Nepal

Country analysis and economic overview

Prepared for International Think Tank for LLDCs
and United Nations Development Programme

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HEAD OFFICE
5 Alfred Street, Oxford OX1 4EH
T +44 1865 261 600

www.oxan.com

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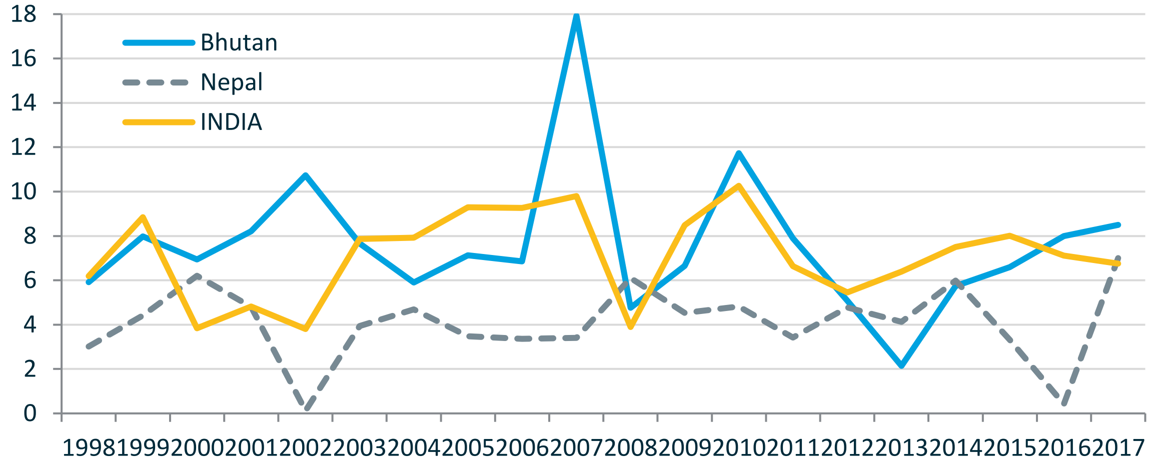
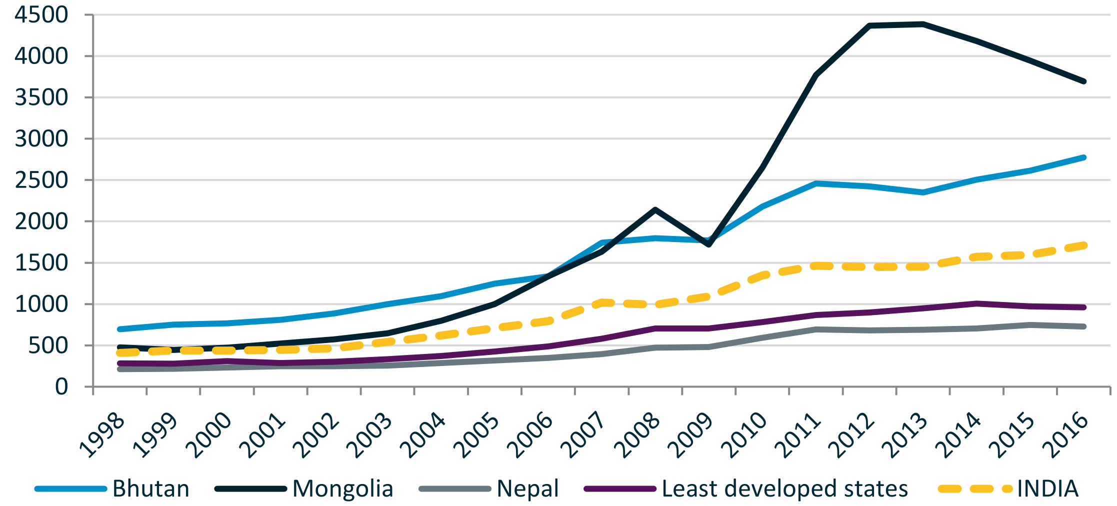
Nepal is a relatively low income 'least developed country' (LDC) that aims to graduate from this status by 2022 and transition to a middle-income country by 2030. It is a small landlocked economy of about 30 million people, strategically located between India and China. Nepal's envisioned transition to prosperity is challenging and requires significant structural transformation and economic diversification. In particular, it requires a shift from a remittance-fuelled economy to one fuelled by new areas of investment and productivity gains.

