NEPAL'S GRADUATION FROM LDC

A private sector persective

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Preface

The United Nations General Assembly has approved a proposal to upgrade Nepal from an underdeveloped country to a middle-income developing country by 2026 on 24th November 2021.

UN Committee on Development Policy (CDP) in February 2021 recommended for the country's graduation from the LDC category with a transition period of five years, or effective from 2026.

The decision to this effect was made by the Committee on the basis of the country's achievement in human assets (HAI) and economic vulnerability (EVI) index - two of the three criteria for the eligibility. But, it didn't meet the GNP per capita income criteria, the average GNI per capita of Nepal (2017-2019) was $1,027 against the requirement of a three-year average threshold of $1,222. It is the only country amongst all eligible countries that secured graduation requirement without meeting the per capita income threshold criteria.

Graduation from LDC is doubtlessly a matter of self-esteem for the country. But, there are potential economic costs caused by the loss of access to international support measures (ISMs) provided to the LDCs. The magnitude of such costs depends on the extent to which the country concerned, benefited from such measures before graduation. The ISMs can broadly be observed in terms of preferential treatment in trade and market access, international financial and technical assistance.

Considering these realities, the FNCCI cautiously supports the adoption of graduation plan focused as a major national goal and the developing programs with target of the graduation criteria by the government. It is indispensable that the government should bring a comprehensive plan for a smooth graduation process that addresses structural vulnerabilities and inherent challenges as discussed earlier. In this report, FNCCI, on behalf of the private sector, proposes a holistic national graduation strategy led by private sector, with the basic objective of minimizing the consequent impact after LDC-specific support measures are phased out.

I would like to thank ILO Nepal office for all the support to prepare this report. I would like to thank Manish Lal Pradhan chair and Export Promotion Committee of FNCCI for taking lead to prepare this report. I sincerely thank Mr. Bijendra Man Shakya for his time and dedication to prepare this report. In this report, we have presented the perspective of private sector on LDC graduation. I hope government and other stakeholders actively work to minimize the risk of graduation particularly in international trade.

Shekhar Golchha
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Nepal's graduation from LDC status: A private sector perspective

1. Background

After being labelled a least-developed country (LDC) for over five decades, Nepal is set to move one step up in its economic development ranking,after the meeting of the UN Committee on Development Policy (CDP) in February 2021 recommended for the country's graduation from the LDC category with a transition period of five years, or effective from 2026.The United Nations General Assembly has approved a proposal to upgrade Nepal from an underdeveloped country to a middle-income developing country by 2026 on 24thNovember 2021.

The decision to this effect was made by the Committee on the basis of the country's achievement in human assets (HAI) and economic vulnerability (EVI)index - two of the three criteria for the eligibility.[1]Although Nepal performed well in these two criteria, it didn't meet the GNP per capita income criteria,the average GNI per capita of Nepal (2017-2019) was $1,027 against the requirement of a three-year average threshold of $1,222. It is the only country amongst all eligible countries that secured the graduation requirement without meeting the per capita threshold criteria (See Table 1).

TABLE 1: Graduation timelines and graduation criteria

	Scheduled graduation year/earliest possible year*	GNI per capita (≥ US $1,222)	Human assets (≥66)	Economic vulnerability (≤32)
Nepal	2024**	1,027	75	24.7
Timor-Leste	2024	1,867	66.6	56.8
Bangladesh	2024	1,827	73.2	25.2
Loa PDR	2024	2,449	72.8	33.7
Myanmar	2024	1,263	68.5	31.7

Note: The thresholds and values for the graduation criteria are based on the 2021 Triennial Review of the list of LDCs by the UN CDP.

Earliest possible year for graduation subject to recommendation by the UN CDP and endorsement by UN ECOSOC as decided in 2018. The normal three-year preparatory period has been extended to five years to 2026 by the CDP triennial review held in 2021.*

Indeed, Nepal had met the graduation criteria for three consecutive reviews. Having accomplished the criteria for the first time in 2015, Nepal requested deferring the graduation during the2018 triennial review citing the setback on the country's economy by the 2015 earthquake. Then the 2021 triennial review recommended the country for graduationovera five-year transition period, considering the impact of the recent pandemicon its economy.This means,countries can receive extra time to prepare for overcoming any vulnerability to the economy and development upon concerns shown by either the CDP or ECOSOC (UN Economic and Social Council).

Nepal's graduation from LDC category was initially envisaged in the approach paper to the 13th Development Plan (2013-2017). Aiming to become a developing country by 2022,

[1]*While the Human Asset Index (HAI) is composed of indicators, such as nutrition, health, school enrolment, and adult literacy ratio, the Economic Vulnerability Index is based on indicators, such as natural shocks, trade related shocks, physical exposure to shocks (share of population living in low-lying areas), economic exposure to shocks, smallness (population, remoteness.*

the approach paper sought an average growth rate of 9.2% throughout the plan period to meet the goal. The current 15th Development Plan has committed to Nepal's graduation from LDC by 2024 and aimed at transforming the country into a developed country in 25 years. Despite these ambitions, the actual growth rates were far below the targeted rates, creating doubt over meeting the per capita income requirement. But Nepal's achievement in human assets and economic vulnerability index had favored it to qualify for the graduation recommendation. Adding impetus to the recommendation, Nepal has to prepare itself to deal with concerns expressed by the stakeholders, particularly the private sector, which has a leading role to play in the economy, rather than considering the graduation plan as an academic exercise and policy ambition. Without a holistic approach, the transition period will be not that smooth to overcome the potential shocks from graduation.

2. LDCs and the graduation experience

Including Nepal, there are 47 LDCs as defined by the UN system. Majority of the LDCs are in Africa, with seven in Asia - mostly concentrated in South Asia, one in North America, and six in the Pacific region.

