



Dispatches from The Hall of Ideas!

YEAR 02 | ISSUE 08 | OCTOBER, 2025

INTERNATIONAL TRADE & REMITTANCE*

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When analyzing a small open economy such as Nepal, it is essential to consider both domestic and external factors. Alongside political risks and the endowment of skilled labor, elements such as the exchange rate and remittance flows play a critical role. This dual perspective informed my research in International Trade and Finance. On the trade side, I examined macro-level questions, particularly whether depreciation of the exchange rate would enhance competitiveness. At the micro-level, I studied firm dynamics to identify the characteristics of successful exporters. In the domain of finance, I analyzed how fluctuations in the US dollar exchange rate propagate through banks' balance sheets and influence lending behavior. Conventional trade theory posits that a weaker currency should make exports more competitive and stimulate export volumes. However, recent patterns suggest that this effect is not straightforward. In particular, the Dominant Currency Paradigm indicates that trade is often invoiced not in the domestic currency but in a dominant foreign currency, typically the US dollar. In Nepal, approximately fifty percent of

imports and thirty percent of exports are invoiced in US dollars. This phenomenon is not confined to trade with the United States, but applies broadly across trading partners. As a result, depreciation of the Nepali rupee does not automatically translate into lower foreign prices and has no impact on foreign demand for domestic goods. Nevertheless, domestic firms may experience higher nominal profits, encouraging new market entrants and exploration of additional export destinations. While this may increase export volumes, it does not necessarily enhance competitiveness in the conventional sense.

The limitations of exchange rate policy are compounded by structural and supply-side constraints. High costs of doing business, political instability, and limited access to finance hinder firms' ability to respond effectively to exchange rate adjustments. Furthermore, the manufacturing sector accounts for only one-third of total value added, with the remainder relying heavily on imported intermediate goods. Currency depreciation increases the cost of these inputs, offsetting potential gains in export competitiveness. The macroeconomic and structural environment, therefore, significantly constrains the capacity of exchange rate movements to deliver the anticipated benefits.

* The text is an abridged and translated version of the October 2025 edition of Sambaad @ Samriddhi. Sambaad @ Samriddhi is a monthly discussion on contemporary issues held on the third Friday of each month. In this edition of Sambaad@Samriddhi, Mr. Abyaya Neopane shares his insights on the key factors that shape Nepal's trade competitiveness, highlighting domestic and external factors, firm dynamics, and institutional capacity that influence export performance. This discussion was moderated by Ashesh Shrestha.

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At the micro level, the behavior of individual firms further illustrates the precarious nature of exports. Even in developed economies like Australia, in any given year, roughly one-third of exporters are first-time participants, and approximately sixty percent of these exit the market within their first year. Such volatility raises important questions regarding the design of export incentives. For instance, in Nepal, the Cash Incentive Scheme for Exports (CISE) is intended to encourage exports to destinations other than India. However, the program operates on a first-come, first-serve basis, often privileging firms with greater administrative access or political connections and creating opportunities for rent-seeking. This calls for a more precise targeting of interventions.

To inform such targeting, I recommend applying machine learning techniques to identify promising exporters using their ex-ante characteristics. My analysis of exporters' characteristics revealed several significant determinants. The number of products a firm offers, which reflects operational

ecosystem.

These findings suggest that policy support should be directed toward marginal firms, where the potential for improvement is greatest. Larger firms may benefit less from additional interventions. Such an approach could enhance the effectiveness of both export incentives and broader government programs, including the Ministry of Finance's start-up fund, which is still in the process of determining allocation strategies.

The broader evidence reinforces these insights. A research published in the European Economic Review indicates that while CISE has expanded export destinations, it has not significantly improved survival rates. This suggests that reaching new markets does not necessarily equate to sustained export performance.

