Nepal Economic Outlook 2013/14

Summary Report

Institute for Integrated Development Studies (IIDS)

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ABBREVIATIONS

ADB	Asian Development Bank
ADS	Agriculture Development Strategy
AHS	Annual Household Survey
APP	Agriculture Perspective Plan
CA	Constituent Assembly
CANN	Clean Air Network Nepal
CBS	Central Bureau of Statistics
CIA	Central Intelligence Agency
CPI	Consumer Price Index
FAO	Food and Agriculture Organization
FY	Fiscal Year
GDP	Gross Domestic Product
GoN	Government of Nepal
GWh	Giga Watt hour
INPS	Integrated Nepal Power System
KM	Kilometer
KWh	Kilowatt hour
MDG	Millenium Development Goal
MoAD	Ministry of Agriculture Development
MW	Mega Watt
NAC	National Agriculture Census
NEA	Nepal Electricity Authority
NEPSE	Nepal Stock Exchange
NLFS	National Labor Force Survey

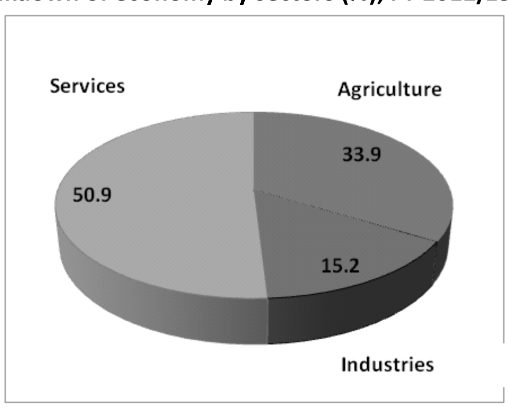
NLSS	National Living Standard Survey
NOC	Nepal Oil Corporation
NRB	Nepal Rastra Bank
NSIC	National Standard Industrial Classification
TIA	Tribhuwan International Airport
WTO	World Trade Organization
WTTC	World Travel and Tourism Council

Nepal Economic Outlook 2013/14

1. Overview of Economy

Nepal is among the poorest and least developed countries in the world. In FY2012/13 Gross Domestic Product (GDP) was US $ 19.1 billion and GDP per capita was US$ 703 (The World Bank). There is wide spread poverty and deprivations. 2013 Human development index score was 0.43 (The Economist Intelligence Unit). Agriculture is the mainstay of the economy, with more than two thirds deriving their livelihood from it. Industrial sector is relatively small. In recent years, foreign employment has emerged as the largest component of services sector and the largest source of foreign reserves. Tourism is a growing industry and a major source of foreign currency. In terms of contribution to GDP, agriculture's share is estimated to be about one third (See Fig. 1). The industrial and services sector account for the remaining two-thirds of total GDP(Central Bureau of Statistics, 2014).

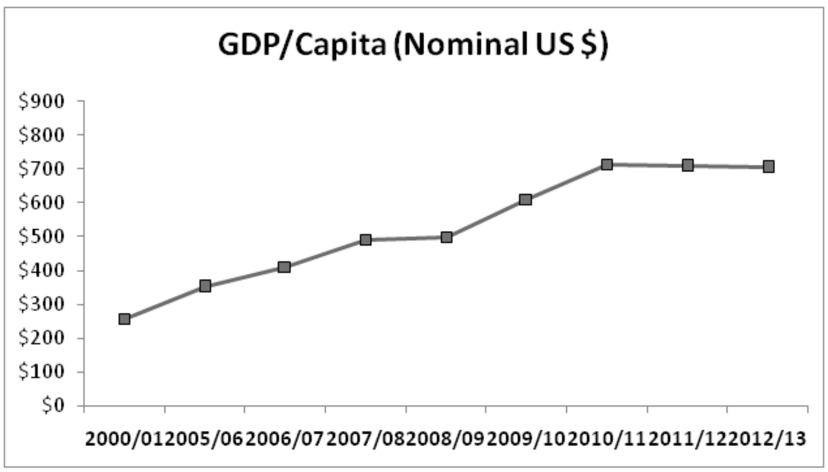
Figure 1: Breakdown of economy by sectors (%), FY 2012/13



Source: CBS, 2014

Nepal's GDP per capita grew from US $ 255 in FY 2000/01 to $350 in FY 2005/06; in FY 2012/13 it had reached US $703. By comparison, GDP rose from $6 billion in FY 2000/01to $9.1 billion in FY 2005/06 to $19.1 billion in FY 2012/13. Thus it can be seen that the growth in economy has been rather slow (Fig. 2).

Figure 2: GDP (Billions) and GDP per capita (US $ in constant prices)



Year	2000/01	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
GDP/Capita	255	350	410	491	497	610	714	707	703
GDP	6.0	9.1	10.3	12.4	12.9	16.0	18.9	19.0	19.1

Source: CBS, 2014

2. Economic Trends

At the start of the new millennium, Nepal was on a progressive growth track started in the 1990's. The political transformation to pluralism in 1990, economic liberalization towards market-friendly economy, and poverty reduction provided the stimulus. Nepal's economic development prospects looked promising, but there were problems looming in the horizon. The Maoist political insurgency was slowly spreading in the country and quota restrictions on world trade was about to be lifted, as part of the World Trade Organization (WTO) trade competitiveness framework being enforced.

Economic performance in 2001/02 compared to 2000/01 was, however, very nominal with only 0.2% growth in GDP. Total exports were much lower than imports in 2001/02 leading to trade disequilibrium of 10.8% of GDP. The total investment in the economy in the form of gross fixed capital was Rs. 85 billion, at constant prices of 2000/01.

2.1 Investment

The investments in the economy improved from about Rs. 85 billion (in terms of gross fixed capital formation) in 2001/02 to about Rs. 122 billion in 2011/12, at constant prices of 2000/01. The total change in investment became negative after 2009/10. There was significant improvement in government investment in 2006/07 after signing comprehensive peace agreement with Maoists, but it fell considerably in 2011/12. Private investment grew at 14.8% in 2003/04 (when the quota restrictions on trade ended), fell -0.6% in the following FY, and recorded significant jump in 2005/06 (at the end of political insurgency). For the next three fiscal years, it either saw very small change or fell. Again in 2009/10 (in the aftermath of first election to Constituent Assembly), private investment rose by 18.5%, then started to fall. The volatility is perhaps explained by political instability in the country.

Table 1: Investment trends (constant price 2000/01)

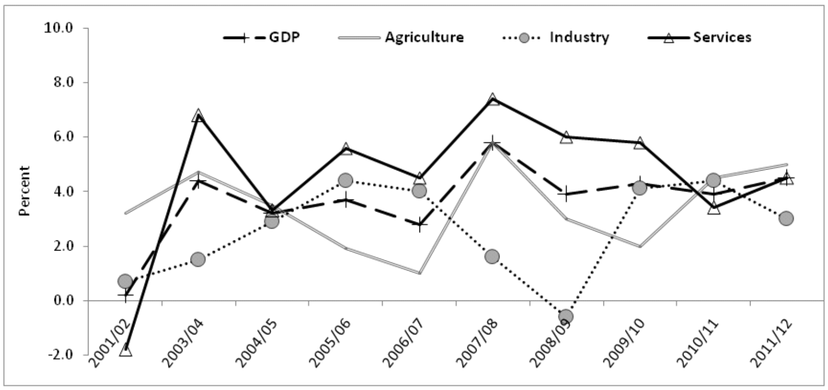
Year	Investment (Million Rs.)	Change%		
		Total	Govt.	Private
2001/02	84,863			
2002/03				
2003/04	90,949	7.2	-24.3	14.8
2004/05	91,427	0.5	7.5	-0.6
2005/06	101,573	11.1	-2.0	13.4
2006/07	106,940	5.3	31.0	1.4
2007/08	108,922	1.9	17.2	-1.1
2008/09	109,459	0.5	10.0	-1.7
2009/10	127,647	16.6	9.3	18.5
2010/11	126,723	-0.7	14.1	-4.2
2011/12	121,978	-3.7	2.8	-5.6

Source: National Accounts of Nepal, 2012/13, CBS

2.2 Economic growth

Nepal's economic growth, measured by change in GDP, was over 4% in FY 2003/04. In the following FYs, the economy grew at rates above 3.2%, except in 2006/07 when it only managed a growth rate of 2.8%. The highest growth rate was achieved in 2007/08 with 5.8% but it could not be sustained. For the next several years, the economy grew at around 4%. The driving force behind the growth was the impressive performance of the services sector, which improved from a negative growth in 2001/02 and remained significant throughout the decade. The agricultural sector growth was inconsistent —with high growth rates in some years followed by dismal growth in other years. Generally, timely monsoon and adequate rainfall results in good harvest and high growth rates. The industrial sector also recorded inconsistent growth over the years, some years posting growth of over 4% while other years recording very small or even negative growth, as in 2008/09. Unfavorable business conditions are responsible for the lackluster performance in some years.

