

# A COMPARATIVE ASSESSMENT OF INDIA'S AND CHINA'S DEVELOPMENT ASSISTANCE IN NEPAL AND BHUTAN AND ITS STRATEGIC IMPLICATIONS

URMI TAT

Using development diplomacy as a tool of foreign policy came into prominence after the end of World War II when there was much to be rebuilt and redesigned the world over. New alliances had to be forged and a new world order had to be shaped. Economic and development assistance soon embodied the new currency of strategic diplomacy. The realists saw developmental assistance as a tool to promote national interests by creating dominant-dependent relationships. The liberals, on the other hand, saw developmental assistance as a platform to create interdependencies between nations, thereby making hostilities between them undesirable. The developed and the developing nations came up with their own models of economic assistance to capitalise on the interconnectedness of this new world. Each approach displayed a unique motive but also had several convergences. This paper examines India's development approach towards its Himalayan neighbours Nepal and Bhutan, to understand how it has aimed to gain strategic leverage through this method of soft-power diplomacy. This is then contrasted with China's approach in the region.

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Ms. **Urmi Tat** is Research Associate at the Centre for Air Power Studies, New Delhi.

**The realists saw developmental assistance as a tool to promote national interests by creating dominant-dependent relationships. The liberals, on the other hand, saw developmental assistance as a platform to create interdependencies between nations, thereby making hostilities between them undesirable.**

At the onset, there are several questions to explore: What are India's motives in offering development assistance in Nepal and Bhutan? What are the convergences and divergences in the approaches of China and India? What is the potential for these bilateral relationships, looking ahead? Has India been able to develop a distinct model of development assistance in this region? What can be added to India's strategy to further its relations? To answer these questions, the paper first delves into a brief account of the economies of Nepal and Bhutan before examining the historical engagement that both India and China have had with these two countries. It then attempts to highlight the differences in approach between India and China.

### **NEPAL'S ECONOMY: HOW IMPORTANT IS FOREIGN AID?**

Nepal's location shares a distinction of being advantageous and precarious at the same time given that it is sandwiched between the cold peace of its neighbours, India and China. Nepal prides itself in being a nation that has never been colonised, and has historically followed a diversified foreign policy, taking full advantage of its geostrategic location.<sup>1</sup> For instance, even during the Cold War, Nepal received assistance from the US and its allies, as well as from the erstwhile Soviet Union. Declassified US intelligence documents pertaining to the 1960s suggest that then Nepalese Prime Minister, B. P. Koirala, was seeking aid from the US on the pretext that the king, Mahendra Bir Bikram Shah Dev, would lean towards the Soviet

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1. Anil Sidgel, "China's growing footprint in Nepal: Challenges and Opportunities for India", Observer Research Foundation. October 3, 2018, at <https://www.orfonline.org/research/chinas-growing-footprint-in-nepal-challenges-and-opportunities-for-india/>

Union in case Washington failed to step up assistance. Like India, which sought to use its non-alignment policy to benefit economically from both camps during the Cold War, Nepal also deployed its foreign policy for economic gain from all powers. Given Nepal's power asymmetry with India and China today, it is no surprise that it seeks to swing between its neighbours to maintain autonomy.

At the outset, however, it becomes pertinent to examine the trappings of Nepal's current economic situation. How dependent is it on foreign assistance to develop its economy? Where is the major potential for investment in Nepal? How well does Nepal do on global development indicators?

In terms of core components of the economy, just over 51 per cent of Nepal's gross domestic product (GDP) comes from its service sector. Agriculture contributed the second largest amount, while thirteen per cent came from the industrial sector. The majority of the Nepalese population lives in rural areas, and is dependent on agriculture for its livelihood.<sup>2</sup> This implies that the economy is run largely by the primary and tertiary sectors and that the secondary or manufacturing and industrial sector lags behind. However, agricultural productivity is also very low. The low yields result from shortage of fertilisers and improved seed and from the use of inefficient techniques. Since only a tiny percentage of Nepal's cultivated land area is under irrigation, output depends upon the vagaries of the weather. Most industries are small, and have localised operations based on the processing of agricultural products. Labour force is mostly in agriculture (76 per cent), services (18 per cent) and industry (6 per cent).<sup>3</sup>

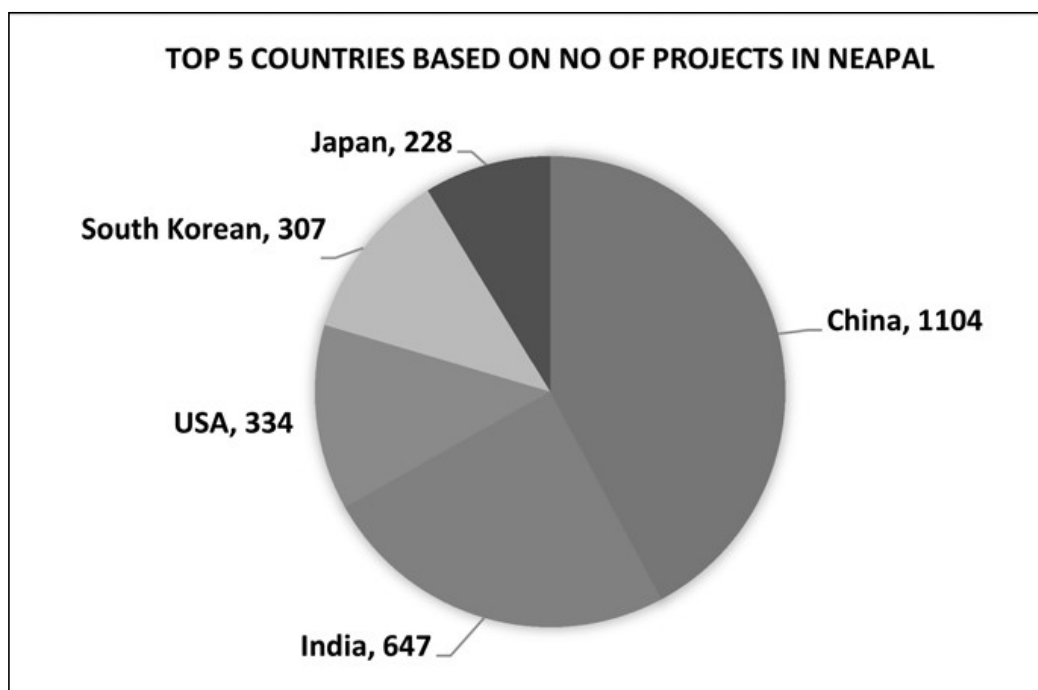
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2. H. Plecher, "Distribution of GDP across economic sectors in Nepal," Statista, at <https://www.statista.com/statistics/425750/nepal-gdp-distribution-across-economic-sectors/>
  3. Ramesh KC, "Nepali Economy, FDI and China", Medium | Business, at <https://medium.com/bizserve/nepali-economy-fdi-china-63a6b7e012c2>

As of 2017 Nepal had a negative trade balance of US\$ 8.75 billion in net imports as compared to their trade balance in 1995 when they still had a negative trade balance of US\$ 262 million in net imports. Growing trade imbalance implies more borrowing to pay off rising costs of imports, creating a difficult environment for local industries and a drain of foreign exchange which could be problematic in times of crises.

Nepal has also been a theatre of economic activity for both India and China, which seek to gain diplomatic leverage with their investments. It is interesting to note that, although Nepal-India ties are historically stronger, China has been able to make quick incursions and initiate several projects in Nepal, even outdoing India. The total amount of foreign investment in Nepal, however, is still favourable to India.

**Fig. 1: FDI in Nepal based on the number of projects initiated<sup>4</sup>**

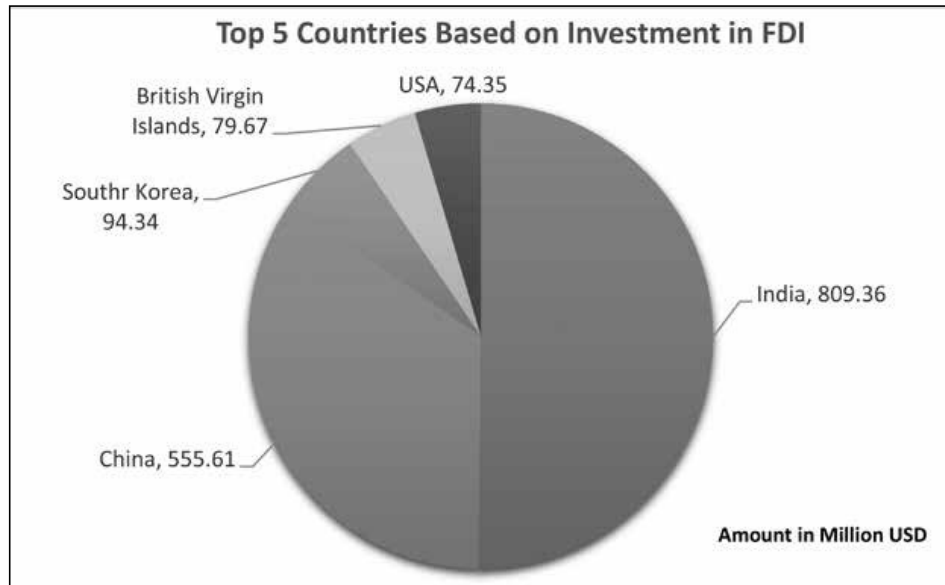


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4. Ibid.



**Fig. 2: FDI in Nepal based on total investments in Nepal<sup>5</sup>**



Connectivity in South Asia is often held ransom to infrastructure and bureaucratic inefficiency and border issues. Transport facilities in Nepal are very limited; few independent nations in the world of comparable size have such little road mileage and so few motor vehicles. Construction of new roads has been undertaken since the 1970s with aid from India, China, Great Britain, and the United States. The meagre road-transport facilities in Nepal are supplemented by only a few railway and air-transport links.

