MACROECONOMIC UPDATE

NEPAL

VOLUME. 5, NO.2

September 2017

ASIAN DEVELOPMENT BANK

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This issue of the Nepal Resident Mission (NRM) *Macroeconomic Update* was prepared by the following team with overall guidance from Sharad Bhandari, Officer-in-Charge / Principal Economist, NRM. Anjan Panday, Senior Programs Officer, NRM and Masato Nakane Economist, SARC, reviewed the draft and provided comments and suggestions.

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ABBREVIATIONS

BFI = banks and financial institutions
CCD = credit to core capital-cum-deposit
FCGO = Financial Comptroller General Office
FDI = foreign direct investment
GATS = General Agreement on Trade in Services
GDP = gross domestic product
ICT = information and communication technology
IT = information technology
NEA = Nepal Electricity Authority
NRB = Nepal Rastra Bank
NTIS = Nepal Trade Integration Strategy
SEZ = special economic zone

NOTE

i. The fiscal year (FY) of the Government ends on 15 July. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2018 ends on 15 July 2018.
ii. In this report, "$" refers to US dollars and NPR refers to Nepali rupee.
iii. $ 1.00 = NPR 105.9 which is the buying annual average for FY2017.

Executive Summary

1. Nepal's economy significantly rebounded from a growth rate of 0.01% in FY2016 to an estimated 6.9% in FY2017. This robust economic performance in FY2017 is the outcome of favorable monsoon leading to better harvest, normalization of trade since February 2016, acceleration of post-earthquake reconstruction work, better supply management of electricity and base year effects.

2. The agriculture sector, which accounts for nearly one-third of nation's GDP, grew by 5.3% in FY2017, up from 0.03% in FY2016. Industry sector, which accounts for slightly more than 10% of nation's GDP, grew by 10.9% in FY2017, up from a fall of 6.4% in FY2016. Growth in construction activities, expansion of energy sector including enhanced supply of electricity are some of the key factors leading to improved output of industrial sector. Services sector with contribution of approximately 55% to nation's GDP expanded by 6.9% in FY2017, up from 2% in FY2016. The growth in services sector is mainly due to the normalization of trade and record arrival of tourists reaching pre-earthquake levels, thus favoring wholesale and retail trade, hotel, restaurant, travel and communication sub-sectors.

3. The economy will likely grow at a slower rate of 4.7% in FY2018. Heavy rainfall in mid-August led to landslides and floods, resulting in the loss of human lives and livelihoods. Floods inundated paddy fields and destroyed crops in most of the Terai districts of Nepal. This will depress farm output, hampering growth prospect. Industry sector, buoyed by increased supply of electricity and availability of construction materials will likely expand by 6.6% in FY2018, albeit down from a growth of 10.9% in FY2017. Services sector is forecast to grow by 5.5% in FY2018 owing largely to likely expansion of wholesale and retail trade, financial intermediation and travel and tourism sub-sectors.

4. Annual average inflation moderated to 4.5% in FY2017 from an average of 8.9% achieved during FY2010-2016. The significant moderation in inflation is largely due to increased domestic production-particularly agriculture output, normalization of trade and subdued Indian inflation. Food inflation declined more than non-food inflation in FY2017. Food inflation moderated to 1.9% in FY2017 from 10.9% in FY2016. Non-food inflation moderated to 6.5% in FY2017, down from 9.2% in FY2016. Inflation is expected to rise modestly to 6.5% in FY2018 from 4.5% in FY2017. The proposed expansionary budget for FY2018 including fiscal transfer and election expenditure could raise inflationary pressure. Inflation could

further intensify on the back of depressed farm output and infrastructure damage from the recent floods.

5. With mere 66.4% of planned capital expenditures spent, poor execution of capital expenditures continued in FY2017. The rate of execution was less than the average rate of 73.3% from 2012 to 2016. But, the year-on-year growth in capital expenditures has remained solid, signaling that the poor execution rate may simply reflect too ambitious target. Nonetheless, delays in project implementation in terms of preparation of detailed project report, environmental impact assessment and procurement related processes along with slow project approval and budget release have resulted in lower than planned capital expenditures. Recurrent expenditures were 83.5% of the planned amount in FY2017. Total government expenditures in FY2017 stood at NPR 822 billion, or 31.6% of GDP, an increase of 4.4% from FY2016.

6. The government has been quite successful in meeting revenue collection target over the years. Revenue collection in FY2017 exceeded the revised budget target of NPR 580.9 billion. Government revenues for FY2017 stood at NPR 609.1 billion, or 23.4% of GDP, an increase of 26.4% from FY2016. With weak capital expenditures and a rise in revenue mobilization, the actual fiscal deficit was less than the revised target for FY2017. Nonetheless, the substantial increase in both recurrent and capital expenditures in FY2017 compared to that of preceding year led to a widening fiscal deficit from FY2016. The fiscal deficit in FY2017 was NPR 135.9 billion, or 5.2% of GDP, up from 0.3% of GDP in FY2016. Nepal currently faces low debt distress given the high level of official borrowing at longer maturity and large treasury surplus resulting from robust revenue collection and weak budget execution. The government's average debt to GDP ratio for FY2012-16 has hovered around 29.6%. The government's total external debt stood at NPR 423.6 billion, or 15.9% of GDP, a drop from 17.3% of GDP in FY2016.

7. Growth in exports has been weaker than the rise in imports leading to a widening trade deficit. Political instability, inadequate infrastructure, lack of a competitive structure in key markets, and appreciation of real exchange rate have negatively affected export competitiveness of goods and services. Merchandise exports rebounded in FY2017 from a low base following the normalization of trade since February 2016. Exports increased by 9.7% to NPR 82.1 billion, or 3.2% of GDP in FY2017 from a drop of 23.8% in FY2016. Merchandise imports fueled by remittances increased by 29%, reaching NPR 977.9 billion, or 37.6% of GDP from

a decrease of 0.7% in FY2016. Consequently, merchandise trade deficit widened by 31.4%, reaching NPR 895.8 billion, or 34.5% of GDP in FY2017.

8. Nepal increasingly faces external sector instability with slower rise in remittances and ballooning trade deficit in recent years. Remittance income increased by 4.6% to NPR 695.4 billion, or 26.8% of GDP in FY2017, down from 7.7% increase in FY2016. A faster growth in imports relative to exports coupled with a slow rise in remittances resulted in current account deficit of 0.4% of GDP in FY2017. The balance of payments surplus contracted to USD 775.8 million, or 3.2% of GDP in FY2017, down from a surplus of USD 1781.7 million, or 8.4% of GDP in FY2016.

9. This edition of Macroeconomic Update's Issue Focus sheds light on the current state and prospects of Nepal's services trade and suggests sector-specific policy recommendations. Landlocked-ness and mountainous terrain have historically impeded the promotion of merchandise trade in Nepal. Lack of competitiveness has further held back merchandise exports. Consequently, Nepal's merchandise trade deficit as a share of GDP has substantially ballooned over the years. Growth in services export, on the other hand, has been better than the growth in merchandise export. The services sector accounted for 66% of total exports and 14% of total imports in FY2017, indicating its growing importance in external trade. But because of infrastructural, institutional, legal and procedural barriers, the services trade in Nepal has yet to achieve its full potential.

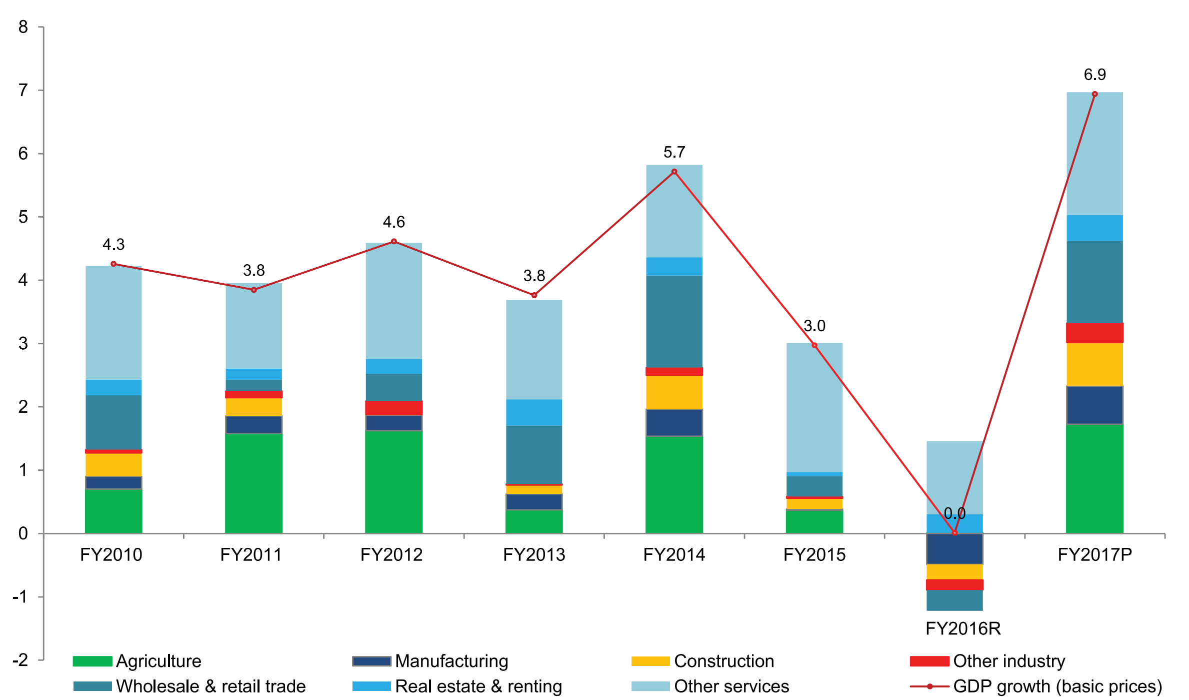
MACROECONOMIC UPDATE

A. Real Sector

I. Economic performance in FY2017[1]

1. **Nepal's economy significantly rebounded from a dismal growth rate of 0.01%[2] in FY2016 to an estimated 6.9% in FY2017** (Figure 1). This robust economic performance in FY2017 is the outcome of favourable monsoon leading to better harvest, normalization of trade since February 2016, acceleration of post-earthquake reconstruction work,[3] better supply management of electricity and base year effects. Agriculture sector, which accounts for nearly one-third of nation's gross domestic product (GDP), grew by 5.3% in FY2017, up from 0.3% in FY2016. Good amount of precipitation, availability of farm inputs, expansion of irrigation facilities and gradual commercialization of agriculture helped increase agriculture output.[4] Among agriculture commodities, paddy[5] production particularly increased to 5.2 million tons in FY2017, an increase of 21.6% from 4.3 million tons in FY2016 (Figure 2).

Figure 1: Supply-side contributions to GDP growth



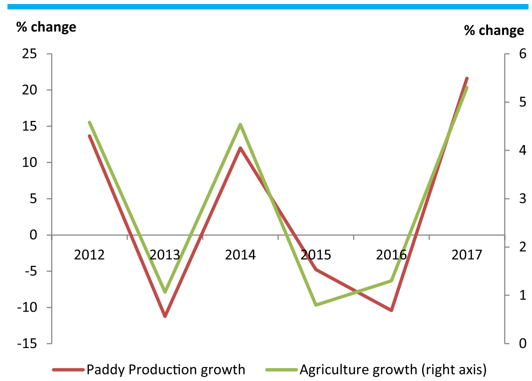
R= revised; P= provisional
Source: Central Bureau of Statistics; NRM staff estimates

[1] FY2017 ended on 15 July 2017.
[2] This is the revised estimate for FY2016 by the Central Bureau of Statistics.
[3] While the first tranche of housing grants to earthquake affected victims has been distributed, the government is yet to expedite the distribution of second and third tranche of housing grants for reconstruction of private houses affected by the earthquake. The restoration of archaeological heritage, trekking trails, rural roads, schools and government services to communities have accelerated in FY2017.
[4] Ministry of Finance. 2017. Economic Survey 2016/17. Kathmandu
[5] Paddy production accounts for nearly 7% of nation's GDP.

2. **Industry sector, which accounts for slightly more than 10% of nation's GDP, grew by 10.9% in FY2017, up from a fall of 6.4% in FY2016.** Acceleration of post-earthquake reconstruction along with other construction activities, expansion of energy sector and enhanced supply of electricity are some of the key factors leading to improved output of industrial sector. Availability of raw materials and ease in the supply of goods resulted in the expansion of construction activities by 11.7% in FY2017 from a contraction of 4.4% in the previous year. Electricity, gas and water output increased by 13% in FY2017 from a drop of 7.4% in FY2016 on the back of increased domestic generation of hydroelectricity[6] including power purchase from India.[7] With increased availability of electricity coupled with better supply management, manufacturing sector grew by 9.7% in FY2017 from a contraction of 8% in the preceding year (Figure 3).