Figure 1: GDP growth rates in Nepal versus neighbouring Asian states (%)



Source: World Bank WDI database

Figure 2: GDP per capita in current US$ in Nepal and a selection of other Asian economies

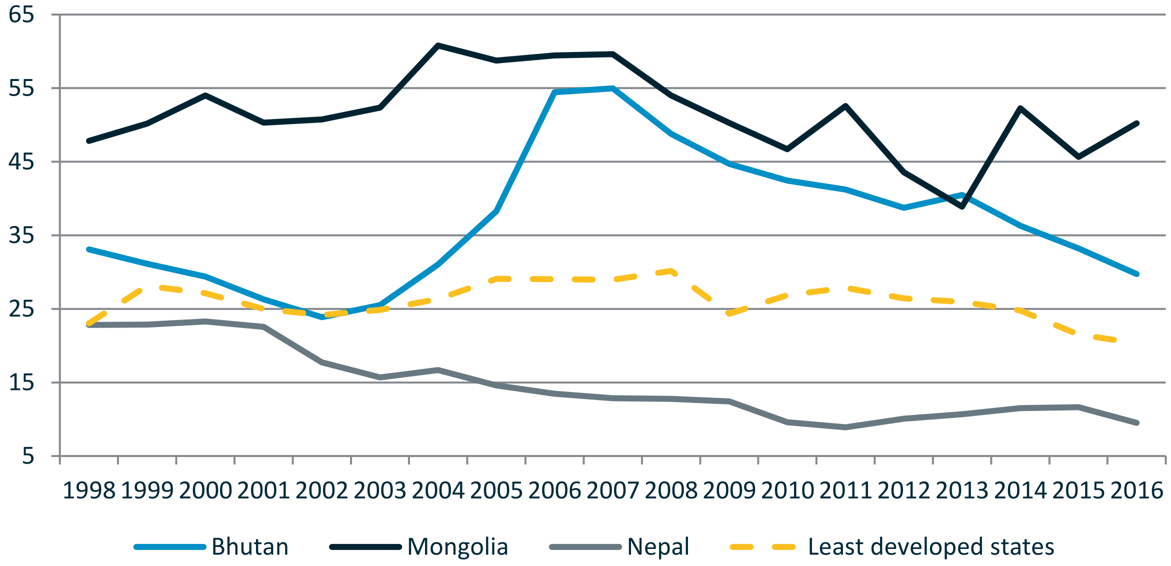


Source: World Bank WDI data base 2017

Nepal has made progress in poverty reduction and human development during the past two decades. While 46% of the population lived in absolute poverty in 1995, this figure fell to 25% by 2010 (World Bank 2018). However, its recent history has been marked by prolonged political instability, civil war and catastrophic natural disaster, the combined impact of which has resulted in heavy humanitarian loss as well as negative effects on sustained economic growth and development.

The analysis in this report shows that Nepal remains an erratic growth economy, which has undergone very limited structural change and upgrading in the key areas of output, employment, trade, and domestic as well as foreign investment. The persistent decline in total exports (goods and services) as a share of GDP to just under 10% in 2016 is particularly alarming, especially as imports reached almost 40% of GDP (implying a trade deficit of more than 6 billion US dollars). Remittances from migrant workers overseas have softened the negative effects of Nepal's sluggish structural transformation, but greater emphasis on development and productivity in agriculture, services and manufacturing is essential if Nepal is to achieve the middle income country status it seeks.