Figure 3: Economic growth Rate (%) by sectors (at constant 2000/01 price)

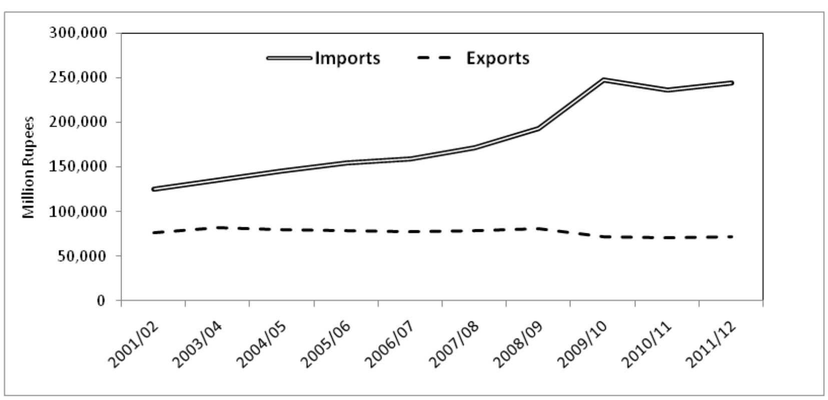


Source: CBS, 2014

2.3 Foreign trade

The trend in total foreign trade (goods and services) is that total exports and total imports are heading in the opposite direction—with exports declining and imports rising over the years.

Figure 4: Imports and exports trend at constant price (Million Rupees)



Source: CBS, 2014

The imports have been growing, which recorded double digits growth in 2008/09 and 2009/10. On the other hand, exports have been falling, except for the positive growth in early years and in 2008/09 (by 3.8%) and 2011/12 (by 1.9%). As a result, disequilibrium in trade increased from 11% of GDP in 2001/02 to 26% in 2011/12(CBS, 2013).

Table 2: Trends in trade and balance of payments at constant prices (Million Rupees)

	Imports			Exports				
	Total	Goods	Services	Total	Goods	Services	Trade Deficit	BoP*
2001/02	124,660	106,025	18,635	76,512	54,440	22,072	-48,148	na
2003/04	135,323	113,725	21,598	81,828	50,469	31,359	-53,495	na
2004/05	144,647	121,307	23,340	79,344	55,343	24,001	-65,303	5,677
2005/06	153,987	128,962	25,025	78,318	54,748	23,570	-75,669	28,992
2006/07	158,523	130,747	27,776	77,578	50,981	26,597	-80,945	10,687
2007/08	171,509	137,795	33,714	78,142	46,470	31,672	-93,367	35,934
2008/09	193,175	157,472	35,703	81,168	46,231	34,937	-112,007	65,150
2009/10	247,762	209,242	38,520	72,695	38,489	34,206	-175,067	-4,357
2010/11	236,156	203,780	32,376	71,158	38,477	32,681	-164,998	5,321
2011/12	244,161	216,413	27,748	72,522	38,083	34,439	-171,639	140,073

* at current prices

Source: National Accounts of Nepal, 2012/13, CBS; BoP: Nepal Rastra Bank

Unlike the trade in goods, the trade in services has remained favorable to Nepal, except for a period from 2005/06 to 2009/10 when imports was higher than the exports. The balance of payments remained positive throughout, except for 2009/10 when imports jumped by 28% that year.

According to Trade and Export Promotion Centre, the four leading import items (in order) were petroleum products, iron & steel and iron steel products, machinery and parts, and motor vehicles and parts in FY 2012/13. The four leading export items for the same FY were woolen carpets, polyester, cotton and other yarns, cardamoms and textiles. The major export items are agricultural products.

2.4 Employment

According to Annual Household Survey (AHS) 2012/13, labor force participation rate is 81.1% and unemployment rate is 3.3% (CBS). Sex wise, female unemployment rate is slightly higher than male: 3.4% vs. 3.2% respectively. Labor underutilization rate, which includes unemployment rate, time related unemployment rate, skills mismatch and inadequate earnings, is 27.8%.

Nepal's current population is estimated to be about 31 million. It was 23.2 million in 2001 and grew to 26.5 million in 2011 (Population Census, 2011). According to AHS 2012/13 data, the share of working age (15-59 years) population is about 57%.

Among people who are employed in 2011, most fall under the category of self-employment in agriculture (61.3%), followed by wage employment in non-agriculture (12.6%), wage employment in agriculture (2.1%) and self-employment in non-agriculture (12.7%) (NLSS, 2011).

Reliable data on unemployment rate in Nepal is very difficult to find. Some sources, like the CIA fact book reports unemployment rate as high as 46% —while the Nepal Labor Force survey puts the number at 3.3% (See Central Bureau of Statistics at (http://cbs.gov.np/wp-content/uplods/2012/02/NLFS-2008%20Report.pdf). Both estimates are way off; the true rate lies somewhere in between. Our own estimate is that unemployment rate is somewhere in the range of 20% - 25%. In absence of reliable data on unemployment rate, one can look at the ratio of the number of the employed to total population to assess the employment situation. That too is not useful in this case, for the reason that about 40% of Nepal's population is under 15 years (NLFS, 2008).

As a predominantly agricultural country with a small manufacturing sector, economic activities and jobs in the non-agricultural sector are limited. Unemployment and underemployment is a major problem, particularly among urban youths. With the expansion of the services sector, educated and skilled are finding jobs in education, banking, and financial and health sector. However, the growth in these sectors is not enough to absorb the number of college graduates each year. Besides, these urban youths are educated and do not go overseas for unskilled jobs—unlike the rural youths going to Gulf countries or to Malaysia. Although foreign employment has grown at a record pace in recent years, it does not address high urban youth unemployment problem.

Furthermore, foreign employment cannot be the long term answer for country's high unemployment rate. Economic growth that increases production and creates jobs should be the answer. So the first priority should be on creating more jobs through expansion of economic activities. To that effort, government should create conditions that stimulate private sector investments. If that approach does not create enough jobs, then the other suggestion is for the government to invest in new infrastructure projects. Our infrastructure—roads and bridges, electricity supply, water supply—is poor and inadequate. In broad terms, there are three benefits from infrastructure projects: (i) it creates lots of construction jobs for unskilled youths, as well as some skilled jobs, (ii) it raises the country's overall productivity promoting future growth, and (iii) improved roads, bridges, and new hydroelectric power plants will address the serious bottlenecks that are hurting Nepal's economy.

3. Sectoral Performance of Economy

3.1 Agriculture

Nepal is an agrarian economy with the agricultural sector contributing 34% of the total GDP in FY 2012/13. In terms of numbers, out of the 5.4 million households, 3.8 million households or about 71% are farming households, according to the National Agriculture Census (NAC, 2011/12). Since the last Agricultural Census 10 years ago, half a million agricultural households have been added. The total agricultural land is about 2.5 million hectares; about 30% of which is irrigated (Pant, 2013). The average size of holdings is down to

0.68 hectare from 0.8 hectare in 2001/02. There were 7.2 million cattle heads in 2012 (MOAD, 2012).

Agriculture is characterized by traditional farming methods, small land holdings and high dependence on monsoon rains for irrigation. Most of the farming households are subsistence farmers who consume what they produce; only 13% of produce is sold in the market (The World Bank). Rice is the main cereal crop; others are wheat, corn, barley and millet. Together, these crops account for about 75% of cultivated area (Pant, 2013).

Table 3: Cereal production (Metric Tons)

Food Crop	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
Rice	428,987	4,209,279	3,680,838	4,299,246	4,523,693	4,023,823	4,460,278	5,072,248
Corn	1,716,042	1,734,417	1,819,925	1,878,648	1,930,669	1,855,184	2,067,522	2,179,414
Wheat	1,442,442	1,394,126	1,515,139	1,572,065	1,343,862	1,556,539	1,745,811	1,846,142
Barley	29,341	27,786	28,293	28,082	23,224	27,587	30,240	34,829.8

Source: Ministry of Agriculture Development, 2012

Besides the cereals, lentils, cardamom, soybean, potato and sugarcane are the other major crops. According to the Food and Agriculture Organization (FAO), Nepal was among the top producers of lentils and ginger in 2012 (Kantipur News, Feb 12, 2014). It ranked as the sixth largest producer of lentils and the third largest producers of ginger. Cardamom, lentils, tea and ginger are also the leading agricultural export items. In FY 2012/13, Nepal exported cardamom worth Rs. 3.8 billion, lentils worth Rs. 2.7 billion, tea worth Rs. 2 billion and ginger valued at around Rs. 1.3 billion (Ministry of Commerce and Supplies, Trade and export Promotion Centre). The other cash crops, potato, sugarcane and oil seeds, go towards domestic consumption rather than for exports. In recent years, there have been some efforts at commercial farming of fruits and vegetables, adopting better and scientific farming techniques, with good results. Newspapers have reported high growth in production of fresh vegetables and some fruits in Nepal, thus displacing some imports from India.

Food security

Food security is defined as "the state in which people at all times have physical, social, and economic access to sufficient and nutritious food that meets their dietary needs for a healthy and active life." (World Food Summit definition). Although an agricultural country, food security is a problem in Nepal. The Economist Intelligence Unit generates food security index of countries by analyzing three core aspects of availability, affordability, and quality and safety. Below is a snapshot of current (2014 first quarter) food security situation in Nepal.

- Nepal's ranked 83 out of 107 countries, with overall score of 34.4. (A higher score indicates higher food security.)
- Prevalence of undernourishment is 18%.
- Intensity of food deprivation is 126/kcal/person/day.

