

# Nepal as a Transit State: Emerging Possibilities

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## Background

His Majesty King Gyanendra Bir Bikram Shah Dev has recently proposed landlocked Nepal as a transit point between two mega-states of Asia--China and India. Addressing the Jakarta's Afro-Asian Summit on April 22, 2005 and second South-South Summit held in Doha on June 15, he expressed the nation's willingness to extend all possible assistance to further this process hoping that it will substantially contribute to transform the region into an engine of viable economic growth. On September 15, King Gyanendra further added, "The concept of building an electric railway linking Birgunj to Kathmandu and Kathmandu to Tatopani should be brought into implementation for developing Nepal as a transit point between the two neighboring countries." Both China and India have been the fastest-growing large economies in the world. The animal spirits of capitalism, long suppressed by planned economy, have been fully unleashed. Nepal is also expecting to get considerable benefit from the growing economic clout of the neighbors.

Predominantly mountainous topographical features, steep rivers and long scratches of thinly populated hills and mountains of Nepal have posed formidable problems in the development of transportation. Only the southern plain, Terai, is flat and fertile land and well connected by roads, communications and circulation of goods and services. Opening of Trans-Himalayan railway from India to China via Nepal would be beneficial to all the countries and open up opportunities for long-term economic cooperation and peace. It will also modernize Nepal's northern region and help to achieve territorial and market integration. Additionally, it would contribute to the development of regional and growth poles. Harmony of economic interests fosters mutual benefits and bears positive impacts for peace. Can landlocked Nepal resume its historical role of a transit country between China and South Asia? What are its possibilities? What cost does it entail?

This paper analyzes brief trade history of Nepal, concept of transit state, international law and the transit rights of landlocked states, diversification of transport linkages, regional treaties and agreements, benefits and costs for the transit state. At the end, it develops a short conclusion.

## Brief History

Historically, Nepal had pro-actively encouraged *entrepôt* trade between Tibet and India and promoted self-reliant economy and political independence. Kathmandu Valley served as an urban economy and society which produced metal works, clothes and small industrial production and traded these products between Tibet and India. Kautilay's

Arthashastra states that during the rule of Kirats people of Nepal used to sell wool, herbs and handicrafts to several Indian markets. This trade was expanded during Malla period as they specialized in activities such as arts, painting, metal casting, gem cutting, wood and bronze carving, sculpture etc and exported to Tibet and India. Trade and other relationships were suspended between 618-907 A.D. and resumed from Yuan dynasty (1271-1368). Arniko help to expand cultural developments across the East and Southeast Asia. King of Kathmandu Pratap Malla and the King of Gorkha Ram Shah, tried to spread their influence in Tibet. In 1625-30 Ram Shah twice tried to expand influence in Tibet. His second effort was successful and reached to Kukurghat. He controlled Kerung for a short time. Then Pratap Malla around 1645-50 crossed over Kuti and reached to Xigaze in the leadership of Bhim Malla. A treaty between Tibet and Nepal was signed whose provisions were:

- Tibet and Nepal established joint authority in boarder trade in Kuti and Kerung.
- Nepal had comparatively more authority than Tibet.
- Kathmandu's traders were allowed to open 32 houses (Kothi) in Lahsa.
- Nepal was not obliged to pay tax to Tibet.
- There should be a leader in Lahsa to take care of Neplease.
- Nepalese should not pay tax to Tibetans while buying and selling goods.
- Tibet should hand over 1 tola gold, 3 masa silver, 1 pathi salt to king Pratap Malla.
- Nepal got the right to mint money with the king's picture and Tibet will return it by paying price on gold and silver.
- Tibet agreed to trade with Sikkim or Bhutan via Kathmandu.
- The property of dead Nepalese in Tibet should be return to Nepal. (Bhattra, 163)