Regarding economic performance, most LDCs had irregular or declining growth rates in the recent past. Nepal had one of the most unpredictable and relatively low growth rates and is supposed to have grown the slowest among the South Asian countries**.** Except for the period between 1986-1996which had the highest average growth of 5% due to broad based reform programmes in its modern history, Nepal witnessed annual average growth of only 4% during the past 45 years (1970-2014).[2]

Attributed to weak economic growth, LDCs had severe problems in generating and mobilizing domestic resources for structural transformation and investment for enhancing the production capacity. Three major traps are considered responsible for restraining LDCs' capacity to economic development.[3]

The first and the well-known trap is the vicious circle of poverty, which illustrated low income and output, resulting in low savings and investment, ultimately leading to low productivity and low income, giving rise to high levels of poverty. Second is the commodity trap, which means depending too much on either commodity production or on a few manufactured products for trade, employment and foreign exchange. For example, very few products made up a major chunk of Nepal's export trade, reflecting the difficulties faced by the country in upgrading within the global value chains and often limiting to specialization in low value-added products. Third is the weak production bases and limited export diversification, which gave rise to very high import content in production and consumption as well as chronic current account deficits. This resulted in over dependency on foreign aid and debt, and increased imports of consumption goods and fuel had led to reduced import of capital and intermediate goods for investment projects, ultimately slowing down the growth rate. Nepal is no exception to these economic traps as well.

Making the situation more complex, LDCs, including Nepal, faced the challenges of globalization. Not only had it increased the competitive environment for trade and

[2] *World Bank (2017), Climbing Higher: Toward A Middle Income Nepal*

[3] *UNCTAD (2016), The Least Developed Countries Report 2016 - The path to graduation and beyond: Making the most of the process, United Nations Conference on Trade and Development, Geneva*

investment but also put pressure on these countries to comply with international rules and standards, and exposed them to external shocks. The international competitive environment often had negative impacts on the LDCs, affecting market share, investment opportunities, and job markets as major adversity to economic development. For a land-locked LDC like Nepal, globalization has further intensified its performance in international trade due to the higher cost of doing business. In addition to this, LDCs have weak institutions and less capacity to engage in policy discussions at the international level and find difficulties to compete internationally. The overall effect has, therefore, been the marginalization of these countries in the global economy.

Against this backdrop, the Programme of Action for the LDCs for the Decade 2011-2020, or the Istanbul Plan of Action, recommended at least 7% growth rate between 2011 and 2020 for these countries with a target of at least half of the LDCs satisfying the criteria for graduation from LDC status by 2020.[4]However, only five LDCs have achieved the goal in the 45 years since the establishment of the category: Botswana (1994), Cabo Verde (2007), Maldives (2011), Samoa (2014), and Equatorial Guinea (2017).

While graduating from LDC category requires the countries to meet the tough income, economic, and social criteria, it is also an indication of breaking the economic traps mentioned above. As an initial cost, the graduating countries have to sacrifice the benefits and preferences associated with the LDCs. That means, graduation can be referred to as a transition from economic dependence to a state of greater self-reliance. Therefore, graduation is considered as an important milestone on the development path of each LDC as it demonstrates strong performance in key macroeconomic indicators and broad-based social developments.

For the graduating LDCs, depending upon the diversity in development situations among these countries, it is not without its cost. This diversity tends to impact the graduating countries in different scope and different magnitude with respect to market access opportunities, international financial assistance, and special and differential provisions for LDCs. The impact of graduation is likely to be intense and more challenging for a country with a larger economic size and a larger trade volume.[5] Thus, the challenges from the loss of benefits associated with LDCs are common with different intensity, while the adjustment costs for them will be more than those that preceded them. Considering these situations, it is necessary to delve into the factors affecting the Nepalese economy upon graduation and needs their assessment to minimize the adjustment costs from it.

3. Implications of graduation from LDC category

Graduation from an LDC is without doubt a matter of self-esteem for the country. But there are potential economic costs caused by the loss of access to international support measures (ISMs) provided to the LDCs. The magnitude of such costs depends on the extent to which the country concerned benefited from such measures before graduation.

The ISMs can broadly be observed in terms of preferential treatment in trade and market access, international financial and technical assistance, and flexibility in the

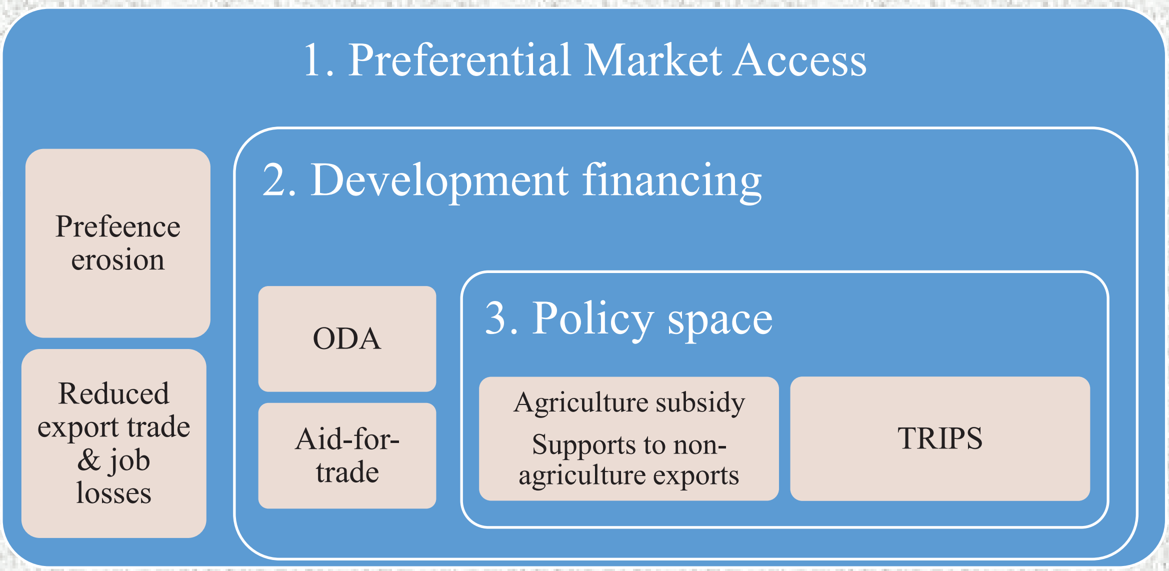
[4] *UN-OHRLLS (2007), Making Globalization Work for the Least Developed Countries, UN Office of the High Representative for the Least Developed Countries, Landlocked Developing Countries, and the Small Island Developing Countries, and UNDP*