Source: The Economist Intelligence Unit, 2013

Affordability looks at the ability of people to buy food, their vulnerability to price shocks, and presence of government programs and policies to protect people from price shocks. Included in this measure are: total food expenditure as a share of total household expenditure; gross domestic product per capita; proportion of population under the global poverty line; agricultural import tariffs; availability of financing for farmers; and presence of food safety net programs. Among the three core aspects of food security, Nepal's affordability score was the lowest, meaning it is the major issue. High food price is the main reason for low affordability score –high prices make food less affordable. One way to look at this is by comparing food expenses as a fraction of total household expenditure. In 2013, 70.1% of total household expenditure went toward food purchase vs. world average of 38.3%. The comparable figure in the U.S. was in the range of 7-14%. This figure for Nepal is among the highest in the world. As a matter of fact, Nepal was among the three countries (The Democratic Republic of Congo and Cambodia are the other two) in the world where total household spending on food was higher than 70% (The Economist Intelligence Unit, 2013).

Availability looks at whether food supply is sufficient, if there is risk of supply disruption, and the capacity of the country to distribute food as well as research efforts to increase food output. The various measures of availability include (i) sufficiency of supply, (ii) public R&D expenditure on agriculture, (iii) fluctuation in food production, (iv) infrastructure like roads, ports and storage capacity, (v) political instability, and (vi) corruption. The third determinant of food security— quality and safety— looks at measures like diet diversification, nutritional standards, protein quality, micronutrient (iron and vitamin A) availability and food safety.

Nepal faces several challenges in food security. According to Economist Intelligence Unit, these are:

- Food consumption as a share of total household expenditure
- Public expenditure on agricultural research and development (R&D)
- Corruption
- Low gross domestic product per capita
- Diet diversification
- Protein quality

One way to tackle food security problem in Nepal is by raising production, increasing the variety of food items and improving distribution mechanism. This calls for modernization of farming methods and overcoming the problems and challenges in agricultural sector. Since agriculture is the principal source of food, income, and employment for the most people in Nepal, improvement in this sector would have wholesome beneficial impacts for the economy.

Over the years, the Government of Nepal (GoN) has implemented a broad set of policies and strategies to promote agriculture, raise production and improve food security in Nepal. Since 1995, agriculture policies have been guided by the Agriculture Perspective Plan (APP), 1995-2015 which set multiple goals to modernize the sector and promote economic growth: to accelerate agricultural growth through increased factor productivity; alleviate poverty and achieve significant improvements in standard of living; transform subsistence based agriculture to a commercial one through diversification. Because of poor implementation APP goals were not achieved.

In light of the shortcomings of the APP and its failure, the GoN has come up with a new Agriculture Development Strategy (ADS) to deal with the problems and issues in agriculture. The goal of ADS is to transform the agriculture sector in the next 20 years through improvements in productivity and promotion of exports. The vision is to develop competitive and sustainable agriculture that brings economic growth, improved livelihoods and food and nutrition to the people over a period of next 20 years. It aims to address the main challenges and problems in agriculture.

Issue in agriculture sector

a) **Land Use**: Small and fragmented land holdings make large scale operation and commercialization difficult. Similarly, delay in implementation of land use policy has resulted in more of the agriculture land being developed for non-agriculture purposes, e., g., for residential use. The real estate bubble in Nepal, fuelled in part by growth in remittances and credit, accelerated this process. Between 2001/02 and 2011/12, the amount of agricultural land fell by 0.129 million hectares. Some of the families that were displaced during the Maoist conflict have not returned to their home towns; as a results some of the productive land has not been cultivated.

b) **Labor**: The unprecedented growth in foreign employment has led to shortage of workers in agriculture (Shishido, 2011). As a consequence, agricultural production has declined in recent years. Import of food items has gone up, partly attributed to the lack of workers. Even in Terai plains with fertile land, agriculture is becoming increasingly dependent on labor from across the border.

c) **Improved seeds:** Higher yielding and better quality seed is critical in raising yield and productivity. Yet easy availability of better seeds is still a problem in Nepal. There have been cases where farmers have planted what they were told were better quality seeds yet the crops did not produce any grain (Kathmandu Post). Though isolated cases, such anecdotes highlight that access to quality seeds is still a problem for farmers.

d) **Fertilizers**: Timely and adequate supply of fertilizers is another issue that is holding back agriculture production in Nepal. Farmers are not always able to get fertilizers on time for planting season.

In fact, the lack of availability of fertilizers along with delayed monsoon was the primary reason behind drop in cereal crop yields in FY 2012/13.

e) **Credit**: Credit is vital not just for supplementing working capital needs of farmers, but also for smoothing consumption over time. To those without a regular source of income and savings, availability of easy credit at a reasonable cost is very important. Many farmers in Nepal do not have access to credit because banks or other financial institutions are not available in the rural areas. Even where banks are present, getting a loan is cumbersome process. Furthermore, interest rates are high.

f) **Infrastructure**: Lack of irrigation and storage facilities, access to market and lack of distribution channels are some of the major infrastructure-related problems in Nepal. Only about 30% of cultivated land is irrigated; the rest depend on monsoon. The dependence on monsoon rain makes farming unpredictable and raises risk for farmers. Likewise, a lack of roads makes transport of seeds and fertilizers difficult. Once the crops or produce are harvested, poor connectivity to cities or places where there is demand means farmers cannot transport their harvest to markets. So distribution is a big problem. Lack of storage facilities further compounds this problem—seasonal and perishable items either have to be stored in controlled temperatures or sold quickly. Fruits and vegetables in some parts of the country go to waste as they can't reach markets at all or markets in time. One example is the abundance of apples in Jumla that cannot find markets due to poor transport infrastructure.

3.2 Industry

Industrial sector in Nepal is relatively small. The major industrial sectors classified according to Nepal Standard Industrial Classification (NSIC)) are construction, manufacturing, electricity gas and water and mining and quarrying. Added together, they represent about 15.2 % of total GDP in FY 2012/13 (CBS, 2014). Most of the manufacturing industries are small, low-tech operations that process agricultural products, produce construction materials (like cement, iron rods, etc.), manufacture carpets, garments for exports or produce household items.

Table 4 below looks at more detailed breakdown of the economy; it shows the relative contribution of various sectors to Nepal's GDP:

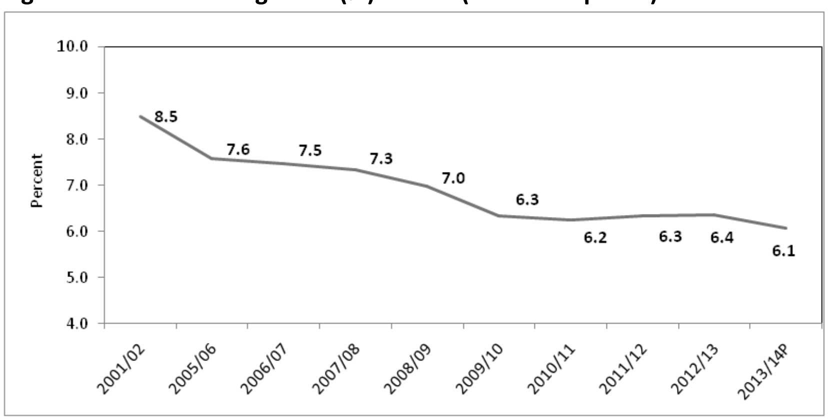
Table 4: Select industrial sectors (NSIC) and share of GDP

Industrial Classification	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14P
Agriculture, forestry & fishing	31.72	32.94	35.38	37.06	35.22	33.87	33.09
Mining and quarrying	0.56	0.54	0.53	0.54	0.57	0.61	0.63
Electricity, gas and water	1.95	1.56	1.36	1.24	1.22	1.29	1.21
Manufacturing	7.34	6.97	6.34	6.24	6.34	6.36	6.08
Construction	6.95	6.79	6.91	6.93	6.86	6.91	6.75
Wholesale and retail	13.51	13.22	14.40	13.90	13.79	14.50	14.95
Transportation, storage and communication	9.86	9.86	8.52	8.20	8.51	8.91	8.74
Financial intermediation	4.30	4.16	4.12	3.88	4.07	3.94	3.76
Real estate, renting and business activities	9.45	8.69	8.38	8.23	8.57	8.78	8.43
Education	6.25	6.67	5.49	5.25	5.69	5.81	6.42
Health and social work	1.41	1.46	1.38	1.32	1.42	1.41	1.48

Source: CBS, 2014. P= projection

Although Nepal's economy is mostly market based, the government has investment in industrial infrastructure and energy projects, in the range of billions of rupees. Private sector investment is centered on manufacturing. In recent years, energy sector has also received much investment from the private sector—perhaps as a result of acute power crisis. Manufacturing has declined in recent years along with the export of manufactured goods. Fig. 5 below shows manufacturing share of GDP in FY 2012/13 was 6.4%, down from 8.5 % in FY 2001/02. This share is projected to decline further in FY 2013/14 to 6.1% (CBS, 2014).

Figure 5: Manufacturing share (%) of GDP (at current prices)



Source: CBS, 2014. P=projection

Although the GoN brought a new industrial policy in 2010 to develop industrial manufacturing sector, this sector continues to suffer. The export of manufactured goods has declined in recent years mainly because of eroding competitiveness. Both internal and external constraints are responsible but the internal constraints are far more "crippling" than the external constraints. The Asian Development Bank (ADB) point out that key to revival of manufacturing is to raise production and supply capacity. In FY 2013, the average capacity utilization of the industries was a dismal 58% (ADB, 2014).

The major constraints undermining the manufacturing sector and its competitiveness, according to the ADB are:

a) Lack of adequate and quality infrastructure,

b) Political instability and strikes,

c) Recurring labor disputes,

d) Lack of skilled human resource,

e) Deficient research and development investment and innovation in the private sector,

f) Policy inconsistency and implementation paralysis.