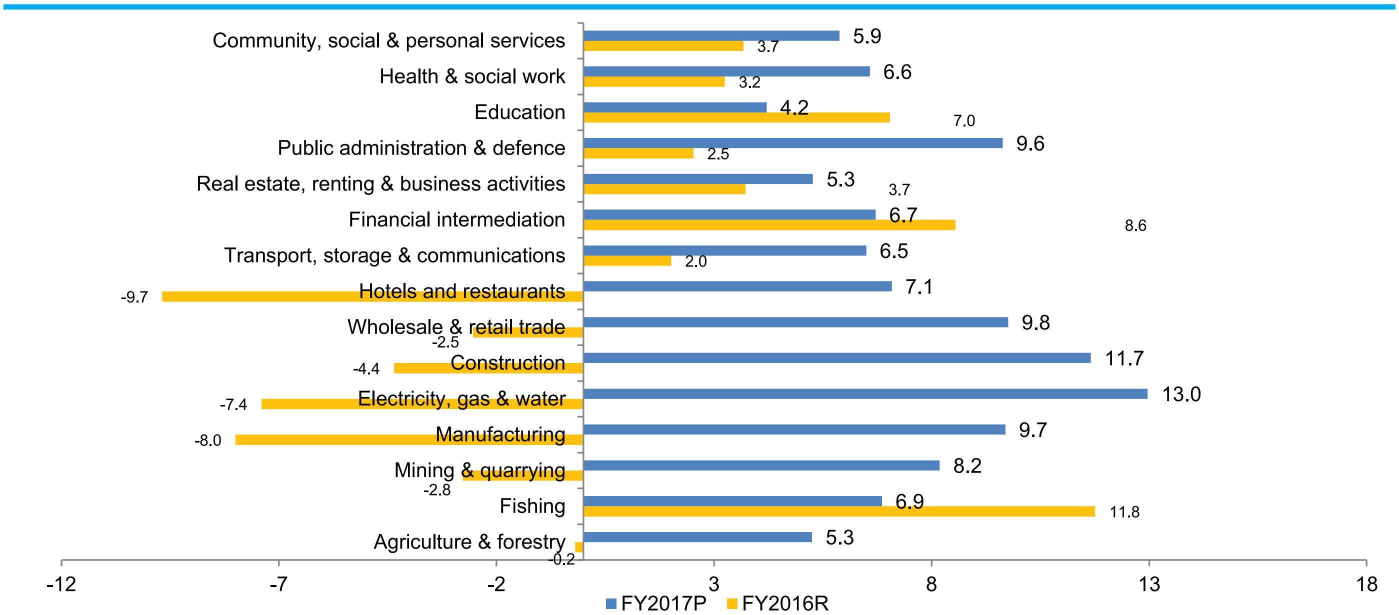
3. **Services sector with contribution of approximately 55% to nation's GDP expanded by 6.9% in FY2017, up from 2% in FY2016.** The growth in services sector is mainly due to record arrival of tourists reaching pre-earthquake levels, thus favouring hotel, restaurant, travel and communication sub-sectors (see Box 1 in Issue Focus). Normalization of trade and subsequent increase in wholesale and retail trade further led to services' sector growth. For instance, hotels and restaurants sub-sector expanded by 7.1% in FY2017 from

Figure 2: Paddy production and agriculture growth



Note: Years are fiscal years ending on 15 July of that year.
Source: Ministry of Agricultural Development; NRM staff estimates

Figure 3: Sub sectoral growth (% change)



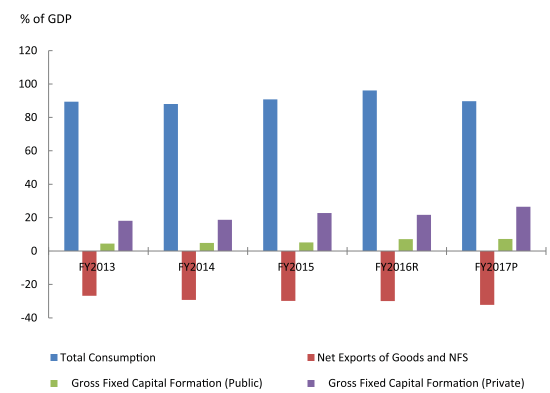
R= revised; P= provisional
Source: Central Bureau of Statistics

6 Nepal Electricity Authority's (NEA) generation of hydroelectricity increased to 2,305.1 GWh in FY2017 from 2,133.1 GWh in FY2016 (NEA, 2017).
7 Power purchase from India increased to 2,175 GWh in FY2017 (an increase of 22.4%) from 1,777.6 GWh in FY2016 (NEA, 2017).

a contraction of 9.7% in FY2016. Wholesale and retail trade grew by 9.8% in FY2017 from a drop of 4.4% in FY2016. And financial intermediation increased by 6.7% in FY2017 with banks and financial institutions (BFI) expanding their outreach, resulting in an increase of savings and credit accounts across the country (Figure 3).

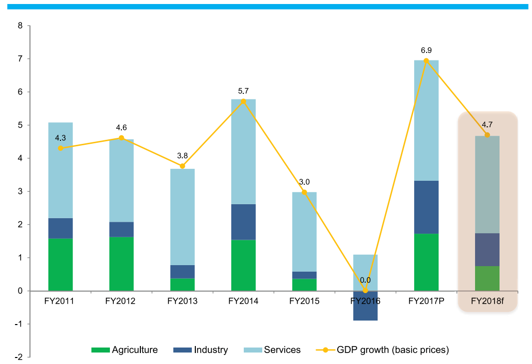
4. **From demand perspective, high consumption prevailed in FY2017 with growing imports stimulated by remittance income.** Consumption expenditures accounted for 89.7% of GDP in FY2017, albeit down from 96.2% of GDP in FY2016 (Figure 4). With a strong rebound in private investment, gross fixed capital formation[8] increased to 33.8% of GDP in FY2017, up from 28.8% of GDP in FY2016 (Figure 4). Significant proportion of private investment has gone into construction sector, purchase of capital goods like machinery, plants and heavy-duty vehicles. Private fixed investment has also surged in other sectors such as hotel, hydropower and aviation. Imports in FY2017 surged with increased purchase of capital goods, construction materials, including telecommunication equipment and devices. Consequently, merchandise trade deficit increased from 30.3% of GDP in FY2016 to 34.5% of GDP in FY2017, resulting in a negative contribution to growth in FY2017.

Figure 4: Share of GDP by expenditure



Source: Central Bureau of Statistics

Figure 5: GDP forecast (% points)



P= Provisional; f = forecast
Source: Central Bureau of Statistics; NRM staff estimates

II. Economic prospects for FY2018

4. **Economic growth in FY2018[9] will likely fall to 4.7% for several reasons** (Figure 5). First, heavy rainfall since mid-August led to landslides and floods, resulting in the loss of human lives and livelihoods. Floods inundated paddy fields and destroyed crops in most of the Terai districts of Nepal (see Box 1 for preliminary estimated loss).[10] This will depress farm output, hampering growth prospect. Second, implementation delays of national pride projects have continued in FY2018.[11] This will likely lead to a substantial shortfall in capital expenditure and depress economic growth. Third, though dates for provincial and federal level elections[12] have been announced, several bills, namely, Natural Resources and Fiscal Commission including Inter-governmental Fiscal Transfer imperative for effective implementation of fiscal federalism have yet to be enacted. In the absence of these bills, distribution of natural resources and revenue among all three tiers of government will be affected, hampering growth prospect in FY2018.

[8] This is based on current price GDP.
[9] FY2018 ends on mid-July 2018.
[10] Ministry of Agriculture and Development has set up a high-level committee to provide relief to flood victims and investigate the losses incurred by agriculture sector from recent floods and landslides.
[11] Poor execution of national pride projects has continued in FY2018, originating from bureaucratic hassles, lack of effective contract enforcement, transparency and accountability. To rectify such issues, the National Planning Commission (NPC) has drafted an Act that defines the characteristics to qualify as national pride projects and charts out effective enforcement mechanism of such projects.
[12] Federal parliament and provincial assemblies' elections have been scheduled in two phases – on 26th November and 7th December 2017.

5. **Agriculture output is expected to expand by mere 2.4% in FY2018 from a growth of 5.3% in FY2017.** This is largely due to the recent devastations brought by incessant downpour especially in the Terai belt of Nepal. However, industry sector buoyed by increased supply of electricity[13] and availability of construction materials[14] will likely expand by 6.6% in FY2018, albeit down from a growth of 10.9% in FY2017. Additionally, the enactment of Labour and Special Economic Zone (SEZ) bills are expected to improve investors sentiment, favouring manufacturing output. Services sector is forecast to grow by 5.5% in FY2018 owing largely to likely expansion of wholesale and retail trade,[15] financial intermediation[16] and travel and tourism[17] sub-sectors.

6. **Rise in investment and government expenditures will likely drive growth in FY2018.** Private investment will likely increase in FY2018 in industries such as cement[18] and hydropower.[19] Public investment will also increase if proposed project implementation and procedural reforms[20] are implemented along with clarity on jurisdictions[21] related to capital spending and revenue mobilization among the three tiers of government. Government consumption will increase with election spending[22] and fiscal transfer to local and provincial governments under the federal structure of governance. Private consumption, on the other hand, will likely remain subdued with slow rise in remittances.[23] Trade deficit will likely increase with falling export to import ratio.

[13] Nepal will import additional 100 MW of electricity from India this fiscal year via Raksaul-Parwanipur and Kusha-Kataiya inter-country transmission lines. Upper Tamakoshi with the generation capacity of 456MW of hydroelectricity will be added to national grid lines by FY2018.

[14] Trade normalization along the southern border has eased the availability of construction materials. With the new federal set-up, import of construction materials like cement, M.S. billet, M.S. wires, rods, coils, bars, other machinery and parts are expected to rise in FY2018.

[15] Wholesale and retail trade is expected to increase with fiscal decentralization leading to expansion of urban, semi-urban and rural markets across the country.

[16] The Monetary policy for FY2018 has mandated banks and financial institutions (BFI) to open bank branch in every local unit without financial institution. The central bank has also offered financial incentives to BFIs given that they open branch offices outside district headquarters of several remote districts across the country. These initiatives will likely improve financial intermediation in FY2018.

[17] Tourists' arrival has been increasing in 2017 with a total arrival of 475,269 from January 2017 to mid-July 2017 (Ministry of Culture, Tourism and Civil Aviation). The momentum is expected to continue in 2018 with acceleration of post-earthquake reconstruction, particularly of ancient heritages and trekking trails. Further, expectations are high that peace, development and economic stability will be attained with the ongoing implementation of fiscal federalism in Nepal, boosting tourism sector.

[18] A joint venture between Nepal's Shivam Holdings and China's Hongshi Group has signed a project investment agreement (PIA) with the Investment Board of Nepal on September 3rd, 2017 for establishing a cement plant in Nawalparasi district of Nepal. It is expected that the plant will begin its production in 2018. For details, please see: <http://ibn.gov.np/ibn-hongshi-shivam-cement-sign-pia>

[19] NEA and Siuri Power Pvt. Limited signed a power purchase agreement on June 2nd, 2017. The private power company has initiated the construction of 40.27 MW of hydroelectricity generation in Lamjung district of Nepal. Private investment in hydropower will continue in FY2018 with the ongoing construction of several hydropower projects such as Mistri Khola hydropower project in Myagdi district of Nepal that is expected to generate 42 MW of hydroelectricity by February 2019.

[20] The budget for FY2018 announced a series of project implementation, policy and procedural reforms to expedite budget execution.

[21] In the absence of Local Level Governance Act, ambiguity had emerged of late in relation to revenue mobilization and budget execution at local levels. For details, please see < http://kathmandupost.ekantipur.com/news/2017-09-08/mayor-shakya-blames-limited-rights-for-failure.html> and <https://thehimalayantimes.com/nepal/lack-laws-hindering-local-level-representatives-exercising-rights/>. However, the parliament recently endorsed Local Level Governance Act on September 19th, 2017, paving the way for local governments to operate in full swing.

[22] Ministry of Finance has apportioned NPR 35 billion for holding third phase of local level election scheduled on September 18th, 2017, including provincial and federal level elections before January 21st, 2018.

[23] With a decrease in the number of out-migrants to major destination countries like Qatar and Saudi Arabia, remittance income is expected to grow modestly in FY2018.

Box 1: Recent flood and devastation

Torrential rains this monsoon triggered landslides and floods resulting in a major loss of life and livelihoods across the country. Though landslides and floods have become recurrent phenomena, devastation this year was on a larger scale with intense and widespread downpour, affecting most of the Terai districts of Nepal. The unplanned construction of banks and embankments obstructed the natural flow of rivers, inundating villages. A total of 35 out of 75 districts were affected, and the worst hit Terai districts were: Morang, Sunsari, Siraha, Rautahat, Mahottari, Dhanusha, Sindhuli, Bara, Parsa, Dang, Banke and Bardiya.

Despite the Department of Hydrology and Meteorology being able to better inform people regarding the imminent flood, human casualties were high (see situation overview). As per the department, 35 out of 40 hydrological stations are functional and not all flood prone areas have hydrological stations, making it difficult to predict water levels.[24] Besides such institutional deficiency, poor pre- and post-disaster flood management system also worsened the situation. For instance, prompt and well managed rescue efforts and adequate community relief centres for temporary shelter could have better served the flood affected victims.