Further, the economy is set to take a hit in the post-COVID scenario. The envisioned growth rate for 2021 is to be 2.4 per cent. The widening fiscal deficit seen above could look to expand even further with the government having to spend more to bail out troubled sectors. It could also mean greater overseas borrowing, thus increasing its debt burden. Post the 2015 earthquake in Nepal, the Himalayan country had seen a new robustness to its economy, with an increase in reconstruction aid, high electricity production, and an increase in big infrastructure projects. However, this pace is set to slow down, due to a loss in revenue via remittances from Nepalis working

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5. Ibid.

abroad<sup>6</sup> and a slowdown in the tourism sector.<sup>7</sup> This may be an opportunity for its neighbours to expand support to Nepal.

In order to better understand the role of development diplomacy to further strategic interest in Nepal, the role of India and China will be looked at from a historical perspective and then compared to bring out points of engagement and contention.

### INDIA AND NEPAL: ECONOMIC ENGAGEMENT OVER THE DECADES

India's engagement with Nepal is fairly unique as there have historically been close people-to-people interactions. For instance, Nepal has many religious sites which are associated with Hindu mythologies like the Ramayana and Mahabharata, as well as Buddhist religious sites. Even in the political realm, there have been instances of members of the Nepalese royal family marrying into Indian royal families. Historically as well, many Nepali leaders have contributed to India's struggle for independence.<sup>8</sup>

However, several thorns have developed in bilateral relations including reluctance to respond to regular border-encroachment complaints, high-structure build-up along the border, inundation complaints, the armed border forces' heated exchanges, trade and transit crises, and embargoes.<sup>9</sup>

Historically, provisions of the 1950 Indo-Nepal Peace and Friendship Treaty (1950 Treaty: Article 5, Letter of Exchange: Article 2, Indo-Nepal Security Cooperation Agreement, 1965: Article 5), constrained Nepal as an

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6. This was responsible for growth in the service sector post-2000s. With many people out of work, the service sector could be affected. The service sector contributes to over 57 per cent of the GDP.

7. Nepal's tourism sector contributes 2.1 per cent to GDP.

8. Jayant Prasad, former Indian Ambassador to Nepal, notes: Many of those who participated in building Nepalese democracy also fought for India's freedom, for which they were jailed by the British. The list included Matrika Koirala, B. P. Koirala and Man Mohan Adhikari, who became Prime Ministers of Nepal.

Jayant Prasad, "A New Template for India-Nepal Ties", *The Hindu*, August 2, 2014, at <http://www.thehindu.com/opinion/lead/a-new-template-for-indianepal-ties/article6272963.ece>

9. One instance of the SSB issue at the border, see <https://thehimalayantimes.com/nepal/nepali-killed-indian-border-security-personnel-open-fire-kanchanpur/>; for the dam build-up and flooding issue, see <https://myrepublica.nagariknetwork.com/news/indian-dams-causing-floods-in-nepal-locals/>; for an example of trade hassle, see <https://thehimalayantimes.com/business/nepali-traders-face-hassles-ginger-export-india/>

ally and made it a state under India's security umbrella.<sup>10</sup> Article 7 of the Treaty states that the Governments of India and Nepal agree to grant, on reciprocal basis, to the nationals of one country in the territories of the other, the same privileges in the matter of participation in trade and commerce and movement.<sup>11</sup> Further, Article 5 grants the Government of Nepal transit rights in terms of import from or through India for commercial items and arms and ammunition.<sup>12</sup> The provision in the treaty for National Treatment has resulted in significant employment opportunities for many citizens coming from Nepal. Approximately six million people from Nepal are working in India.<sup>13</sup> This has resulted in significant remittances to Nepal.

Despite being a seminal document governing relations between the two countries, this Peace and Friendship Treaty of 1950 is now perceived by Nepalese political leadership as outdated and out of sync with modern times since it does not address key economic issues. To address the points of discontent in the treaty, an Eminent Person's Group (EPG) was formed by the two governments in 2014. However, the proposals are yet to be accepted. Thus, there continues to be a shadow on the overarching friendship between the two countries.

Nepal was the first country to receive India's development assistance, in 1951. In 1954, the Indian Aid Mission was initiated, and approximately 75 developmental projects were agreed upon. In 1966, it was rechristened the India Cooperation Mission. India's objective with its aid programme was to supplement the efforts of the local government in sectors like education, health and infrastructure. India has been actively involved in small development projects which focus on infrastructure and capacity building in areas of education, health and community development and are implemented by local bodies in Nepal.

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10. Anil Sigdel, "China's Growing Footprint in Nepal: Challenges and Opportunities for India", Observer Research Foundation. Issue Brief. October 3, 2018, at [https://www.orfonline.org/research/chinas-growing-footprint-in-nepal-challenges-and-opportunities-for-india/#\\_edn8](https://www.orfonline.org/research/chinas-growing-footprint-in-nepal-challenges-and-opportunities-for-india/#_edn8)

11. Treaty of Peace and Friendship between the Government of India and the Government of Nepal, Ministry of External Affairs, Government of India, July 31, 1950, at <http://mea.gov.in/bilateraldocuments.htm?dtl/6295/Treaty+of+Peace+and+Friendship>

12. Ibid.

13. "India-Nepal Relations", Ministry of External Affairs, Government of India, February 2017, at [http://www.mea.gov.in/Portal/ForeignRelation/India\\_Nepal\\_Relations\\_11\\_04\\_2017.pdf](http://www.mea.gov.in/Portal/ForeignRelation/India_Nepal_Relations_11_04_2017.pdf)

**In the telecommunications sector, India provided assistance for laying of the 904-km Optical Fibre cable along the East-West Highway. For connectivity, India had helped in building and upgrading roads from highways to local rural constructions.**

Education initiatives include construction of school and college buildings with state-of-the-art equipment. Health was an expansive sector of investment for India. Apart from providing a regular supply of cheap medicines and equipment, hospitals and trauma centres had also been constructed with Indian assistance. India had even involved itself in combating Iodine Deficiency and Goitre in Nepal, in line with its national programmes.

In the telecommunications sector, India provided assistance for laying of the 904-km Optical Fibre cable along the East-West Highway. For connectivity, India had helped in building and upgrading roads from highways to local rural constructions. India has also been involved in construction of roads along the swampy Terai region of Nepal. Electrification, flood control and drinking water projects have also been undertaken by India even in remote villages of Nepal.

As far as cross-border projects are concerned, Government of India has committed to provide assistance to Government of Nepal for the establishment of Integrated Check-Posts (ICPs) at four major points along the India-Nepal border. These are: Raxaul (India)-Birgunj (Nepal), Sunauli (India)-Bhairahawa (Nepal), Jogbani (India)-Biratnagar (Nepal) and Nepalgunj Road (India)-Nepalgunj (Nepal). Government of India had also agreed to establish cross-border railway links at five locations on the Indo-Nepal border. These are (i) Jaynagar in India to Bardibas in Nepal, (ii) Jogbani in India to Biratnagar in Nepal, (iii) Nautanwa in India to Bhairahawa in Nepal, (iv) Rupaidiha in India to Nepalgunj in Nepal and (v) New Jalpaiguri in India to Kakarbhitta in Nepal.

Cooperation in internal security related areas include developing quality human resources for Nepal Police to achieve organisational and individual objectives with a strong commitment to service.<sup>14</sup>

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14. Embassy of India, Kathmandu, Nepal, "Development Partnership", at <https://www.indembkathmandu.gov.in/page/about-development-partnership/>

In terms of connectivity projects, the Tribhuvan Rajpath is one of the first substantive connectivity projects undertaken by India. The 116-km highway construction was completed within three years in 1956. Although this initiative was welcomed by some scholars in Nepal, it was also seen by many to be of strategic significance to India. India's road-building activity seemed guided by the need to touch economically important areas of Palung, Daman and Thankot.<sup>15</sup> In the early years of Cold War politics, India and the US collaborated on connectivity projects in Nepal. In 1958, the US, India and Nepal signed a regional agreement concerning the development of the transportation facilities.<sup>16</sup> Following the agreement, the three countries decided to create a Regional Transport Organisation (RTO) which stands defunct today. Under the auspices of the RTO, the construction of eight roads was planned.<sup>17</sup> However, the very functioning of the RTO was plagued by numerous design and administrative challenges and this multilateral agreement was terminated in 1963. The US\$ 1 million worth of American road-building equipment that was left behind in Nepal was used in the construction of the Chinese aided Kathmandu-Kodari road later.<sup>18</sup> The collapse of the RTO also meant that India took the lead in constructing some of the roads that were initially planned under the organisation.

The Mahendra Rajmarg (East-West) highway was an important project for rural Nepal, built with Indian assistance. The project began in the early 1960s and ended in the early 1980s. Prior to its construction, people were forced to

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15. Mahendra P. Lama, "Aid in pre-1990 Nepal", *The Kathmandu Post*, March 8, 2017, at <http://kathmandupost.ekantipur.com/printedition/news/2017-03-08/aid-in-pre-1990-nepal.html>

16. "United States Treaties and Other International Agreements", Vol. 14, Part I, Department of State, United States Government, 1964.

17. "Development assistance of India to Nepal from 1952 to 1972", Indian Cooperation Mission Kathmandu, Government of India, March 1972.

18. Christa A. Skerry, Kerry Moran and Kay M. Calavan, "Four Decades of Development. The History of U.S. Assistance to Nepal 1951-1991", United States Agency for International Development (USAID) in Kathmandu, 1991, at [https://pdf.usaid.gov/pdf\\_docs/PNABR755.pdf](https://pdf.usaid.gov/pdf_docs/PNABR755.pdf)

travel through India to reach the east or west of Nepal, due to the presence of densely forested regions. Besides enhancing intra-country connectivity, the highway also accounted for positive changes in demographic, sociological, and economic sectors of development. Various urban centres prospered in areas along the highway that would have otherwise been left relatively unpopulated.