[5] *For example, Bangladesh is the largest exporter among the graduating LDCs and it is expected to face the largest increase in applied tariffs as a result of graduation.*

implementation of subsidy, intellectual property rights, and other international rules, such as WTO obligations. All graduating LDCs are susceptible to challenges from these impacts. But the primary source of implications on Nepal will be the loss of preferential market access, which will likely generate other ramifications in the economy. The overall impact will be immense to a country where productive capacities expand in the export sectors, which are largely covered by trade preferences that have been largely utilized. The impact can be relatively severe in the initial period of graduation.

For a national policy approach to graduation, political influence is equally important along with the economic considerations. There is a big opportunity for a government to gain political advantage by claiming responsibility for having brought a country from LDC status to parity with other developing countries. Such considerations may have encouraged the LDC governments to develop strategies especially oriented towards graduation by a specified date. Private Sector does not aspire the graduation plan if it is explicitly politically motivated and without proper assessment of the economic impact, because it can demotivate the private sector as it must bear the cost of losing special privileges, resulting in intense competition for the country's trade and economy after the graduation.

FIGURE 1: Implications on Nepal from loss of ISMs



The degree of implications from the loss of ISMs will depend on the country's ability to respond to such incidences and a smooth transition process that takes place after the graduation. This highlights the importance of early preparation for the consequences of graduation. This study classifies the implications of graduation for Nepal into three ways as illustrated in Fig. 1 above while elaborating on them in the following sections.

3.1 Loss of preferential market access and tariff advantage

As an LDC, Nepal is eligible for a number of ISMs. But it has not benefited from all ISMs due to its inherent constraints. Yet the treatment of preferential market access for its exports is the most important one as indicated by its contribution to the promotion of the country's external trade and business.

Nepal has been benefiting from almost all preferential market access schemes offered under the generalized system of preference (GSP) program by the developed countries, and also from some developing countries. Table 3 illustrates the major preferential schemes available to Nepal. Generally, all preferential schemes are non-reciprocal in nature, but they differ with respect to country and product coverage, and the preferential rules of origin.

TABLE 3: Major preferential market access schemes available to Nepal

Preference giving countries	Description	Duty-free tariff-line (and major exclusion)
Australia	DFQF entry for LDCs	100%
Canada	GSP-Least-developed Countries' Tariff Programme	98.5% (dairy and other animal products, meat, meat preparations, cereal products)
China (2017)	DFQF for LDCs	96.6% (chemicals, transport vehicles, machinery and mechanical applications, electric machinery, paper)
European Union (EU)	GSP- Everything But Arms (EBA) initiative	99.8% (arms and ammunition)
Japan (2018)	GSP-Enhanced duty and quota-free market access	97.8% (fish and crustaceans, footwear, milling products, cereal products, sugar)
South Korea	Presidential Decree on Preferential Tariff for LDCs	89.9% (fish ad crustaceans, mineral fuels, oil seeds and oleaginous fruits, wood products, vegetables)
New Zealand	GSP-Tariff Treatment for LDCs	100%
Norway	GSP – Duty- and quota-free market access	100%

Adapted from Trade Impacts of LDC graduation, WTO/EIF

Most developed countries accord either full or nearly full duty-free, quota-free (DFQF) market access to LDC products, while developing countries like China and India also provide comprehensive DFQF facilities.[6] Although the Chinese scheme is important for Nepal in this respect, it rarely matters in the case of India as Nepal has a bilateral preferential arrangement with India, which is broader and deeper in all aspects. The bilateral trade treaty is partially reciprocal in favor of Nepal and has nothing to do with Nepal's graduation from LDC status. It covers more than half of the country's total exports, suggesting its importance in Nepal's export transactions.

In terms of export volume and its scope of expansion, EU is the second most important export destination as it contributed in average 10%-14% to the country's export volume for the last couple of years with the potential of promoting niche markets in the EU countries. The importance of EU's preference cannot be undermined as Nepal benefits largely from the most generous EBA (Everything but Arms) initiative, which covers almost 100% of LDC export products to countries within the regional bloc. EU is the largest destination market for the graduating LDCs, absorbing 31% of merchandise exports of these countries. Thus the loss of preference with regard to the EU needs cautious assessment as the implications of post-graduation in Nepal's trade with the EU will be far-reaching due to loss of preference margins.

Because the EBA program allows imports from LDCs at zero applied tariffs, Nepal is expected to experience one of the highest tariff increases in the EU, equivalent to the

[6] *As agreed at the WTO Hong Kong summit in 2005, developed country members, and developing countries that declare themselves to do so, are to provide DFQF market access for at least 97% of products originating from LDCs.*

average of 8.1%against an average tariff rate increase of 4.1% points based on their current export structure in the LDCs.[7] This is because the export of carpets and clothing are the largest items, which have relatively higher preference margins. The preference margins for the two export product categories, apparel items and carpets, in the EU before and after Nepal's graduation is given in Table 4. The preference margins as indicated in the table will erode after graduation as there are none or only minor differences between the GSP and MFN tariff rates.[8] However, Nepal can maintain the preference margin on apparel products if it can secure access to GSP-plus preference.

Moreover, Nepal will face the tough rules of origin requirement for apparel items after graduation as it will be required to meet a double transformation requirement from the current single transformation, which is applicable to LDC preferential rules of origin. This means Nepali apparel items should be made from domestic fabric or should add more value equivalent to 50%.[9]Hence, Nepali clothing export will be affected doubly in the EU countries and will probably see reduced export of the product due to the increased tariff rates and the stringent rules of origin immediately after graduation.