Situation overview

Dead*	159
Missing*	28
Injured*	45
Houses completely destroyed*	43433
Houses partially destroyed*	158197
Families displaced**	91,000
People affected**	1.7 million

A preliminary estimate by the Government of Nepal shows a total damage worth NPR 37.3 billion,[25] or 1.4% of GDP due to the recent flood. The catastrophe induced monetary loss across all sub-sectors of the economy (Table 2).

Damage to various sectors of the economy

	Damage (NPR)
Agriculture	8.1 billion
Livestock	10.1 billion
Irrigation	15.5 billion
Physical Infrastructure (roads and bridges)	4 billion[26]
Drinking water and sanitation	500 million

Source: Ministry of Agricultural Development; Ministry of Livestock Development; Ministry of Irrigation; Department of Roads; Ministry of Water Supply and Sanitation

The government has initiated humanitarian relief work in flood affected districts. It announced a compensation of NPR 2,00,000 to each bereaved family, who lost family member in the floods. The government also decided to provide NPR 70 a day for a month to each affected victim. The Prime Minister's Disaster Relief Fund has also released $10 million to Central Disaster Relief Fund maintained with the Ministry of Home Affairs for flood victims. In addition, various non-governmental organizations, communities and development agencies have been providing humanitarian assistance in flood affected districts.

[24] For details, please see <http://www.myrepublica.com/news/26059/>
[25] For details, please see <http://www.myrepublica.com/news/26088/>
[26] For details, please see <https://thehimalayantimes.com/business/department-of-road-seeks-rs-420-million-immediately/>
* Information available from the Ministry of Home Affairs, Government of Nepal.
** Information available from the United Nations Office for the Coordination of Humanitarian Affairs (OCHA).

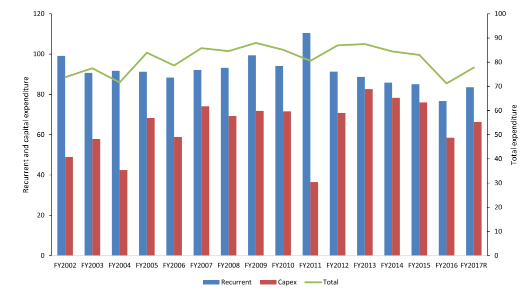
B. FISCAL SECTOR

I. Expenditure performance

7. **With mere 66.4% of planned capital expenditures spent, poor execution of capital expenditures continued in FY2017.** The rate of execution was less than the average rate of 73.3% from 2012 to 2016 (Figure 6). But, the year-on-year (y-o-y) growth in capital expenditure has remained solid, signalling that the poor execution rate may simply reflect too ambitious target (Figure 7). Nonetheless, delays in project implementation in terms of preparation of detailed project report, environmental impact assessment and procurement related processes along with slow project approval and budget release have resulted in lower than planned capital expenditures. In addition to institutional and procedural barriers, shortage of construction materials and capital goods,[27] skilled and semi-skilled labour force[28] are other hurdles that have impeded civil work leading to poor execution rate of capital expenditures (Figure 8). The bunching of capital expenditures towards the last quarter continued in FY2017 with 61% spent in the last quarter (Figure 9). The hasty nature of capital spending in the last quarter is likely to have undermined the quality of capital projects requiring maintenance of physical infrastructure within a short span of completion. Moreover, weak execution of capital budget in the first three quarters has also fuelled liquidity shortage,[29] limiting the availability of loanable fund in the banking sector.

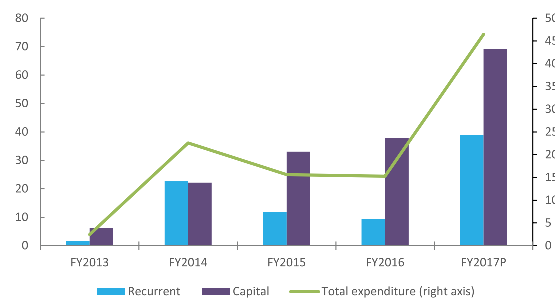
8. **Though the fiscal policy for FY2018 announced a series of budget implementation reforms,[30] particularly aimed at expediting capital expenditures, their implementation remains to be seen.** For instance, previously, projects included in Line Ministries Budget Information System (LMBIS) had to seek approval from National Planning Commission (NPC) again after budget approval and before implementation. Such procedural requirement had hindered project implementation process in the past. The fiscal policy for FY2018 removed this provision. Projects mentioned in LMBIS are the final approved ones and on this basis, District Treasury Comptroller Offices (DTCOs) can release budget to their respective spending units. This amendment[31] has come into effect with the parliament endorsing "Appropriation bill" on July 10th, 2017. Likewise, other policy,

Figure 6: Budget execution



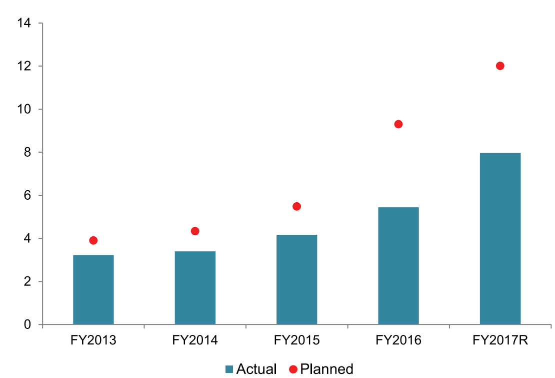
Source: Ministry of Finance; FCGO; NRM staff estimates

Figure 7: Year-on-year growth in expenditure



Source: Ministry of Finance; FCGO; NRM staff estimates

Figure 8: Capital expenditure (% of GDP)



Source: Ministry of Finance; FCGO; NRM staff estimates

[27] Trade disruptions along the southern border led to a shortage of construction materials, petroleum products and capital goods.

[28] Nepal currently lacks skilled workforce such as plumbers, carpenters, electricians, technicians essential for building and construction activities. For details, please see <https://www.adb.org/sites/default/files/linked-documents/38176-015-nep-oth-01.pdf>. One of the reasons for delay in post-earthquake reconstruction activities is the shortage of skilled labor force. For details, please see <https://thehimalayantimes.com/nepal/shortage-of-skilled-workers-affects-reconstruction-work/>.

[29] Liquidity crunch emerged during mid FY2017. Due to poor capital spending, huge cash balances of the Government of Nepal maintained at Nepal Rastra Bank (NRB) remained outside the banking system. Had the money been injected into the economy, this would have eased liquidity shortage.

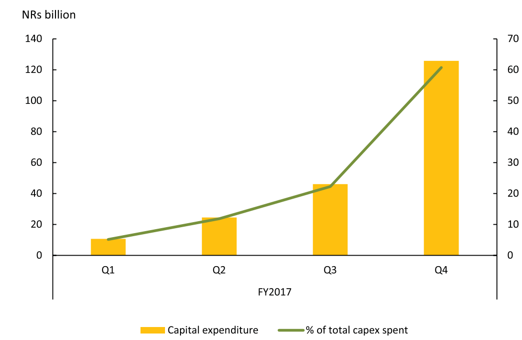
[30] Several budget implementation reforms such as allocation of sufficient fund for the construction of national pride projects, mentioning of timeframe for the completion of projects, avoidance of double taxation, facilitation of e-payment system as well as project implementation reforms were announced in FY2018 budget.

[31] This reform is applicable to central level projects as well.

procedural and system based reforms must be timely implemented for meeting targets on capital expenditures.

9. The execution rate of recurrent expenditures has been far better than capital expenditures. Government expenditures in FY2017 stood at NPR 822 billion (31.6% of GDP), an increase of 4.4% from FY2016. The substantial spending is under recurrent expenditures[32] with 83.5% of the planned amount spent in FY2017 (Figure 6).

Figure 9: Bunching of capital expenditure

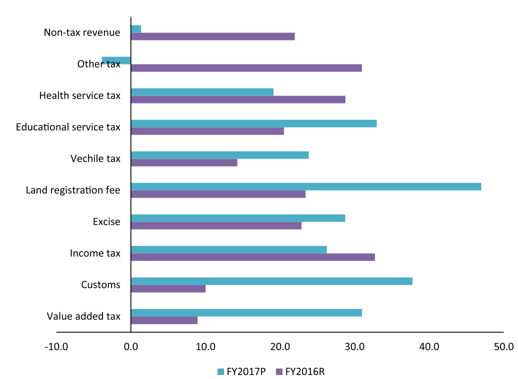


Source: Ministry of Finance; FCGO; NRM staff estimates

II. Revenue performance

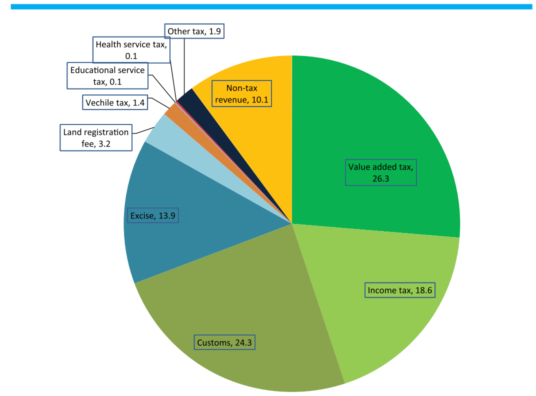
10. The government has been quite successful in meeting revenue collection target over the years. Increase in imports and reforms aimed at boosting tax collection via widening tax net such as systematic analysis of tax policies, follow up on non-compliance and non-payment, decrease in compliance costs, establishment of a transaction-based taxpayer categories have helped improve revenue collection over the years.[33] Government revenues for FY2017 stood at NPR 609.1 billion, or 23.4% of GDP, an increase of 26.4% from FY2016. Revenue collection in FY2017 exceeded the revised budget target of NPR 580.9 billion. Custom duties, stimulated by surge in imports, contributed significantly to revenue collection. It increased to NPR 113.8 billion, in FY2017, an increase of 37.8% over custom collection in the previous year (Figure 10). Income tax revenue as well increased to NPR 148.2 billion, an increase of 26.3% over the last year's income tax revenues. This was boosted by Ncell's tax payment on its capital gains.[34] Likewise, VAT revenue increased to NPR 160.3 billion in FY2017, an increase of 31% over the FY2016 VAT collection. Hence, growth in custom duties, income tax, VAT, excise duties and registration fee contributed to a record level revenue collection in FY2017 (Figure 10). Overall, VAT comprised of 26.3% of total revenue mobilization, followed by income tax at 24.3%, custom duties at 18.6%, excise duties at 13.9% and non-tax revenues at 10.1% in FY2017 (Figure 11).

Figure 10: Revenue growth (% change)



P=provisional; R= revised
Source: Nepal Rastra Bank

Figure 11: Composition of total revenue in FY2017



Source: Nepal Rastra Bank

32 Recurrent expenditures constituted compensation of employees, use of goods and services, grants, subsidies, social security, interest and services payment among others.

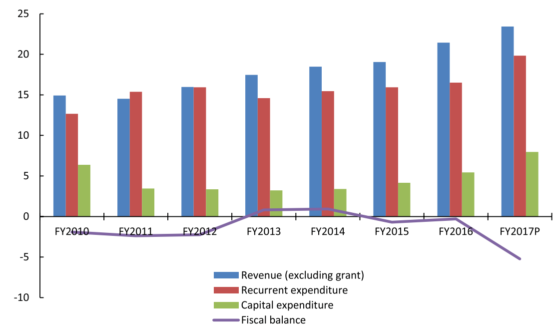
33 Government of Nepal/Ministry of Finance/Inland Revenue Department: Reform Plan 2015/16-2017/18. Available online at: <https://ird.gov.np/Content/ContentAttachment/4/ReformPlanIRD8122016114507AM.pdf>

34 Ncell is one of the largest telecom service providing companies. For details, please refer to <https://thehimalayantimes.com/business/ncell-files-rs-13-6-billion-capital-gains-tax/>and <https://thehimalayantimes.com/business/exponential-import-growth-backs-revenue-collection/>

III. Fiscal balance

11. **With lower than planned capital expenditures and a rise in revenue mobilization, the actual fiscal deficit was less than the revised target for FY2017.** The recently announced fiscal policy for FY2018 had revised down fiscal deficit[35] target to 6.4% of GDP in FY2017. But the actual fiscal deficit[36] in FY2017 was NPR 135.9 billion, or 5.2% of GDP, up from 0.3% of GDP in FY2016 (Figure 12). The substantial increase in both recurrent and capital expenditures (see figure 7) in FY2017 compared to the year earlier led to a widening fiscal deficit. The country recorded fiscal surplus in FY2013 and FY2014 but ran a fiscal deficit of 0.7% of GDP in FY2015. Nonetheless, fiscal sustainability has been maintained, mainly as a reflection of weak budget execution.