All these connectivity projects mentioned above had a positive socio-economic impact in Nepal. For instance, the 1971 Census report clearly states that the eradication of malaria in the infected districts and the construction of the roads across the Mahabharat Range and the Terai belt to India played an important role in the rehabilitation of people in the Terai and in marketing the production of cereals from the Terai region in the metropolitan city of Kathmandu, as well as in promoting the export of these products to the Indian markets and abroad.<sup>19</sup> The report also goes on to state that the population of eastern Terai “increased by 45 per cent in the intercensal period” (1961-71).<sup>20</sup> There has also been an acknowledgement of an increase in literacy rates in the areas connected by the projects.

Railway connectivity between India and Nepal had been less than satisfactory in the initial years. In the recent past, however, there has been a renewed effort to revive old railway lines and establish new railway lines between India and Nepal. Railway networks between India and Nepal were initiated during the colonial period for the transfer of natural resources. For example, the railway line between Janakpur in Nepal and Jaynagar in Bihar was built in 1937 to carry forest products from Nepal to India.<sup>21</sup> There are currently two lines operating between the countries: these are Jaynagar to Janakpur and Raxaul to Birgunj. There is no rail link to Kathmandu till date, although a railway project between Kathmandu and Raxaul is currently at the pre-feasibility assessment stage. Any improvements to the railway lines or addition of new lines would result in

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19. “The Analysis of the Population Statistics of Nepal, 1971,” Central Bureau of Statistics. Jore Ganesh Press, 1977, p. 29.

20. Ibid.

21. “Nepal’s Colonial-Era Rail Link Slowly Chugs Back to Life”, *The Wire*, June 16, 2017, at <https://thewire.in/147940/nepal-colonial-era-rail-link/>

significant positive impact on the local economy, and increase the number of tourists visiting the temple towns such as Janakpur. While there is renewed emphasis on upgrading and operationalising railway lines between the two countries, such efforts have had to take on multiple challenges, such as land acquisition and compensation for the landowners.

In terms of building railway links, India has a few advantages: first, robust railway infrastructure is in place on the Indian side, specifically in the states of Uttar Pradesh and Bihar. So, any India-Nepal railway project would merely be an extension of existing networks. Second, the geography between the plains of Uttar Pradesh, Bihar and the Terai region of Nepal is relatively friendly. Finally, there is a substantive movement of people already in place. Thus, the financial viability of the railway networks is not a challenge. The objective of these railway projects is to establish greater connectivity between the high-density population centres of the two countries. The Indian Railways Minister noted in 2017 that there would be a need to operationalise the Delhi-Kathmandu and Kolkata-Kathmandu railway lines as well.<sup>22</sup>

India has also played an important role in Nepal's aviation sector. In the early 1950s, the airport in Kathmandu, which was later renamed Tribhuvan airport, was upgraded with Indian support. In fact, the first chartered flight was between Kathmandu and Calcutta in 1950. In 1964, an agreement on air services was signed between India and Nepal.<sup>23</sup> However, in the recent past, the Chinese have also made their presence felt in Nepal's aviation sector by offering soft loans and expertise for three international airports in places such as Pokhara, Lumbini and Janakpur.<sup>24</sup>

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22. Dipanjan Roy Chaudhury, "India proposes direct rail link to Kathmandu from Delhi & Kolkata; mulls cargo train to Bangladesh", *The Economic Times*, February 24, 2017, at <https://economictimes.indiatimes.com/industry/transportation/railways/india-proposes-direct-rail-link-to-kathmandu-from-delhi-kolkata-mulls-cargo-train-to-bangladesh/articleshow/57323387.cms>

23. Agreement between the Government of India and His Majesty's Government of Nepal Relating to Air Services, Ministry of External Affairs, November 26, 1964, at <http://mea.gov.in/bilateral-documents.htm?dtl/6430/Air+Agreement>

24. Mihir Mishra, "India to discuss aviation assistance with Nepal to help build three airports," *Economic Times*, January 10, 2017, at <https://economictimes.indiatimes.com/industry/transportation/airlines/-aviation/india-to-discuss-aviationassistance-with-nepal-to-help-build-three-airports/articleshow/56429373.cms>

Trade and transit between the two countries is governed by the Nepal-India Transit Treaty of 1991.<sup>25</sup> The treaty allows for traffic in transit to be exempt from customs duties and makes a provision for developing warehouses, sheds and open space at the Calcutta port to use for transit trade. In order to facilitate easier movement of goods between the two countries, integrated customs ports (ICP) have been operationalised.<sup>26</sup> The ICP will have several infrastructure facilities such as warehouse, parking lots, etc. These agreements are particularly significant for Nepal since two-thirds of Nepal's total trade is with India only. Not only that, more than 90 per cent of landlocked Nepal's exports and imports transit through its large southern neighbour.

There were several pressure points in this area of transit that were identified in the bilateral relationship over the decades. Primary among them was that Nepal found itself to be reliant on India for its exports, and thus never acquiring the comparative advantage to increase the competitiveness of its own exports. This equation had failed to uplift local enterprises and give impetus to them. Going into the new millennium, there is a new emphasis on self-reliance and freeing itself from over-reliance on India.

Added to this, the lackadaisical implementation of river water treaties has left a bitter taste. Water cooperation between Nepal and India has involved agreements on major rivers like Kosi, Gandaki, Karnali or Mahakali, for large hydroelectric and irrigation projects through building of dams or barrages. However, no project except the Kosi barrage has been completed yet and the smaller rivers have also been ignored. Since 1954, when the Kosi Agreement was signed between India and Nepal, talks between the two governments have stalled and water rights issues have not been addressed.

The water issue had made the bilateral relations bitter even before India's independence. The colonial administration had signed the Sarada Treaty with Nepal in 1920, on the basis of which India constructed the Sarada barrage on Mahakali River after exchanging 4,000 acres of territory. However, people of

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25. "Nepal-India Transit Treaty 1991", Nepal-India Chamber of Commerce and Industry (NICCI), at <http://www.nicci.org/resources/nepal-india-transit1991.php>

26. "Nepal-India joint team inspects ICP Birgunj", *Madheshvani*, October 16, 2017, at <http://www.madheshvani.com/en/details/9492/news>



Nepal considered the treaty being partial to India and became angry over the meagre amount of water allocated to them. After independence, India again pushed Nepal to sign agreements to build Kosi barrage in 1954 and Gandak Barrage in 1959. These India-financed projects in Nepal were increasingly being perceived as a 'sell-out' of the national interest by many in Nepal and has served to be a catalyst for popular opposition to any of India's new projects in Nepal.

Nepal claims that India's handling of the issues involving the Kosi and Gandaki rivers has been far from satisfactory and that the Mahakali agreement has remained in limbo for over two decades. The latter has been delayed due to increasing popular opposition to 'Indian water projects', as well as the failure on India's part to start the Pancheswar dam project under the Mahakali Treaty despite repeated promises.<sup>27</sup> In 2008, the collapse of Kosi's embankment unleashed massive floods, highlighting India's failure to take precautionary measures and its refusal to take responsibility. Further, there have been accounts of widespread resentment towards India's perceived exploitation of Nepal's rich water resources for its own agricultural and energy needs.<sup>28</sup> The 1950 Indo-Nepal treaty of Friendship and Peace established "special relations" between the two countries, but did not set up any overarching principle under which issues like water sharing on transboundary rivers could be worked out.

While the government of Narendra Modi has hit all the right chords in bilateral talks, differences continue on power trade, especially on the issue of pricing of electricity. The perception that Nepal remains India's "client state" will not be helpful to the aims of working towards a higher level of cooperation.

### **THE MILLENNIUM: INDIA'S ENGAGEMENT WITH NEPAL**

Post the year 2000, Nepal continued to receive a huge bulk of India's development assistance and most of it was devoted to connectivity projects

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27. Shawahiq Siddiqi, "India-Nepal Border Plagued by Water Problems", *The Wire*, May 2017, at <https://thewire.in/diplomacy/india-nepal-border-plagued-water-troubles>

28. Ashok Swain, "It is water not China that has ruined Nepal's relations with India", *Outlook India*, April 2018, at <https://www.outlookindia.com/website/story/it-is-water-not-china-that-has-ruined-nepals-relations-with-india/310684>

**A unique initiative of India in Nepal has been the Small Development Projects started in 2003. Through these projects, India hoped to gain a foothold at the grassroots level involvement in Nepal. The project runs on the philosophy of reducing unwarranted overhead costs and ensuring greater stakeholder participation.**

like road, rail and air links. Connectivity projects are crucial since 98 per cent of Nepal's transit trade takes place through India and 65 per cent of Nepal's total trade is with India. So, there is a lot of dependency<sup>29</sup> on India, as far as Nepal's economy is concerned.

A unique initiative of India in Nepal has been the Small Development Projects started in 2003. Through these projects, India hoped to gain a foothold at the grassroots level involvement in Nepal. The project runs on the philosophy of reducing unwarranted overhead costs and ensuring greater stakeholder participation. The SDPs focus on decentralisation by giving a greater role to local bodies in Nepal.<sup>30</sup> The projects under the scheme are implemented

via District Development Committees, which have representation from local officials of the departments concerned, local governments, as well as local community organisations.