Later king Ranajit Malla supplied mixed silver coin throughout Tibet to gain considerable benefit. This created the possibility of friction between the two countries. Again in 1775 Nepal and Tibet made a treaty to close eastern route way and used Kuti and Kerung including a number of other small routes. War between Tibet and Nepal had occurred due to various causes but were amicably settled. The land-locked geography isolated Nepal from the center of world flows of goods, people and ideas and increased costs for trade and commerce. Before the unification of several principalities into a modern state, Nepal was geographically isolated from the international social, political and economic developments. Prithivi Narayan Shah (1743-75) established the first modern state and began its internal consolidation. "The Alaichi Kothi in Patna, India, which was established during Mukhtiyar Bhim Sen Thapa's premiership, was geared towards promoting Nepal's trading interests" (Pandey, 2005: Preface). The Anglo-Gurkha war of 1814-16 removed Nepalese control over some areas of the Terai, marked the start of British efforts to liberalize trade and especially allowed the East-India Company easier access to the north-south trade from Tibet (Blaikie, Cameron and Seddon, 1982:30). The Rana regime imposed after the Kot Massacre of 1846 by Jung Bahadur Rana ended elite rivalry for power and established hereditary succession of Prime Minister's position. "Prime Minister Jung Bahadur Rana was instrumental in getting a bilateral agreement popularly known as the Treaty of Thapathali signed between Nepal and Tibet in 1856. The agreement, envisaged the stationing of a Nepalese Bhardar or Vakil (envoy) in Lhasa

while Nepalese trade agencies were established at Kuti (Nyalam), Kyerong, Shigatse and Gyanze” (Pandey, 2005: Preface).

In the latter part, a trade treaty was signed with British India on December 1923 which allowed unrestricted import of British goods to Nepal. The Rana regime had established Development Board to promote economic activities. Trans-Himalayan trade routes continued for the people of northern border while Terai was modernizing itself due to the spillover effects of economic development taking place in India. The movement for the establishment of multi-party democracy in Nepal in the latter part of 1940s marked a break with the feudal past. In 1950, Nepal joined the democratic community of nations. But in the 1950s, political rivalry among various interest groups of society and chronic political instability remained strong. “The emergence of middle class, independent of connections with either foreign nationalities or the Rana regime, had not occurred” (Karan and Ishii, 1996:2) in Nepal to serve as a backbone of democracy and economic development.

During 1960-1990 Nepal adopted state-led industrialization and import substitution oriented economic policies. Nepal had a small entrepreneurs, poor transportation and education, communication was undeveloped and traditional social structure of caste dominated attitude towards rational social change. The country’s diplomatic opening towards the outside world started very lately. One can find a connection between Nepal’s landlocked ness and least developed status. The least developed status of Nepal is largely characterized by poverty, inequality, poor productivity of workforce and heavy dependence on few commodities in its structure of trade. Despite nearly sixty years of planned development, Nepal is predominantly an agricultural country and agriculture sustains the livelihoods of majority of population.

Industrialization is at incipient stage and bulk of the income comes from the export of commodities. Effective co-operation of Nepal with neighboring countries and international community is, therefore, important to overcome its development problems and expand access to regional and international markets. The “Treaty of 1923 between Nepal and British- India led Nepal’s trade to be India-oriented” (NPC, 1983, 29). This policies continued until recently. Landlocked situation, Peace and Friendship and Trade and Commerce Treaties with India (1950), open door policy for Nepalese workers and vital trade links to the outside world through India strongly influence Nepal’s development policies and strategies. Still, reducing the costs of transit is a major policy challenge for Nepal to become competitive in the world economy and realize the goal of economic and diplomatic diversifications. The new economic policy of finance and service has weakened the base of traditional manufacturing that was the base of its industrial development.

### **The Concept of Transit State**

Transit state entails a country whose functional transaction crosses the frontiers of two countries. The development of a transit state implies the conveyance of people or goods

from one country to another, especially on a local public transportation system. Recently, the government of Nepal has constituted a committee to give concrete manifestation to make Nepal a transit country between India and China. Nepal's nearest seaport is Kolkatta in India which is 1,150 kilometers away. Administrative hassles and time-consuming handling of customs often delay in the shipment of goods. Dependence on a single seaport has made Nepal vulnerable to regular interruption of transit and trade. Economic blockade imposed by India in March 1989 is still vivid in the memory of Nepalese business community and people as to how a lack of perennial transit could inflict problems on a small landlocked country. Economic growth, export expansion and the utilization of foreign direct investment (FDI) have generated the demand for transport and communication facilities. Mounting costs of transit and transport have increased the costs for import and export and posed additional barrier for Nepal's development. To realize Nepal's potential for a transit state, development disparity between Kathmandu and the periphery and the urban and rural areas has to be bridged by modern transportation and infrastructure developments.