Figure 12: Capital expenditure (% of GDP)

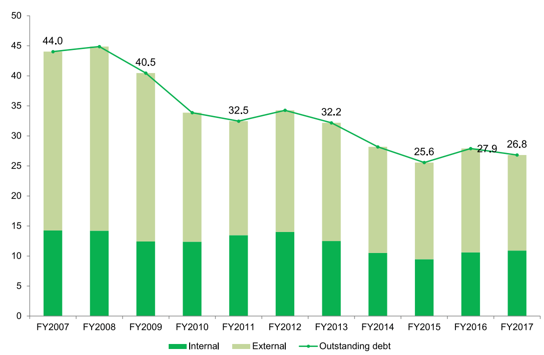


Source: Ministry of Finance; NRM staff estimates

IV. Public debt

12. **Nepal faces low debt distress given the high level of official concessional borrowing at longer maturity[37] and large treasury surplus resulting from robust revenue collection and weak budget execution.** The government's average debt to GDP ratio for FY2012-16 has hovered around 29.6%. The government's total external debt stood at NPR 413.6 billion, or 15.9% of GDP, a drop from 17.3% of GDP in FY2016 (Figure 13). Likewise, the government's total internal borrowing stood at NPR 283.7 billion (10.9% of GDP) from NPR 234.1 billion, or 10.4% of GDP.

Figure 13: Public debt (% of GDP)



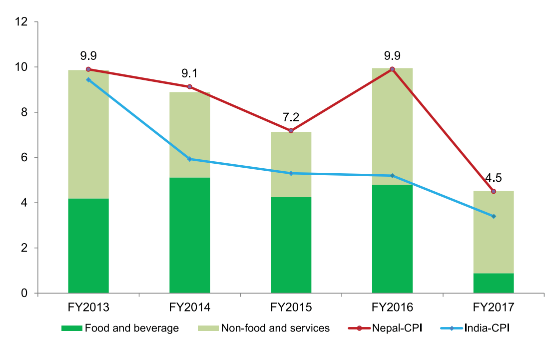
Source: Financial Comptroller General Office; Nepal Rastra Bank

C. MONETARY SECTOR

I. Inflation

13. **Annual average inflation moderated[38] to 4.5% in FY2017 from an average of 8.9% achieved during FY2010-FY2016** (Figure 14). Inflation moderated to 2.7% y-o-y in mid-July 2017, down from 10.4% in the same period of FY2016. The significant moderation in inflation is largely due to increased domestic production-particularly agriculture output - normalization of trade and subdued Indian inflation. Food inflation declined more than non-food inflation in FY2017. Food inflation moderated to 1.9% in FY2017 from 10.9% in FY2016 (Figure 15). The moderation of food inflation[39] resulted from a fall in prices of pulses and legumes, vegetables, ghee and oil, meat and milk products. Non-food inflation moderated to 6.5%

Figure 14: Contribution to overall inflation (% points)



Source: Nepal Rastra Bank

[35] This is calculated as total resources (inclusive of grants, non-budgetary receipts, reconstruction fund account and local authorities account) minus total expenditures (including financial provision). Using this definition, NRB reported that the actual fiscal deficit for FY2017 was NPR 125.6 billion or 4.8% of GDP.
[36] NRM, ADB calculates fiscal deficit as the sum of revenues including foreign grants and cash carryover minus expenditures and net lending.
[37] For details, please see <https://www.imf.org/external/pubs/ft/dsa/pdf/2017/dsacr1774.pdf>
[38] This is the lowest average annual inflation achieved since the annual inflation of 4% in FY2004.
[39] Prices of basic food staples dropped mainly due to increased domestic agriculture output and moderation of Indian inflation.

in FY2017, down from 9.2% in FY2016 (Figure 16). The decline in non-food inflation in FY2017 compared to that of preceding year resulted from a fall in prices of clothing items, footwear, housing and utilities, transportation and communication services.

II. Inflation differential between Nepal and India

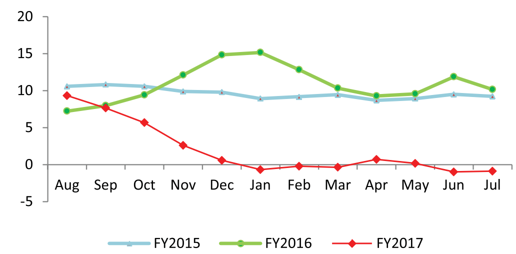
15. **Inflation differential between Nepal and India has substantially narrowed in FY2017.** The average consumer price inflation in India was 3.4%, while it was 4.5% in Nepal, indicating an inflation differential of 1.1% (Figure 14). Such inflation differential was 4.7% in FY2016. Indian inflation has a direct bearing on inflation in Nepal given the significant trade[40] volume with India alone and fixed exchange rate regime[41] with Indian currency.

III. FY2018 Inflation outlook

16. **Inflation is expected to rise to 6.5% in FY2018 from 4.5% in FY2017** (Figure 17). The proposed expansionary budget for FY2018 (an increase by 36.7% in expenditure), including fiscal transfer[42] and election expenditures[43] could raise inflationary pressure. The 2018 forecast for inflation is partly based on expectations of higher domestic demand, notably from reconstruction, election-related spending and higher government expenditures under the new federal structure.

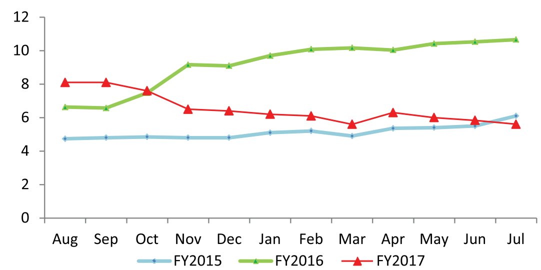
17. **Inflation could further intensify in the back of depressed farm output and infrastructure damage from the recent natural catastrophe triggered by heavy rainfall.** Preliminary estimate shows that agriculture production worth of NPR 8.1 billion, livestock worth of NPR 10.1 billion and irrigation infrastructure worth of NPR 15.5 billion have been destroyed. Additionally, infrastructure damage[44] from the recent flooding has obstructed smooth flow of goods within and outside the country. This will likely result in short-supply deficits and intensify consumer price pressure in FY2018.

Figure 15: Food inflation



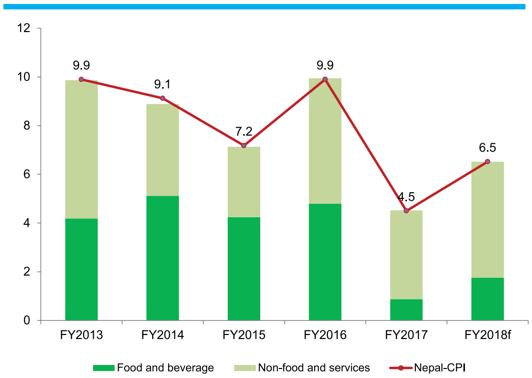
Source: Nepal Rastra Bank

Figure 16: Non-food inflation



Source: Nepal Rastra Bank

Figure 17: Projected annual inflation for FY2018 (% points)



f = forecast
Source: Nepal Rastra Bank; NRM staff estimates

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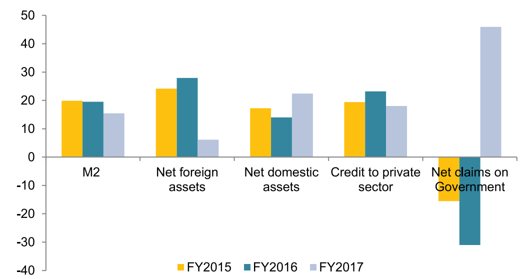
[40] India alone accounts for more than 60% of Nepal's total trade.
[41] Nepali currency is pegged with Indian currency at INR 1 = NPR 1.6 since 1992.
[42] Fiscal transfer (including both recurrent and capital expenditures) to local and provincial governments has the highest share in recurrent expenditure, accounting for 28.9%. Such a provision was non-existent in FY2017.
[43] Ministry of Finance has apportioned NPR 35 billion for holding third phase of local level election scheduled on September 18th, 2017, including provincial and federal level elections by January 21st, 2018.
[44] Preliminary estimate shows that floods have damaged roads and bridges worth NPR 3 billion.

IV. Money supply

18. **With a decline in net foreign assets (NFA), broad money supply (M2) increased by mere 15.5% in FY2017, down from an increase of 19.5% in FY2016.** The larger trade deficit and slow rise in remittances contracted the balance of payment (BOP) surplus in FY2017 and NFA increased by NPR 82.1 billion (3.2% of GDP) in FY2017 compared to an increase of NPR 188.9 billion (8.4% of GDP) in FY2016 (Figure 18). Net domestic assets (NDA), on the other hand, increased by NPR 264.9 billion (10.2% of GDP) in FY2017 compared to an increase of NPR 177.8 billion (7.9% of GDP) in FY2016.

Figure 12: Monetary sector (% change)

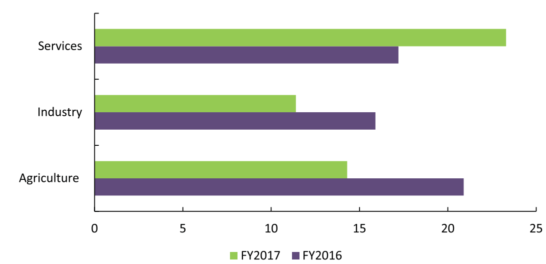


Source: Nepal Rastra Bank

V. Deposit and credit

19. **Both deposit collection and credit disbursement increased at a slower rate in FY2017 owing to decelerated growth of remittances.** Deposits at BFIs increased by 14% in FY2017, down from an increase of 19.4% in FY2016. Credit by BFIs to private sector moderately increased by 18.2% in FY2017 compared to a rise of 23.7% in FY2016. Credit to agriculture, industry and service sector industries increased by 14.3%, 11.4% and 23.3%, respectively (Figure 19). But credit to risky and unproductive assets[45] expanded by more in FY2017 than in the preceding year. Real estate loan, hire purchase loan and overdraft increased by 16.5%, 35.6% and 22.1%, respectively in FY2017 (Figure 20).

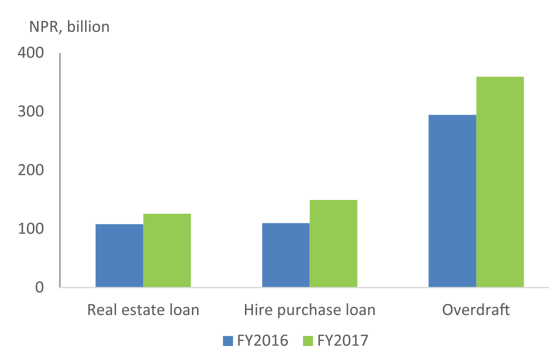
Figure 19: Growth in credit to real sector (% increase)



Source: Nepal Rastra Bank

20. **The provision of refinance facility made available to BFIs by Nepal Rastra Bank (NRB) has proved helpful in increasing credit disbursement to productive sector, including export oriented industries.** A total refinance facility of NPR 14.6 billion, or 0.6% of GDP was utilized in FY2017, which is an increase of 64.1% from FY2016. Also, commercial banks disbursed 18.2% of their total loan portfolios to productive sector in FY2017, albeit less by 1.8% as per the policy provision of NRB.

Figure 20: Change in product loan



Source: Nepal Rastra Bank

VI. Liquidity management

21. **Though liquidity crunch emerged since mid FY2017, NRB successfully addressed the shortage.** The central bank intervened via open market operations and issued directives that restricted credit flow to unproductive sector. For instance, NRB directed BFIs not to finance more than 50% of the value on hire purchase for personal use.[46] The central bank injected net liquidity of NPR 435.8 billion,

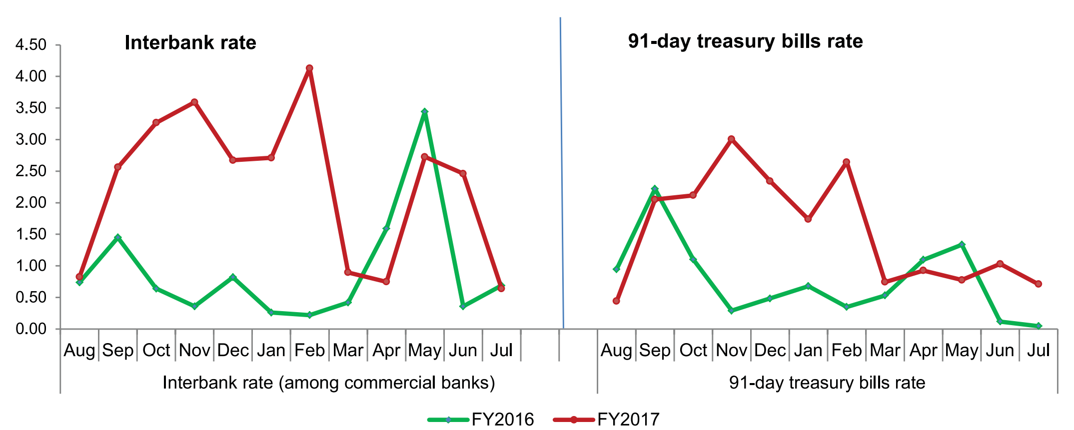
[45] Real estate, hire purchase for personal use and margin lending are categorized as risky and unproductive assets.
[46] However, the monetary policy for FY2018 has provided some relaxation on hire purchase, allowing BFIs to finance up to 65% of the value on hire purchase for personal use.

or 16.8% of GDP into the economy via open market operations[47] in FY2017. The NRB also mopped up a total of NPR 124.4 billion (4.8% of GDP) in FY2017, significantly less than the amount of NPR 542.5 billion (24.1% of GDP) mopped up in FY2016. To further ease the liquidity crisis, NRB allowed BFIs to deduct 50% of their total credit lent to productive sectors while calculating credit to core capital-cum-deposit (CCD)[48] ratios. This facility has however been removed for FY2018. Instead, the central bank has extended the deadline for maintaining the requisite CCD ratio by mid-October 2017 to those BFIs that have exceeded their CCD limits.