Figure 3: The share of total exports in GDP in Nepal and across comparator countries (%)



Source: World Bank WDI database 2017

Economic growth

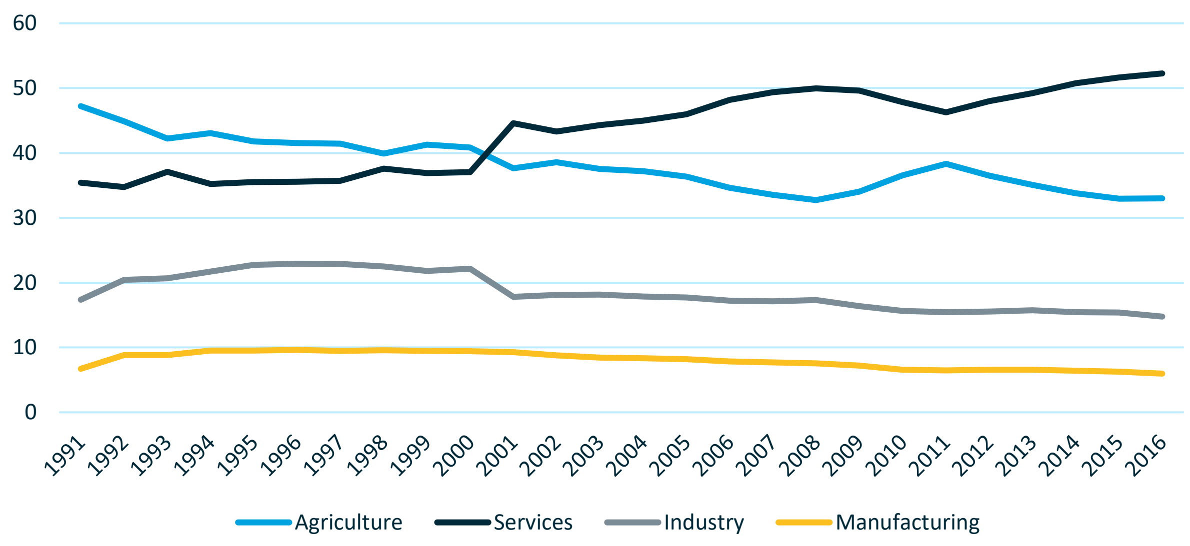
Historically, Nepal's economic growth has been slow by Asian standards. Growth rates have remained at an average of around 4% over the past ten years, with some exceptions such a growth spurt in 2017 when growth was spurred largely by post-earthquake reconstruction. The growth of both the agricultural and industrial sectors has been sluggish over this period, averaging 3.2% and 2.8%. The service sector has performed better, however, registering an average growth rate of 5.3%. The latter offers some scope for optimism regarding the potential motors for faster growth in Nepal.

Structural transformation of the economy

In order to achieve sustained economic growth, developing countries need to undergo structural transformation that moves them towards high productivity sectors and the potential to achieve export revenue growth. This type of productivity enhancement has so far been very limited in Nepal. Indeed, as the later discussion of productivity will show, productivity has made little progress over the last 30 years.

Although the share of GDP represented by agriculture has decreased from 46.5% in 1991 to 29.3% in 2016/2017, this has not been matched by an expansion in high productivity sectors. While the service sector has expanded significantly, much of this has been in low productivity areas such as community services (although service exports are a brighter spot). In addition, the significance of manufacturing in the economy has not increased. In fact, there are even some signs of 'premature de-industrialisation' in Nepal: for example, manufacturing value-added as a percentage of total GDP declined from over 9% in the mid-1990s to around 6% in 2016.

Figure 4: Value added by economic sectors (% of GDP)



Source: World Bank

Employment and productivity

Structural transformation of a subsistence agriculture-based economy obviously requires a movement of labour out of agriculture and into the manufacturing and service sectors. Again, this type of employment transformation in Nepal has been limited. A high share of the working population remains in agriculture. The share of the labour force in agriculture fell from 81% in 1991 to 66% in 2001, but increased slightly to 67% in 2011. (Data on employment is only available from the National Census, which was last conducted in 2011).

Table 1b shows that the growth rate of total employment was only 0.6% between 2001 and 2011. Agricultural employment growth was negligible, while employment growth rates in manufacturing were negative during this period.

While employment growth in agriculture can be expected to fall during a period of structural transformation, this should be compensated for by growth in manufacturing and service sector employment. This has not occurred in Nepal, with the employment elasticity of the manufacturing sector being negative in the period 2001-2011 (ODI 2014). This indicates that not only did the manufacturing sector contract during this period, it laid off workers at a fast rate.

