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**India-Nepal Seminar Vision Paper**

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## **“Strengthening Nepal-India Economic Partnership: Addressing Trade Deficits, Connectivity Challenges, and the Need for a Modern Free Trade Agreement”**

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**Abstract:** *This paper examines the evolving economic partnership between Nepal and India, with a focus on trade and transit relations. While the historical treaties like the 1950 Indo-Nepal Treaty of Peace and Friendship and the 1960 Treaty of Trade and Transit have fostered strong bilateral ties, Nepal continues to face a widening trade deficit with India due to tariff barriers, non-tariff restrictions, and infrastructural challenges. The paper analyzes these issues and proposes key solutions, including enhancing cross-border infrastructure, resolving air connectivity bottlenecks, and negotiating a modern Free Trade Agreement (FTA) to address current economic realities. By advocating for more frequent bilateral meetings and incorporating security and defense concerns into trade discussions, the paper outlines a pathway to a more balanced and prosperous partnership that benefits both nations and promotes regional stability.*

**Keywords:** Nepal-India relations, Trade and Transit Treaty, bilateral trade, trade deficit, FTA, economic cooperation, infrastructure.

### **Introduction**

The close geographic relationship and robust trade ties between Nepal and India form the foundation of their bilateral economic partnership. As Nepal is a key focus of India's "Neighborhood First" policy, strengthening their economic relationship is crucial and offers significant opportunities for both nations (MEA, 3 annexure-A neighbourhood first policy india's '...').

The historical roots of the economic relationship between India and Nepal run deep. The 1950 Indo-Nepal Treaty of Peace and Friendship and the 1960 Treaty of Trade and Transit, along with other bilateral agreements, have played a crucial role in promoting trade and establishing a significant aspect of their economic relations (Chaudhary, 2023). Driven by shared interests, India

entered into peace and trade agreements with Nepal, providing landlocked Nepal with access to global markets for its exports. Through this paper the author delves into the existing economic relationship between India and Nepal and how both countries can enhance cross border connectivity and address trade imbalances by negotiating a new Free Trade Agreement via increased levels of communication through bilateral consultations.

## Background

The 'Treaty of Peace and Friendship' between India and Nepal, followed by the 1954 'Treaty of Trade and Transit,' established the groundwork for a strong strategic and economic partnership. Over the next sixty years, these agreements—particularly the trade and transit treaty—were periodically revised to address new challenges, strengthening bilateral ties and promoting deeper economic integration (Taneja & Chowdhury 2010). A testament to this relationship is India's position as the largest source of foreign direct investment (FDI) in Nepal, with Indian firms investing 75.81 billion Nepalese rupees, accounting for over a third of Nepal's total FDI stock. Similarly, India has consistently been Nepal's top trading partner, with bilateral trade reaching \$10.5 billion, representing more than two-thirds of Nepal's global trade (Vashisht, 2024).

India has been a major investor in Nepal, with Indian firms accounting for approximately one-third of the total foreign direct investment (FDI) in the country. This amounts to nearly \$670 million. India is also Nepal's largest trading partner, with over \$8.85 billion in bilateral trade in the financial year 2022-23 (*India -Nepal Bilateral brief* 2024). Of this, India exported goods worth about \$8 billion to Nepal, while Nepal exported goods worth \$840 million to India. Nepal's exports to India primarily include edible oil, coffee, tea, and jute, while its imports from India consist mainly of petroleum products, iron and steel, cereals, vehicles and parts, and machinery parts. There are around 150 Indian companies operating in Nepal in various sectors such as manufacturing, services (including banking, insurance, logistics, education, and telecommunications), power, and tourism (*India -Nepal Bilateral brief* 2024).

However, challenges persist in India-Nepal economic relations, particularly with regard to the growing trade deficit since the signing of the New Treaty of Trade in 2009. Despite duty-free access to the Indian market, Nepal's exports to India have not significantly increased, exacerbating the trade imbalance.

## Policy Outlook: Trade and Transit

The India-Nepal Trade and Transit Treaty, first signed in 1950 and revised multiple times since, is a cornerstone of the economic relationship between the two countries. It governs trade and transit arrangements, allowing Nepal, a landlocked nation, access to Indian ports for its international trade. The treaty grants Nepal duty-free access to the Indian market for certain goods and facilitates bilateral trade by reducing tariffs on select items (*Treaty of Trade and Transit* 1960).