In 2004, the total number of SDP projects amounted to 26 and this number expanded to about 510 in 2015.<sup>31</sup> It is interesting to note that the SDP scheme has been scaled up not only in Nepal but has also been extended to other countries in the region. For instance, in 2006, India initiated approximately 50 SDPs in Afghanistan.<sup>32</sup> They are also being implemented in Sri Lanka as part of its development assistance.<sup>33</sup>

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29. Riya Sinha, "The Road from India to Nepal: Development Assistance and Connectivity Projects." Brookings Blog, at <https://www.brookings.edu/2020/04/15/the-road-from-india-to-nepal/>

30. "About Development Partnership", Embassy of India, Kathmandu, Nepal, at <http://www.indianembassy.org.np/>

31. "About Development Partnership", Embassy of India, Kathmandu, Nepal, at <http://www.indianembassy.org.np/>

32. "Third Phase of Small Development Projects (SDP-III) in Afghanistan", Press Information Bureau, Government of India, November 8, 2012, at <http://pib.nic.in/newsite/PrintRelease.aspx?relid=88917>

33. "Visit of External Affairs Minister to Sri Lanka," Ministry of External Affairs, Government of India, February 6, 2016, at <http://www.mea.gov.in/press-releases.htm?dtl/26330/Visit+of+External+Affairs+Minister+to+Sri+Lanka+February+56+2016>

India's efforts to build connectivity networks with Nepal are also happening in larger multilateral frameworks. The South Asian Association for Regional Cooperation (SAARC) framework did not make satisfactory progress in this regard. Regional cooperative efforts resulted in the emergence of platforms, such as the Bangladesh-Bhutan-India-Nepal (BBIN) and the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC), or fora which do not include China. The BBIN Motor Vehicles Agreement (MVA) envisages unhindered movement of vehicles between member countries. There are also proposals to usher in a BIMSTEC MVA as well. A BIMSTEC developmental fund has also been floated to account for the infrastructural needs of the region. These MVAs will make it easy for Nepal to access the Bay of Bengal ports. The emergence of such frameworks indicates growing confidence among the member countries on developing connectivity projects and closer regional cooperation.

**One of the major turning points in India's relationship with Nepal, however, was the 2015 blockade on the Madhesi issue. This ensured that relations took a turn for the worse, and the biggest beneficiary in this tirade was China.**

One of the major turning points in India's relationship with Nepal, however, was the 2015 blockade on the Madhesi issue. This ensured that relations took a turn for the worse, and the biggest beneficiary in this tirade was China. China was able to use this situation to build closer ties with Nepal and parade as an all-weather partner. Here, New Delhi objected to Nepal's new constitution for allegedly discriminating against the Madhesi ethnic people who have close ties to India. Rioting broke out and India imposed an unofficial blockade on imports of fuel and essential supplies at a time when Nepal was already reeling from a recent earthquake. Kathmandu blamed New Delhi for the disruption, and China stepped in with emergency oil supplies. The demonetisation exercise further dented relations between the two countries as Nepal relies greatly on remittances from expatriate workers in India.

In 2016, tensions were on the rise with Nepal's President cancelling his trip to India and with Kathmandu recalling its ambassador. Further, Nepal's Prime Minister K. P. Oli visited Beijing soon after, to sign agreements on trade and transport. China also offered Nepal access to some of its ports, in order to offset India's importance as Nepal's only route to the sea. More recently, the territorial dispute between India and Nepal which resulted from a road construction project to Lipulekh, signals the need for India to tweak its strategy towards Nepal in order to prevent it from drawing closer to China.

India has increased its share in financial aid to Nepal by 73 per cent from Rs. 375 crore in 2017-2018 to 650 crore for the year 2018-2019.<sup>34</sup> Nepal's share in India's total financial aid was 12 per cent in 2017-2018, which stepped up to 18 per cent in 2018-2019. In the new millennium, India increased aid to Nepal to counter China's vigorous efforts to build up infrastructure projects in its neighbourhood. In this regard, India's parliamentary committee's report clearly spelt out, "China is making serious headway in infrastructure projects in our neighbourhood. Specifying the strategy devised to counter increasing Chinese presence in our backyard, the government is committed to advancing its development partnership with [Bhutan and] Nepal, as per their priorities."<sup>35</sup>

## CHINA AND NEPAL'S ECONOMIC ENGAGEMENT OVER THE DECADES

Nepal's mandate for a pro-China Prime Minister in Oli reflects that this sentiment may run deep. China, on the other hand, is clear on leveraging its economic diplomacy in the region and considers it foundational to its foreign policy.<sup>36</sup> Over 63 years, since the establishment of diplomatic relations between the two countries, economic cooperation, though significant, has

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34. Roshan, "India's aid to Nepal up 73% to check China's infra push," *The Times of India*, March 21, 2018.

35. "India's Financial aid to Nepal up by 73%," *Nepal Foreign Affairs*, March 2018, at <http://nepalforeignaffairs.com/indias-financial-aid-to-nepal-up-73-bhutan-first-nepal-second/>

36. Shawn Ho and Benjamin Ho, "After China's 19th Party Congress—implications for the regional architecture and order," Center for Strategic and International Studies, 2017, at <https://www.csis.org/analysis/pacnet-82-after-chinas-19th-party-congress-%E2%80%93-implications-regional-architecture-and-order>, accessed on July 16, 2018.

gained rapid traction in recent times. In ancient times, economic diplomacy started off as local trade between Tibet and Kathmandu. The first agreement on economic cooperation was the 1956 Agreement on Economic Aid. An Inter-Governmental Economic and Trade Committee (IGETC) was established in 1982 to facilitate trade and investments and became a forum for discussions on economic and technical cooperation. The Nepal-China Chamber of Commerce and Industry (NCCCI) founded in 1999, also promotes engagement between companies and entrepreneurs from the two countries.

The 1960s saw tentative relations between the two countries, with Kathmandu choosing to stay neutral in the face of the 1962 War. Nepal continued to walk the tightrope as it simultaneously pressed for China's membership into the UN, while warning against any aggression, albeit from China, in the region during this time. The only notable economic progress in the 1960s was the construction of the Kathmandu-Kodari road which opened for operations in 1967. Although it did not yield much commercial benefits for Nepal at the time due to severe restrictions on movement imposed by China, it was of strategic importance as it established direct links between two major Chinese army bases to forward bases in Tibet.

The 1970s and the emergence of a strong and confident India introduced a new element to this triad, where Nepal would be able to play off one party against the other in anticipation of a better agreement. However, the 1989 decision by King Birendra to consider an arms purchase from China, had invited a crippling blockade from India. According to India, these negotiations contravened an earlier agreement under which Nepal was to procure all its defence supplies from India.

In 2009, Nepal and China established 'China-Nepal Comprehensive Cooperative Partnership', to heighten bilateral relations. This Partnership led to more frequent engagements between the bureaucracies of the two countries.

Chinese aid to Nepal started as early as 1956, with Nepal being one of the top five countries to receive aid from China in the years spanning

1956-1973,<sup>37</sup> in terms of disbursement. Other countries in the mix included Pakistan, Indonesia, Sri Lanka and South Yemen. A significant aspect in the aid disbursement during this time is the composition of the aid basket. Of the total Chinese aid received, Nepal received the largest share in grants, over and above Pakistan. This can be seen in the Table below:

**Table 1: Aid disbursement by China in South Asia for the years 1956-1973<sup>38</sup>**  
China's Grants as percentage of Aid

	Total Aid committed (US\$ mn)	Of which grants (US\$ mn)	Grants as percentage of total Aid
Nepal	98.7	43.7	44
Pakistan	445.7	110.0	25
Sri Lanka	118.0	26.3	22
Burma	92.4	4.2	5
Afghanistan	76.5	7.0	9

Much of the Chinese investment was in construction, budget stabilisation, repair and maintenance of roads and highways, not unlike today.<sup>39</sup> The roads were seen to serve military objectives by providing China more direct access to the Indian border in the event of further hostilities and justified the presence of Chinese workers in Nepal, many of whom were intelligence or propaganda agents or trained soldiers.<sup>40</sup> Future grants in the 1970s and 1980s have been for energy projects like the Seti dam to generate 1,000 kW for irrigation and energy purposes and the Pokhara water conservancy and irrigation projects. Among the unique characteristics of Chinese aid to Nepal has been the large quantities of consumer goods which are sold by government agencies in Nepal, whose proceeds are used to finance Chinese projects when Nepal was unable

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37. In that year, Nepal bagged one-third of China's total aid disbursement. Of the 13 countries in Asia which received Chinese aid during 1956-1973, Nepal ranked fifth. P. K. S Namboodiri, "China's Aid to Nepal in Perspective". Sage, *India Quarterly*, vol. 35, no. 2, (April-June 1979).

38. Ibid.

39. Early projects include Kathmandu-Kodari road, Kathmandu-Pokhara Highway and Pokhara-Surkhet highway, among others.

40. John Franklin Copper, "China's Foreign Aid: An Instrument of Peking's Foreign Policy" (London: Lexington Books, 1976), p. 44.

to meet local costs of aid projects. Chinese aid was also utilised by the Nepali authorities to invite more aid investments from India, the US, and the former Soviet Union.<sup>41</sup>

China's goals in the early 1990s were best outlined in Zhou Enlai's eight principles, which he outlined in his tour of Africa.<sup>42</sup> These were: Economic Aid would be based on the principles of equality and mutual benefit; China would respect the sovereignty of recipient countries and seek no privileges nor attach any conditions; loans must be provided either interest-free or on low interest; aid was not to make recipients dependent on China but to make them self-reliant; aid was to be aimed at projects which require low investment while yielding quicker results; China was to provide best quality equipment and material of its own manufacture at the international market prices; China was to train personnel of recipient countries to acquire full mastery of such techniques; and Chinese technicians to enjoy the same standards of living as their counterparts in recipient countries. Although these goals are merely stated objectives and do not necessarily reflect the ground realities of Chinese Aid, it does go to show how deeply ingrained the Chinese want their aid to be. Money, material, personnel, techniques would all be micromanaged by the Chinese.

An aggressive India forced Nepal to tilt closer to China in the 1970s and by 2004, China had provided more than US\$ 181 million in grants to Nepal and completed around 25 projects. Since then, China's engagements have increased; it has contributed to a host of projects like building the Ring Road, civil service hospitals, optical fibre project, Upper Trishuli 3A Hydropower Station, transmission lines and construction of numerous roads and ports. In terms of the energy sector, China with its strong record of implementing projects, has been able to execute projects like Upper Marsyangdi Hydropower Project, Upper Madi Hydropower Project, among others.