VII. Interest rate

22. **The goal of addressing short-term interest rate volatility via implementation of interest rate corridor[49] in FY2017 was largely unmet.** The weighted average rate of 91-day treasury bills jumped to 0.71% in FY2017 from 0.05% in FY2016 (Figure 21). The weighted average interbank rate for commercial banks dropped to 0.64% in FY2017 from 0.69% in FY2016. However, the weighted average interest rate spread of commercial banks stood at 5.2% in mid-July 2017, down from 5.6% in mid-July 2016 (Figure 22). This is in line with the NRB's objective of maintaining interest rate spread of 5% for commercial banks.

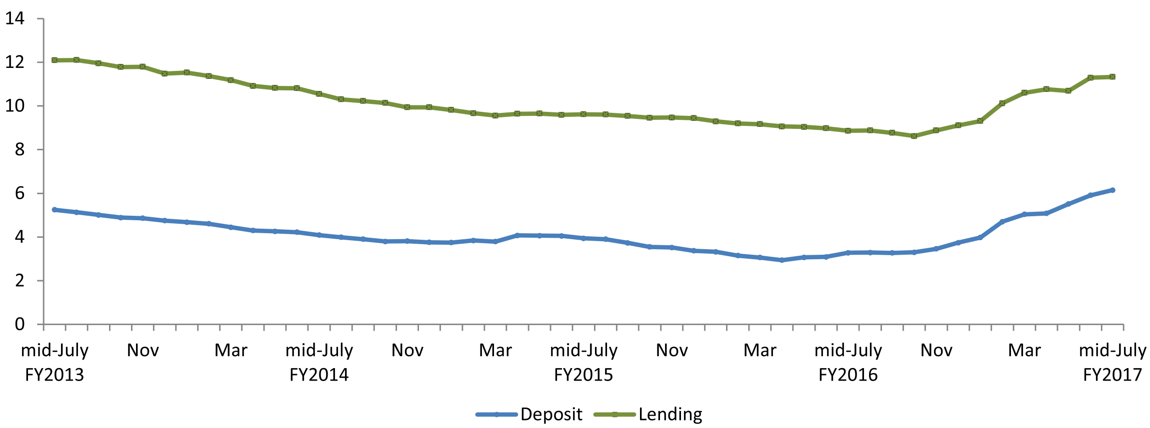
Figure 21: Weighted average Interbank and 91-day treasury bills rate (%)



Source: Nepal Rastra Bank

[47] Open market operations such as sale, purchase, repo and reverse repo auctions are the main instruments of NRB used to maintain liquidity management.
[48] NRB has mandated BFIs to maintain credit to core capital-cum-deposit (CCD) ratio within the ceiling of 80%.
[49] This monetary tool has been continued for FY2018, albeit with some changes. The standing liquidity facility (SLF) or the ceiling rate has been kept unchanged at 7%, which is also the bank rate. Banks and financial institutions (BFIs) can borrow from NRB at SLF rate against their securities for a period of 7 days, compared to 5 days in FY2017. The two-week repo or policy rate has been fixed at 5%, and the two-week floor or term-deposit rate has been maintained at 3%. In FY2017, both the policy and floor rates were determined based on weighted average interbank rate of commercial banks

Figure 22: Weighted average deposit and lending interest rates of commercial banks

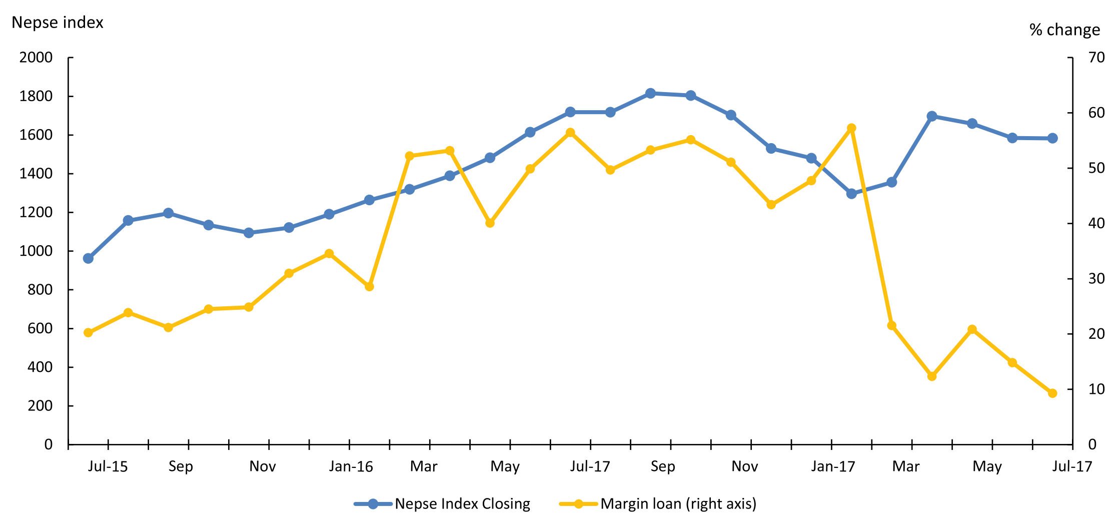


Source: Nepal Rastra Bank

VIII. Capital market

23. **An increase in the margin loan increases the availability of money to be invested in the stock market, which in turn increases the demand of shares and finally the NEPSE index.** With the liquidity shortage since mid-FY2017, BFIs curtailed margin lending that led to a moderation in the NEPSE index. It fell by 7.8% (y-o-y) from 1,718.2 points in mid-July 2016 to 1,582.7 points in mid-July 2017. This was also marked by a falling growth of margin loan on year-on-year basis (Figure 23).

Figure 23: NEPSE index and margin loan



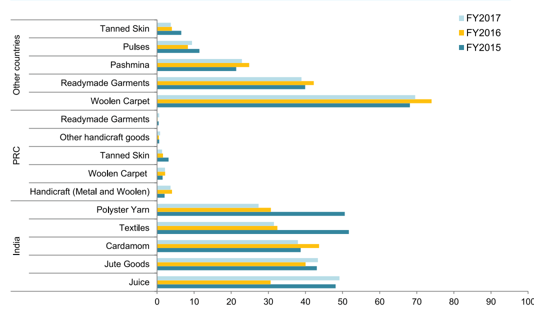
Source: Nepal Stock Exchange Ltd.; Nepal Rastra Bank; NRM staff estimates

D. EXTERNAL SECTOR

I. Exports

24. **Merchandise exports rebounded in FY2017 from a low base, normalization of trade since February 2016 and restoration of road networks damaged by the earthquakes.** Exports of goods increased by 9.7%, reaching NPR 82.1 billion in FY2017 from a drop of 23.8% in FY2016. Manufacturing output increased with the availability of raw materials and increased supply of electricity. Trade disruptions along the southern border ended after months of political unrest that had paralyzed life across the country. And road networks damaged by the earthquakes of 2015 have been restored. Consequently, merchandise exports[50] to India, China and the rest of the world increased by 5%, 1.2% and 3.3%, respectively (Figure 24). Exports of juice, jute items and pulses increased while that of cardamom, woollen carpet, readymade garments and pashmina decreased in FY2017 (Figure 24).

Figure 24. Top five exports to India, PRC, and other countries



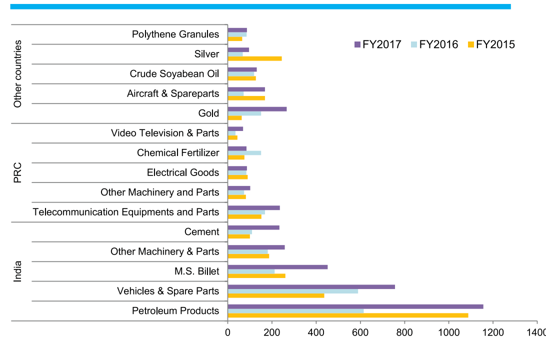
Source: Nepal Rastra Bank

25. **Service exports particularly related to travel and tourism substantially increased in FY2017 with increased peace and stability and acceleration of post-earthquake reconstruction work.** Travel receipts increased by 40.1% totalling NPR 58.5 billion, or2.3% of GDP in FY2017 from a drop of 21.8% in FY2016.

II. Imports

26. **With remittances stimulating import, its growth has substantially increased.** Merchandise imports (cost, insurance and freight) in FY2017 increased by 29% to NPR 977.9 billion, or 37.6% of GDP from a decrease of 0.7% in FY2016. Again, this boost in import level from the previous year is largely due to the end of supply disruptions since February 2016. Merchandise imports[51] from India, China and the rest of the world increased by 32.8%, 10% and 26.8%, respectively (Figure 25). Imports of petroleum products, vehicles and spare parts, and cement increased while that of medicine, chemical fertilizer, battery and others decreased in FY2017 (Figure 25).

Figure 25. Top five imports from India, PRC, and other countries



Source: Nepal Rastra Bank

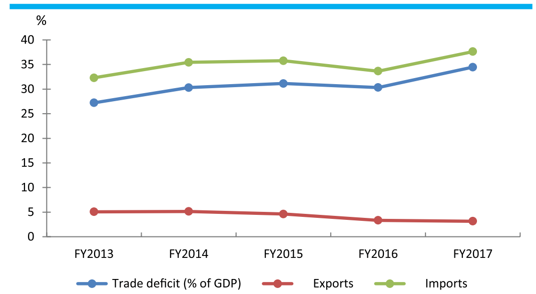
27. **Merchandise trade deficit has widened with an increasing volume of imports compounded by a sluggish rise in exports** (Figure 26). Economic liberalization and accession to World Trade Organization (WTO) not only opened Nepal's economy for foreign goods and services but also provided an access to foreign market for domestic goods and services. But domestic goods and services

[50] Nepal mainly exports readymade garments, pashmina, jute, cardamom, juice, tea and ginger, among others.

[51] Nepal mainly imports petroleum products, vehicles and spare parts, electrical and electronic equipment, cereals, medicines, apparel and clothing items, among others.

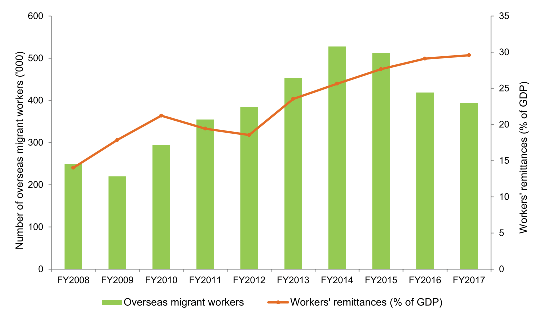
simply could not compete with foreign goods and services that were far competitive. Political instability, inadequate infrastructure, lack of a competitive structure in key markets[52] and appreciation of real exchange rate[53] have negatively affected export competitiveness of goods and services. Nepal's merchandise export suffered from loss of competitiveness, low productivity, lack of product diversification, quality issues,[54] non-tariff measures[55] and poor infrastructure.[56] Consequently, merchandise trade deficit increased by 31.4% reaching NPR 895.8 billion, or 34.5% of GDP in FY2017 (Figure 26). One of the reasons as to why domestic manufacturers simply cannot compete with foreign goods is because of high custom duties[57] levied on imports of raw materials for manufacturing products. To address such deterrents, SEZ Act and Industrial Enterprise Act (IEA) 2016 have been enacted that aims at providing tax incentives and relaxation on custom duties for export oriented manufacturing firms. Such legal improvements, depending on their effective implementation, are expected to boost export, thereby lowering trade deficit.

Figure 26: Trade deficit (% of GDP)



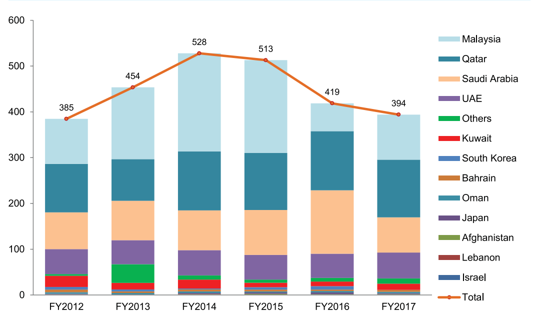
Source: Nepal Rastra Bank

Figure 27: Number of migrants and remittance inflows



Source: Department of Foreign Employment; Nepal Rastra Bank

Figure 28: Overseas migration excluding India (in thousands)



Source: Department of Foreign Employment

III. Remittances

28. **Although out-migration for foreign employment decreased in FY2017, workers' remittances continued to increase at a slower rate.** It increased by 4.6% to NPR 695.4 billion (26.8% of GDP) in FY2017, down from 7.7% increase in FY2016 (Figure 27). The significant drop for foreign employment is observed in Qatar and Saudi Arabia with weaker demand in these countries. As per the Department of Foreign Employment, the number of labour migrants to Qatar and Saudi Arabia (top destination countries) has dropped by 2.4% and 44%, respectively in FY2017 (Figure 28).