Table 1a: Employment share

	1991	2001	2011
Agriculture, Fisheries and Forestry	81.2	65.7	66.7
Mining and Quarrying	0.0	0.2	0.3
Manufacturing	2.0	8.8	5.5
Electricity, gas and water supply	0.2	1.5	0.2
Construction	0.5	2.9	3.2
Trade, Restaurant and Hotel	3.5	9.9	8.1
Transport, Communication and Storage	0.7	1.6	2.4
Financial and Real Estate	0.3	0.8	0.7
Community, Social and Other Services	11.6	8.6	12.8
Total	100	100	100

Source: Census Surveys 1991, 2001 and 2011, Central Bureau of Statistics

Table 1b: Employment growth (annual average, %)

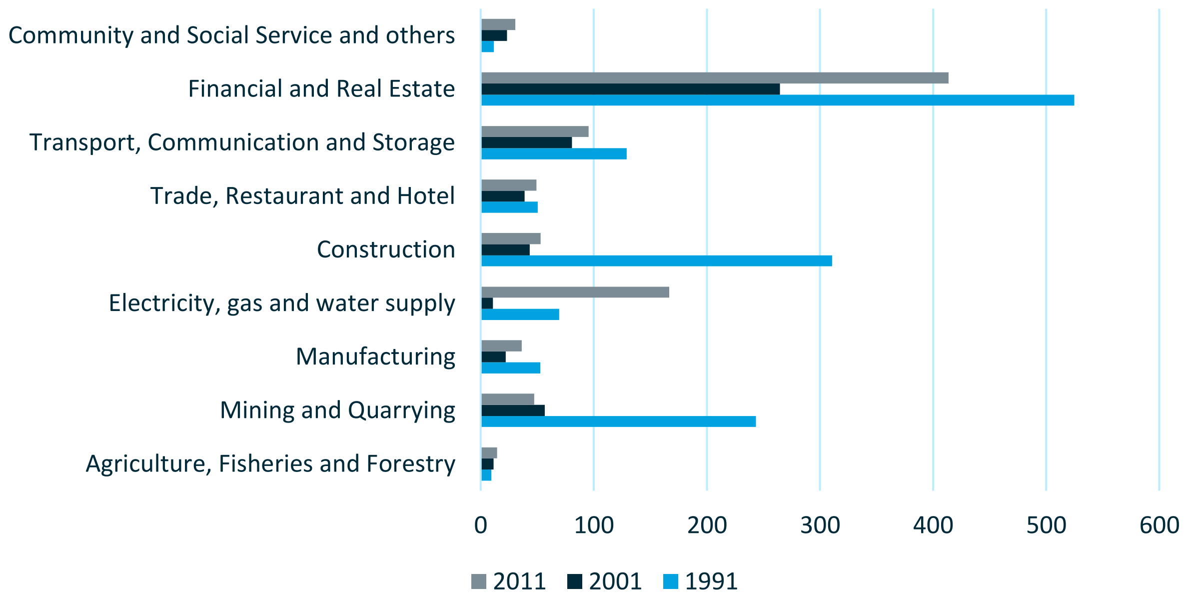
	1991-2001	2001-2011
Agriculture, Fisheries and Forestry	0.8	0.7
Mining and Quarrying	17.4	5.1
Manufacturing	16.0	-3.7
Electricity, gas and water supply	23.1	-16.0
Construction	18.9	1.6
Trade, Restaurant and Hotel	12.2	-1.3
Transport, Communication and Storage	10.5	4.3
Financial and Real Estate	11.8	0.2
Community, Social and Other Services	0.0	4.2
Total	2.7	0.6

Source: Census Surveys 1991, 2001 and 2011, Central Bureau of Statistics

Labour productivity

Labour productivity gaps between different sectors are typically very large in the Nepalese economy. The agricultural sector has very low (and stagnant) labour productivity. And, as the data below reveal, labour productivity in manufacturing actually declined during the period 1990-2011. While the financial and real estate sector has high levels of productivity, it employs only a small proportion of the labour force. Labour productivity in the community, social and other services sector is the lowest of all, but this is the major non-agricultural sector for employment.