China has been Nepal's largest source of foreign direct investment and second largest trading partner, after India. However, despite China being

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41. B. L. Maheshwari, "Foreign Aid in South Asia" (Unpublished Seminar paper, mimeograph edition), South Asia Studies Centre, University of Rajasthan, 1968, p. 17.

42. Bruce D. Larkin, *China and Africa, 1940-70* (Berkeley: University of California Press, 1971), p. 103.

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**However, despite China being geographically close to Nepal, the tilt in diplomatic relations was more pronounced with the 2015 OBOR Initiative, in which Nepal saw immense gain.**

geographically close to Nepal, the tilt in diplomatic relations was more pronounced with the 2015 OBOR Initiative, in which Nepal saw immense gain.

#### **THE MILLENNIUM: CHINA'S TRYST WITH THE GLOBAL ORDER AND NEPAL**

In 2006 the trade volume between Nepal and China stood at US\$ 268 million, with 36.5 per cent increase over the previous year. The statistic has doubled in recent years though the trade balance is largely tilted towards China. In the fiscal year

2014-2015 the total trade volume between Nepal and China was NRS.101 billion and in fiscal year 2016-2017 it was above NRS.131 billion. Similarly, there has been massive growth in investment from Chinese private as well as state-owned firms. Although India stands ahead of China when it comes to trade volume, the foreign investment sector has been overtaken by the Chinese business firms.

The biggest development on the foreign aid landscape in these years was China's BRI. The BRI is China's Marshall Plan in the region and was initiated in 2013. It involves a combination of a 'belt' of overland corridors and 'road' of maritime shipping lanes. Apart from being an economic corridor, it is also seen as a strategic tool since the ports and transport infrastructure being built could be utilised for both commercial and military purposes. China would be able to influence shipping routes in the Strait of Malacca, Strait of Hormuz, Gulf of Aden, Suez Canal and the Panama Canal as a result of its endeavours. The BRI is also a method of creating economic dependency amongst the countries involved via debt trap diplomacy. The Centre for Global Development has identified 68 countries as potential borrowers of funds under or due to the BRI.



China has often used debt trap diplomacy<sup>43</sup> to gain strategic concessions from the countries enrolled in BRI, in areas related to the territorial disputes in the South China Sea and in buying silence from countries with regard to human rights violations. There has also been a spurt in the number of arbitration cases between Chinese companies and governments and participating entities on the other side,<sup>44</sup> which goes to show that the initiative may not be in the best interests of the eager participants.

**China has often used debt trap diplomacy to gain strategic concessions from the countries enrolled in BRI, in areas related to the territorial disputes in the South China Sea and in buying silence from countries with regard to human rights violations.**

The creation of the Chinese International Development Cooperation Agency (CIDCA) in 2018 under the broader BRI framework, has given a further impetus to development assistance in Nepal. As of March 2019, the CIDCA has offered to take care of the infrastructural needs of the northern districts of Nepal, which border Tibet Autonomous Region. Chinese aid includes direct development support to local bodies in the 15 districts in Northern Nepal to promote health, infrastructure and education in these districts. China's foray into livelihood missions include the development of three North-South corridors in Nepal, namely, Koshi Economic Corridor, Gandaki Economic Corridor and Karnali Economic Corridor in order to create jobs and improve local livelihood, and stimulate economic growth and development. Further, the upgradation of the technical skill set of those working on rail, road, tunnel engineering and shipping projects, has also been promised by the Chinese.

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43. In 2018 alone, eight Belt and Road countries, including Djibouti, Kyrgyzstan, Laos, the Maldives, Mongolia, Montenegro, Pakistan and Tajikistan, expressed their inability to repay their loans as they faced a serious economic crisis due to the debt distress. These countries owe over half of their total foreign debt to China.

44. The number of arbitrations between Chinese companies and parties involved in BRI stepped up from 12 in 2016 to 38 in 2017. The Chinese have made a provision for courts in Beijing on the model of Dubai International Financial Centre Courts and the International Commercial Court in Singapore to settle disputes related to BRI projects. But it is feared that such courts will hardly be independent and so they might go in favour of Chinese firms. Josephine Ma, "Is this just the beginning of 'belt and road' disputes between China and its partners?", *South China Morning Post*, October 12, 2018.

China has gone on to make investments in connectivity beyond railways and transport. In 2018, a fibre optic link was inaugurated and Huawei also concluded a deal to develop a 4G network.

Involvement in the BRI offers Nepal innumerable opportunities to sharpen its domestic infrastructure. The two sides have already concluded trade and transit agreements, and Nepal is eyeing connections with the Chinese market and oil refineries as well as the global supply chain via Chinese ports. Domestic infrastructure projects include the most recently concluded MoU in June 2018 on the “Cooperation in Railway Project”, to develop a cross-border railway line, as well as the older Kathmandu-Pokhara-Lumbini Railway Project. The two countries signed several MoUs, including one on Investment and Cooperation on Production Capacity, another on Human Resource Development Cooperation, and a third on Economic and Technical Cooperation. China has agreed to “take positive measures to facilitate Nepal’s export to China” and support “product development and post-harvest technology in agro-products”. It wants to tap Nepal’s resources such as “construction materials, water conservation and hydropower and organic agriculture and herbs” and cooperate on production capacity by building economic and trade cooperation zones.<sup>45</sup>

The overall economic framework for the projects undertaken in Nepal, has been institutionalised with the Nepal-China Joint Commission on Economy and Trade. Under its aegis the two sides will establish a working group on investment cooperation and a working group on trade led by secretary/vice minister-level officials to facilitate bilateral investment and trade.

In terms of investments in the energy sector, China has been involved in several hydropower projects. Nepal lacks the capital and technology to build large dams and other water projects and also needs a buyer for its hydropower. In 2019, Nepal’s Hydroelectricity Investment and Development Company Ltd. (HIDCL) and Power China have entered a joint venture to build two hydropower projects in Nepal. The projects are the 762 MW Tamor Project and the 157 MW Madikhola Project. In November 2019 Nepal’s Prime

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45. Joint Statement between Nepal and the People’s Republic of China, op. cit.

Minister inaugurated a China-funded 60 MW hydropower project which had started producing electricity recently. Known as the Upper Trishuli 3A Hydropower Project, it was developed by the state-owned Nepal Electricity Authority (NEA), and constructed by China Gezhouba Group Company. During the inauguration of the project, the Prime Minister of Nepal was particular to mention that the project would help reduce electricity import from India and promote industrialisation and modernisation of agriculture by increasing the use of electricity.<sup>46</sup>

While China does not have people-to-people interactions on par with India, it has a long history of deploying overseas assistance to Nepal. Recently proposed Chinese projects such as a railway line connecting Tibet with Kathmandu, will have significant geopolitical and geo-economic implications for India. China has also announced scaling up road networks into Nepal. It has also proposed multilateral frameworks, such as the China-Nepal-India corridor and Trans-Himalayan Developmental Cooperative Framework, wherein Nepal assumes a central and important position. However, the Chinese connectivity projects need to overcome two challenges. Firstly, the economic viability of these projects is contingent on their ability to access the Indian market. Secondly, they will have to be constructed across the Terai region, which enjoys a close sociocultural relationship with India.

China has even made forays into the religious domain, despite Nepal's Hindu majority. It has invested millions into funding universities, temples and even an international airport, in Lumbini, the birthplace of the Buddha. It has even tried to co-opt Tibetan Buddhism in Nepal, as a part of a larger campaign to marginalise Tibetan separatists led by Dalai Lama. Nepal, on its part, has taken reciprocal measures such as banning the country's 20,000 or so Tibetan Buddhists from celebrating the Dalai Lama's birthday in Kathmandu in 2019.

Xi Jinping's visit to Nepal in October 2019 was hailed by many scholars as a new era in Nepal-China relations. On October 12, 2019 the Nepalese

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46. "Nepali prime minister inaugurates China funded hydro project in Nepal". Xinhua, Asia and Pacific, at [http://www.xinhuanet.com/english/2019-11/18/c\\_138564821.htm](http://www.xinhuanet.com/english/2019-11/18/c_138564821.htm)

President and the Chinese Premier announced a new nomenclature for designating intracountry relations. "Nepal-China Comprehensive Partnership of Cooperation Featuring Everlasting Friendship" was to be elevated to "Strategic Partnership of Cooperation Featuring Everlasting Friendship for Development and Prosperity."<sup>47</sup> The strategic partnership has several implications for Nepal's democracy, development and governance. It effectively implies that Nepal is aligning itself with the four-point blueprint brought out by Xi Jinping to integrate each other's security and economic development. The four points highlighted by him in an authored article in Nepali newspapers, prior to his October visit, included deepening strategic communication, broadening practical cooperation, expanding people-to-people exchanges, and enhancing security cooperation.