29. **While remittances have helped improve living standards in Nepal, its productive use[58] remains far from reality.** There is no accurate picture on the real volume of funds transferred to Nepal as huge sum of income is remitted via informal channels. This is primarily due to lack of official records on the number of Nepali

[52] Competition Promotion and Market Protection Act 2007 was introduced much later after the adoption of economic liberalization in early 1990s. Nonetheless, the effectiveness of Competition Act remains a serious concern with the prevalence of syndicate system in transportation, one of key sub-sectors of the economy. For details, please refer to "Structure of Nepal's Trucking Industry: Results from a Nationwide Survey." Available online at: <http://dx.doi.org/10.12774/eod_cr.january2015.poudelb>

[53] High remittance income in Nepal has resulted to an increased demand in non-tradable sector vis-à-vis tradable sector. This, in turn, has led to rising prices and output in the non-tradable sector against the tradable sector, appreciating real exchange rate. This is famously known as Dutch disease.

[54] Products like pashmina, leather goods, silver jewellery and ceramic articles including several agricultural products face quality issues.

[55] Several agriculture products like tea, coffee, ginger, vegetables and cardamom lack quarantine and accreditation facilities. Manufactured products like jute items, woollen carpet, handicrafts and silver jewellery face non-tariff barriers like marking and labelling, rules of origin, quota restrictions and anti-dumping.

[56] Major highways of Nepal are below the international standards. The only international airport of Nepal, TIA with its single runway and limited parking bays is unable to handle growing air traffic.

[57] While duty draw back facility is available for export-oriented firms, they can claim refund only after the export of finished goods, and the process is cumbersome often requiring years to get refund. For details, please see <http://nepalitimes.com/news.php?id=8392#.WbpQTbIjHIU>. Further, the duty drawback is applicable on export volume only and not on firm's entire output. For more information, please visit <http://doind.gov.np/index.php/industries/facilities-incentives>.

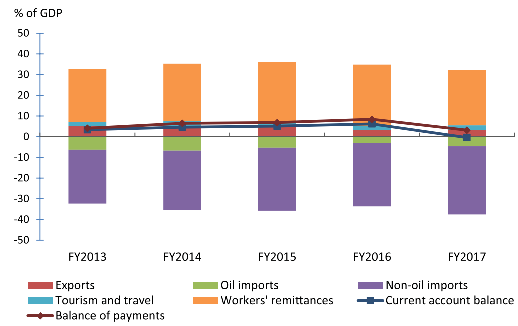
[58] It refers to channelizing funds to productive sector such as agriculture, hydropower, tourism, small and medium enterprises, and various industries like cement, garment, pharmaceuticals and so forth.

migrant workers[59] working in India and money remitted back home. A study by the World Bank shows that only 30% of remittances from the Republic of Korea are sent via formal banking channels.[60] The use of formal banking channels can be promoted via streamlining of financial products, opening bank branch in several remote areas of the country and providing incentives that decrease transaction costs of migrant remittances. NRB has floated Foreign Employment Savings Bond[61] for migrants so that remittance income could also be used for country's development. But despite being a safe investment, overseas migrant workers have been reluctant to investing in bond. This could be due to low level of awareness on bond market and the fear of monetary loss owing to continued depreciation of Nepali currency vis-à-vis US dollar.

IV. Balance of payments

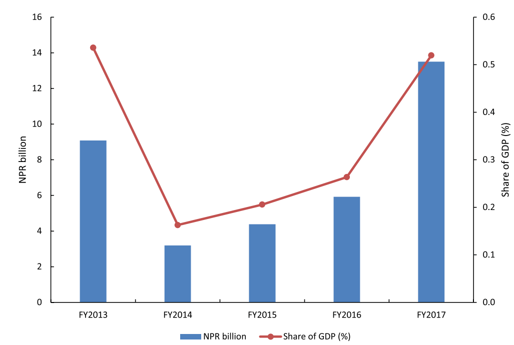
30. **Nepal increasingly faces external sector instability with slowing rise in remittances and ballooning trade deficit in recent years.** This is a major concern as remittances constitute a lion share of foreign currency inflows to Nepal. A drastic growth in imports relative to exports coupled with a slow rise in remittances resulted in current account deficit[62] of 0.4% of GDP in FY2017 (Figure 29). BOP surplus contracted to $775.8 million (3.2% of GDP) in FY2017 from a surplus of $1781.7 million (8.4% of GDP) in FY2016 (Figure 29). Foreign direct investment (FDI) inflows, on the other hand, substantially increased to NPR 13.5 billion (0.5% of GDP) in FY2017 from NPR 5.9 billion (0.2% of GDP) in FY2016 (Figure 30). Nonetheless, its share of GDP is less than South Asian average of 2% from 2002-2015.[63] Passage of some of the bills like SEZ Act, IEA and formulation of one stop policy have helped improve business confidence among

Figure 29: Current account indicators



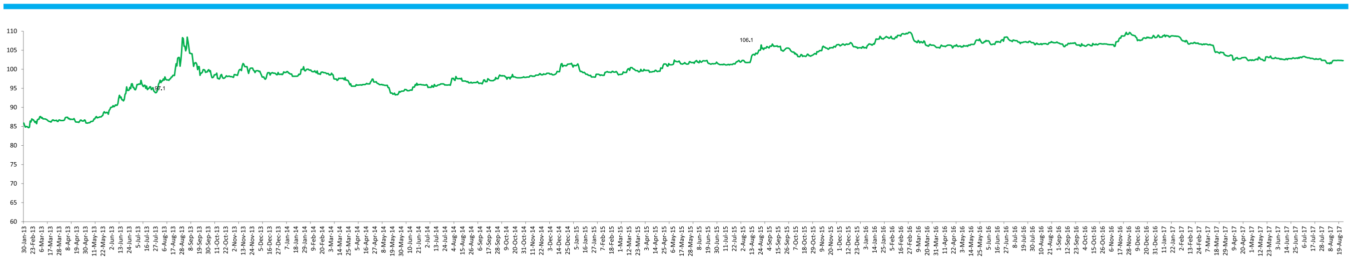
Source: Nepal Rastra Bank; NRM staff estimates

Figure 30: Foreign direct investment and its share of GDP



Source: Nepal Rastra Bank; NRM staff estimates

Figure 31: Daily nominal exchange rate (NPR per 1 $)



Source: Nepal Rastra Bank

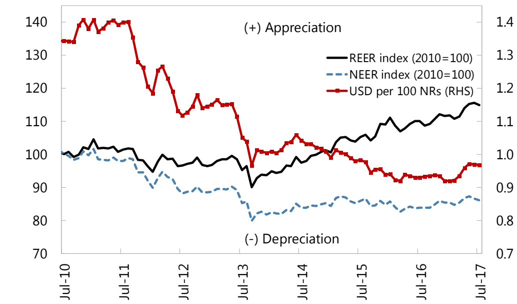
59 Migrant workers from Nepal and India can move freely across the border for work without work permits.
60 Nepal Development Update, May 2017, The World Bank.
61 NRB has been issuing Foreign Employment Savings Bond since 2010. Despite being a safer financial instrument with five-year maturity period at a fixed annual interest rate of 10%, the bond remains undersubscribed every year.
62 The current account was in surplus to the tune of $1338.8 million in FY2016.
63 The World Bank data. Available online at: <https://data.worldbank.org/indicator/BX.KLT.DINV.WD.GD.ZS?locations=BD-BT-IN-MV-NP-PK-LK>

investors. Gross foreign exchange reserves increased from NPR 1039.2 billion (46.2% of GDP) in FY2016 to NPR 1079.5 billion (41.5% of GDP) in FY2017, sufficient to sustain 11.4 months of imports of goods and non-factor services.

V. Exchange rate

31. **Nominal exchange rate of Nepali rupee against the US dollar appreciated by 3.8% in mid-July 2017 from mid-July 2016, owing to an appreciation of Indian rupee to which the Nepali currency is pegged** (Figure 31). Nonetheless, the huge inflow of remittance income in recent years has increased demand in non-tradable sector vis-à-vis tradable sector, leading to an appreciation of real exchange rate (Figure 32). This effect has hampered the export competitiveness of agriculture and manufactured output while favouring a surge in import.

Figure 32: Appreciation of real effective exchange rate



Source: IMF staff estimates

ISSUE FOCUS
Unleashing the potential of trade in services in Nepal[1]

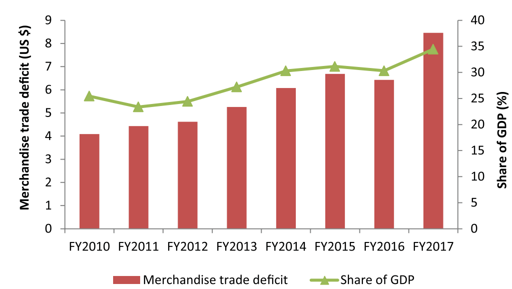
A. Introduction and objective

1. Landlocked-ness and mountainous terrain have historically impeded the promotion of merchandise trade in Nepal. Lack of competitiveness, in par with international goods, emanating from structural bottlenecks and policy inconsistencies has further held back merchandise exports. Consequently, Nepal's merchandise trade deficit as a share of gross domestic product (GDP) has substantially ballooned over the years (Figure 1).

2. Growth in services export, on the other hand, has been better than the growth in merchandise export (Figure 2). Services income, particularly from travel and tourism and communication has increased, signaling a shift[2] from agro-based to service oriented economy. But because of infrastructural, institutional, legal and procedural barriers, the services trade[3] in Nepal has yet to achieve its full potential.

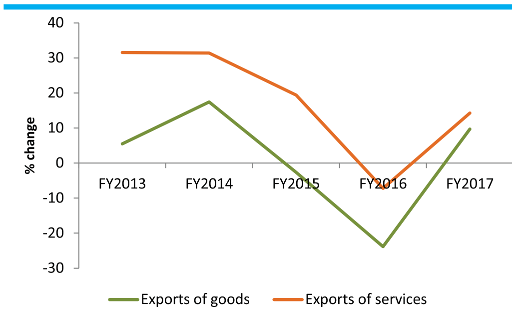
3. Landlocked and least developed countries like Nepal can bridge their trade deficit via export diversification in services sector.[4] The services sector accounted for 66% of total exports and 14% of total imports in FY2017, indicating its growing importance in external trade (Figure 3). This Issue Focus sheds light on the current state and prospects of Nepal's services trade and suggests sector-specific policy recommendations.

Figure 1: Merchandise trade deficit



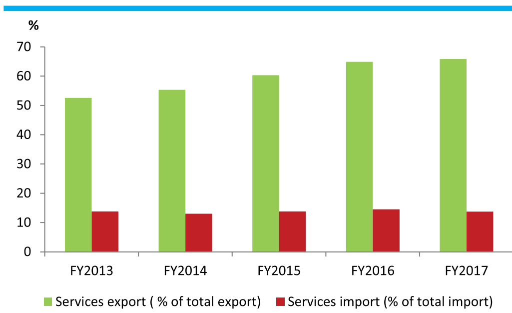
Source: Nepal Rastra Bank; NRM staff estimates

Figure 2: Growth in exports of goods and services



Source: Nepal Rastra Bank; NRM staff estimates

Figure 3: Share of services sector in external trade



Source: Nepal Rastra Bank; NRM staff estimates

B. Shift towards services sector

4. The contribution of services sector to GDP has been steadily increasing since the early 2000s, reaching 56% in FY2017 (Figure 4). By contrast, gross value addition to the economy by agriculture sector has sharply declined, while industrial sector's contribution has fairly stabilized at 10-15%. Various hypotheses have been put forth to explain the structural shift observed across economies. For instance, Fischer-Clark hypothesis argues that with income growth, consumption pattern changes from goods to services, prompting a growth in services

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1 This section was written by Manbar Singh Khadka of NRM, ADB in collaboration with Rudra Suwal, former Deputy Director General at Central Bureau of Statistics/Government of Nepal.
2 This transformation is atypical as Nepal seems to overleap the industrialization phase as observed in many developing nations.
3 It refers to services that can be traded across economies. The General Agreement on Trade in Services (GATS) of the World Trade Organization (WTO) has defined four modes of service delivery, namely, mode 1 or cross-border supply, mode 2 or consumption abroad, mode 3 or commercial presence and mode 4 or movement of natural persons.
4 Geographical location is not a barrier to trade in services.

