupees) | | | | | |
|--|--------------|--------------|-------------|---------------|--|
| Fiscal Year | Total Import | Total Export | Total Trade | Trade Balance | |
| 1991-92 | 31940 | 13706.5 | 45646.5 | -18233.5 | |
| 1992-93 | 39205.6 | 17266.5 | 56472.1 | -21939.1 | |
| 1993-94 | 51570.8 | 19293.4 | 70864.2 | -32277.4 | |
| 1994-95 | 63679.5 | 17639.2 | 81318.7 | -46040.3 | |
| 1995-96 | 74454.5 | 19881.1 | 94335.6 | -54573.4 | |
| 1996-97 | 93553.4 | 22636.5 | 116189.9 | -70916.9 | |
| 1997-98 | 89002 | 27513.5 | 116515.5 | -61488.5 | |
| 1998-99 | 87525.3 | 35676.3 | 123201.6 | -51849 | |
| 1999-00 | 108504.9 | 49822.7 | 158327.6 | -58682.2 | |
| 2000-01 | 115687.2 | 55654.1 | 171341.3 | -60033.1 | |
| 2001-02 | 107388.9 | 46944.8 | 154333.7 | -60444.1 | |
| 2002-03 | 124352.1 | 49930.6 | 174282.7 | -74421.5 | |
| 2003-04 | 136277.1 | 53910.7 | 190187.8 | -82366.4 | |
| 2004-05 | 149473.6 | 58705.7 | 208179.3 | -90767.9 | |
| 2005-06 | 173780.3 | 60234.1 | 234014.4 | -113546.2 | |
| 2006-07 | 194694.6 | 59383.1 | 254077.7 | -135311.5 | |
| 2007-08 | 221937.8 | 59266.5 | 281204.3 | -162671.3 | |
| 2008-09 | 284469.6 | 67697.5 | 352167.1 | -216772.1 | |
| 2009-10 | 374335.2 | 60824 | 435159.2 | -313511.2 | |
| 2010-11 | 396175.5 | 64338.5 | 460514 | -331837 | |
| 2011-12 | 461667.7 | 74261 | 535928.7 | -387406.7 | |
| 2012-13 | 556740.2 | 76917.1 | 633657.3 | -479823.1 | |
| 2013-14 | 714365.9 | 91991.4 | 806357.3 | -622374.5 | |
| 2014-15 | 774684.1 | 85319.1 | 860003.2 | -689365 | |
| 2015-16 | 773599.1 | 70117.2 | 843716.3 | -703481.9 | |
| 2016-17 | 990113.2 | 73049.1 | 1063162.3 | -917064.1 | |
| 2017-18 | 1242826.8 | 81633.3 | 1324460.1 | -1161193.5 | |
| Source: Table is formulated on data collected from Economic Survey of Nepal, Various Issues | | | | | |

It is clear from table-2 that there has been persistent deficit in Nepal's balance of trade (BOT). The trade deficit was 18233.5 million rupees in 1991-92 it increased to 70916.9 million rupees in 1996-97. In subsequent year of 1998-99, it slightly declined amounting to 51849 million rupees. Since then it again started rising. It was 60033.1 million rupees in 2000-01, which became rupees 135311.9 in 2006-07. In subsequent years too, it has been continuously increasing and the deficit became 1161193.5 million rupees in 2017-18. On the whole, it can be concluded that in 2017-18

over 1991-92, the deficit in balance of trade of Nepal showed 64 times increase. Thus, there has been continuous deficit in Nepal's balance of trade and the deficit has been widening, with a few exceptions.

Testing of Hypotheses:

1. If tariff/quota is imposed the terms of trade of a country increase. When terms of trade increase, imports become cheaper and exports dearer. Consequently, deficit in balance of trade (BOT) is enlarged. In case of Nepal the terms of trade have been deteriorating over the years. So, there is inconsistency in examining the impact of terms of trade of Nepal over Nepal's balance of trade. Hence, the hypothesis one is not established.
2. In case of devaluation the terms of trade fall resulting into surplus in BOT as exports increase and imports fall, leading to surplus in BOT. In case of Nepal, there has been persistent deterioration in terms of trade. As a result, there should be surplus in BOT of Nepal, but we find that there has been heavy deficit in balance of trade of Nepal over the years. Hence, the hypothesis of fall in terms of trade results into surplus in BOT is not found in case of Nepal. Thus, the second hypothesis is not empirically found true in Nepal.

Conclusion: In Nepal terms of trade do not influence balance of trade effectively. There are several reasons behind it. Among them domestic consumption pattern, march towards industrialization, liberalization and privatization, tendency to re-exports, large smuggling practices are crucial factors in Nepal to affect balance of trade, not only the trade policy through its terms of trade. Hence, hypotheses to be tested are not proved.

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