Ahead of Xi Jinping's visit in October 2019, the popularity of "Xi Jinping thought" amongst the Nepalese bureaucracy was manifest. Officially called "Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era", the doctrine is enshrined in both state and party constitutions, and is seen as Xi's blueprint for a modern China, laying out the roadmap for the next 30 years. This involves goals such as eradicating poverty, building a world-class military and bolstering its markets. In China this thought was mobilised via dissemination through schools, newspapers, television and mobile apps. The influence of China's ideology and form of governance in Kathmandu is hard to miss, with the Prime Minister and bureaucrats frequently making statements in favour of closer ties and attending training programs on Xi Jinping Thought.<sup>48</sup>

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47. Joint Statement between Nepal and PRC, October 2019, at <https://mofa.gov.np/joint-statement-between-nepal-and-the-peoples-republic-of-china-2/>

48. A closer look at "Xi Jinping Thought" shows that at the heart of the political doctrine lies Xi's ambition to bolster his own authority inside China by celebrating nationalism and consolidating power, something that Oli himself did in the last election. Further, China is steadily expanding its footprint in Nepal not only through joint military programmes and by teaching Mandarin in Nepali schools, but also through training and grooming the country's bureaucracy, at <https://www.outlookindia.com/newscroll/nepals-ruling-party-carrying-favour-with-xi-jinping-thought/1627671>

### **FROM ECONOMIC THINKING TO STRATEGIC THINKING: WHERE DO THESE INVESTMENTS FEATURE IN CHINA AND INDIA'S GRAND SCHEME OF THINGS?**

A close examination of the recent status of strategic partnership and the four-point blueprint referenced before, highlight a few indicators to explain the current status of ties between China and Nepal. Among the four points mentioned are strategic communication, practical cooperation, people-to-people exchanges and security cooperation. Strategic communication implies a focus on more high-level exchanges as well as engaging on ideas about governance and development. An intensification of exchanges between the government ministries and departments indicates that China may be interested in shaping Nepal's governance and development process. This would negatively affect Nepal's strategic autonomy at the opportunity cost of greater efficiency.

Practical Cooperation implies hastening the Trans-Himalayan Multi-Dimensional Connectivity Network as well as business investment in four priority cooperation areas of trade and investment, post-disaster reconstruction, energy, and tourism. This is, in effect, a form of development cooperation as vital security components such as ports, roads, railways and aviation come within the framework of the Trans-Himalayan Multi-Dimensional Connectivity Network.

Expanding People-to-People Exchanges in areas like education, youth, tourism appears to be a part of China's long-term soft power strategy to build cultural ties. Tourism is also seen by Nepal as a practical way to relax the trade deficit in the near future.

Enhancing Security Cooperation covers a wide ambit for China in Nepal. It does not merely involve defence cooperation but also involves building law enforcement capacity, including border defence and information exchanges.

These four principles fit in well with the Chinese model of assistance post the Deng Xiaoping era which moved on from the ideological idealism of the Mao model. The former is driven by the need to find markets for manufactured goods from China, exploitation of natural resources and raw materials from abroad, generation of employment for

**One of the recurring issues China has with countries across the world is a trade balance in its favour. Nepal is no exception. Bilateral trade between China and Nepal reached US\$ 1.1 billion while Chinese investments exceeded US\$ 300 million in 2018-2019.**

Chinese nationals, technical cooperation and promotion of Chinese commerce. This is one of the reasons why, in the graph on export destinations of Nepali products, China cuts a sorry picture, as opposed to India. It seeks markets abroad, and not the other way round.

A few points of contention remain in the Nepal-China relationship. One of the recurring issues China has with countries across the world is a trade balance in its favour. Nepal is no exception. Bilateral trade between China and Nepal reached US\$ 1.1 billion while Chinese investments exceeded US\$ 300 million

in 2018-2019. Particularly after enhanced connectivity with China through Rasuwagadhi border, the trade imbalance has only deepened. While imports from the Rasuwagadhi transit have more than doubled in the last year to Rs. 43.24 billion, Nepal's export has dropped 25 per cent to Rs. 1.16 billion. China has tried to assuage Nepal's fears on account of this situation by offering Nepal the chance to sell specialty products by participating in its International Import Export Expo. However, Nepal does not have the infrastructural capacity to scale up its products to bridge the trade deficit. Further, Nepal has also not been able to gain any concessions to promote exports to China. Opening up and enhancing communications further still leaves this problem unaddressed.

China's engagement in Nepal has been outlined as a form of 'security diplomacy', which implies a focus on securing its people and assets on foreign territory.<sup>49</sup> This outlines a priority to Chinese interests on foreign soil and aligns with the previously discussed Chinese model of development.

India, like China, has defined its aid/grant and concessional Line of Credit (LOC) in an altruistic manner as serving 'mutual interests', based on priorities 'defined by the partner'. The importance of aid in Indian diplomacy

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49. Manish Kumar Jha, "Diplomacy: Power Play in Nepal", in *Business World*, December 23, 2019.

was reiterated by the Cabinet Committee on Economic Affairs which states that the LOC is part of diplomatic strategy to promote India's interest and is used to generate goodwill.<sup>50</sup> Indian aid is mostly aimed at its immediate neighbourhood, which is considered as the first circle of its security perimeter and has a direct bearing on its stability. Although it does not explicitly cite democracy as a concern for investment or interference, its aid programme in Nepal has, on certain occasions, involved a strings-attached approach. The 1989 and 2015 blockades are examples of this. Further, India's anxiety about external presence in the neighbourhood has compelled India to identify with certain political parties and regimes. This has not panned out well for India as it has allowed several classes of elites such as the Pahari community to view India as partisan, and thus resort to Nepali nationalism in opposition to dependence on India.<sup>51</sup>

Concerns with India's development diplomacy in Nepal include a poor record of project completion. Although the charge against India not completing the proposed projects is a serious point to ponder, there is also the matter of Nepal delaying certain projects on account of China. Similarly, India completed work on the 34-km Jaynagar (Bihar)-Kurtha (Nepal) rail line in 2018 but it is yet to be operated. The same is the case with many other key connectivity projects initiated by India wherein Nepal has yet to begin acquiring land. A 200-km rail link from Raxaul in India to Nepal's capital Kathmandu proposed by Prime Minister Narendra Modi during his 2019 Nepal visit has proved to be a non-starter. Thus, bureaucratic hurdles on both sides have been responsible for the overall picture.

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50. Press Information Bureau, Government of India, Cabinet Committee on Economic Affairs (CCEA), "Extension of the Indian Development and Economic Assistance Scheme", November 18, 2015, at <http://pib.nic.in/newsite/PrintRelease.aspx?relid=131605>

51. Smruti Pattanaik, "India's Policy Response to China's Investment and Aid to Nepal", *Strategic Analysis*, 43:3, 240-59, DOI: 10.1080/09700161.2019.1616372

Delaying tactics have thwarted key Indian water projects as well—the Budhi Gandaki hydropower project and the proposed Pancheshwar dam on the Mahakali River along the India-Nepal border are among a few. India has been looking to augment its irrigation and drinking water needs as well as develop Nepal's rich river water resources to produce hydropower for its growing economy.

The Indian side is quick to weigh in on its cultural links with Nepal as and when it seeks to gain leverage over China. For instance, to reaffirm the shared cultural heritage between India and Nepal, Narendra Modi was the first Indian prime minister to visit the Sita temple in Janakpur in the Terai region. He also planned a visit to Muktinath in the northern part of Nepal, which is revered by both Hindus and Buddhists. By his gestures of visiting cultural destinations in Nepal's south as well as north, Prime Minister Modi emphasised the depth of cultural linkages between the two nations.

India should take note of the rapid socio-economic changes that are taking place in Nepal and tailor its development assistance accordingly. It is possible that the advantages bestowed by connectivity projects implemented in the early 1960s by India may have started to taper off. Regular project assessments and upgrades need to be carried out on existing infrastructure. India needs to be able to assess its progress regularly in order to bring about sustained change.

There is a need to increase the number of ports for trade and also increase third-country trade options for Nepal to provide greater choice to Nepalese traders and, more importantly, also bring greater efficiencies. The possibility of accessing more ports in India, particularly in the South, requires serious consideration.

The prospect of trilateral cooperation has been explored many times but it remains confined to discussions and meetings and has not been able to see the light of day. During Modi's 2018 visit to Wuhan, China, for an informal summit with President Xi Jinping, both leaders agreed that they should collaborate in third countries such as Afghanistan. Will India and China also collaborate to build connectivity projects in Nepal? It is doubtful



at the moment. In addition to traversing the Himalayas, such collaboration would also have to overcome a mountain of distrust.

## **BHUTAN**

### ***Bhutan's Economy: How Dependent Is It on External Assistance?***

Bhutan, like Nepal, is a landlocked country that has to deal with two powerful neighbours in the form of China and India. However, Bhutan unlike Nepal still continues to be overwhelmingly dependent, both economically and diplomatically, on India. It has not had its share of watershed moments like Nepal, which made the latter lean towards China. Bhutan has also not been adept at playing the two rivals against each other in order to reap dividends. However, fissures among Bhutan's political brass are growing and it is only a matter of time before Bhutan chooses to diversify its markets and allies.

Bhutan's economy is based on agriculture, which employs the highest share of population, and small industries. This is not unlike Nepal, as seen earlier. However, the contribution of the agricultural sector is going down while the employment in the agricultural sector remains high at over 54 per cent.<sup>52</sup> This may imply issues of disguised unemployment.

Its main source of revenue is the sale of electricity to India. The country has a sustained growth due to the development of the hydroelectric sector and the dynamism of the tourism sector. India has even chosen to finance most of Bhutan's hydroelectric power plants, in exchange for power imports.