TABLE 4: Tariff rates on major export products of Nepal in EU

HS code	Product	LDC	GSP+	GSP	MFN
5701	Carpets and other textile floor coverings (knotted)	0	0	5.2	6.9
6109	T-shirts, singlets and other vests (knitted)	0	0	9.6	12.0
6110	Jerseys, pullovers, cardigans (knitted)	0	0	9.5	11.9
6203	Men's suits, ensembles, jackets, blazers (not knitted)	0	0	9.6	12.0

**Based on WTO (2020)*

As a distinct feature, the EU's EBA scheme explicitly provides a three-year transition period or will continue to offer the same treatment for Nepal even after graduation. After this time period, Nepal is entitled to either standard GSP or GSP- plus schemes, the latter being more generous. The GSP-plus is available only if Nepal is considered a vulnerable exporter or if its exports are concentrated in a few sectors and with total GSP-covered exports accounting for less than 6.5% of the EU's GSP-covered imports from all GSP-eligible countries as the first condition for eligibility. As the second condition, Nepal should have ratified and implemented 27 international conventions associated with worker and human rights, protection of the environment, and good governance.[10]If it does not qualify for GSP-plus, the application of EU standard GSP could imply that over 80% of Nepal's exports to the EU, including all major items such as apparels and carpets, would

[7] *WTO (2020), Trade impact of LDC graduation, World Trade Organization, Geneva*
[8] *Most-favoured nation tariffs which apply equally to all trading partners under the WTO rule.*
[9] *Upon the request made by the Government of Nepal, EU provided to Nepal a facility of the preferential rules of origin from 1997 to 2010 allowing Nepalese apparel to undergo only one processing operation from materials originating from SAARC and ACP countries. After 2010, the rule was applied indiscriminately to all LDC eligible countries.*
[10] *Elliot, Kimberly Ann (2019), A Smoother Trade Transition for Graduating LDCs, Centre for Global Development, London*

be subject to some tariffs. About 40% of Nepal's exports are expected to fall under the average tariff of 5-7.9% while another 35% will be subject to 9-9.9% on average.[11]

In the case of the US- the next important export destination with an average annual share of 12% in Nepal's export in 2016-17-Nepal has been benefiting from two preferential schemes: the Least Developed Beneficiary Country scheme (LDBDC) and the Nepal Trade Preference Act (NTPA), which explicitly applies only to Nepal.[12] While the LDBDC scheme offers about 5,000 tariff lines for preferential tariffs, the NTPA grants duty-free market access for 93 products at the HTS 8-digit level in addition to the products covered by the former scheme.

Compared to the EU, the US preferential scheme excludes a large number of products which are of export interest to Nepal, indicating low product coverage by the US preferential scheme. However, Nepal has been benefiting from the special NTPA Act of zero duty applicable on some key products, including hand-knotted carpets, headgear and parts, and a few articles of apparel and clothing accessories such as Pashmina shawls, stoles and scarfs. While the low preference coverage had affected Nepal's ability to exploit the scope of the US market and tariff advantage to a greater extent, the rate of preference utilization in the US looks comparatively attractive, establishing its importance in terms of export volume. Nevertheless, Nepal will lose the benefit from both schemes after its graduation. Market access conditions and potential tariff increment for major export items from Nepal in the US after the graduation is given in Table 5.

TABLE 5: Application of tariff onselected Nepali export items in the US

Product description	MFN tariff	Post-graduation tariff (GSP for developing countries)
Carpets and other textile floor coverings	0%-8% 6% for most items Average rate 2.7%	Tariff suspension for few products
Article of apparel and clothing accessories, not knitted or crocheted	0% - 27% Average rate 10.3%	9 out of 383 HTS 8-digit products are included in GSP for BDCs
Wadding, felt and nonwovens; special yarns; twine, cordage and articles thereof	0%-19% Average rate 4.7%	Duty suspension for few items
Other made-up textile articles; sets; worn clothing and worn textile articles; rags	0%-20% Average rate 6.6%	7 out of 94 HTS 8-digit products are included in GSP for BDCs
Headgear and parts thereof	0% - 11% Average rat 5%	6 of 25 HTS 8-digit products are included in GSP for BDCs

Source: UNESCAP working paper

[11] *Razzaque, Mohammad A. (2020), Nepal's graduation from the least developed country group: Potential implications and issues for consideration (Working paper series), United Nation Economic and Social omission for Asia and Pacific, Geneva.*

[12] *Under this Nepal-specific tariff preference programme, the US provided duty free market access to 66 products including carpets, shawl, scarves, and travel goods in February 2016 and in July same year, additional 27 items covering luggage, backpacks, handbags and wallets were included in the same facility.*

Upon graduation from the LDC category, Nepal will be eligible for the US GSP program under the Beneficiary Developing Country (BDC) title applicable to other developing countries. Application of this scheme will reduce preference margins for Nepal and raise tariffs on those products which were previously under the tariff advantages. Product-wise, export of carpets will most probably experience an export shock immediately after graduation as it constitutes almost half of the county's total export to the US market. But it can be recovered in a short to medium period as the preference margin between the LDBC and the MFN rate is not really large to regain competitiveness in this product category even after graduation.

Overall, Nepal will see comparatively less impact in the US mainly because of the low preferential product coverage and low volume of export of major items, on the one hand, and the application of high MFN tariffs on apparel items,[13] which are supposed to be one of the major product categories exported to the US, on the other.

Nepal's trade with China is vital for two reasons: historical trade connection and geographical proximity. Adding more value to these benefits, Nepal also benefits from the preferential market access for its exports to China under the comprehensive DFQF scheme, which covers 96.6% of China's tariff lines or over 7,000 products eligible for tariff concession.