3.3 Services

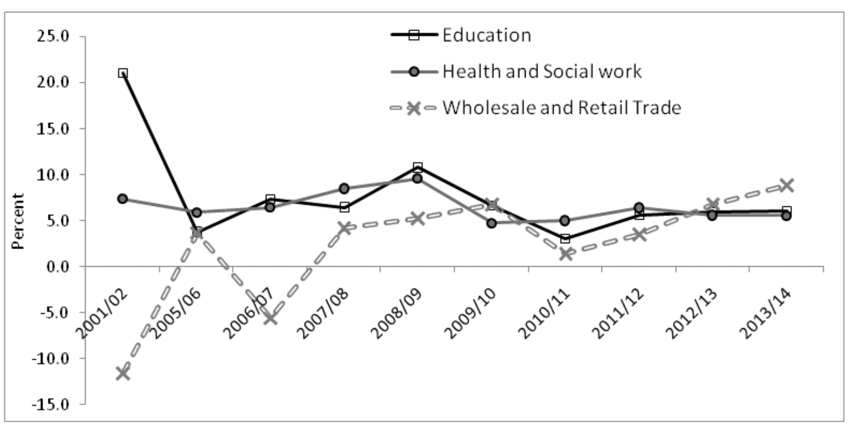
The service sector includes a range of economic activities—foreign employment, tourism, the financial services, engineering, labor, health, education, telecommunications, transportation, wholesale and retail trade and so on. Services have been growing and expanding in Nepal, accounting for about 50% to GDP in 2012. The exact estimates about the share of service sector to the overall economy vary somewhat; but they are around 50% of GDP (CBS, 2014). In fact, service sector is now the largest component of the economy and generates about one half to two thirds of total employment in the economy (Pyakuryal, 2010).

As the service sector has expanded in Nepal, so has the trade in services. Total trade in services rose from Rs. 58,694 million in FY2004/05 to Rs. 125,928 million in FY 2008/09. This increase represents doubling of trade in services over the 5 year period (Pyakuryal, 2010). Nepal's export of services was Rs. 30,375 million in FY2004/05; it grew to Rs. 62,221 million in FY 2008/09 (Pyakuryal, 2010). In contrast to trade in goods and services, Nepal's trade in services has a surplus. Whereas about two thirds of trade in goods is with India, the share of trade in services with India is much smaller.

The various service sectors, mentioned above, have grown over time. Hotels and restaurants have recovered from sluggish period during the days of Maoist conflict. Transportation and support facility remains confined to roads and air based services. One industry that has made great strides in recent times is telecommunications. Financial sector has also grown and expanded; this is obvious from the large number of private banks, finance companies and cooperatives that have opened up mostly Kathmandu and the other major cities.

Wholesale and retail sector, whose share of GDP was 14.5% in FY 2012/13 is estimated to grow to about 15% in FY 2013/14. Education and health services were the traditional domains of the government. However, in the last two decade or so, private investment in these fields has exploded. Education sector grew 21% in FY2001/02, 10.8% in FY 2008/09 and has been growing at rates higher than 5%, except for FY 2005/06; Health and social work segment has grown at least about 5% from 2002 to 2009 (CBS, 2014).

Figure 6: Select service sectors growth(%)



Source: CBS, 2014. FY 2013/14 data is projection

In FY 2012/13, education and health and social work sectors contributed about 6% and 1.4% of total GDP respectively (CBS, 2014). With rapid population growth, the demand for education and health services has grown significantly in the capital city. There has been a sharp growth in the number of private schools and colleges. Private hospitals and several medical colleges have opened up in Kathmandu and in Pokhara, Bharatpur and Biratnagar.

3.3.1 Tourism

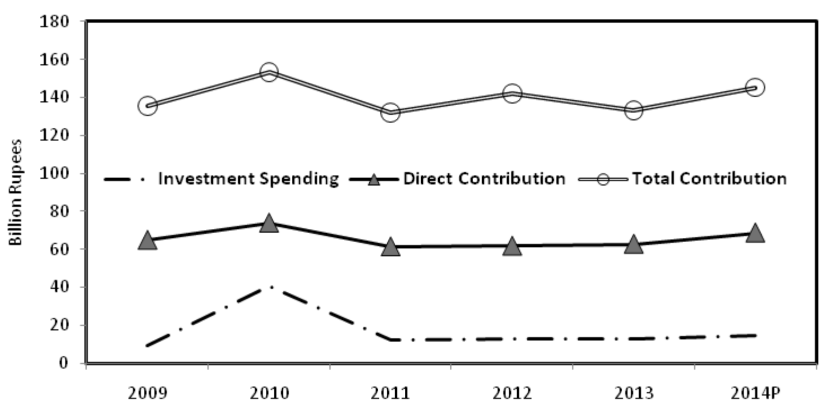
Travel and tourism ("tourism") is a growing industry and an integral part of the economy. Because Nepal is an agricultural country with bulk of trade with India, sources of foreign currency are critical for sustaining imports. Tourism, one of the main sources of foreign reserve, generates billions of rupees in total revenue each year, providing employment for thousands of people. Tourism contributes to the economy directly, indirectly and through induced impacts. The direct economic impact is the total expenditure (within Nepal) on travel and tourism by residents as well as foreign visitors. For example, spending on hotel and resorts, airlines, airports, travel agents, leisure and recreation services are targeted to tourists (domestic as well as foreign).

Indirect impact includes travel and tourism investment spending, e.g., purchases of new aircrafts, building new hotels and resorts, as well as money spent by central as well as local governments on promotion and marketing, aviation administration and security services. Also included is spending on goods and services, e.g., food and meals, cleaning services, by sectors of the economy directly associated with tourism. Induced impact of tourism captures the ripple effect on the economy, i.e., spending by those directly or indirectly employed by tourism. In aggregate, tourism makes a significant contribution to Nepal's economy, providing much needed income and improving living standards.

Contribution to economy

According to *2014 World Travel and Tourism Council (WTTC) Report*, travel and tourism contributed a total of Rs. 145.3 billion to the Nepali economy in 2013. This figure represents about 8.2% of Nepal's GDP.

Figure 7: Tourism's impact on economy(Billion Rupees)



Source: World Travel and Tourism Council (WTTC) Report 2014; 2014 numbers are projections

In terms of employment, 1.11 million jobs were generated by travel and tourism activity in Nepal, about 7% of total employment. Travel and tourism is expected to grow in 2014. WTTC projects tourism's total contribution to the economy to rise by 8.6% and employment numbers to rise by 6.5% to 1.18 million jobs.

Table 5: Tourism's impact on the economy (GDP)

(Rs. billions, 2013 prices)	2009	2010	2011	2012	2013	2014P
Investment Spending	9.4	40.6	12.1	13.1	13.1	14.6
Direct Contribution	65.0	73.9	61.5	61.9	62.9	68.8
Total Contribution	135.5	153.2	132.2	142.1	133.5	145.3
Direct Employment 000s)	441.3	485.6	403.6	522.7	472.2	503.8
Total Employment (000s)	991.1	1,087.5	936.1	1,123.7	1,038.0	1,112.0

Source: World Travel and Tourism Council (WTTC) Report 2014; 2014 numbers are projections

Issues in tourism

Although Nepal has much to offer in terms of natural beauty with opportunities for river adventures, trekking and hiking, sight-seeing, and other recreation activities, Nepal suffers from several infrastructure related problems. One of the major problems is that the country's only international airport, Tribhuwan International Airport (TIA), has limited capacity and reputation as the one of worst airports in the world (CNN website).

Lack of adequate facilities and poor service aside, TIA just can't handle the air traffic and passengers volume in an efficient manner. TIA was not designed to handle the current level of flights that come and leave from Kathmandu. This has resulted in overcrowding, poor service at the airport and damages to the runway requiring periodic repairs. The stress is evident from the temporary shutting of the airport for runway repairs. When repairs are done, the quality of the work has raised serious questions. Fraud, corruption and embezzlement of funds have been responsible for poor quality repair work. This is a serious issue that puts safety of air travelers in jeopardy and Nepal's tourism prospects at risk.

It may not be possible to build a new international airport in the short run, but in the long run if Nepal expects to grow tourism sector, this issue must be seriously addressed. Nepal's economy will benefit more if more people visit Nepal and spend their money. However, the country needs an airport that is large enough and modern with facilities befitting an international airport. Poor connectivity, lack of good roads and the geography make air travel crucial and all the more important.

Another issue related to air travel is safety. In the past decade or so, there have been several plane crashes in Nepal. Multiple factors are responsible for the crashes: bad weather, old and unreliable aircrafts, and inadequate supervision and enforcement of safety regulations. Whatever may be the causes, such events harm Nepal's reputation as an attractive tourist destination. In fact, European Aviation Safety Agency raised the issue of air safety with the authorities in Nepal (Kathmandu Post). It is hard to convince more tourists to visit Nepal in light of such air disasters.

Other factors like political instability, frequent strikes ("bandh") and violence (even occasional) also hurt tourism. The adverse impact of the decade long Maoist insurgency on tourism is telling. Although other sectors of the economy also suffered, tourism bore the brunt of the decade-long civil conflict. It is recovering from the damage suffered during that period. However, there are lingering effects. For Nepal or any other country to take full advantage of tourism, peace and stability is critical.