Nepal's northern neighbor, China, has never been a transit state for Nepal for third country trade and the movement of people and goods. High Himalayas in the north of Nepal pose formidable barriers, Tibet is sparsely populated and the great distances between Nepal and China's industrial heartland cities make trade highly costly. In fact, "China's industrial heartland is on its eastern sea-bound, 5,000 km away by train from Tibet" (Shrestha, 2005:8). Just this year Chinese completed a Sanghai-Lhasa railways line and Chinese authorities are trying to expand this rail lines to other Tibetan towns. There are 28 passes on the Nepal-China border but only 3 of them are open and functional throughout the whole year. This has set critical limitation on Nepal's growing commercial interaction with China. Unless the Chinese develops supermarkets and sound infrastructures in border areas, market integration will not occur very soon. So far, Nepal has not signed any transit agreement with China. China's national goals of sustaining high economic growth rate, reducing regional inequalities and exploiting the rich resources of western region will probably increase imports and exports in the future which will likely to increase the economic activities of Nepal in the northern region.

To expand economic cooperation China-Nepal Non-Governmental Cooperation Forum was set up in 1996. Nepal also serves as a transit country for the Indian and the Chinese trades through land routes. The Raxual-Kathmandu-Khasa road links the three countries. This link road is 390 kilometers. But the Barhabise-Kodari part of northern road is not well enlarged and well maintained. Therefore, it has created barriers in transport during rainy season. If Syaprubesi section of highway, which is 92 kilometer long and links to Rasuwa, is constructed distance will be shortened and there is every possibility that transit importance of Nepal will be significantly increased. The Raxual-Trishuli-Rasuwa (265 kilometers) will be the shortest road connecting Nepal's southern with northern borders. The Chinese are helping to build a 22-kilometer road that links Syprubeshi with the Chinese border and is expected to augment growing cooperation between Nepal and China.

Nepal-India Transit Treaty was signed in 1971. With the signing of this treaty, Nepal Transit and Warehousing Company Limited (NTWC) have been established by the government to provide transit facilities for Nepalese exports and imports to and from abroad. This transit agreement with India is periodically renewed. Nepal has only one dry port at Birgunj. It does not have well-equipped storage facilities. The system of tax and revenue collection is not scientifically managed either. An agreement has recently been signed with India to modernize the custom offices and upgrade other facilities of Biratnagar, Birgunj, Bhairahwa and Nepalgunj. It is equally essential to develop an internet and intranet system to link together industrial and business facilities as a part of efforts to more efficiently manage the transit economy.

To make Nepal transit country, it needs to develop good link roads, transportation and communication and storage facilities and develop good neighborly political understanding with both India and China. The completion of railway line in Lhasa by the Chinese government and its possible extension to Nepal's border together with the wide transport connectivity in the south are going to create convenient north-south transport links. This will also link Nepal to China's industrial cities (Lohani, 2005:3). Nepal Multi-modal Transit and Trade Facilitation Project (NMTTFP) will facilitate Nepal's economic development in the south as this project is aimed at reducing transport costs with the country's imports and exports as well as rationalizing trade and transit procedures in order to improve the efficiency and organization of transit trade documentation and data exchange. The progress report prepared by the Ministry of Industry, Commerce and Supplies in March 2003 articulates the following objectives for the trade facilitation:

- Improve Nepal's transit transport operations,
- Implement trade facilitation measures,
- Modernize transport-related legislation,
- Prepare an express procedure for transit of containerized cargo by rail,
- Establish a MOC based technical team,
- Promote the benefits of the multi-modal transport concept on the Nepal/Kolkatta corridor, and
- Offer standard carrier insurance policies to the road haulage industry. (Pyakuryal, 2005:8).

Bangladesh has also offered Nepal an access to its seaports Chittagong, Khulna and Chalna. Nepal and Bangladesh are separated by a narrow piece of Indian territory of about 15 kilometers in the Southeast. To promote trade between Nepal and Bangladesh, Nepal has been given Radhikapur route and importers and exporters have to liaison with Indian authorities. Bangladesh at the request of Nepal, has constructed an Inland Container Depots (ICDs) at Banglaband. High cost and time-consuming overland transportation across

national borders, distance from major world markets and inadequate transport infrastructure have increase costs to trade transactions of landlocked countries.