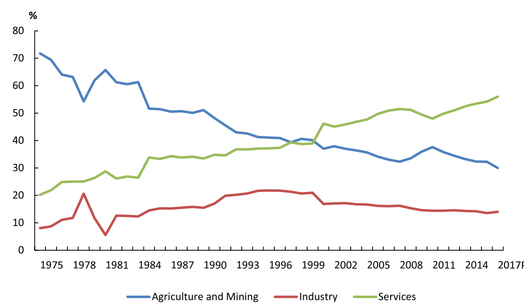
sector (Fischer, 1935; Clark, 1940). On the other hand, Cost-Disease hypothesis argues that the jump from manufacturing to services sector is due to productivity gaps between the two sectors (Baumol et al., 1985). In the case of Nepal, empirical analyses identifying the root causes of such structural shift are lacking. Nonetheless, the increased integration[5] of Nepal's economy with the rest of the world has helped propel growth in services sector.

5. While services sector has boomed, there is also a growing inclination towards non-tradable versus tradable aspects of services sector, induced by remittance income. Among service industries, wholesale and retail trade including real estate and renting businesses contribute significantly to the economy compared to education, health, communication and other related services (Table 1). This illustrates that non-tradable sub-sectors of the economy like real estate and renting business including wholesale and retail trade[6] are flourishing on the back of remittance income. Unfortunately, productivity enhancing tradable sectors like health, education, travel and communication have failed to take off as expected.

C. Nepal's potential in trade in services

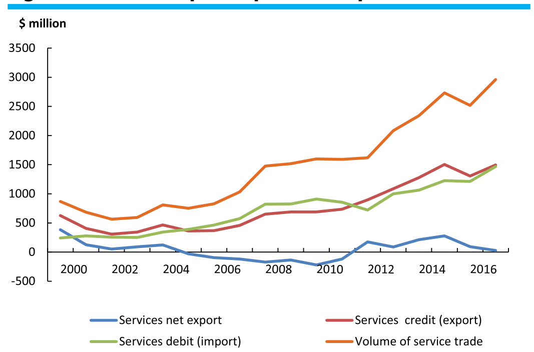
6. Nepal's foreign trade in services gained momentum with the adoption of economic liberalization and privatization in the early 1990s. Services trade balance has remained positive except for a period from 2005-2011[7] (Figure 5). The major components of services trade are: travel, transport, insurance and finance, communication, government and other business services. Though positive, the net surplus from foreign trade in services has declined in recent years (Figure 5). This is largely due to increased number of Nepalis going abroad for higher education, medical treatment, holidaying and other recreational activities.

Figure 4: Gross value addition by major economic sectors



Source: Central Bureau of Statistics

Figure 5: Trend of Nepal's export and import of services trade



Source: Nepal Rastra Bank

Table 1: Composition of gross value added among service industries for selected fiscal years (in %)

Industries	2001	2003	2005	2007	2009	2011	2013	2015	2017	Direction, 2015-2017
Wholesale and retail trade	35.6	31.6	29.6	26.1	25.8	29.0	28.5	27.5	24.2	↓
Hotels and restaurants	4.3	3.5	3.3	2.8	2.9	3.4	3.7	3.8	3.5	↓
Transport, storage and communications	16.0	18.1	19.0	19.6	19.3	17.1	17.5	15.7	14.5	↓
Financial intermediation	5.8	5.9	6.4	8.0	8.1	8.1	7.7	8.7	9.6	↑
Real estate, renting and business activities	18.0	17.6	18.2	19.9	17.0	17.2	17.3	15.8	17.7	↑
Public administration and defense	2.7	3.7	3.5	3.4	3.9	4.0	4.0	4.9	5.4	↑
Education	8.9	11.3	11.7	11.5	13.0	10.9	11.4	12.3	12.9	↑

Source: Central Bureau of Statistics

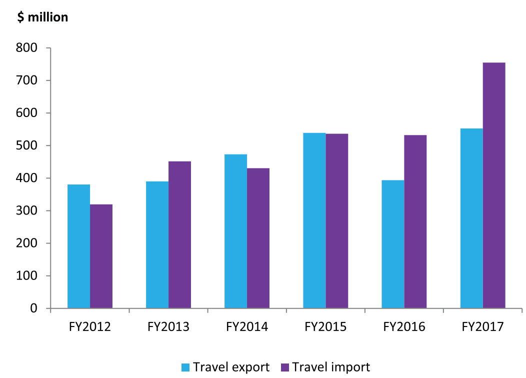
5 Nepal joined WTO in 2004. As per the agreement under GATS, Nepal has committed to liberalize 11 services sub-sectors, and travel and tourism is one of them in which Nepal has a revealed comparative advantage. Nepal is also a signatory to South Asia Trade in Services (SATIS) agreement.
6 It refers to growing outlets of wholesale and retail trade induced by remittance income and captures labor services embedded in wholesale and retail trade that are non-tradable.
7 Though services trade balance was in deficit, the volume of services trade increased during the period.

i. Travel and tourism related services

7. This is one of the services sub-sectors identified by Nepal Trade Integration Strategy (NTIS 2016) with high export potential (see Box 2). Nepal is indeed blessed with scenic beauty ranging from high Himalayas to low-lying riverine lands. The varied climatic conditions and attractive destinations, be it from religious, cultural and/or geographical perspectives, can lure tourists from across the globe. In fact, Nepal has prominently featured as one of the top destination countries for tourism in Lonely Planet.[8] Yet, its contribution to GDP has hovered around 2-3% from 2008-2017.[9]

8. While export of travel services has expanded in recent years, much needs to be done to further expand the sector and be a net exporter of travel services (Figure 6). Poor infrastructure is the major constraint to expansion and development of tourism sector in Nepal. The road networks across the country are sub-standard. Air connectivity within the country is not only limited but also unreliable. The only international airport, Tribhuvan International Airport (TIA)

Figure 6: Travel services trade



Source: Nepal Rastra Bank

Box 2: Importance of hospitality and tourism industry

Travel and tourism industry has a distinctive place in Nepal's economy. The industry earns on an average 25% of the total foreign exchange and provides direct employment to more than 200,000 people.[10]

The sector was hard-hit by major earthquakes in 2015 and subsequent trade disruptions along the southern border. This resulted in a decline in the number of tourist flow in 2015 by 33%. However, the sector has revived since then with growing number of tourist. Adventure travelers for trekking and mountain biking and religious pilgrims are the major drivers of growth in tourism.

The government has set a target of attracting 2 million tourists by 2020. Domestic and foreign investment in hotel and restaurant sub-sector has increased. The entry of international hotel chains and gradual improvement in the quality of services will help bring high-end tourists to Nepal. Likewise, the goal of attracting 2 million tourists by 2020 seems plausible[11] with timely construction of basic infrastructure like roads and airports, preservation of natural habitat, trekking trails and exploration of new travel destinations.

Tourists' arrival and tourism related enterprises

Tourist arrival by	2012	2013	2014	2015	2016	Increase in 2016
Air	598,258	594,848	585981	407412	572563	40.5%
Land	204,834	202,768	204137	131558	180439	37.2%
Total	803,092	797,616	790118	538970	753002	39.7%
Average length of stay (days)	12.2	12.6	12.4	13.2	13.4	1.8%
Tourism related enterprises						
Hotel (star)	107	117	118	116	120	3.4%
Hotel (non-star)	746	909	957	957	985	2.6%
Beds (number)	31657	34523	36179	36950	38242	3.5%
Travel agencies	2239	2450	2611	2768	3444	24.4%
Trekking agencies	1598	1761	1903	2016	2367	17.4%
Tourist guide	-	3141	3335	3507	3717	6.0%
Trekking guide	-	9741	10436	11358	13049	14.9%

[8] For details, please see: <https://www.outfitternepal.com/blog/nepal-features-on-lonely-planets-list-of-best-countries-to-travel-in-2017.html>
[9] Government of Nepal/ Ministry of Finance: Economic Survey 2016/17.
[10] Government of Nepal/ Ministry of Culture, Tourism and Civil Aviation.
[11] This is based on discussion with a senior official at the Hotel Association of Nepal.

is unable to handle increasing air traffic and flow of passengers. Other factors hindering the sector are lack of development and expansion of tourist destinations. For instance, despite being immensely rich in natural beauty, the far-western belt of the country remains largely unexplored. Nevertheless, tourism is expected to boom in coming years with the recent surge in foreign direct investment (FDI) inflows in hotel and restaurant sub-sector emanating from increased political stability and favorable business climate.

ii. Transport services

9. Nepal's poor transport infrastructure and its limited regional connectivity has not only widened transport services trade deficit (Table 2) but also decreased export competitiveness of merchandise goods. Road networks within the country and across the border are sub-standard, thereby increasing the time taken to import and export merchandise goods. Furthermore, syndicate system in Nepal's transportation system has eroded export competitiveness. It is estimated that the syndicate system in transport sector results in a deadweight loss of around USD 27.6 million a year (Poudel, 2016). Not just road connectivity but also air connectivity is in a primitive stage. Ethiopia, a land locked country, has advanced with improvement of its air transport infrastructure. Ethiopian Airlines has largely helped expand growth of the country's services export (Hollweg, 2016). Nepal should also move towards developing and expanding its air transport infrastructure. This will not only help promote travel and tourism but also airlift several high value and low volume products[12] like cardamom, ginger, lentils, tea and coffee in which Nepal has a revealed comparative advantage.

10. If Nepal is well-connected with its regional member countries, then this will help reduce transport services trade deficit. Nepal is a signatory of Bangladesh, Bhutan, India and Nepal (BBIN) Motor Vehicle Agreement[13] as well as Belt and Road Initiative (BRI).[14] With significant investment in infrastructures, particularly on roads and bridges and subsequent implementation of such initiatives, Nepal can reap economic benefits in the long-run.

iii. Communication services

11. A study by the World Bank shows that Nepal has a revealed comparative advantage in communication services, and this is evident with Nepal being traditionally a net exporter of telecommunication services (Table 2). The surge in export of telecommunication services is the byproduct of tourism and labor migration (Hollweg, 2016).

[12] Ethiopian horticulture grew alongside Ethiopian airlines.
[13] Nepal signed the BBIN Motor Vehicle Framework Agreement on 15th June, 2015.
[14] Nepal signed the framework agreement on One Belt One Road Initiative (OBOR), also known as Belt and road initiatives on 12th May, 2017.

Table 2: **Service trade (US $ million)**

	2014/15 11months' total	2015/16 11 months' total	2016/17 11 months' total
Services	245.7	89.3	56.6
Services: credit	1358.4	1187.9	1375.4
Services: debit	-1112.7	-1098.6	-1318.8
Transportation: credit	25.8	33.7	71.0
Passenger services	21.3	29.3	67.1
Freight	0.0	0.0	0.0
Other	4.5	4.4	3.9
Transportation: debit	-411.8	-377.3	-389.7
Passenger services	-152.4	-86.0	-69.4
Freight	-208.9	-213.6	-221.3
Other	-50.5	-77.7	-98.9
Travel: credit	505.6	367.5	519.9
Travel: debit	-489.6	-478.3	-686.9
O/W education	-158.4	-166.6	-293.8
Communication services: credit	337.2	267.4	280.4
Communication services: debit	-18.9	-30.4	-7.0
Insurance services: credit	14.1	10.9	14.4
Insurance services: debit	-42.0	-38.0	-43.3
Government services: credit	282.3	323.9	214.9
Government services: debit	-19.7	-19.5	-10.1
Other services: credit	193.4	184.4	274.8
Other services: debit	-130.8	-155.1	-181.8

Source: Nepal Rastra Bank, Balance of Payments Division

Tourists visiting Nepal use telephone services and data plan, including roaming charges. And Nepali migrants residing in various countries make international calls back home, enabling the use of domestic telecommunication service providers.

12. Communication is one of the growing services sectors of the country. Its coverage has considerably increased over the years especially with mobile penetration at more than 90% (Ministry of Information and Communication/Government of Nepal, 2016). But the sector is also marred with inadequate power supply and insufficient number of telecommunication repeater towers, thus limiting the supply of communication services. Moreover, the use of communication and internet services in Nepal are costlier given the low level of per capita income and high tariff structure of telecommunication and broadband services (Ministry of Information and Communication/Government of Nepal, 2016). This has further limited its growth potential. Nevertheless, the implementation of Spectrum policy in 2013 and its first amendment in 2016, including

the formulation of Information and Communication Technology (ICT) policy 2015 are some of the notable initiations on the part of the government to expand the sub-sector.

D. Way forward

13. The growth of services trade hinges on several crucial inputs like education, telecommunication, transport and connectivity along with proactive policies favoring services trade (Ghani, (ed.) 2010). For instance, provision of fiscal incentives[15] to exporters and investors, infrastructural facilities[16] for setting up industries and trade promotion activities can help propel growth of services trade (Goswami et al., 2012). The Philippine BPO sub-sector, to some extent, has benefitted from favorable fiscal incentives. Nepal can also positively impact trade in services via proactive polices.

14. If Nepal is to leapfrog in services trade, then human resource development is imperative. Service subsectors like banking and finance, telecommunication, health and education are more skill intensive than the manufacturing sector (Jensen, 2008). This therefore necessitates skilled manpower to produce quality service products.