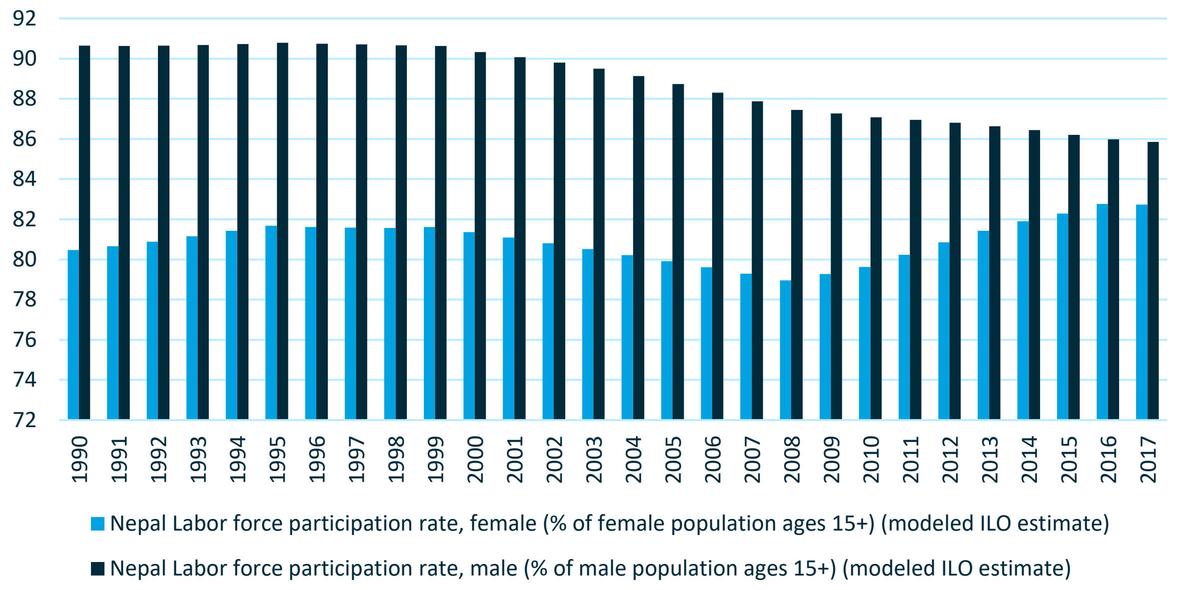
Figure 5: Sector wide labour productivity



Source: CBS, Nepal

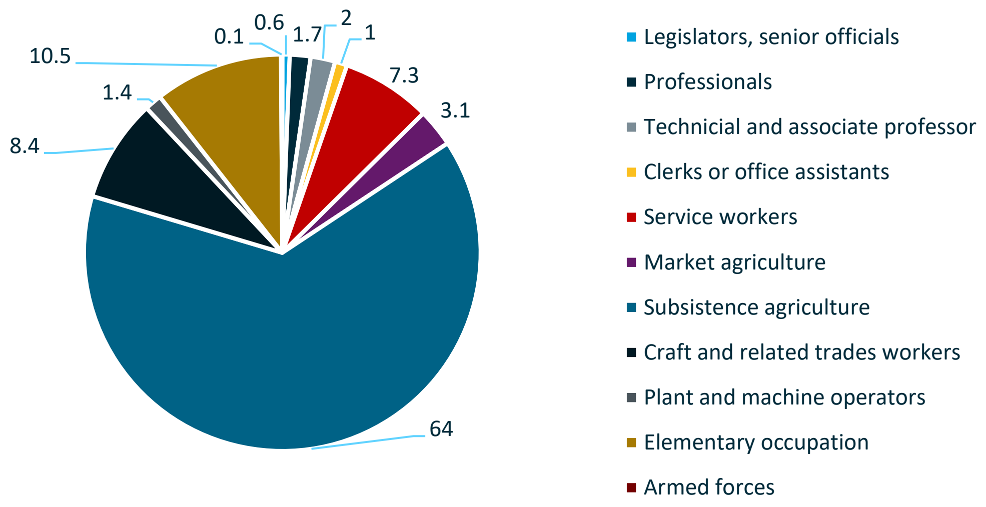
The above discussion highlights key shortcomings of the structural transformation that has occurred in Nepal. In terms of the structure of output, Nepal has shifted from an agriculture-based to a service oriented economy. However, productivity improvement in the service sector has been limited. In addition, the manufacturing sector has not expanded its share of national output and has experienced a decline in productivity in recent decades.