## **International Law and the Right of Landlocked States**

In January 1956 when Economic Commission for Asia and Far East (ECAFE) considered the problems of its three landlocked members--Nepal, Afghanistan and Laos, its recommendations specified the “needs” of these countries, not their rights. In October 1964 on the recommendation of United Nations Conference on Trade and Development (UNCTAD) a committee on preparation of a Draft Convention Relating to Transit Trade of Landlocked Countries convened its first conference. It was for the first time an international law-making conference had dealt unequivocally with the question of landlocked countries’ access to the sea. During 1967-82 in the United Nations Third Law of Sea Conference (UNCLOS/III) landlocked states tried to achieve guaranteed rights of free transit to and from the sea and access to the resources of the sea.

Article 125 of the 1982 Convention on the Law of the Sea is framed as follows:

- Landlocked countries shall have the right of access to and from the sea for the purpose of exercising the right provided for this convention including those relating to the freedom of the high sea and the common heritage of mankind. To this end, landlocked states shall enjoy freedom of transit through the territory of transit states by all means of transport.
- The term and modalities for exercising freedom of transit shall be agreed between the landlocked states and the transit state concerned through bilateral, sub-regional or regional agreements.
- Transit states, in the exercise of their full sovereignty over their territory shall have the right to take all measures necessary to ensure that the right and facilities provided for in this part for landlocked states shall be in no way infringe their legitimate interest (Shaw, 1997:416).

Despite these provisions, bilateral negotiation and agreements between Nepal and India govern the implementation of the right of access to and from the sea. Recently, landlocked countries have joined the group of “Small and Vulnerable Economies” of the UN in a bid for improved trade and transit access. The current WTO provisions on “freedom of transit” have aimed to strengthen and operationalize the improved access of landlocked developing countries to world markets through their transit neighbors in the most effective and cost-effective manner. It also said that the transit services should be further liberalized to encourage competition and transit rules and regulations should be simplified, harmonized, streamlined and made transparent. The WTO provisions also provide technical assistance for the capacity building of landlocked states. (UN, 2005:1). At the UN landlocked countries are building solidarity and articulating their collective voices for self-revitalization and enhancement of competitiveness.

## **Diversification of Transport Linkages**

Nepal's trade diversification and promotion of economic diplomacy largely rest on the modernization of link towns, diversification of production structure and easy availability of modern facilities for the entrepreneurs and businesspersons. India needs well-developed trade routes to reach to Lhasa and other industrial towns of China while China also requires the same facilities for developing access to India's major industrial and commercial cities. Modernization of Nepal's roads can serve this purpose and can reduce the cost of transportation. So far, trade and commerce between India and China are largely conducted through sea and air. Both want to expand the structure of trade and use Nepal as a transit country. Nepal is aiming to geographical and commodity-wise diversification of exports. Liberalization of trade involves the removal of trade barriers.

Although China and India are linked through Nathu La pass of Sikkam and has opened this route in 2003 but this route does not seem feasible in terms of cost, technology, topographical and climatic factors. It has been used so far for military supplies as the route is narrow, too risky and snowbound for four months and stands at the height of above 4, 400 meter. Nathu La pass is far from India's major industrial cities. Therefore, India prefers the shortest route Tanakpur-Pithauragarh-Taklakot-Shigatse-Lhasa. But due to controversy in Kalapani territory (Nepal claims exclusive sovereignty over this territory (Shrestha, 2003:338) this project has not been realized. China has, however, accepted King Gynendra's proposal to make Nepal a transit country.