3.3.2 Foreign employment

Foreign employment has emerged as the largest component of services sector in recent years. Up until the 1990s, it was very small both in terms of the numbers of people leaving the country and the amount of remittance that they sent. In the last decade, there has seen a tremendous growth in foreign employment resulting in billions rupees in remittance inflow. The top destinations for Nepali workers are Korea, Malaysia and the Gulf countries namely Saudi Arabia, United Arab Emirates, and Qatar Nepal Migration Survey 2009). Though there are various estimates of number of Nepali migrant workers, the NMS puts the number at about 2.1 million. Given the growth in foreign job seekers every year, this number is likely to be much higher. *Karobar Daily* reports that, on average, 1,748 youths (in FY 2013/14) are going abroad every day.

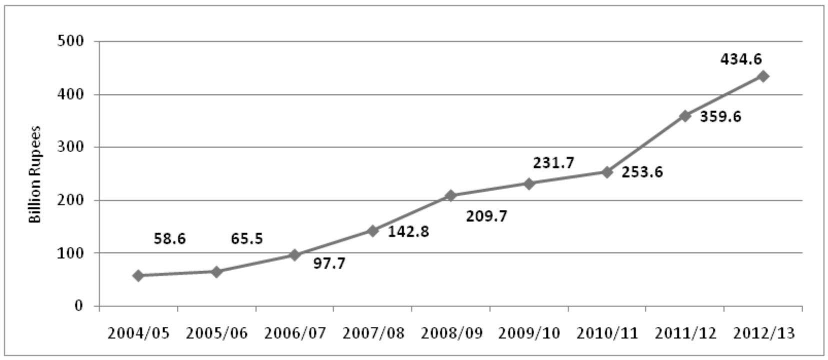
Here are some statistics that underscore the scale and growth of foreign empolyment and remittances in Nepal:

- **Almost half of households have at least one migrant abroad or a returnee.**
- **One third of working male population may be abroad.**
- **Measured by remittances as share of GDP, Nepal ranks third.**
- **Remittance is the largest source of foreign exchange, accounting for 25% of GDP in 2012**

Source: Shishido, *Large-scale Migratons and Remittances: benefits and Cost; Migration and Remittances: Recent Developments and Outlook,* The World Bank 2014

Foreign employment and remittance income has become one of the major components of Nepal's economy. It is in fact the largest source of foreign reserve. In 2012, measured by remittance income as a share of GDP, Nepal ranked third among the countries receiving remittance. Among countries with at least 10 million people, Nepal was first in terms of remittance.

Figure 8: Remittances inflow (Billion Rupees)



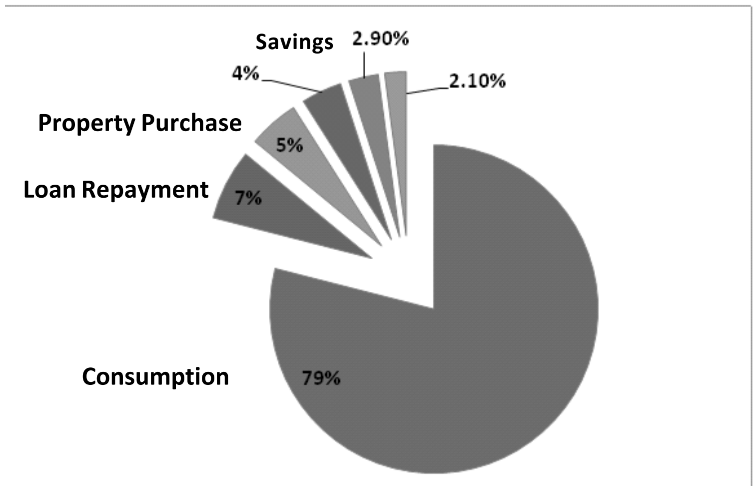
Source: Nepal Rastra Bank

Foreign employment has significant effects on the economy; most are positive while some are negative. The most visible impact is the remittance income. Fig. 8 above shows a steady growth in remittance income until FY 2006/07, then a sharp rise in the subsequent years. According to Nepal Rastra Bank, Nepal received 434.6 billion rupees in Fiscal Year 2012/13 (Kathmandu Post, October 6, 2013*).* At the macroeconomic level, one of the benefits is the generation of foreign currency. In absence of the remittance income, Nepal's imports would not be sustainable. Remittance is largely responsible for balance of payment surplus. Other benefit is that it reduces unemployment and underemployment in Nepal. Many who would not find meaningful jobs in Nepal are working, earning and supporting their families.

At the household level, remittance has lifted many families out of poverty. In absence of remittance income, poverty rate would be at 35.3% vs. the current rate of 9.3%, according to *2013 Nepal Millennium Development Goal Report (MDG) Report* (Kathmandu Post). According to *Nepal Living Standard Survey 2010/11* data, 79% of remittance income goes towards consumption, 7% for loan repayment, 5% towards purchase of household property, 4%

towards education, 2.1% for other uses and only 2.9 % towards capital formation. (Fig. 9)

Figure 9: Breakdown of household remittance income by expenditure



Source: Nepal Living Standard Survey 2010/11

A country's prosperity depends on productivity of its workers; productivity in turn depends on capital formation. So savings and investment are the key for long term economic growth and improvements in living standards. However, Nepal is failing to take advantage of the remittance income for investment and capital formation. This is a missed opportunity. (The one positive aspect of remittance fueled consumption is that some of the money is going towards better education for the children of those working abroad. This investment in human capital could have beneficial impact in the future for those families.)

On the negative side, when young people at their peak and most productive years leave the country, the country suffers. Lack of people to work in the fields has left otherwise arable and productive land barren leading to decline in agricultural production (Shishido, 2011). This decline (in food production) worsens the food security situation. Karobar newspaper attributes rising imports of agricultural products to foreign employment, among other factors. Industrial production could also suffer if there aren't enough workers to support domestic industries. Some also point to the real estate bubble in Nepal (mostly in urban areas) and partly attribute it to remittance flow.

4.Challenges and Bottlenecks

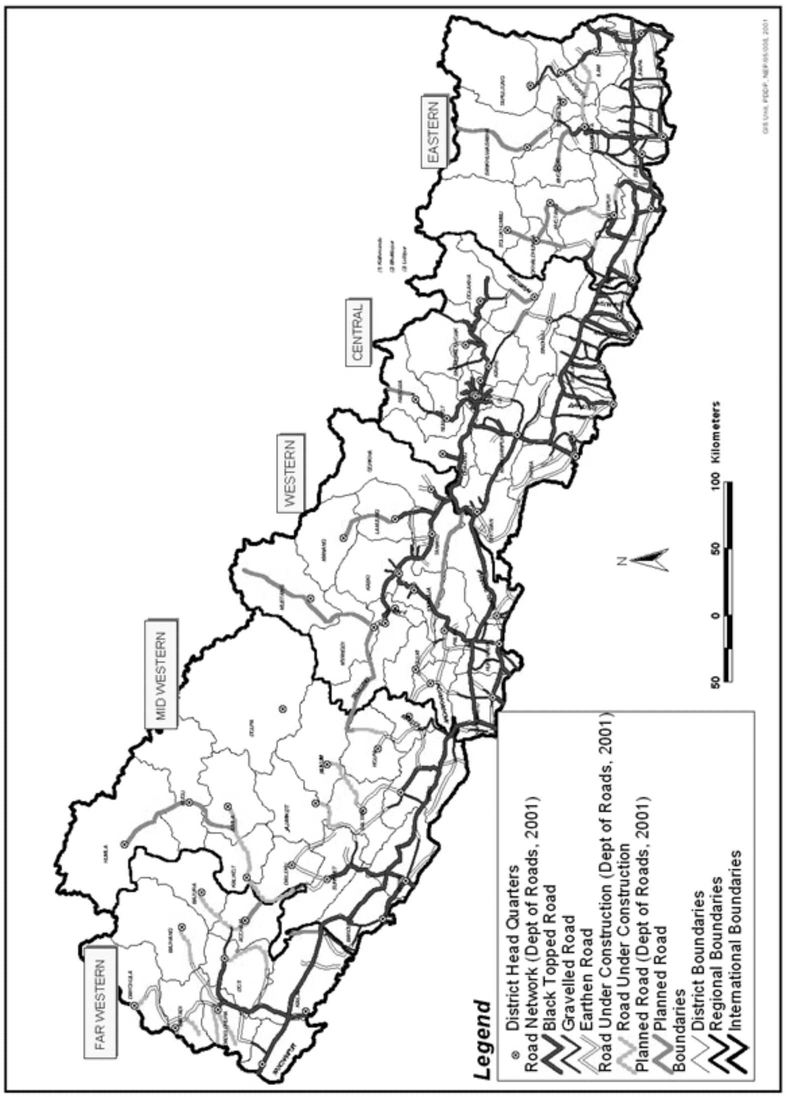
4.1 Improving transport infrastructure

Nepal suffers from inadequate and poor transportation infrastructure. This has impeded economic growth so improving it should be a top priority. Fig. 10 below shows the existing road network in the country. At present, the total motorable road is 24,583 kilometers (km); 10,320 km is black topped, 5,828 km is graveled, and 8,435 km is earthen (Ministry of Industry).The Mahendra Highway, also known as East-West highway, comprises the bulk of road network running through the Terai plains from Mechi to Mahakali. Major cities and the district headquarters are connected to it by smaller and regional highways. Most of these regional highways run from the south, connecting the Terai plains with the hills and mountains in the north. These include Araniko highway, Sagarmatha highway, Karnali highway, Mechi highway, Mahakali highway, Tribhuwan and Rapti highway.