Export strategy must also consider sector-specific opportunities. For example, Nepal presents a substantial market for affordable medicines. While countries such as Australia have similar population



productivity, is positively associated with survival. Market destination choice is another critical factor: firms typically begin with a single, manageable market and expand based on expected profits. Firm size also matters, with larger firms better able to withstand shocks. Network effects are observable: the presence of compatriot firms in a primary export market can facilitate entry and performance. Intellectual property rights and intangible assets contribute meaningfully to firm success. Notably, labor skill appears to be country-specific rather than firm-specific, functioning as an endowment that underpins the broader export

sizes, higher income levels make their domestic markets larger. In Nepal, production of essential medicines could meet local demand while enabling export of surplus. Policy design should consider such market realities. Similarly, higher tariffs in other countries can create opportunities for Nepali exporters. Historical examples, such as trade measures imposed by the United States on India, highlight the potential for Nepal to benefit, though structural constraints and supply-side limitations often prevent such gains from being realized.

Competitiveness in global markets is influenced

not only by relative costs but also by product quality. Firms in developed economies often receive subsidies that enable them to capitalize on price sensitivity, whereas firms in developing economies face structural disadvantages. For instance, US agricultural subsidies have negatively impacted Jamaica's exports. Trade literature reflects this complexity, acknowledging that simple prescriptions often fail to capture the nuanced effects of policy interventions. In some cases, negotiation capabilities may matter more than inherent competitiveness.

Intangible capital is another determinant of export performance. Industries with higher endowments of intangible assets tend to export more. Nepal could leverage this potential, particularly in sectors such as information technology, where intangible capital, geographic factors, and skilled labor converge to create competitive advantages.

Regarding subsidies, existing studies indicate that they can have mixed outcomes. While firms may experience modest gains in profit and employee compensation, domestic consumers may bear higher costs if subsidized goods are priced at export levels, as observed in the pashmina sector. Export promotion programs vary significantly in design and purpose: grants in some contexts aim to address informational asymmetries rather than provide direct financial support. The efficacy of such interventions is therefore context-dependent.

Institutional quality remains central to policy effectiveness. Without secure property rights and credible enforcement mechanisms, subsidies and grants are unlikely to achieve intended outcomes. In Nepal, weak enforcement reduces both compliance and entrepreneurial confidence. Incidents such as the vandalism at Bhat-Bhateni illustrate the limited deterrence present in the system, a phenomenon that extends to multiple sectors, including healthcare. Strengthening institutions is thus essential to foster confidence, incentivize investment, and support sustainable economic activity.

Remittance, a cornerstone of Nepal's economy, warrants particular attention. It sustains household incomes, enables investment in

education and health, and provides a financial cushion that facilitates risk-taking. I analyzed its impact on fiscal outcomes, focusing on indirect tax revenue. Remittance inflows are pro-cyclical relative to economic conditions in host countries: they increase during booms and decline during recessions. Short-term deviations influence indirect tax revenue by approximately two percent. In contrast, remittance's impact on GDP in the short term is limited, though longer-term effects may be more substantial.

Indirect tax revenue patterns closely follow import activity, given that a large share of consumption financed by remittance is import-based. Consequently, much of the economic benefit of remittance leaks out of the domestic economy, with only two to three percent contributing to capital formation. In comparison, domestic production exerts a more sustained influence on GDP and fiscal revenues. Remittance use for loan repayment, health, and education supports household stability and entrepreneurial behavior, but these effects manifest over longer periods.

The exchange rate regime further shapes these dynamics. Nepal's pegged currency may limit competitiveness in theory, yet it provides stability and mitigates balance-of-payments risks. Floating the currency in a context of shallow forex markets could induce volatility, given the sensitivity of large transactions in exports, imports, or remittance flows.

In summary, Nepal's economic strategy requires a shift from broad, blanket policies to targeted, evidence-based interventions. Policy should leverage analytical tools to identify high-potential firms, strengthen institutions to ensure enforcement and property rights, and emphasize domestic production alongside remittance. Sustainability and competitiveness will emerge not solely from currency policy, subsidies, or external shocks, but from an ecosystem in which firms can operate efficiently, innovate, and trust the institutional framework that governs them.