Over the years, the treaty has been revised to address emerging trade challenges, enhance economic integration, and expand trade opportunities. Key provisions include duty-free access for Nepalese exports to India and transit rights through Indian territory for Nepal's foreign trade. However, issues such as trade imbalances, non-tariff barriers (Taneja 2018), and tariffs on specific goods have raised concerns, particularly from Nepal, regarding its growing trade deficit with India.<sup>1</sup>

The treaty remains a crucial framework for enhancing bilateral trade, while periodic revisions have allowed both countries to adapt to changing economic conditions.

India and Nepal offer duty-free access to a selection of agricultural products, though Nepal imposes an Agriculture Reform Fee on certain agricultural imports. Additionally, Nepal grants India a rebate on customs duties for manufactured goods, with the rebate amount determined by the applicable tariff rate. India's duty concessions for manufactured products, meanwhile, have fluctuated over time, based on where the products are produced and the extent of value added during the manufacturing process (Taneja et al. 2020).

## Recent Statistics

### Exports:

In 2023, Nepal's primary exports included items such as palm oil, soybean oil, cardamom, woolen carpets, iron and steel products, and polyester yarn. Traditional exports also consisted of jute products, leather goods, ginger, tea, ready-made garments, handicrafts, Agro- and forest-based products, and medicinal herbs. Emerging export goods include plywood, noodles, rosin, toothpaste, and shoes. Additionally, products like energy, drinking water, mushrooms, saffron, and floriculture hold significant potential for export growth. Other promising export items are

vegetable seeds, Orthodox and CTC tea, Niger seeds, essential oils from medicinal and aromatic plants, leather goods, woolen products, silver and gold jewelry (*Trade and Commerce* 2024).

### **Imports:**

Nepal's imports have surged over the years, with key imports including petroleum products, transport equipment and parts, electronics, machinery, rice, crude soybean oil, medicines, telecommunications equipment, ready-made garments, fertilizers, and coal (*Trade and Commerce* 2024).

### **Bilateral Mechanism and Connectivity:**

The Nepal-India Treaty of Trade (2009), Agreement of Cooperation to Control Unauthorized Trade (2009), Treaty of Transit (1999), and Rail Services Agreement (2004) form the basis for the bilateral trade and transit framework. Under the Treaty of Trade, Nepali-manufactured goods enjoy duty-free access to the Indian market on a non-reciprocal basis, excluding a few items like cigarettes, alcohol, and cosmetics. However, to qualify for duty-free access, Nepali exports must meet a 30% domestic value addition requirement and demonstrate a change in HS classification at the four-digit level during processing in Nepal. There are also annual quotas for certain sensitive items, such as vegetable fats (100,000 metric tons), acrylic yarn (10,000 metric tons), copper products (10,000 metric tons), and zinc oxide (2,500 metric tons) (*Trade and Commerce* 2024).

Bilateral trade is typically conducted in Indian rupees, but Nepal's central bank maintains a list of around 163 items that can be imported from India in U.S. dollars using a Letter of Credit. The Indian rupee is fully convertible at all banks and financial institutions in Nepal, with an exchange rate of 1.6 Nepalese rupees to 1 Indian rupee (Shekhawat, 2024).

The Agreement for Cooperation to Control Unauthorized Trade, signed on October 27, 2009, provides a legal framework to curb illegal trade between the two nations. The Nepal-India Treaty of Transit (1992) renewed every seven years, grants Nepal access to Indian ports at Kolkata/Haldia and Visakhapatnam and defines various transit routes between these ports and the Nepal-India border. For bilateral trade, 27 designated entry/exit points exist along the Indo-Nepal border (*Commerce Wing Brief*).

The Rail Services Agreement of 2004 governs rail services between India and Nepal, originally covering routes from Kolkata/Haldia port to the Raxaul/Birgunj transit point in Nepal. In 2016, the Vishakhapatnam port was added for Nepal-bound transit trade, and the rail service was extended to this port. A Letter of Exchange signed on July 9, 2021, further expanded rail services, allowing all cargo train operators to use the Indian rail network for transporting containers to and from Nepal. This development aims to boost efficiency and reduce costs, ultimately benefiting Nepalese consumers (*India-Nepal Developmental Partnership: A shining example of strong bilateral cooperation* 2023).