The higher altitude hilly and mountain regions have limited road accessibility or none at all. A lack of an extensive road network and poor quality of the existing roads and bridges, even by standards of other poor countries, is a major growth bottleneck (The World Bank). In an effort to increase road connectivity and improve transport infrastructure, GoN has started work on two national highways that run parallel to the Mahendra (East-West) highway: Mid-Hill highway and the Hulaki highway. The former runs through the mid hills, connecting Panchthar district in the east to Jhulaghat in Baitadi district in the west. The Hulaki highway runs east to west through the Terai plains. Both of these highways are included in the "National Pride Projects", an indication of their importance to Nepal's development efforts. When completed, they will bring road accessibility to lots of places benefitting many people and communities.

Better roads and increased connectivity spur economic growth by facilitating movement of goods and people. At the same time, road accessibility would also benefit the tourism industry. However, geography and terrains make it difficult to expand the existing road network and maintain its quality. Building roads in the mountains and hills is tough because the terrains make it complex to open tracks. Such work is challenging, time consuming and costly. Maintaining quality and doing repair work is severely hampered by monsoon rains. Most years, it is common for floods to wash away some sections of roads, particularly the non-black topped roads, and damage bridges during rainy seasons. Similarly, landslides destroy or block roads with large deposits of mud and rocks making them inoperable.

Figure 10: Road network



Source: United Nations Nepal Information Platform

Although there are a handful of road outlets from Kathmandu valley to other parts of Nepal, there is only one road that is wide enough to accommodate regular passenger and transport vehicles. It is the road going from Thankot in Kathmandu to Mugling and to Narayanghat and Pokhara. BP highway, connecting the valley with Sindhuli in the east, is still under construction but partially operational. The Tribhuwan highway,running from Naubise to Hetuada, and the road linking Dakshinkali to Hetauda (much of it still not blacktopped) are the other main outlets, but are too narrow for the regular passenger buses and transport trucks. Therefore those routes are only used by smaller and private vehicles. So passenger and freight vehicles are forced to make a 250- kilometers detour to reach Kathmandu from outside (The World Bank).

As an alternative, the GoN has proposed and started work on a Fast Track linking Kathmandu Valley with Terai plains through Hetauda. This alternative route would result in significant time and fuel savings: about 4-5 hours, and about US $30 fuel savings per one way travel for a heavy truck. When operational, it could reduce fuel consumption by some 32 million liters in just the first year (The World Bank). In addition, the fast-track would greatly facilitate trade with India reducing significant transport costs. A big and complex project, it is estimated to cost about US $ 1 billion. Because of high cost, GoN wants investment from the private sector. The GoN has opened the track but the work has stalled due to lack of interest from private investors. Because of its importance, government should start and speed up the necessary regulatory and other background works as soon as possible. Once that is done, it would hopefully attract private investors and work can commence.

The other pressing transport problem is the traffic in Kathmandu valley. Along with a rapid population growth, the number of vehicles has also increased rapidly. In the course of 10 years from 2000 to 2010/11, the number of vehicles in Kathmandu valley grew about 3.8 times, reaching 570, 145 (CANN, 2012).

Latest vehicle registration data covering the past nine months shows that 50,073 vehicles were registered in Bagmati zone vs. the country total of 145,254 (Kantipur news, May 23, 2014). Assuming that most of the vehicles registered in Bagmati zone are in Kathmandu valley, which is a fair assumption, slightly more than one third (about 34%) of total new vehicles were added in Kathmandu valley in that period. Narrow roads and high traffic volume combine to create major traffic congestion during peak hours. One can see it every day in almost all major intersections. The recent widening of the roads, some still in progress, has made a big difference in easing traffic jams and congestion. This has been the most effective solution to the traffic congestion in the valley so far. However, this is not enough. More vehicles will be added to the roads. So in the long term, easing traffic congestion requires looking at other options, like commuter trains.

4.2 Energy crisis

Energy crisis is the other factor adversely affecting the economy, the industrial sector in particular. As one of the poorest countries in the world with very limited hydroelectric power generation, no petroleum or natural gas deposits, energy availability is a major problem in Nepal. Nuclear, wind and coal-fired power generation are non-existent; there are some diesel-powered generation plants that supplement electricity produced by hydroelectric power plants. Nepal also buys some power from India which is fed to the national grid. However, that is not enough to meet the demand. Electricity peak demand has been rising every year. (See Table 6)

Access is a major problem—only one third of the population live in homes connected to electricity; the rest make do with kerosene lights, firewood for cooking and solar powered electricity. But the bigger problem is the inadequate supply of electricity relative to demand. Despite having abundant water resources and huge hydroelectric potential, Nepal has the lowest per capita electricity consumption in Asia: 93Kwh vs. Asia average of 806 KWh (The World Bank, 2014).

Table 6: Total peak demand and electricity supply

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013P
Peak Demand (MW)	515.2	557.5	603.3	648.4	721.7	812.5	885.3	946.1	1,026.7	1,094.6
NEA Generation (GWh)										
Hydro	1,345.5	1,522.5	1,568.6	1,747.4	1,793.1	1,839.5	2,108.7	2,122.1	2,357.4	2,273.1
Thermal	9.9	13.7	16.1	13.3	9.2	9.1	13.0	3.4	1.6	18.8
Total	1,355.4	1,536.2	1,584.7	1,760.7	1,802.3	1,848.6	2,121.7	2,125.5	2,359.0	2,292.0
Power Purchase (GWh)										
India	186.7	241.4	266.2	328.8	425.2	356.5	638.4	694.1	746.1	792.5
IPPS	838.8	864.8	930.0	962.3	958.4	925.7	591.4	1,038.8	1,073.6	1,176.0
Total (GWh)	1,025.5	1,106.2	1,196.3	1,291.1	1,383.6	1,282.2	1,229.8	1,732.9	1,819.6	1,968.5
Total Available Energy (GWh)	2,380.9	2,642.4	2,780.9	3,051.8	3,186.0	3,130.8	3,351.5	3,858.4	4,178.6	4,260.5

Note: 2013 data is projection

Source: http://www.nea.org.np/images/supportive_docs/A-Year-in-Review-FY-2012-13.pdf

Nepal Electricity Authority (NEA), a government-owned utility is responsible forpower generation, transmission and distribution. For instance in the U.S., the three functions mentioned above are handled separately by different firms. It controls more than two thirds of generation capacity in the country and has a monopoly in the transmission and distribution of electric power. Created under the Nepal Electricity Authority Act of 1984, NEA has not been able to achieve its objective of supplying reliable and adequate power to customers—as is evident from the acute shortage that is gripping the country. The situation is unlikely to improve anytime soon, as the money-losing utility is not in a position to make investment in generation and transmission capacities (The World Bank, 2014). The World Bank report points out that only about 92 MW of electric power has been added to supply since 2002 and no new transmission lines have been added.

Energy crisis has two components: load shedding and the shortage of petroleum products in the market. Nepal Oil Corporation (NOC) is a government body with monopoly in the import and distribution of petroleum products and cooking (natural) gas. Fuels—petrol (gasoline), diesel, kerosene— as well as cooking gas is subsidized by the government. Corruption, mismanagement and inefficiency also play a role but NOC is forced to sell fuel at a loss. Therefore NOC is not able to make full payment to Indian Oil Corporation on time for imports. Any disruption in supply whether due to delay in making payments or because of strikes by the transporters' cartel results in shortage of fuel in the market causing hardships for consumers and adverse overall impact in the economy.

Access to electricity is a problem that needs to be addressed but the more urgent and pressing issue is load shedding that is stifling the economy and adversely impacting the quality of life. The power crisis is so severe that households and business face long hours of load shedding every day. Effective February 2014, NEA increased load shedding to 84 hours a week, exactly 12 hours a day. In other words, there is no electricity half the time.

The current supply of electricity is grossly insufficient to meet the needs and demands. Tables 7a and 7b below summarize total peak hour demand and supply of electricity as well as total energy demand and supply for FY2012/13 (NEA Annual Report 2012). The total peak demand of the Integrated Nepal Power System (INPS) in FY 2012/13 was 1,094.6 MW—this represents a 9% growth from the previous fiscal year (FY). The total supply was only 719.6 MW, a shortfall of about 375 MW (NEA Annual Report, 2012). Out of the total 719 MW that was supplied, 443 MW was generated by NEA (hydro and thermal combined), 177.1 MW was produced by independent power producers and the remaining 102.5 was imported. Like the peak hour demand and supply situation, there was substantial shortfall in energy supplied vs. what was demanded in FY 2012/13: shortfall of nearly 1,228 GWh.

Table 7a: Peak hour electricity demand and supply

	FY 2012/13
Annual Peak Demand	1,094.6 MW
Total Supply	719.6 MW
Shortage (Shed)	375 MW

Table 7b: Total Energy Demand and Supply

	FY 2012/13
Total Energy Demand INPS	5,446.29 GWh
Total Supply	4,218.14 GWh
Shortage (Shed)	1,228.15 GWh

Source: NEA Annual Report, 2012 at http://www.nea.org.np/images/supportive_docs/A-Year-in-Review-FY-2012-13.pdf

Impact on economy

Load shedding— an improvised way of dealing with power shortage— is having serious impacts on the economy, manufacturing sector in particular. Reliable and uninterrupted power supply is essential for industries and business alike. An economy cannot grow and prosper when lack of power contracts economic activities and hampers production of goods and services. This is what is happening in Nepal. Load shedding about 12 hours a day has interrupted work schedule and the production process, seriously undermining the manufacturing sector. Kantipur news reports that factories in Sunsari-Morang industrial corridor are "crippled by power shortage" (Kantipur news). This industrial area has about 500 factories that produce daily essential goods as well as construction materials.