Figure 6a: Labour force participation rate



Source: World Bank, WDI

Figure 6b: Employment distribution by occupation



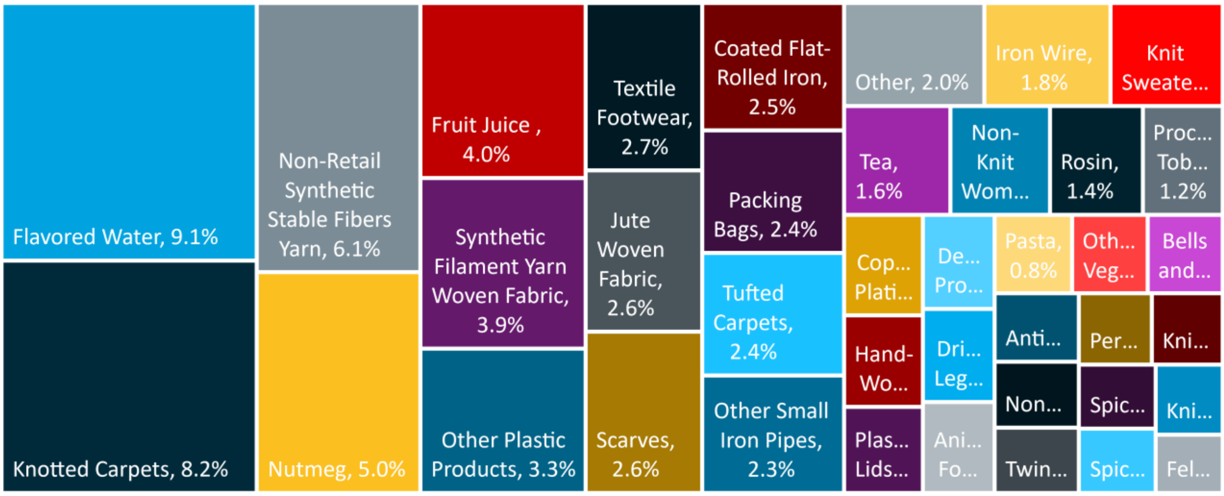
Source: World Bank, World Development Indicators

External trade

A dynamic, rapidly expanding export sector can be a key source of growth and structural transformation for a developing country economy. However, in Nepal, the merchandise exports sector is characterised by several shortcomings that prevent it from assuming this role. Services exports, especially travel and tourism, have grown and now account for about 1 billion US dollars worth of revenues per annum -- more than half of total export revenues (WTO data for 2016). But recent data suggest that even this engine of growth has currently stalled.

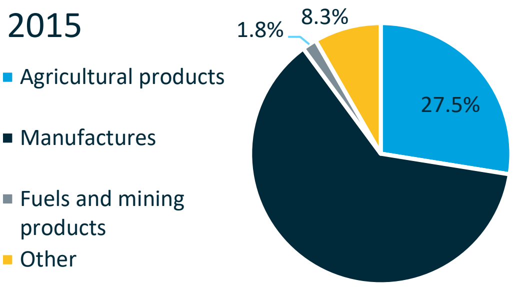
In goods trade, Nepal is primarily an exporter of manufactured consumer goods as shown below. However, it has failed to upgrade its export structure through moving away from labour-intensive, low-skill and low value-added exports towards higher value-added manufacturing exports. Flavoured water dominates Nepal's merchandise exports (9.1%), followed by knotted carpets (8.1%), yarn (6.1%), nutmeg (5%) and fruit juice (4%).