In the long run, Nepal corridor is of great strategic importance to India, as it will allow exporters easy access to the three regional markets of western China-Tibet, Shanghai and Sichuan (Roy, 2005). During Inter-Government Committee (IGC) meeting in Kathmandu on January 29, 2004, India had asked Nepal to provide transit to China for carrying out trade with the northern neighbor through Nepali territory. It also asked Nepal to allow Indian goods carriers to operate in north-south route up to major Nepali cities bordering Tibet. India in its agenda also included earlier unresolved issue of bilateral agreement on trans-border movement of passenger vehicles. Nepali agenda involved various Indian measures, which have been obstructing flow of Nepali goods into Indian market despite the provisions of Nepal-India trade treaty that promised unhindered duty-free market access for Nepali goods except a few in India. Growing improvement in Sino-Indian relations, especially in trade and investments, has hold there is every possibility to realize the proposal of Nepal to become a transit state and serve to enhance the extent of interaction and relations between China and South Asia. Indians view Nepal corridor as a "step towards fulfilling India's ambition to play a central role in Asian trade, investment, energy, security and geopolitics (Roy, 2005).

## **Internal Transport Development**

In order to remain an effective transit state Nepal has to improve its internal transportation, communication, cargo handling, storage facilities, and administration of internal freight movement and service facilities. Communications, central to the smooth flow of traffic, are inadequate in Nepal to manage traffic. Road and rail transport in Nepal's south is better developed than the north. The major towns of Nepal's Tarai are well connected with the bordering towns of India by market, roads, communications and mobility of people. Only one rail line links Janakpur of Nepal to Jayanagar of India. Recently, the Indian government has started a survey to expand this railway link up to Bardibas which will be connected to Kathmandu by a shortest road via Sindhuli. The expansion of new transportation will stimulate production for economic exchange and growth of industrial towns. Financial and trade networks can also foster communications and travel and integrate national economies with the globalize network of manufacturing, capital and technology.

Nepal has better advantage with India as it has multiple entry and exit points. With the north, Kathmandu has just started a regular bus service to Lhasa since May 1, 2005. This has enabled Nepal to forge regular transport and transit links with India and Tibet Autonomous Region of China. What is required soon is the modernization and upgrading of these links. Air transport is also significant in most landlocked countries for foreign trade and commerce. There are also over a dozen international airlines operating regular flight to and from Kathmandu and connecting Nepal with international capitals and facilitating the transportation of goods, services and travel of tourists.

In order to increase Foreign Direct Investment (FDI) the Nepalese government is working to create Economic Processing Zones (EPZ), Export Processing House (EPH) and Export Processing House (EPH). An EPZ has already been created in Birgunj to improve the regular hassles of Kolkatta port. Nepalese government is trying to fully implement Automated System of Custom Data (ASYCUDA) at major custom points and Advanced Cargo Information System (ACIS). To facilitate trade and transport, Ministry of Industry, Commerce and Supplies (MICS) has also set up National Trade and Transport Facilitation Committee (NTTFC) and the Ministry of Foreign Affairs (MOFA) is articulating the need for Nepal's vigorous economic diplomacy by means of developing a cooperative relationship with the private sector. Nepal's economic diplomacy largely rests on the promotion of five fundamental pillars: foreign trade, foreign investment, development cooperation, tourism and foreign employment opportunities (Singh, 2005:54) where Nepal's missions abroad can play catalytic roles. The legendary problem of Nepalese government such as red tape, regulation, inefficient and delay have to be overcome and the government should be reformist to modern challenge of globalization.

## **Regional Treaties and Agreements**

Bilateral, regional and international agreements and treaties can facilitate trade and transit developments of Nepal. A good neighborly relation between Nepal, India and China is,

therefore, important for Nepal to get transit right as well as facilitate them similar benefits from Nepal. Nepal is already a member of World Trade Organization (WTO) and trying to achieve global market integration to increase benefit to its consumers through cheaper import, increased export and possibility of increased foreign direct investments. The Doha Ministerial Meeting of WTO has acknowledged the development dimension of trade. Through South Asian Free Trade Area (SAFTA) and Bangladesh, India, Myanmar, Sri Lanka and Thailand-Economic Cooperation (BIMST-EC), it is trying to develop and guarantee access to a large market and this arrangement is likely to encourage economics of scale.