"Poor reliability and access to power are the most serious infrastructure bottlenecks to growth. Increasing access to electricity in a timely and cost-effective manner is one of the most significant development challenges facing Nepal today."

Load shedding affects production process in two ways: either factories are forced to shut down during power outage or seek alternative sources of power. Shutting down factories means reduced production which could translate to lower supply and shortage. Business may be unable to meet demand and this could result in higher prices for consumers. To keep the factories running at times of power outage, they can produce their own electricity from diesel-powered generators. Doing this, however, raises the cost of production as power from (diesel-fueled) generators is much more expensive than power supplied by NEA. For example, generator power costs Rs. 35 per unit in Morang-Sunsari corridor compared to Rs. 8 per unit for electricity supplied by NEA. The higher electricity cost pushes price of goods and services higher, creating inflationary pressure.

Factories in Morang-Sunsari corridor forced to switch to much costlier source of power shows how load shedding is hurting industries. It is not the only area that is suffering from power shortage. Such scenario is playing out in other parts of the country, in other industrial areas. The aggregate effect of power shortage to industries and the economy is significant. In fact, load shedding or power shortage is one of the reasons for high inflation rate in Nepal.

The importance of reliable and adequate power supply to an economy cannot be overstated. The World Bank, in its country report, underscores the challenge of overcoming the electricity crisis and states it as the most serious challenges to economic growth in Nepal:

"Poor reliability and access to power are the most serious infrastructure bottlenecks to growth. Increasing access to electricity in a timely and cost-effective manner is one of the most significant development challenges facing Nepal today. Efforts to reduce the 16-hour load-shedding gap during the dry season have been unsuccessful. Ironically, Nepal has one of the largest untapped hydropower resources in the world – an estimated 83,000 MW of hydropower potential." (The World Bank, at http://www.worldbank.org/en/country/nepal/overview)

4.3 Weak institutions

The other major obstacle to development efforts is weak institutions— utter lack of good governance, corruption, and politicization of civil work force. Rampant corruption, nepotism and dereliction of duty are common in Nepal. Not surprisingly, Transparency International ranked Nepal 116th among 177 countries in Corruption Perception Index (http://cpi.transparency.org/cpi2013/). Starting a business requires approval from several government branches in Nepal. Among others, weak or selective law enforcement, cumbersome procedures and demand for bribes, raise cost of doing business and create less business-friendly environment.

Similarly, the civil work force and government agencies suffer from excessive interferences from political parties and politicization. The political parties in government appoint people close to them for important posts or for lucrative job positions often overlooking qualified or capable people. This practice hurts morale and diminishes incentives for hard work. In addition, infighting between government workers loyal to the major political parties unnecessarily stalls key appointments as well as important decisions in the government. Politics has been deeply institutionalized in the country, seriously undermining bureaucracy and the performance. This has serious implications for economic growth and development. One of the major challenges is cleaning up the system, making it more efficient, accountable and business friendly.

4.4. Labor unrest and strikes

In recent times, along with the growth in the number of labor/trade unions, the incidence of labor unrest has gone up. This has had an adverse effect in the economy, specifically the manufacturing sector. According to the World Bank, labor unrest is one of the reasons for adverse investment climate in Nepal (Business Age). The expansion and growth of labor unions have created problems for business. Most unions are affiliated with political parties. They have been forceful in demanding better compensation, often with the backing of political parties. In some instances, unions have asked for unreasonable and unrealistic demands, resulting in disputes (Business Age). Failure to resolve these demands and disputes have led to unrest and strikes, temporary shutting down business. Recent examples include the KFC and Pizza Hut shutdown, as well as Shikhar Shoes (after workers assaulted management personnel). In some cases, some businesses have shut down for good. The spread of labor unions and unrest has hurt existing business, manufacturing in particular, as well as investor confidence in Nepal. Because of labor problems in manufacturing, big business names in Nepal—Chaudhary Group, Golchha Organisation, Dugar Group— have shifted focus to service sectors, hurting investment in manufacturing (Business Age). Already suffering from power outages and poor transport networks, this drop in investment further exacerbates the decline of the manufacturing sector. Therefore, decreasing labor disputes, unrest and strikes has become crucial for economic progress.

5. Outlook

5.1 Economic growth

Nepal's economy that grew by 4.5% in 2011/12 only recorded 3.6% growth in 2012/13. Several factors were responsible for the slowdown in 2012/13. One of the causes was a sharp decline in agricultural production due to unfavorable monsoon and shortage of chemical fertilizers. In FY 2012/13, rice harvest declined 11.2%, corn harvest fell 8.2% and millet harvest also fell by about 3% (CBS, 2014). Production of food grains are affected by delayed monsoon or insufficient rain. Unavailability of chemical fertilizers further compounded the problem. As agriculture still accounts for over one third of Nepal's GDP, it weighs heavily on the overall economy. In addition, the government's failure to bring a full budget for the year hurt other sectors.

The economic prospects look more promising in FY 2013/14. IIDS projects the economy to grow by about 5.1%. Several favorable events are cited as reasons for the optimism. A strong expected growth in agriculture production, successful election to the Constituent Assembly as well as strong remittance inflows are expected to drive the economy forward in FY 2014. Availability of fertilizers and good monsoon season should be good for cereal output, rice, corn and wheat in particular. CBS projects rice, corn and wheat production to increase in the current FY by 12%, 10% and 6% respectively (CBS, 2014). This rise in production will boost the agricultural sector and the economy. Similarly, strong growth in remittance income, education services and retail trade will drive growth in the service sector.

Table 8: Economic growth forecast at constant price.

Sector	FY2013/14
Agriculture	4.4%
Industry	3.8%
Services	6.7%
Overall	5.1%

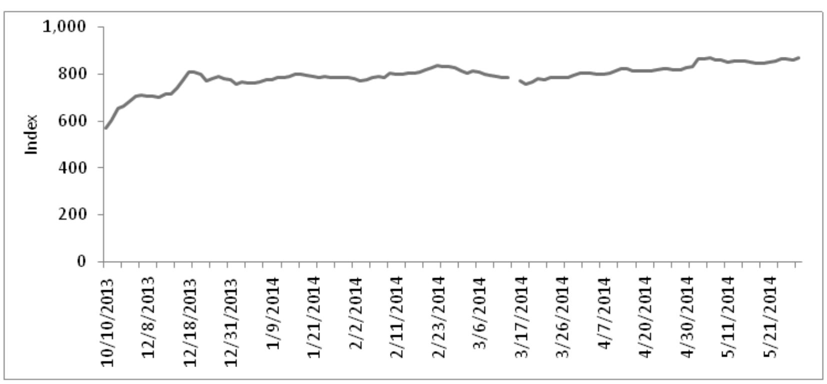
Source: IIDS analysis.

5.2 Investment

Investment climate has improved considerably in FY 2013/14. A largely peaceful and successful election to CA-II has boosted business and investor confidence. The formation of new government under the leadership of a centrist party has also raised optimism among the business community and people at large. This is evident from the increase in investment commitment and the rise in Nepal stock market index, the Nepse index (Fig. 9). According to the ADB, the total domestic capital investment commitment rose to Rs. 192.7 billion in the first half of FY 2013/14. This represents a very steep increase of about 383% from mid-January 2013. The bulk of the investment commitment is for the energy sector, small to medium scale hydroelectric power plants. Likewise, foreign direct investment commitment for approved projects rose nearly 50% to Rs. 14.6 billion from mid-January 2013. Again, much of the investment is in the energy sector, a total of Rs. 10.3 billion (ADB, 2014).

The Nepse index rose from 566.7 on October 10, 2013 (before the CA election) to over 800 in mid December 2013, after the CA election (Nepal Stock Exchange; http://www.nepalnews.com/index.php/economy/28460-nepse-index-hits-6-year-high-crossing-800-pts?-Economy=).

Figure 9: Nepal stock market index (Nepse)

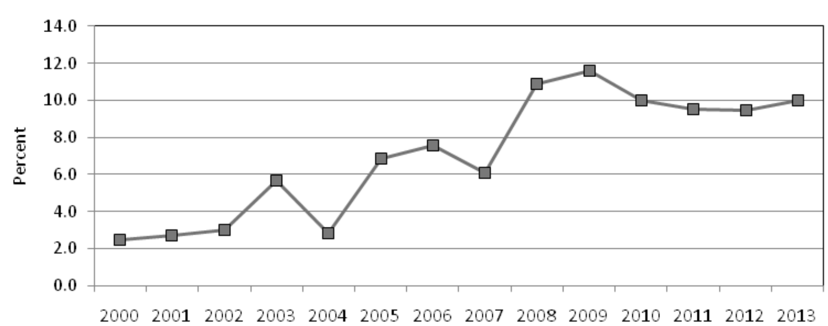


Source: http://www.nepalstock.com/datanepse/Indices.php

5.3 Inflation

Inflation rate, as measured by the Consumer Price Index (CPI), was close to 10% in FY 2012/13 and is expected to stay high in FY 2013/14. Both demand side and supply side factors are responsible for it. Supply side (push) factors include the rise in food prices, record depreciation of the Indian and Nepali currency, load shedding as well as two rounds of fuel price hikes. Food production declined in 2013, so the shortfall was made up through imports from India. Rising price of food (and other items) in India means higher prices in Nepal. Nepal not only imports finished products but also raw materials for many industries. The sharp depreciation of the Indian currency against the U.S. $ resulted in across the board price rise in India. As a result, imports from India became more expensive leading to inflationary pressure in Nepal. Higher prices of raw materials directly feed into higher cost of production and rising prices. (For reasons of sustaining high volume of imports from India and maintaining competitiveness of Nepali exports with Indian goods, Nepali rupee is tied to the Indian rupees—it maintains a fixed exchange rate. So when Indian rupee exchange rate fluctuates, so does Nepali rupee.)