15. NTIS (2016) identifies healthcare and education as potential services sectors for export promotion. In fact, healthcare services have expanded at an accelerated rate with a visible growth of private nursing homes and teaching hospitals in recent years. And yet, not all healthcare services demand is met by domestic healthcare institutions, leading to a significant resource outflow seeking healthcare services. There is a need to formulate better health policies[17], provide incentives and address the infrastructure bottlenecks to spur private investment in health sector.

16. Information technology (IT) and business process outsourcing (BPO) is one of the prospective areas in which Nepal has a promising future (see Box 3). Companies like D2Hawkeye and Deerwalk have been providing IT solutions and services to foreign-based companies. Medical transcription, that is, analysis and reporting, for the global health industry has surged since the 2000s.[18] While these are some of the success stories, Nepal has miles to go to enhance and gain economic benefits from this sector. Currently, the sector suffers from infrastructure bottlenecks, poor business climate and deficiencies in policy measures (Hollweg, 2016). Capacity development in terms

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15 Fiscal incentives can be in the form of income tax holidays, tax deductions and duty exemption.

16 This can relate to special economic zones with dedicated facility such as power.

17 The government has prepared a draft Health Insurance Bill 2017. It is expected that this insurance scheme will protect the poor from falling into further poverty due to health issues and medical bills. However, a family of five should pay an annual premium of NPR2,500 to get health services amounting NPR50,000.

18 For details, please see: <http://nepalitimes.com/article/Nepali-Times-Buzz/it-is-all-about-it-in-nepal,3887>

of producing quality IT professionals, software developers and engineers is essential for the betterment of this sector. Besides capacity development, the government needs to improve business climate in relation to good governance, transparency and efficient bureaucracy. This will help formalize and expand many informally operating services software contractors in Nepal (Hollweg, 2016). Apart from business climate, other sector-specific policy reforms are provision of risk capital and support of accelerators and incubators to IT firms. More importantly, the government should address IT infrastructure bottlenecks related to power supply and transport (Hollweg, 2016).

17. Greater economic benefits can be achieved via diversification of tourism related products along with development of tourism infrastructure. With conservation of natural parks and trekking trails, eco-tourism can be promoted. With greater regional connectivity, religious tourism like the Buddhist circuit can be strengthened. And with the development and exploration of other tourist destinations, more tourists can be attracted and their stay in Nepal can be lengthened. These ideas can be facilitated via improvement in the quality of roads, airports, domestic transportation facilities including the expansion of road networks.

18. While developing service-oriented industries, the maintenance of quality and safety standards of service products is equally important. At present, Nepal does not have a regulatory body to administer the production and trade in services. The issue of safety standards in adventure tourism, aviation and quality standards in hotel and restaurants has emerged time and again. Therefore, a separate government entity needs to be formed that will oversee the production and trade of service activities.

19. FDI is crucial to promotion of service sector industries. Service industries requiring huge investment, skill and technology transfer cannot grow with domestic investment alone. A joint venture with international companies is essential for domestic firms to be competitive in foreign market. This will help mobilize local

Box 3: ICT business – Deerwalk Nepal

Deerwalk Nepal is one of the leading institutions in the country that deals with BPO (business process outsourcing), exporting ICT services to the US based company. It provides technical support and solutions through software development. It is also focused on producing skilled human resource for developing quality ICT products. The institution envisions to expand its services and provide ICT solutions to domestic market as well. Currently, the institution provides employment to more than 300 skilled IT professionals and engineers.

Source: www.deerwalk.com

investment with the added advantage of foreign know-how and technology transfer. In recent years, with the opening of electricity production and distribution to the private sector along with some legal and institutional reforms, Nepal could attract FDI in hydropower sector. Yet, specific reforms in relation to profit repatriation and forest clearance are needed to sufficiently attract FDI in this sector. Furthermore, the enactment of Foreign Investment Act that will replace Foreign Investment and Technology Transfer Act, 1992, may pave way towards greater FDI inflows that will help propel service oriented industries.

20. NTIS has identified labor services (skilled and semi-skilled professionals) as one of the services sub-sectors that can drive export growth of the country. Nepal should in fact aim for export promotion of labor services via Mode 2 (consumption abroad) and Mode 4 (temporary movement of natural persons) service delivery mechanisms. With higher proportion of working age population and lower dependency rate, Nepal can take advantage of the demographic dividend. But employment opportunities must be created to tap the labor productivity of working-age population. However, Nepal has limited timeframe to capitalize on this gain as dependency rate will increase again in 2050 (Cosic et al., 2017). If trained health professionals can be produced along with the establishment of world-class health facilities, then this will promote health tourism, i.e., Mode 2 service delivery under the GATS of the World Trade Organization. Likewise, with better trained professionals in various fields such as IT, medicine, construction, hospitality and scientific research, Mode 4 service delivery under GATS can be promoted. At present, on an average, 1144 migrant workers[19] (mostly unskilled) leave Nepal for foreign employment in Malaysia, Korea and Gulf countries. Their hard-earned money has not only helped reduce poverty but also maintain external sector stability in recent years. Had Nepali workers migrated for skilled jobs, then remittance inflows would have been much higher. Further, the growing human casualties of Nepali migrants abroad resulting from poor work conditions and menial tasks could have been drastically reduced.

21. Finally, a sound database system is required for analysis, monitoring and evaluation of the performance of service industries including trade in services. At present, data pertaining to Mode 1 (cross border trade) and Mode 2 (consumption abroad) service delivery mechanisms under GATS are available only at aggregate level.

[19] This is the daily average figure from 2010-2017.

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Appendix 1: Country Economic Indicators

Item	Fiscal Year				
	2013	2014	2015	2016	2017P
A. Income and Growth					
1. GDP per Capita ($, current)	709	725	766	745	851 [a]
2. GDP Growth (%, in basic prices)	3.8	5.7	3.0	0.01	6.9 [a]
a. Agriculture	1.1	4.5	1.1	0.03	5.3 [a]
b. Industry	2.7	7.1	1.4	(6.3)	10.9 [a]
c. Services	5.7	6.2	4.6	2.1	6.9 [a]
B. Saving and Investment (current and market prices, % of GDP)					
1. Gross Domestic Investment[b]	22.6	23.5	28.0	28.8	33.8
2. Gross National Saving	40.7	45.7	44.1	40.0	43.8
C. Money and Inflation					
1. Consumer Price Index (average annual % change)	9.9	9.1	7.2	9.9	4.5 [c]
2. Total Liquidity (M2) (annual % change)	16.4	19.1	19.9	19.5	15.5 [c]
D. Government Finance (% of GDP)					
1. Revenue and Grants	19.5	20.6	20.8	23.2	24.6[d]
2. Expenditure and Onlending	18.8	20.0	21.8	23.7	30.0 [d]
3. Overall Fiscal Surplus (Deficit)[e]	0.8	0.9	(0.7)	(0.3)	(5.2) [d]
E. Balance of Payments					
1. Merchandise Trade Balance (% of GDP)	(27.2)	(30.3)	(31.1)	(30.3)	(34.5) [c]
2. Current Account Balance (% of GDP)	3.4	4.6	5.1	6.2	(0.4) [c]
3. Merchandise Export ($) Growth (annual % change)	(2.9)	5.1	(3.9)	(28.8)	9.8 [c]
4. Merchandise Import ($) Growth (annual % change)	10.9	13.9	8.0	(7.1)	29.4 [c]
5. Remittances (% of GDP)	25.6	27.7	29.0	29.6	26.8 [c]
F. External Payments Indicators					
1. Gross Official Reserves ($ million)	5,613.7	6,938.6	8,147.7	9,736.8	10,495.1 [c]
Months of current year's imports of goods)	10.1	10.0	11.2	14.1	11.4 [c]
2. External Debt Service (% of exports of goods and services)	9.5	8.9	8.1	9.9f	
3. Total External Debt (% of GDP)	19.7	17.7	16.1	17.3f	
G. Memorandum Items					
1. GDP (current prices, NPR billion)	1,695.0	1,964.5	2,130.2	2,247.4	2,599.2 [a]
2. Exchange Rate (NPR/$, average)	87.7	98.0	99.2	106.1	105.9 [c]
3. Population (million)	27.3	27.6	28.0	28.4	28.8

GDP = gross domestic product; P = provisional
Note: FY2017 starts on 16 July 2016 and ends on 15 July 2017.

[a] Based on FY2017 National Accounts Statistics, Central Bureau of Statistics
[b] Refers to gross fixed investment and does not include change in stocks
[c] Based on FY2017 annual data from Nepal Rastra Bank
[d] Based on FY2017 preliminary annual data from Financial Comptroller General Office
[e] Includes cash balance of previous year
[f] Based on FY2016 annual data from Financial Comptroller General Office

Sources: Ministry of Finance. FY2017 Budget Speech. Kathmandu; Nepal Rastra Bank. 2016. Macroeconomic Situation. Kathmandu; Central Bureau of Statistics. April 2017. FY2017 National Accounts Statistics. Kathmandu; Central Bureau of Statistics. 2014. National Population and Housing Census 2011 (Population Projection 2011 – 2031). Kathmandu; Financial Comptroller General Office.

Appendix 2: Country Poverty and Social Indicators

Item	Period					
	1990s		2000s		Latest Year	
A. POPULATION INDICATORS						
1. Population (million)	18.5	(1991)	23.2	(2001)	26.5	(2011)
2. Population growth (annual % change)	2.1		2.2		1.4	(2011)
B. Social Indicators						
1. Fertility rate (births/woman)	5.1	(1996)	3.6	(2004)	2.3	(2015)
2. Maternal mortality ratio (per 100,000 live births)	539.0	(1996)	281	(2006)	258.0	(2015)
3. Infant mortality rate (below 1 year/1,000 live births)	82.0	(1991)	48.0	(2006)	29.4	(2015)
4. Life expectancy at birth (years)	55.0	(1991)	62.0	(2001)	70.0	(2015)
a. Female	54.0	(1991)	63.0	(2001)	71.5	(2015)
b. Male	55.0	(1991)	62.0	(2001)	68.6	(2015)
5. Adult literacy (%)	35.6	(1996)	48.0	(2004)	63.7	(2015)
a. Female	19.4	(1996)	33.8	(2004)	53.3	(2015)
b. Male	53.5	(1996)	64.5	(2004)	76.2	(2015)
6. Primary school gross enrollment (%)	57.0	(1996)	72.0	(2004)	125.0	(2015)
7. Secondary school gross enrollment (%)	43.8	(2001)	54.4	(2004)	78.1	(2015)
8. Child malnutrition (% below 5 years old)	57.0				37.4	(2015)
9. Population below poverty line (international, %)	68.0	(1996)	53.1	(2003)	24.82	(2011)
10. Population with access to safe water (%)	45.9		82.5	(2006)	90.1	(2015)
11. Population with access to sanitation (%)	22.0	(1995)	24.5	(2006)	77.3	(2015)
12. Public education expenditure (% of GDP)	2.0		2.9	(2005)	4.4	(2016)
13. Human development index	0.341		0.429	(2005)	0.558	(2015)
14. Rank/total number of countries	152/173		136/177	(2003)	144/188	(2015)
15. Gender-related development index	0.33	(1995)	0.511	(2003)	0.925	(2015)
16. Rank/total number of countries	148/163	(1995)	106/140	(2003)	144/188	(2015)
C. Poverty Indicators						
1. Poverty incidence	42	(1996)	31	(2004)	25.16	(2011)
2. Proportion of poor to total population						
a. Urban	23.0	(1996)	9.55	(2004)	15.46	(2011)
b. Rural	44.0	(1996)	34.62	(2004)	27.43	(2011)
c. Mountain	57.0	(1996)	32.6	(2004)	42.77	(2011)
d. Hills	40.7	(1996)	34.5	(2004)	24.32	(2011)
e. *Terai*	40.3	(1996)	27.6	(2004)	23.44	(2011)
3. Poverty gap	11.75	(1996)	7.55	(2004)	5.43	(2011)
4. Poverty severity index	4.67	(1996)	2.7	(2004)	1.81	(2011)
5. Inequality (Theil Index)	…		…		…	
6. Multidimensional poverty index[1]	…		…		0.116	(2015)

… = not available, GDP = gross domestic product,

Sources: Central Bureau of Statistics. 2012. National Population and Housing Census 2011. Kathmandu; Central Bureau of Statistics. 2011. Nepal Living Standards Survey 2010/11. Kathmandu; Central Bureau of Statistics. 2016. Annual Household Survey 2014/15. Kathmandu; Ministry of Health and Population. 2012. Nepal Demographic and Health Survey 2011. Kathmandu; United Nations Development Programme. 2017. Human Development Report 2016. New York; Central Bureau of Statistics. 2011. Poverty in Nepal (2010/11). Kathmandu; World Health Organization, United Nations Children's Fund, United Nations Population Fund, and World Bank. 2012. Trends in maternal mortality 1990 to 2010, Kathmandu; Ministry of Education. 2015. Flash II Report 2014-2015. Kathmandu; Ministry of Finance. 2016. Budget Speech of FY2016/17. Kathmandu

1 UNDP replaced Human Poverty Index with Multidimensional Poverty Index from Human Development Report 2011.

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