During his visit to Kathmandu in January, Indian External Affairs Minister S. Jaishankar made a significant statement emphasizing that India is committed to redefining its relationships with neighboring countries, particularly Nepal. Jaishankar highlighted the transformation of India-Nepal relations in recent years, with a focus on expanded partnerships in connectivity—physical, digital, and energy-related. During the joint commission meeting, Nepal raised concerns about additional air entry routes, floods, and a review of the 1950 Treaty of Peace and Friendship. However, India's official statement did not mention these issues (Giri, 2024).

An outcome of the meeting was the formalization of a long-term power trade agreement. This will enable Nepal to export 10,000 megawatts of electricity to India over the next decade, with the agreement valid for 25 years and renewable every 10 years (*India, Nepal ink 4 key pacts to boost trade ties and improve connectivity*, 2024).

The latest session of the India-Nepal Inter-Governmental Sub-Committee (IGSC) on Trade, Transit, and Cooperation to Combat Unauthorised Trade took place in Kathmandu on January 12-13, 2024 (*Nepal, India Express commitment to implementing bilateral initiatives for strengthening cross-border connectivity* 2024). The IGSC, a crucial bilateral mechanism for enhancing trade and investment relations, facilitated comprehensive discussions on several important topics. Both nations explored avenues for mutual market access, particularly for pharmaceuticals and Ayurvedic products. India emphasized the importance of Nepal adopting an intellectual property rights (IPR) regime in line with the Paris Convention to encourage foreign direct investment (FDI) (*Press Release: Meeting of the India-Nepal Inter-Governmental Sub-Committee (IGSC) on Trade, Transit, and Cooperation to Combat Unauthorised Trade*, 2024).

Key issues on the agenda also included the review and potential amendments of the Treaty of Transit and the Treaty of Trade, as well as strategies for improving investment, harmonizing standards, and developing trade infrastructure. The meeting placed significant emphasis on initiatives to enhance cross-border connectivity between the two countries, including the construction of new Integrated Check Posts and railway links, with both sides reaffirming their commitment to these projects as part of a broader vision for strengthened bilateral trade (*Press Release: Meeting of the India-Nepal Inter-Governmental Sub-Committee (IGSC) on Trade, Transit, and Cooperation to Combat Unauthorised Trade*, 2024).

## Analysis

Nepal's trade deficit with India remains a significant challenge, despite enjoying duty-free access to Indian markets, largely due to its limited and undiversified export base as well as supply-side constraints. Indian-imposed tariff rate quotas on products like vegetable oils and industrial goods further restrict Nepal's export potential, while complex rules of origin add to the difficulties in accessing Indian markets. Additionally, cross-border trade suffers from slow infrastructure development, including delays in expanding Integrated Check Posts and railway links, and limited access to Indian seaports hampers Nepal's global trade (Bose 2018). Air connectivity issues, particularly from key airports like Pokhara and Bhairahawa, also remain unresolved, restricting Nepal's international linkages (*Nepal seeks additional air routes with India to enhance connectivity* 2024). Non-tariff barriers, especially in pharmaceuticals and agricultural products, also create hurdles for Indian exports (Vashisht, 2024). Moreover, India has called for Nepal to strengthen its intellectual property rights (IPR) framework to encourage more foreign direct investment, but Nepal's current regime is underdeveloped, needing significant reforms to attract greater investment. Addressing these issues is crucial for enhancing bilateral trade and fostering deeper economic cooperation between the two countries (Taneja et al. 2020).

## Proposed Policies and Recommendations

The Author suggests the following to bolster the economic cooperation between India and Nepal:

- While the IGSC meetings have been productive, there is a pressing need for them to occur more frequently and yield more concrete results. To make these discussions more impactful, they could intersect with the bilateral consultative committee on security and

defense between India and Nepal. Such coordination would help address broader strategic concerns, such as the unresolved air route issues from Nepal's Pokhara and Bhairahawa airports, which remain unconnected. Tackling these interconnected challenges would not only enhance trade but also strengthen regional connectivity and security cooperation between the two countries.