Figure 10: Consumer prices annual change (%)



Source: The World Bank, Nepal Rastra Bank

The other cause is acute load shedding and the rise in fuel prices. Load shedding either disrupts production process or industries are forced to seek alternative source of electricity—which is much more expensive. This translates to higher price of goods. Nepal Oil Corporation (NOC) raised price of petrol (gasoline), diesel and kerosene twice in 2013. Increase in fuel price has ripple effects in prices of most other goods and services. Goods have to be transported from the point of production to distribution centers and ultimately to retail locations. When fuel price goes up, cost of transportation and distribution goes up. That higher cost gets passed on to consumers in the form of higher prices.
A high growth in money supply fueled by record remittances is also responsible for high inflation (See Fig. 10). Households receiving remittances spend most of that money on consumption: purchases of goods, services, household property and education. As a major driver of domestic consumption, remittance income has caused a significant growth in demand for goods and services. This growth in demand further reinforces the inflationary pressure created by the supply side factors, causing high inflation in Nepal.

Inflation is expected to stay high in FY 2013/14 for basically the same set of reasons as in FY 2012/13. Although higher agricultural output should at least put downward pressure on food prices, higher public spending in the second half of the fiscal year, wage pressure as well strong remittance flows will keep inflation high. Price of some food items, meat (chicken, mutton) have gone up as a result of the Bird flu epidemic in 2013. Increased demand for mutton because of Bird flu fears caused mutton price to rise. The culling of chicken and quarantine on imports lead to a sharp reduction in supply of chicken meat. As demand picked up after the Bird flu cases subsided, chicken price rose. Further, in March 2014, fuel prices and milk price were raised. The impact of higher fuel price reverberates throughout the economy. When fuel prices rise, retailers raise their prices. Anecdotal evidence also confirms this chain of events.

High inflation is a major macroeconomic problem: Inflation rate in the last 6 years was above 9%, double-digit in 2008-2010 and again in 2013. (See Fig. 12) High inflation erodes purchasing power, inflicts costs on consumers and discourages investment. It also creates inflationary expectation in the future, leading workers to demand wage hikes, causing wage spiral which in turn feeds to further price rise. Therefore, controlling inflation should be a policy priority for the government.

5.4 Remittances

Remittance income is expected to stay strong in FY 2013/14. In the first half of FY 2014, remittance grew 34.4% compared to 22% growth in the same period of FY 2013 (a difference of Rs. 62 billion) (The World Bank, 2014). A high growth in the first half of the FY might drop slightly because record weakening of the Nepali currency vs. US $ in August of 2013 might lead many in the United States and other countries to send money, to take advantage of the high exchange rate. A very strong US $ vs. Nepali rupees means remittance income in rupees rises even if the amount in $ stays constant. This could be partly responsible for the high growth in the first half of FY 2013.

High remittance inflow presents both opportunities and challenges. At the household level, it provides income to thousands of families. However, as most of it is spent on consumption, the country cannot benefit from savings and investment. Investment and capital formation is the driver of long-term growth. If the country does not take advantage of this resource, it will suffer in the future. The World Bank country report 2014 points this out.

"Nepal has significant resources in the form of remittances from abroad, but the economy cannot use these resources in a productive manner to enhance the overall welfare of all citizens." (The World Bank, 2014)

A large inflow of remittance income has created excess liquidity in the financial sector. Nepal Rastra Bank (NRB), has been absorbing the excess liquidity through the reverse repo process and the sale of government securities. In fact, since the second half of 2013, NRB has engaged in 15 rounds of reverse repo, worth Rs. 216 billion (The Himalayan Times, February 25, 2014). NRB must soak up the excess money in the market to ease the inflationary pressure without hurting access to credit, which is necessary for economic growth. This requires a careful balancing act and a calibrated approach lest inadequate liquidity hurt investment and growth prospects. It is a policy challenge for the central bank.

5.5 International trade

According to Nepal Trade and Export Promotion Centre, Nepal exported goods worth Rs. 77.4 billion rupees and imported Rs. 601.2 billion worth of goods in FY 2012/13 (http://www.tepc.gov.np/news-events/details.php?id=18). Trade deficit was about Rs. 524 billion, an increase of 23.5% compared to previous FY. Nepal's exports relative to imports is declining: the ratio of imports to exports was 6 to 1 in FY 2010/11, it rose to about 7 to 1 in FY 2011/12 and then to 8 to 1 in FY 2012/13.

Table 9: Total trade and growth rate

	FY 2012/13 Value (Billion Rs.)	FY 2013/14* Growth rate
Total Exports (goods)	Rs. 77.4	16%
Total Imports (goods)	Rs. 601.2	23.1%
Trade Deficit	Rs. 523.9	24.4%

Source: FY2012/13 trade data is from Trade and Export Promotion Centre; FY 2013/14 growth data for the *first 6 months is from the World Bank

A sharp depreciation of Nepali currency resulted in significant improvement in exports to India in the first six months of FY 2013/14. Exports to India grew by 18.5% vs. 3.8% in the same period of the previous FY, resulting in total export growth of 16%. Import growth slowed slightly in the same period, falling to 23.1% from 25.2% probably helped by the depreciation of Nepali rupees. As Nepali rupee becomes weaker, imports falls because foreign goods become more expensive. Trade balance improved slightly but there is big imbalance as exports to imports ratio is 1 to 7. In other words, Nepal imports 7 times as much as it exports. Such a skewed overall trade would have been a big problem in absence of cash flows to Nepal. Fortunately, record remittance income from Nepali workers in foreign countries is financing consumption and rising imports.

Since petroleum is by far the biggest import item, what happens to its price will effect overall trade balance. If oil price stays high or rises, its impact on trade will depend on if improvements in exports can offset the impact of oil imports at a higher price. There will be some volatility in oil price, but it is unlikely to fall or fall by much. With rising demand in Nepal, petroleum imports will continue to affect overall trade balance and hence the balance of payments.

Despite a lopsided foreign trade, with imports of goods several times the size of exports, record remittances flow into the country has resulted in current account surplus. In the first half of FY 2013/14, current account surplus was Rs. 554.6 million compared with a much smaller sum of Rs. 50.7 million a year ago (ADB). Gross foreign currency reserve rose to Rs. 6.3 billion in Mid-January 2014 from Rs. 5.5 billion in FY 2012/13, enough to sustain slightly more than 10 months' imports of goods and non-factor services. If the current trend in imports, exports and remittance flows holds or improves, Nepal's external position should further improve in FY 2013/14.

6. Conclusion and Recommendations

Although two thirds of people derive their livelihood from agriculture, it is marred by several problems. The dependence on monsoon, traditional farming methods, lack of storage facilities and access to markets, and unreliable supply of chemical fertilizers are the major ones. Modernization of agriculture would raise productivity and output thus addressing the food security problem in Nepal.

The industrial sector is suffering from severe energy crisis and lack of adequate transport infrastructure. Poor and limited road connectivity and acute energy crisis are the two most serious challenges to economic growth in Nepal. In absence of a shorter route linking the Kathmandu valley to the Terai plains, passenger and transport vehicles have to use a much longer route to the capital thus increasing time and cost. The GoN should speed up work on Fast Track that connects capital with the Terai plains.
Load shedding has adversely affected the economy, industrial sector in particular. It has crippled the manufacturing industries as power outages disrupt normal operation or force business to seek alternative source of electricity—much more expensive thus significantly raising input costs. Therefore, addressing the energy crisis is an economic imperative.

Unemployment and underemployment are other pressing problems in Nepal, forcing thousands to seek foreign employment each year. Income from foreign employment is the largest source of foreign reserve and has raised many families out of poverty. Furthermore, it has provided jobs to many youths, addressing the unemployment problem in a substantial way. However, it cannot be a permanent solution. When thousands of youths in their prime leave the country, the economy suffers from shortage of workers. The country is also failing to take advantage of record remittances by channeling the funds to investment and productive activities. Data shows that most of the remittance income goes towards consumption, leaving less than 3% for savings. Improving investment climate would make it more attractive for the private sector to tap this resource and channel it to investments.

The successful election to the second CA II has improved investor and business confidence. A steep increase in investment commitments and the rise in Nepse index are clear indications. (The Nepse index rose from 571.8 on October 18, 2013 to 811 on May 28, 2014). With the election over, now the critical question is whether the political parties can introduce a new constitution. If the CA can deliver a constitution that reflects the wishes of the majority, it could stimulate even more investment in the economy. Political instability and uncertainty has been an economic strait jacket. A successful drafting of the constitution would be a major shot in the arm and provide significant stimulus for investment in the economy. That in turn would lead to higher growth in the future. So a lot rests on the political parties and the process.

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