China is the second largest country after the EU in absorbing LDC exports under the preferential treatment globally. Despite these advantages, Nepal's exports to China have remained dismal, and limited to a very narrow export product base, such as essential oils, perfumery, carpets, sugar, leather, articles of metal, art works and antiques. Considering China's MFN tariffs, which range from 5% to over 30% on these products, Nepal has been enjoying higher preference margins in the concentrated products. Therefore, upon graduation, Nepal is likely face an adverse impact on its export to China no matter how insignificant the export value as a result of the loss of preference margins on these products. However, in totality, the preference loss will be less intense due to the higher simple average tariff of 8.4% in China, indicating less increase in tariffs following Nepal's graduation from LDC. Nevertheless, the loss of preference would restrain Nepal's ability to exploit the vast export potential offered by the world's second largest economy. No matter how small the benefit from the preferential treatment, it has assisted Nepali exporters to pave the way for gaining market knowledge and exploiting opportunities in the world's largest market. To continue with this advantage, Nepal can request for extending the transition period as China has such a provision even after graduation.14

Assessment of the implications of the loss of preferential access for Nepal in other developed countries, such as Australia, Canada, and Japan appears relevant because of the higher than predicted export transactions with these countries. However, exports to these countries are quite low in absolute and relative terms. As shown in Table 3 above, these countries respectively provided duty-free treatment on 100%, 98.5% and 97.8% of their tariff lines. After graduation from the LDC status, Nepal will be entitled for GSP schemes for developing country status in all three countries, which are relatively less generous than the LDC status. Table 6 shows difference between the MFN and GSP rates illustrating preference margins in all three countries. Transition to GSP developing country status will be subject to increased tariffs and changes in the rules of origin provisions in the respective

[13] *MFN tariff peak on textiles and clothing ranges from 16% to more than 30% in the US.*
[14] *China has provided a transition period to Somao for a period of three years to benefit from LDC preference in agro-processing products following its graduation.*

countries. Since textiles and clothing are excluded in the GSP developing status in these countries, Nepal may face some implications of the product origin rule in this product category. In a similar vein, Nepal will be subject to non-LDC provision of sensitive list and rules of origin with regard to trade with SAFTA countries. This implies the requirement of reducing the number of products under the sensitive list and the minimum value addition requirement of 40% against 30% for the LDCs, and 50% value addition for SAARC regional cumulation. The likely impact of these provisions will be insignificant in terms of the country's present trade volume with regional partners, whereas it may deter the potential trade with Bangladesh to some extent.

TABLE 6: Preference programmes applied by other relevant countries to Nepal

	Programmes relevant to LDCs	Unweighted average tariffs LDCs (%)	Non-LDCs (%)
Australia	MFN	3.78%	
	GSP scheme	0.00	1.8
Canada	MFN rates	6.77	
	GSP scheme	2.69	5.42
Japan	MFN rates	9.31	
	GSP scheme	1.07	8.14

Source: Market Access, Transparency and Fairness in Global Trade: Export Impact for Good,ITC (2010)

Hence, although the adverse impact in totality will tend to be less pronounced due to insignificant export from Nepal to these countries, it will restrain Nepali exporters' drive for export product and market diversification.

Overall impact of preferential loss to Nepal

As already observed, the transition from LDC to GSP developing country status will put a stop to tariff advantages and reduce preference margins for Nepal in the preference-giving countries. The preference margin is computed as the difference between the best available tariff after graduation and the current tariff under LDC-specific preferences, the latter being zero for majority of tariff lines. Erosion of the preference margins will possibly reduce Nepal's exports to preference-giving countries in comparison to the exports before graduation, at least in the initial period of the graduation. Nepal is expected to lose a sizable share of its export. Meanwhile, the loss of export to EU is estimated to be more than 50% of the total loss of export under the preference.

Product-wise, the export of apparels, carpets, and pashmina, which are subject to relatively large tariff increases an in all major preference-giving countries, will be the hardest hit areas. Loss of export of these product categories is certain to contract the size and number of small and medium enterprises (SMEs)in the economy. This is because the SMEs are the major source of manufacturing of almost all major products exported from the country. Similarly, the production and export of promising agricultural products, such as tea, coffee, and aromatic herbs and ayurvedic remedies, which are concentrated in the EU and USA, may be affected to a large extent as these products have relatively larger preference margins under different LDC preference schemes. Since both the sectors are labor intensive in nature and highly specialized in the economy, the ultimate effect could be huge job losses. Majority of the job losers would be female workers, who are involved in weaving, sewing, and packaging jobs in the export industries or sowing, plucking, and collecting in the field.

While the impact of the loss of preference and tariff costs will possibly be intense on production and employment, the impact on export competitiveness cannot be undermined as a result of the stringent rules of origin requiring higher local content, especially in the apparel sector, for non-LDCs in the importing countries.

Likewise, the level of competitiveness in post-graduation could be intense after Nepali exporters find themselves on the same playing field as the emerging economies, like India and China. Nepali exporters will have difficulty in competing with the product categories similar to these countries' export products.[15]Consequently, these drawbacks will make Nepal's export diversification drive more difficult, while there are chances of overly depending of exports to countries where the preferential access is still valid under other provisions.

The after-effect of graduation is also imminent on private investment and capital flows. Graduation may discourage FDI inflows motivated by preferential market access that may be lost as a result of graduation from the LDC category.

3.2 Impacts on development financing

Another area of critical importance in the context of LDC graduation is the impact on Nepal's access to international development financing. Although it is concerned directly with the government, it is obvious for the private sector to take account of its implications as development financing in trade logistics and supply capacity is of prime importance for them in enhancing their competitiveness in international markets.

Implications of the loss of access to development financing on Nepal can be evaluated with respect to bilateral official development assistance (ODA) and multilateral financing schemes, including the aid-for-trade. International donors and financing institutions do not consider LDC status as a basis for providing assistance to LDCs. Therefore, the resultant impact of LDC graduation will be minimal on development financing for Nepal irrespective of the type of financial assistance and donors.

Regarding bilateral financial assistance, Nepal's relations with the donor countries will be a critical determining factor in the post-LDC period. Commitments and allocation of bilateral aid depend largely on the donor's strategies and political considerations with respect to Nepal's performance in the utilization of development finance. Bilateral donors also consider historical ties, income level, and regional cohesion as conditions for allocating funds for development assistance. Financing by multilateral agencies, including the International Development Association (IDA) of the World Bank and Asian Development Bank, may be inaccessible due to the income criteria as the basis of financing at lower interest rates. This means borrowing may involve some additional costs due to the loss of the privilege of soft loans.