The biggest indicator of dependence on the Indian economy is that inflation is closely linked to the Indian economy as Bhutan's domestic currency Ngultrum is pegged to the Indian Rupee. Inflation rate remained stable in 2019, at 2.6 per cent, against 2.7 per cent in 2018, but is expected to rise further to 3.5 per cent by 2021 as the rupee loses value against major international currencies and food prices rise in the country.<sup>53</sup>

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52. World Bank Data, at <https://www.worldbank.org/en/country/bhutan/overview#1>

53. Country Risk Analysis, Society Generale. March 2020, at <https://import-export.societegenerale.fr/en/country/bhutan/economy-country-risk>

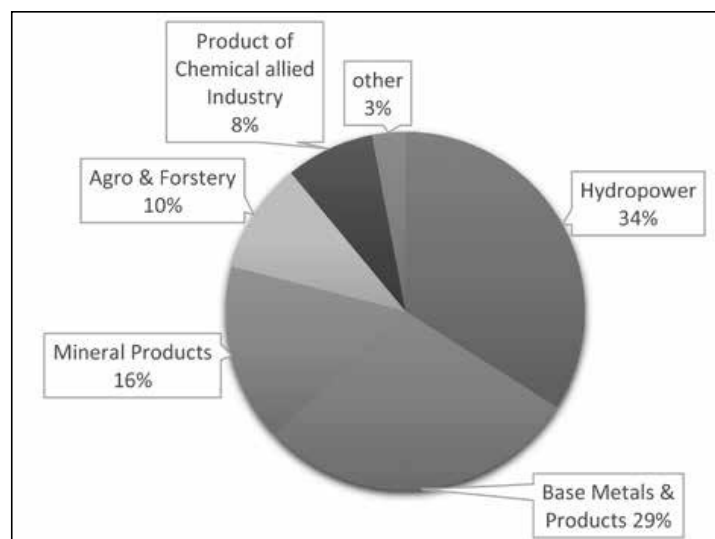
There are several pressure points in the economy. Among them is the absence of a robust private sector. The private sector in Bhutan is in its early stages of development. Its potential to engage in sectors that are currently dominated by the state is yet to be realised with an appropriate regulatory and policy environment. This remains an area for potential investment and engagement for India.

There are also several difficulties when implementing development projects concerning infrastructure in this region which is characterised by steep mountains and deep valleys. The population here has aligned itself in scattered population settlement patterns and thus projects run into difficulties of financial viability.

Further, although Bhutan has shown improvement in several socio-economic indicators such as poverty alleviation and access to piped drinking water and electricity, its staggering youth unemployment rate of 10.6 per cent causes discontent. The overall unemployment is low but high youth unemployment reflects Bhutan's challenge to create more and better jobs. Although India has provided a line of loans and grants, Bhutan is seeking greater investments. It has also been trying to shed its tag as one of the world's least developed countries.

Bhutan's economy continues to be dominated by hydropower and its economic relationship with India. Growth is estimated to have rebounded to 5 per cent in FY2019 after a deceleration to 4.6 per cent in FY2018 due to maintenance and on-boarding delays on two major power plants (Tala and Mangdechhu). This reflects an uncomfortable dependence on hydropower exports to boost its economy.

**Fig 3: Bhutan Export Composition. It reflects an Overwhelming Dependence on Hydropower Exports<sup>54</sup>**



Approximately 90 per cent of Bhutan's imports are from India and the latter is known to be closely involved in Bhutan's economy. For instance, the current account deficit of the last fiscal year was primarily financed through capital inflows from India. Bhutan also has a large and growing trade deficit with India due to its import dependence. India is deeply involved in Bhutan's economy, having made large contributions towards the revenue side of Bhutan's Five-Year Plans, over the years.

Diversification into non-hydropower sectors remains the key challenge to accelerating job creation in non-farm sectors for Bhutan. Maximising the growth potential of the tourism sector could significantly contribute to jobs and income growth, especially among the rural poor and low-skilled. As poverty is almost exclusively rural, efforts to develop agribusinesses and increase agricultural productivity will need to continue, by investing in the downstream value chain. Thus, external assistance would go a long way in expanding the robustness of its economy and keeping up with new demands.

54. Source: Tandin Wangchuk. "Bhutan's Economic Vulnerability: Policy challenges and Recommendations", Regional Capacity Building Workshop, Thimphu, November 2017, at [https://www.unescap.org/sites/default/files/Presentation\\_ESCAP\\_Tandin%20Wangchuk.pdf](https://www.unescap.org/sites/default/files/Presentation_ESCAP_Tandin%20Wangchuk.pdf)

**India is Bhutan's largest development partner and Bhutan is the highest recipient of India's overseas aid. Bhutan received from India a total of US\$ 4.7 billion in grants between 2000 and 2017. The composition basket of development assistance to Bhutan consists of a considerable amount of grants as opposed to loans.**

#### **INDIAN ENGAGEMENT WITH BHUTAN OVER THE YEARS**

The development cooperation between the two countries can be effectively divided into three significant waves.<sup>55</sup> The first wave (1960s-1970s) focused on building the social and physical infrastructure. The second wave (1980s-1990s) saw substantive efforts towards democratisation and decentralisation. The third wave of the relationship (1990s onwards) focused on developing hydel projects, which has now expanded into other areas such as information technology, disaster risk management, education and research cooperation.

India's contribution to Bhutan's socio-economic development began in 1961 with India funding Bhutan's entire first (1961-1966) and second (1967-1972) Five-Year Plans. India is Bhutan's largest development partner and Bhutan is the highest recipient of India's overseas aid. Bhutan received from India a total of US\$ 4.7 billion in grants between 2000 and 2017.

The composition basket of development assistance to Bhutan consists of a considerable amount of grants as opposed to loans. India's share of grants in the 11th Plan period (2013-2018) was 74.54 per cent and the share of the rest of the donors stood at 25.46 per cent. India's share in grants received by Bhutan increased in the latter's democratic transition, while the share of other donors (excluding India) saw a decrease in the same period. Although contributions have seen an increase in absolute terms, there has been a slowdown in the rate of increase in allocations to Bhutan. This is primarily because of India's need to diversify its development assistance, especially to the Indian Ocean states. This has paralleled Bhutan's desire to increase the diversity of its donors as well.

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55. Medha Bisht, "India-Bhutan Relations: From Development Cooperation to Strategic Partnership", 2010, *Strategic Analysis*, 34:3, 350-53.

Bhutan's trade with India is guided by the Agreement on Trade, Transit and Commerce signed in 1972 (and renewed every 10 years since then). India has always been Bhutan's largest trading partner. In 2001, about 94 per cent of Bhutan's exports and 78 per cent of its imports took place with India. In 2018, India's share in Bhutan's exports was 72 per cent, and in imports, 84 per cent.

India is also the biggest source of Bhutan's Foreign Direct Investment (FDI). From 2002, when the Himalayan Kingdom allowed FDI into the country, India had the maximum 51 per cent share in the total FDI in the country. The other major sources of Bhutan's FDI are Singapore and Thailand. Between India and Bhutan, a total of 73 projects have been approved by the end of 2018 out of which 64 have begun commercial operations.

In terms of the commodities of import from India in the period from 2004 to 2018, machinery, mechanical/electrical appliances and equipment, base metals, mineral products inclusive of oils and fuels, transport vehicles, aircraft and engines were key components. Most of these imports were on account of construction of huge hydropower projects. The sectors of investment for India have been road and air transport, revenue support for the five-year plans, hydel power projects, industries, animal husbandry and telecommunications projects. In 1959 India offered to build Bhutan's first motorable road from Phuentsholing near the Indian border to the country's capital Thimphu, a distance of some 175 km.<sup>56</sup> The Border Roads Organisation has also created a network of roads in Bhutan under Project Dantak.

Hydropower has always been the major source of electricity generation in Bhutan. Cooperation with India began in 1988, with the commissioning of the Chukha hydropower plant that was funded with 60 per cent grant and 40 per cent loan assistance at a low interest rate of 5 per cent. Similarly, the

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56. Sukhdev Shah, "Developing Bhutan's Economy: Limited Options, Sensible Choice", *Asian Survey*, no. 8, August 1989, p. 816.

Tala hydropower project and the Kurichhu plant were both built by India in a 60:40 grant to loan ratio. The Punatsangcchu-II and Mangdecchu projects were built with 70:30 loan to grants ratio in 2010, thus gradually increasing Bhutan's debt burden. However, the change in financing pattern was owing to Bhutan's increased capacity for repaying loans through revenues generated by electricity trade. Loans disbursed by India to Bhutan were self-liquidating in nature, i.e., such loans are to be repaid only through revenue earned by electricity exports from Bhutan.

Hydropower is also a source of friction between the two countries. Bhutan exports 70 per cent power to India, forming about 20 per cent of Bhutan's gross domestic product. Although bilateral trade between India and Bhutan is US\$ 516 million, much more than with China—with which Bhutan's trade is just US\$ 10 million—Bhutan's trade deficit with India is over US\$ 150 million. However, even with the prospect of energy cooperation, the terms of the hydropower agreements are seen as unfair by Bhutanese policymakers. Indian engagement, however, faces a significant challenge with the new Bhutanese government's desire to slow down new hydropower projects in order to soften the country's rising debts. India is the largest buyer of Bhutanese hydropower and has significant investments in this sector. Eighty per cent of the projects under construction in Bhutan, are financed by Indian entities. Bhutan is currently contemplating diversifying its energy basket in order to become more self-reliant. India needs to step in and fill the void in energy resources—before China does.

Other irritants in the economic relationship between the two countries include the continuous engagement of India in Bhutan's foreign affairs, which has irked many quarters in Bhutan. The lack of diplomatic ties with China at the behest of India signals an affront to the sovereignty of Bhutan, in the eyes of many people. Further, the lack of relations is also a hindrance to smooth border settlement talks between Bhutan and China.

A recently resolved point of contention in 2007 was the amendment of the 1949 Treaty of Perpetual Peace and Friendship. It did away with Bhutan

being required “to be guided by the advice” of India in the conduct of its foreign policy or seek its “approval” on arms purchases. Thus, the 2007 Treaty of Friendship brought into their relationship an element of equality. It requires both countries to not allow the use of their “territory for activities harmful to the national security and interest of the other”. However, India’s behaviour has at times not been conducive to creating an environment of equality between them. For instance, it withdrew fuel subsidies from Bhutan due to the meeting of Bhutan’s then Prime Minister Jigme Thinley and Wen Jiabao on the sidelines of the Rio+20 Summit. During this meeting, Jigme Thinley expressed the desire to establish diplomatic relations with China, which was echoed by Wen Jiabao.