Figure 7: Export structure in 2015



Source: The Observatory of Economic Complexity

Figure 8: Total exports by main commodity group and partner



Top 5 export destinations 2015 (US$ million)		Top 5 import origins 2015 (US$ million)	
India	419	**India**	4,008
United States	70	**China**	920
Germany	27	**UAE**	266
United Kingdom	21	**Indonesia**	118
Turkey	13	**Switzerland**	112

Source: World Trade Organization Country Profiles

A narrow concentration of exports in a few products or a few markets can result in volatility and vulnerability for a developing country. In Nepal, product concentration actually appears to be very low: it has a HH export product concentration index value of 0.034 for 2015. However, this may be misleading as the product mix involved (low value-added sectors with weak dynamics) looks unlikely to provide the substantial and dynamic growth that Nepal needs. Moreover, Nepal's export markets (destinations) are very concentrated, chiefly focused on India.

India is Nepal's largest trade partner, accounting for over 60% of the country's merchandise exports and imports in 2015. Nepal's reported exports to India are mainly concentrated in labour-intensive textiles, zinc sheet, thread and yarn.

Table 2: Product diversification and market diversification

Product diversification (based on HS02, 4-dig.)	2015
Number of exported products (max 1245)	260
Number of imported products (max. 1245)	998
HH export product concentration (0 to 1)	0.034
HH import product concentration (0 to 1)	0.017

Market diversification	2015
Number of export markets (max 237)	86
Number of import markets (max. 237)	113
HH export market concentration (0 to 1)	0.414
HH import market concentration (0 to 1)	0.387

Source: WTO Secretariat; UN Comtrade

Nepal's concentration in low value added, low quality exports is also revealed in its external terms of trade. These have worsened over the past 15 years, and the purchasing power of exports has gone down significantly.

Both the relatively high dependence on India and the worsening purchasing power of exports are linked to the dual quality distribution of both agricultural and non-agricultural exports in Nepal. In general, there seems to be a dual price structure for exports, with some firms exporting high-volume low-price products (mainly to India) and others exporting low-volume high-price exports to other destinations (EU, US, Japan).

These specific features of export composition and price trends severely constrain the capacity of the export sector to be a source of dynamism and structural change for the Nepalese economy.

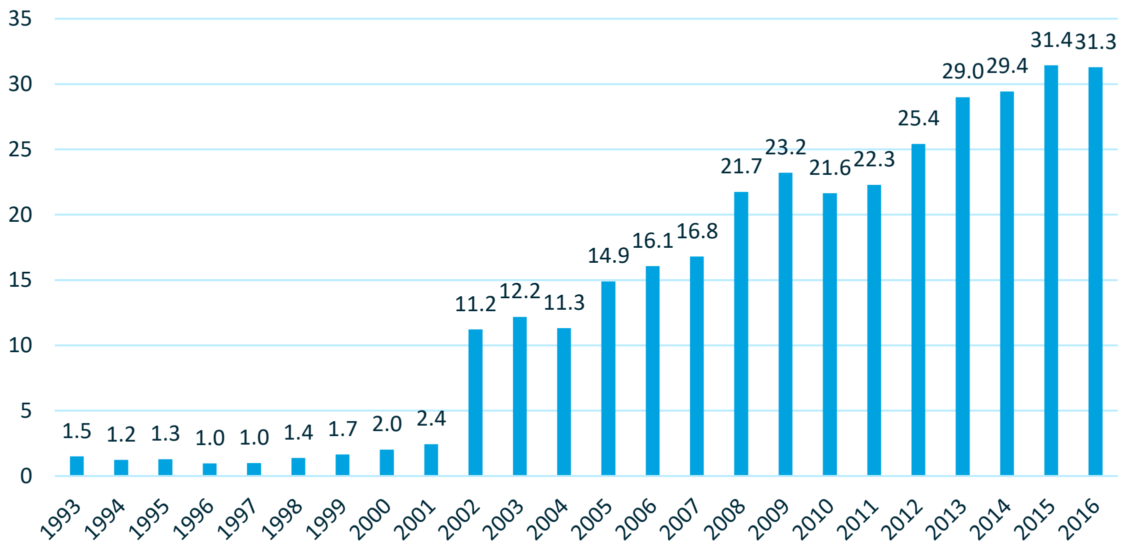
Intra-sectoral diversification and transformation