Essentially, Nepal will lose access to LDC specific technical assistance and capacity building programs, such as the Enhanced Integrated Fund (EIF), despite the provision of providing assistance for five years following the effective date of graduation. With respect to aid-for-trade, LDC graduation should not hamper the prospect of future support under this program. Nepal may continue to get access to this financing program to build its trade capacity and to make the trade regime more consistent with the WTO system in the future.

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[15]*Shakya, Bijendra M. (2021), Rite of passage: Nepal is excited by the prospect of moving up from the LDC status, but dreads losing the benefits, The Kathmandu Post, March 21, 2021*

3.3 Loss of policy space

Nepal as an LDC has been exempted or extended time from making commitments and implementing complicated provisions with respect to subsidy, sanitary and technical standard requirement, and intellectual property protection under the WTO agreements. Since there are no provisions regarding LDC graduation, Nepal will be refrained from supporting agriculture exports and subsidizing non-agricultural products afterwards.[16]

However, since exports from Nepal currently enjoy cash subsidy, there is a possibility of WTO members challenging the non-complaint export support. But the impact from ceasing this support will be minor considering the volume of subsidy. Nevertheless, it highlights the problem of reduced policy space for the country in supporting export and export market diversification in the post-graduation period.

Another important area of interest with regard to loss of policy space is the WTO Agreement on TRIPS, which covers intellectual property rights that incorporate certain other intellectual property treaties. LDCs have received special flexibility in the implementation of the TRIPS Agreement. Nepal had made commitment to apply the TRIPS provisions by January 1, 2007 in its accession negotiation. Still, the LDCs, including Nepal, have benefitted from a specific transition period for pharmaceutical products until January 1, 2033 or until a country ceases to become a LDC member, whichever comes earlier.[17]In Nepal most of the pharmaceutical production is not covered by patents and is dominated by generic ones, thus the impact of general obligations under the TRIPS agreement tends to be negligible even after its graduation from LDC status. Yet there is a chance of adverse impact on Nepal's ability to manufacture and import generic versions of patented medicines.[18]Hence, the loss of policy space in this regard will be of greater concern to the private sector in the post-graduation era.

WTO provides special and differential (S&D) treatment with provisions for increasing trade opportunities; safeguarding trade interests; flexibility of commitments, action, and use of policy instruments; and technical assistance. With respect to these provisions, Nepal will continue to benefit because these special treatments are equally applicable to other developing countries. Moreover, Nepal as a landlocked LDC will qualify as a small and vulnerable economy. It should, therefore, implement the Trade Facilitation Agreement and engage in WTO work programs on small economies, where it can raise the issues concerning the country and explore ways to minimize the loss of policy space after it upgrades to developing country status.

4. A private sector perspective and recommendations

With graduation imminent, the FNCCI that represents the country's private sector is seriously concerned about whether or not the graduation will be favourable for the economy, in general, and the private sector, in particular. Graduation gives a message of economic independence and reduced exposure to structural vulnerabilities in the country's

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[16] *Nepal's accession treaty allows it to maintain its right to administer certain subsidy programs in conformity with the WTO Agreement on Subsidy and Countervailing Measures (SCM.).*

[17] *As per the Doha Ministerial Declaration on the TRIPS Agreement and Public Health, adopted in November 2001, it originally exempted LDCs from protecting patents and undisclosed information for pharmaceutical products until 2016.*

[18]*Razzaque, Mohammad A. (2020), Nepal's graduation from the least developed country group: Potential implications and issues for consideration (Working paper series), United Nation Economic and Social omission for Asia and Pacific, Geneva*

development process in the international arena. This helps to attract FDI and technology transfer, supporting integration of the Nepali economy with regional and global value chains. Yet it is "not the winning post of a race to cease being an LDC, but rather the first milestone in the marathon of development" as UNCTAD[19] has stated.

Nepal being a landlocked LDC is caught up in additional challenges attributed to economic remoteness and dependence on the economic and political situation of neighboring countries, which may complicate its effort to graduation. One particular sector which is very vulnerable to after-effect shock is the country's international trade and business. Consequently, the trade sector which is recognized as an accelerator of economic growth can be exposed to a more difficult situation without alternatives to LDC-specific preferences.

Despite Nepal being one of the most trade-dependent countries with a trade-to-GDP ratio of 31% in 2019,[20] it had a very disappointing export-to-GDP ratio, which has plummeted from almost 9% in the past to barely 3% currently. Although it has performed satisfactorily in services trade, it did poorly in goods trade as its share is insignificant in the total LDC exports as illustrated in Table 7.

TABLE 7: Goods and services exports of selected LDCs(2018)

	US$ million	Share of services	Growth rate 2011-2018	Share in LDC export	Trade balance (US$ million)
Bangladesh	41,919	7%	7.1%	17.8%	-23,672
Bhutan	780	23%	0.7%	0.3%	-460
Lao PDR	6,210	15%	14.7%	2.6%	-1,103
Myanmar	16,824	30%	10.4%	7.1%	-2,653
Nepal	2,933	61%	7.4%	1.2%	-15,001

Source: WTO-UNCTAD-ITC estimates

Apart from the hardships created by the land-lockedness and difficult topography, Nepal has been encountering a number of inherent barriers to trade promotion. Chief among them are the bottlenecks to export drive, such as high export market concentration, low export market penetration, and low export sophistication. According to a recent World Bank report, Nepal failed to exploit untapped export opportunities worth $9.2 billion (against the present value of $1 billion) having the potential to generate 220,000 new jobs with significant implications for productivity growth.[21] These situations reflect a gloomy business environment in the country with difficulties caused by changes with respect to starting a business, getting credit, and paying taxes as mirrored by the World Bank's Doing Business Ranking, which placed Nepal in 94th position out of 190 countries.