Bhutan, however, as a gesture of goodwill towards India, has refrained from accepting the package deal that China offered it in 1996 to settle the border dispute. Under this deal, China was reportedly willing to give up claims on Jakurlung and Pasamlung Valleys in north-western Bhutan in exchange for Bhutan relinquishing control over Doklam. Accepting this deal would give Bhutan settled borders. Yet, in deference to India’s security concerns, Thimphu has not accepted this deal as yet.

China’s manoeuvres in the region also include contributing significantly to the tourism sector in Bhutan, which is the country’s second largest economic contributor to Bhutan’s GDP. There has been a significant increase in Chinese tourists in Bhutan over the past decade.<sup>57</sup> The sudden drop in tourists post the Doklam stand-off was a signal to Bhutan on the losses it could incur if it chose the Indian side over the Chinese side.

It is worth noting that despite the lack of diplomatic relations, high-level visits have continued between the two countries. In fact, China has conducted frequent high-level visits to Bhutan after the stand-off over Doklam between China and India in June 2017. In July 2018, Vice Foreign Minister Kong Xuanyou toured Bhutan to push forward the boundary negotiation as well as economic cooperation with Bhutan, followed by Chinese ambassador to India, Luo Zhaohui’s Bhutan trip.

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57. Kashish Kumar, “India Losing its grip of Bhutan?”, *Modern Diplomacy*, South Asia, July 5, 2019, at <https://moderndiplomacy.eu/2019/07/05/india-losing-grip-of-bhutan-china-on-the-edge/>

Although Bhutan has not yet built diplomatic relations with China, it has not taken a hostile attitude towards China. Conversely, Bhutan supported China's efforts of resuming her legal seat in the United Nations and adheres to the One China principle, including on Taiwan, Tibet and Xinjiang issues.

### **CHINESE ENGAGEMENT WITH BHUTAN**

Bhutan remains the only country amongst India's neighbours to not join the BRI. China and Bhutan share 470 km of unfenced borders but do not have official diplomatic relations. Bhutan is proximate to the Siliguri Corridor, a narrow strip of land linking mainland India with its eight north-eastern states, including Arunachal Pradesh, which China claims as "South Tibet".

Bhutan has emerged as the latest beneficiary of Chinese soft power, with China making quiet inroads into it, at India's expense. For long, the traditional irritants in China-Bhutan relations such as the unresolved border dispute between the two, have kept them apart.<sup>58</sup> Chinese shipments have shot up in the past decade, with goods from machinery and cement to electrical appliances and toys being imported, making Beijing the third largest source of foreign products to a heavily import-dependent Bhutan.

Chinese outreach to Bhutan has been through sports, religious and cultural visits, as well as via scholarships to Bhutanese students. Frequent high-level exchanges have also taken place between Chinese and Bhutanese dignitaries.

Public perception has also shifted to a demand for loosening India's stranglehold on Bhutan. The government is also facing pressure from the private sector to establish economic relations with Nepal. Bhutanese experts recently attended seminars in China in fields like security and development of small hydropower. Chinese experts have been visiting Bhutan to identify sectors of cooperation in disaster management and environment conservation audit policy.

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58. The four major areas of dispute between Bhutan and China include Doklam, Gamochen to Batangla, Singhela and Amo Chhu.



China's strategy towards Bhutan in the earlier years had combined aggressive military posturing with diffusing of diplomatic tensions soon after. In 1966 for instance, the Chinese troops entered Doklam and China extended its claim to about 300 square miles of north-eastern Bhutan and to areas north of Punakha. China followed this up with strongly supporting Bhutan's membership of the UN in 1971. Similar incursions were again seen in 1979. What is of strategic importance to China in this region, is the Chumbi Valley. This vital trijunction between Bhutan, India and China is significant as it is hardly 50 km from the Siliguri corridor—the chicken's neck which connects India to North East India and Nepal to Bhutan. The North-Western areas of Bhutan which China wants in exchange for the Central areas lie next to the Chumbi Valley trijunction.

From China's point of view, resuming trade with Bhutan is part of an overall strategy in the Himalayas, which has been framed in the global context of the development of China's western provinces. The resumption of trans-Himalayan trade is a key element of that strategy. Another aspect to be considered in Bhutan's China policy concerns the resumption of religious links between Bhutanese and Tibetan monasteries.<sup>59</sup>

Nevertheless, the most important geopolitical consideration for China in keeping Bhutan engaged, remains India. The approach of Beijing over the last five decades has been to minimise the role and importance of India in Bhutan. By consistently refusing to accept any Indian advocacy for Bhutan coupled with the "pressure tactics of border incursions", the Chinese have brought Bhutan to the negotiation table even though they have been unsuccessful in making deep inroads in it.<sup>60</sup> Thus Bhutan could be important for China in furthering its strategic depth against India's North-East and in restraining the Tibetan issue from spilling over into Bhutan.

China has kept its movements in Bhutan limited. This indicates that China fully takes into account the existing geographical and economic limitations of Bhutan. China realises the extent to which Bhutan can go against

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59. Rajeesh CS, Ashwati CK, "Bhutan's China Policy", *South Asia Journal*, April 19, 2018.

60. J. Mohan Malik (2001). "South Asia in China's Foreign Relations". *Pacifica Review*, 13(1): 73-90, at [http://sga.myweb.uga.edu/readings/sa\\_in\\_chinas\\_fr.pdf](http://sga.myweb.uga.edu/readings/sa_in_chinas_fr.pdf), accessed on April 26, 2020.

**China realises the extent to which Bhutan can go against India, and definitely does not expect it to overwhelmingly lean towards China in the near future. However, it aims at neutralising Bhutan in the wake of any political or military conflict with India and use it as a base to further trade and commerce in Tibet and the rest of South Asia.**

India, and definitely does not expect it to overwhelmingly lean towards China in the near future. However, it aims at neutralising Bhutan in the wake of any political or military conflict with India and use it as a base to further trade and commerce in Tibet and the rest of South Asia. It might expect Bhutan to look up to China as an effective and reliable counterbalance to contain the inevitable Indian domination.

**CONCLUSION: HOW SHOULD INDIA SHAPE ITS FOREIGN POLICY IN THE REGION?**

This appears to be a difficult time in the neighbourhood for India. According to external affairs minister S. Jaishankar, India-China ties are currently in the most difficult phase in the last 30-40 years. The neighbours, Nepal and Bhutan, are caught in the quagmire with constant flare-ups concerning one or the other country. Bhutan has refrained from upsetting its neighbours but has constantly faced pressure from the Chinese to rethink its stance on the BRI and its relationship with China. In October 2020 US satellite imagery showed Chinese construction activity on the Bhutanese side of the disputed border and soon after in November 2020, Bhutan's Satkeng wildlife sanctuary was claimed as 'disputed' by China. On the Nepalese side, relations have witnessed a pro-China tilt with Nepal publishing its map incorporating 300 sq km of Indian territory. Between India and China itself, the Ladakh stand-off seeks to endanger not only political but also economic ties. However, even amidst the diplomatic pressure, long-term engagement must not be forgotten. Economic relationships between countries affect the common man, and he/she stands to lose the most from an inward looking or isolated neighbourhood.

With regard to promoting economic growth, a strategy that the Indian government can develop in Nepal and Bhutan is a 'growth-pole strategy'.<sup>61</sup> The concept implies that growth cannot appear everywhere and at the same time. Governments often spread thin their resources by trying to ensure equitable development. While this can be the strategy for national governments, India can adopt a different approach. Growth becomes manifest in certain areas or poles and this growth, if strong, could propel economic growth through the whole economy. Some regions have economic and demographic advantages which can be propelled through agglomeration. This was evident in the Japanese development strategy in Myanmar. It established the Thilawa Special Economic Zone near Yangon and this automatically improved transport networks between Yangon and Mandalay. Similarly, the Indian government should also consider the possibility of the growth-pole approach when planning its development assistance. Two urban centres can be identified and developed as growth poles, and this might also help to address concerns about regional inequality. This would result in development of connectivity projects being supplemented by development efforts which aim at improving human development indicators and the industrial/service sectors as well. There is a need to explore the possibility of greater convergence between schemes implemented.

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61. Elżbieta Wojnicka-Sycz, "Growth-Pole Theory as a Concept Based on Innovation Activity Development and Knowledge Diffusion", Faculty of Management and Economics, Gdańsk University of Technology, at [https://zie.pg.edu.pl/documents/30328766/30681540/REME\\_6\\_%283-2013%29-Art2.pdf](https://zie.pg.edu.pl/documents/30328766/30681540/REME_6_%283-2013%29-Art2.pdf)

Building a robust business climate between the two countries is important. The possibility of joint ventures (Indian/Nepalese firms), as identified in the 2016 Terai MoU, can be given a renewed emphasis. This also applies in the case of Bhutan. Improving the business climate by greater engagement with Indian companies, especially at the small-scale level, could help improve people-to-people interactions as well.

Increasing capacities of Indian Missions should also be explored. There is a need to increase the technical capabilities at the Indian Embassy in Nepal and Bhutan. For example, the number of civil engineers could be increased to ensure greater quality of monitoring and evaluation. Since Nepal and Bhutan are receiving significant development assistance from India, there is a need to create adequate workforce at the Indian mission.

The COVID-19 situation is a new opportunity for India to make the best use of its soft power diplomacy. The 6th Nepal-India foreign ministers meet is scheduled to take place on January 14, 2021 with Nepal showing a greater inclination towards buying Indian vaccines. This opportunity should not be lost in fostering closer partnerships in healthcare.

China and India's areas of assistance and investment are very similar in the case of both Bhutan and Nepal. However, India enjoys the advantage of longer and more sustained cooperation over decades. Even in unpredictable geopolitical situations, it will be India's strong grassroots operations and people-to-people connections which will prevent tensions from escalating beyond a point. India looks to fight a battle on two fronts: one of competitiveness of economic assistance, and the other the ideological perception war. China's aid giving practices give off the perception of a horizontal partnership and equal power dynamic, though it comes with unmistakable geopolitical ambitions.