- The increased frequency of committee meetings would bring in transparency to the process leading to an understanding of reasons behind refusal thus far and potentially lead to a mutually agreeable solution.
  - If the committees are able to come to a consensus with Nepal's air route contentions it would have a positive impact on Nepal's trade to India and to other third countries.
  - The two countries should also continue on to have further negotiations on granting Nepal access to more seaports in India besides the ones already being used to boost its trade which would further lead to a spillover effect on the economy of both the countries.
  - India and Nepal should prioritize the development of physical infrastructure and establish efficient immigration facilities at key border points to improve connectivity and facilitate smoother cross-border movement through road routes. Enhanced infrastructure and streamlined immigration processes would strengthen trade, tourism, and people-to-people ties between the two countries, while also contributing to regional integration.
- To achieve these objectives more effectively, both countries would benefit from negotiating a new Free Trade Agreement. While the existing Trade and Transit Treaty has undergone multiple revisions and facilitated trade and investment, the evolving global landscape calls for a fresh agreement. A modernized pact, with newly negotiated provisions tailored to current economic realities, would better address the challenges and opportunities both nations face today, ensuring a more seamless and mutually beneficial partnership.
  - An FTA would enhance the exports of both countries, it would give a chance to both the countries to revisit the tariff and non-tariff barriers current in place and to potentially reimagine them as would suit them.



- It would directly impact the people-to-people connectivity, health, climate and defense, trade and investment (Palit, 2022).
  - Nepal can target for deeper access to Indian Markets and beyond (other third countries) for its primary exports such as palm oil, soybean oil, cardamom and other such commodities. While India can focus on non-tariff barriers hindering its exports in Nepal specifically pharmaceuticals.
  - A push for an investment chapter could also be made under the FTA which would provide adequate protection to investors from both countries while also promoting a higher quantum of investment.
- Nepal and India do not have a transactional relationship but one based on friendship and neighborhood fraternity. Nepal, as a country soon to be graduating from its LDC status stands to lose trade preferences it enjoys under this category. Here India may come in and help Nepal with accessing essentials such that business cartels in such commodity markets are prevented.
- India should prioritize people-to-people relations when making decisions about food dependence, rather than considering broader foreign policy factors.
- Nepal should augment a system of investment protection and consider giving special status to Indian investors to prevent money laundering and attract investments. It will repair the trust deficit between the countries and also encourage the Indian government to encourage Indian conglomerates to invest in Nepal.
- India as a vast state should consider sub-national diplomacy to target sector specific imports and exports, to increase competition and fair market approach.
- India and Nepal should consider forming a dedicated bloc in South Asia and lead the economic dialogue in the region. In existing Multilateral fora such as BIMSTEC, SAARC, BBIN etc. the activity is at a standstill. A partnership of the two countries with a strong stance would help in streamlining the trade and investment dialogue and promote the same.
  - In line with the above India may propose for Nepal to be a direct beneficiary of the India-UN Development Partnership Fund which would assist Nepal owing to its status of a landlocked country and aid it in its journey of rising from a LDC to a higher middle income country.

## Conclusion

The economic partnership between Nepal and India, while historically robust, faces several contemporary challenges that must be addressed to unlock its full potential. Despite longstanding treaties providing Nepal with access to Indian markets, the country's trade deficit with India continues to widen, revealing structural issues in Nepal's export capacity, compounded by tariff and non-tariff barriers. Additionally, logistical and infrastructural constraints, such as limited port access and unresolved air connectivity issues, hinder Nepal's ability to maximize its trade potential.

To overcome these challenges, both countries must engage in more frequent and results-oriented discussions, ensuring a coordinated approach to not only economic issues but also security and defense concerns that impact connectivity. Negotiating a new Free Trade Agreement, tailored to the realities of the modern economic landscape, would provide the flexibility needed to address tariff barriers, promote investment, and deepen bilateral trade relations. Furthermore, integrating Nepal more comprehensively into India's infrastructure projects and expanding access to Indian seaports would yield significant economic benefits for both nations.

By strengthening bilateral mechanisms, adopting a forward-looking trade framework, and enhancing cross-border connectivity, Nepal and India can create a more balanced and prosperous partnership that benefits both economies and promotes regional stability. The proposed solutions hold the potential to transform the trade and investment landscape, fostering deeper cooperation in the years to come.

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