Considering these realities, the FNCCI cautiously supports the adoption of the graduation plan focused as a major national goal and the developing programmes with target of the graduation criteria by the government. It is indispensable that the government bring a comprehensive plan for a smooth graduation process that address structural vulnerabilities

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[19] *UNCTAD (2016), The Least Developed Countries Report 2016 - The path to graduation and beyond: Making the most of the process, United Nations Conference on Trade and Development, Geneva*

[20] *World Bank website*

[21] *World Bank (2021), Harnessing Export Potential for a Green Inclusive and Resilient Recovery, Nepal Development Update, World Bank/IBRD/IDA, Country Office, Kathmandu*

and inherent challenges as discussed earlier. Against this background, the FNCCI, on behalf of the private sector, proposes a holistic national graduation strategy with the basic objective of minimizing the consequent impact after LDC-specific support measures are phased out. The following sections present a series of steps to be undertaken under the proposed graduation strategy:

i. **Alternative approach to preferential treatment**: One of the ways to minimize the impact of loss of LDC-specific preferences is to explore a scheme that is in between the most generous duty-free, quota-free scheme and the standard GSP that is less generous, which is applied after the country graduates. For example, the EU has a provision of GSP-plus as an option to the EBA initiative, which virtually is similar to the preferences under the EBA. It is available to vulnerable economies on two conditions. One is export concentration in a few sectors with a very low export share in the EU's total GSP-covered imports. Two is the ratification of 27 international conventions related to human and labor rights, environment protection, and governance. Nepal can be eligible for this scheme with regard to the former condition, but the latter one needs further observation to push the idea. Necessary action should be initiated in this regard without delay.

   Likewise, it should move forward with an idea for the continuation of the NTPA Act with a longer period and additional product coverage to compensate for the loss of exports to the US after the graduation. In a similar vein, it is important to push for extending the facility provided by China under the letter of exchange for special preferential treatment which was signed in 2010. These approaches should be initiated correspondingly as alternatives to minimize the likely impact of export losses even for a long period.

ii. **Longer transition period**: If there is no alternative approach to the schemes equivalent to the LDC-specific ones, Nepal should try for a longer preparation period for transition in the preference-giving countries. The EU provides an additional three-year transition for a graduated LDC to receive EBA benefits automatically after the effective date of graduation. This period should be used efficiently for boosting competitiveness by Nepali exporters. Similarly, there is a possibility of extending the transition period for Chinese preferences for three years following graduation.[22] In the case of other important export destinations, such as Australia and Canada, the transition facility is provided on an ad hoc basis, while Japan revokes the LDC benefit immediately upon graduation.[23] Thus the government should start consultation with these countries for any possible options without delay. Some graduating countries are requesting to extent transition period 12 years from 2026. Nepal should join those countries to extend transition period.

iii. **Bilateral or regional free trade agreement (FTA):** If the previous two approaches are less feasible or implies complex situations to achieve, Nepal can engage with the trading partners for bilateral or regional free trade (FTA) negotiations with the preference-giving countries. Unlike the LDC schemes, FTA will be reciprocal in general. In this context, Nepal should consider the existing Trade and Investment Framework Agreement (TIFA) with the US as a stepping stone for bilateral FTA

[22] *China provided a transition period to Samoa for a period of three years to benefit from LDC preferences following its graduation.*

[23] *Elliot, Kimberly Ann, (2019), A Smoother Trade Transition for Graduating LDCs, Centre for Global Development, London*

with the US, despite this is not an easy task to materialize anytime soon. Similarly, as the Nepal-China Bilateral FTA is in its final shape, the process should be expedited to materialize it as a substitute for China's DFQF scheme. Although not related directly to Nepal's graduation implications, an FTA with Bangladesh can pave a way to promote Nepal's export, particularly to enhance the export of high-value agricultural products, such as large cardamom, which are in high demand but subject to high tariff in Bangladesh. More importantly, FTA with Bangladesh can overcome the provision of sensitive list which has been obstructing the bilateral trade. Equally important is to use Bay of Bengal Initiative for Multi-sectoral Technical and Economic Cooperation (BIMSTEC) as a means to promote trade with South-East Asian countries. Increased trade with these countries can compensate for the loss accrued from the preference-giving countries following graduation. However, there are no LDC-graduation specific arrangements in these regional agreements.

iv. **Trade capacity building and compensation measures:** It is important that the private sector entrepreneurs are well informed and familiar with the changed international provisions, particularly associated with the WTO regulations. WTO has a provision for granting waivers in the event that a member faces difficulty in remaining compliant with its rules in the post-graduation period. A graduating LDC country can request a waiver from certain obligations in the WTO if it faces complications in complying with the rules concerning sanitary and phytosanitary requirement, technical standards, intellectual property rights, trade related investment measures, and other trade remedy measures. These regulations are flexible in many instances. But businessmen in Nepal tend to forego such facilities either they are not updated or lack information about these preferential treatments. Nevertheless, knowledge about the flexibility provisions and effective use of such measures will depend on the institutional arrangements available for the private entrepreneurs.

WTO provides trade-related technical assistance to graduating LDCs under EIF support for five years after graduating from LDC status.[24] As its distinct feature, graduation support includes the development of a graduation strategy, which applies appropriately to the proposed plan mentioned in the next section. Equally important is the preparation of a list of potential donors and trading partners so as to initiate consultation with them for negotiations on possible assistants beforehand. This helps to maintain the existing development cooperation and also compensate for the export losses caused by the phasing out of tariff preferences and other provisions available to the country. The next possible alternative could be exploration of new ideas for support in international fora, including in the next LDC Program of Action (2021-2030). Similarly, the UN CDP has proposed a technical assistance program for graduated countries to address the potential loss from LDC-specific preferences and sharing experience on graduation.