After Nepal and Bhutan joined BIMST-EC it is now called Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BBIMST-EC). Nepal's membership in this initiative is hoped to boost tourism, cooperation expansion in regional transportation network and energy promotion. This initiative stands as a bridge between two development regions South and South-East Asia. Recently, SAARC countries have agreed to draft agreements on a Limited Multilateral Tax Treaty on Avoidance of Double Taxation and Mutual Administrative Assistance in Customs matters. China has also shown interest to join SAARC. In April 2004, India, China, Nepal and other Asian countries had signed a historic international agreement to complete an Asian Highway network running 140,000 km. Full utilization of this highway would significantly promote regional integration and cooperation. This highway is expected to link major capitals, ports, commercial centers and tourist sites of Asian nations. Upon its completion in 2010, vehicles from Japan can easily ply up to Turkey and Tehran. After the highway is brought into operation, Nepal can become a transit point between India and China.

The vision of Nepal serving as a land bridge for the expansion and diversification of bilateral trade between China and India is of considerable importance from long-term prospect of developing transport and trade links among the countries of north, south and central Asia. As eight landlocked countries, including three central Asian nations, share common borders with China and maintain good economic relations with both China and India, the transit point may become a vital link to the promotion of the trade relations between north, south and central Asian regions. The relation may further result into enlarged economic cooperation in trade, investment, tourism and transportation, and supply of oil and gas pipelines could be well extended from the resourceful central Asian countries to the South Asian region. In fact, both India and China are considering an Asian Economic Community (AEC) comprising Association of Southeast Asian Nations (ASEAN), China, India, Japan and Korea (Roy, 1995). If this vision is realized Asia will become a dominant force in global political economy.

## **Benefits and Costs for the Transit State**

There are a number of tangible and intangible benefits for Nepal. First, Nepal can modernize its southern and northern towns and both the neighbors can help it to develop

dry ports in border areas. Secondly, it might increase the possibility of foreign direct investment and help to expand service sector industries, create job opportunities, strengthen its tax and revenue base, provide huge markets for Nepalese products and eventually contribute to poverty alleviation and sustainable development. The recent meeting of Non-Resident Nepalese (NRN) has shown growing interest bringing resources to cash-strapped Nepal that is struggling to cut a massive budget overspend. They have floated a proposal to establish a Nepal Investment Fund worth US \$ 100 million to be invested in Nepal on various sectors that generates additional employment and expedite industrialization.

It is equally important for Nepal as to how to ensure national security, protect national economy from regional competition and cross-border smuggling of goods and services. The stakes that Nepal holds in China's security interests and China's policy objective objectives in South Asia are high (Han, 2005:4). Because of its security interests in Tibet, Chinese puts Nepal in high profile. So does Indian's where Indian public thinks that there is an organic linkage between Nepal and Indian's security. A serious study of the costs and benefits has yet to be undertaken by Nepal. Nepal has to develop good policies and laws to protect its economy and strengthen its competitive and comparative advantages. The regionalization of economy can contribute to regional dispersal of services, such as banking, accounting and administration. Nepal has to build capacity on these aspects. To be sure, Nepal has to follow the East Asian model of development, with a strong government promoting and regulating economic growth.

## **Conclusion**

Development of landlocked Nepal as a transit country between India and China holds tremendous potential for Nepal's economic prosperity. Both the neighbors have shown keen interest in developing trade, investments and other cooperation through Nepal are territory. But, it requires Nepal to fulfill all the preconditions such as freedom of transit, fuller integration of its economy into the regional and multilateral trading system, encouragement of business competition, modernization of roads, communications, upgrading of warehouse facilities, expansion of dry ports, scientific custom handling procedures, security of vehicles, proper banking etc. Infrastructure developments have to be accompanied with political understanding and market integration in tune with regional and global integration processes envisioned in SAFTA, and WTO. Reducing the costs of transactions is a critical precondition to make trade an engine of economic growth and poverty alleviation.

But, Nepal has to see the welfare and well-being of its people and seek political stability through economic development, expansion of production and trade diversification. Otherwise, it would have to face a series of unavoidable problems such as national debt, mounting budgetary deficit, inflation and financial crisis. To address these, it has to approach major financial institutions for loan which are by no means condition-free. This distorts national priorities and might bear serious long term political

consequences. This means national priority must take precedence over all other economic and political initiative. Poor governance and weak institutions are at the economic and political initiatives. Poor governance and weak institutions are at the root of Nepal's development problems. Now, it is gearing up and brimming with an idea that works. To be sure, turning Nepal into a transit state holds immense hope and feasible prospect for the modernization of Nepalese state, society and economy and the promotion of good neighborhood.

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