v. Negotiation within SAFTA

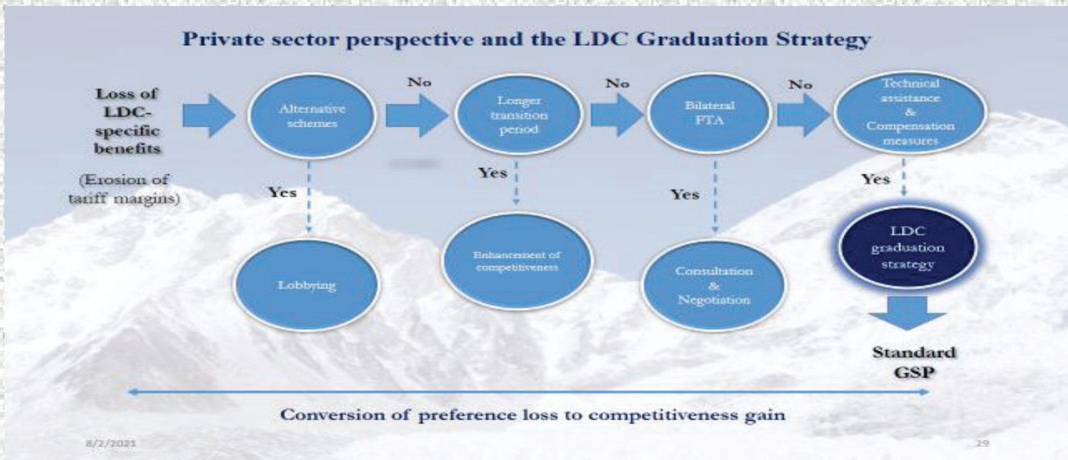
Under the SAFTA rules of origin, LDC are allowed 30 percent value addition compared to 40 percent for non-LDCs. Graduation from LDC status would therefore not allow graduating LDCs to avail of such liberal treatment. After graduation Nepal would have to fulfill 40 percent value addition requirement. That will have impact

[24] *WTO (2020), Trade impacts of LDC graduation, World Trade Organization, Geneva*

within SAFTA and need to address negative impacts within regional economic integration framework.

vi. Private sector led graduation strategy

The recommendations mentioned above cannot be implemented effectively without a graduation strategy, which is indispensable for the smooth transition of Nepal from LDC status. But these actions are not easily attainable without integrating them with the national trade policy and development strategy. For example, Bangladesh and Vanuatu had formed a graduation plan and task-force to assess the likely implications of the graduation impacts and ways for the smooth transition. Following the same trend and considering the suggestions as mentioned above, the figure given below illustrates the LDC graduation strategy with a target of transforming the loss of preference to a competitive gain for the country.



To complement the government's graduation plan, the FNCCI has devised the following steps:

- Constitute an independent think-tank with the basic objectives of analyzing and synergizing the plan, emphasizing private sector concerns- particularly the loss from preferential market access, and exploration of alternative policy space after graduation.
- The two after-effects (loss of preferential access and policy space) are directly concerned with the private sector and the FNCCI emphasizes two complementing policy interventions integrated with the graduation strategy: (i) internal policy intervention, and (ii) the private sector institution.
- With regard to the internal policy intervention, it will emphasize on diversification of export-based industries with comparative advantage and high value-added as well as higher tariff margins. This is not simple task without the assurance of the government incentives as compensation for the loss of preference margins in the post-graduation period. Thus, the revision of the Nepal Trade Integration Strategy (NTIS) with additional products for export promotion is recommended for this purpose. FNCCI is eager to coordinate with the government in NTIS strategy work programme.
- Next, the proposed private sector institution is intended to lobby the government as well as be a source of inputs for the government in the forthcoming LDC Program of Action with respect to private sector interests in safeguarding national

trade interests. The Fifth UN LDC Conference has been scheduled for 2022 in Doha, Qatar. This can be a very influential step of the private sector in coordinating with the government strategic plan.

Complementing to this proposal, FNCCI has already initiated a strategic plan for the promotion of export and substitution of imports with a basic objective of increasing the growth rate and reducing the trade deficit as part of its vision paper. This holistic approach is believed to be effective means in embracing the private sector by the government in the graduation plan. After all, the private sector cannot be overlooked by the government as the major implications of the graduation are to be borne by the private sector.

5. Conclusion

After the UN General Assembly endorses and accepts the CDP recommendation for Nepal's graduation from LDC status, Nepal will rise to developing country status. Nepal's case is a unique one as it is the only country amongst all eligible countries which got recommended without meeting the per capita income threshold, and was considered three times by the CDP triennial review for this purpose.

The graduation from LDC category is both a stature and a distress for the private sector. On the one hand, the up gradation is a landmark in the country's economic development, but not an end to the economic endeavor. On the other hand, it will have to bear great losses with an end to LDC-specific international support for the country, broadly covering preferential market access, privileged international development financing, and the flexibility of compliance with stringent international rules, particularly associated with WTO obligations. Among these, the loss of preferential access is of much concern to the private sector as it not only erodes the preference margins, but also implies stringent rules of origin on the country's exports to preference-giving countries in the post-graduation period.

Although Nepal will be subject to either standard GSP privilege or to an alternative preferential program similar to LDC status after graduation, the magnitude of the after-effect will depend on the preference margins between these programs and the LDC-specific ones as well as the rate of preferences utilized in the respective countries. And the adjustment costs, as a subsequent effect of the loss in all export destinations, are unavoidable at least immediately after graduation.

Considering the export scope and the preference margins, Nepal will likely lose a sizable amount of export to the EU, followed by the USA and China, which broadly provide preferences to the country's exports. Although negligible, the expected loss in other potential markets, such as Australia, Canada, and Japan, appears to be a daunting challenge for the country's export diversification plan. Additionally, there are unavoidable challenges as a result of losing special and differential treatment with respect to various WTO obligations. The intensity of loss from special and differential treatment will depend on the private sector's ability to respond to these provisions.

Minimization of the adverse effects and the adjustment costs of the transition from an LDC to developing country status calls for a comprehensive graduation plan and strategy, embracing alternative schemes for preferential treatment, extension of the preparatory period, negotiation for bilateral free trade agreements, and capacity building. Effectiveness of the graduation strategy is not possible without a lead role of the private sector, which will be exposed directly to all sorts of implications in the post-graduation.

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