Structural transformation requires not only an inter-sectoral movement of resources but also an intra-sectoral shift from low productivity to high productivity activities *within* each sector. This means not necessarily shifting *out* of the sector but expanding the depth of engagement *within* it. In particular, the aim is to increase the amount of *value-added* within the sector, beyond what would accrue from a proportionate increase in output. The level of intra-sectoral diversification during the period 2011-2016 in Nepal is broadly similar to the group of comparator developing countries used for this analysis. This relatively low level of intra-sectoral diversification is consistent with the slow productivity growth in each sector of the economy. A higher degree of intra-sectoral diversification could have resulted in sustained increases in productivity growth during this period.

Remittance economy and structural transformation

The agricultural sector in Nepal remains the main source of livelihoods for two-thirds of the population and productivity in this sector remains low. In addition, the manufacturing and service sectors have also had low levels of labour absorption coupled with low and negative rates of productivity growth. This sluggish growth in the non-agricultural sectors has resulted in an exodus of workers to foreign labour markets. This makes the Nepalese economy heavily dependent on remittances, both to provide family incomes and to boost the balance of payments (given the gaping trade deficit).

Figure 9a: Personal Remittances received (% of GDP)

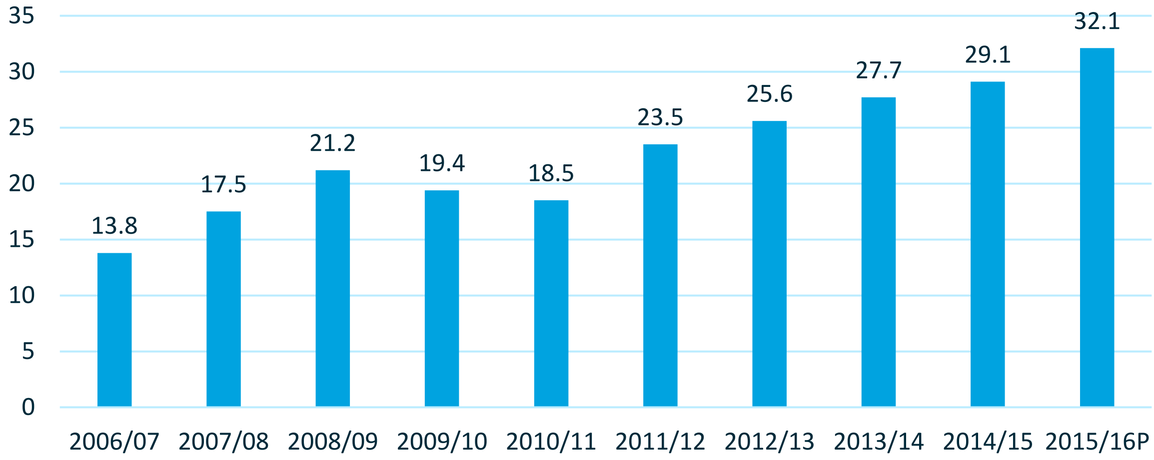


Source: World Bank

Since 2008, Nepal has been consistently ranked as one of the top ten remittance recipient countries in the world when remittances are measured as a share of GDP. In 2016 remittances comprised approximately 29.6% of GDP.

The effects of remittances on economic performance in Nepal are complex. On the one hand, remittances are a key source of aggregate demand and have boosted household consumption. Microeconomic research has also shown remittances to have a significant positive effect on human capital development.

Figure 9b: Remittance income / GDP (%)



Source: Ministry of Finance, Nepal

On the other hand, remittances have led to currency appreciation, which has reduced export competitiveness. It is estimated that an increase in remittances by 10% could lead to a 0.5% appreciation of the real exchange rate over the longer term. Remittances put upward pressure on the prices of non-tradable goods and, with a nominal exchange rate regime that is pegged to the Indian rupee, the result is an appreciation of the real exchange rate. This appreciation favours imports, and biases against exports by making domestic goods uncompetitive. The impact is possibly largest on low-value, low-margin manufactured goods, which account for a large share of Nepal's export bundle.

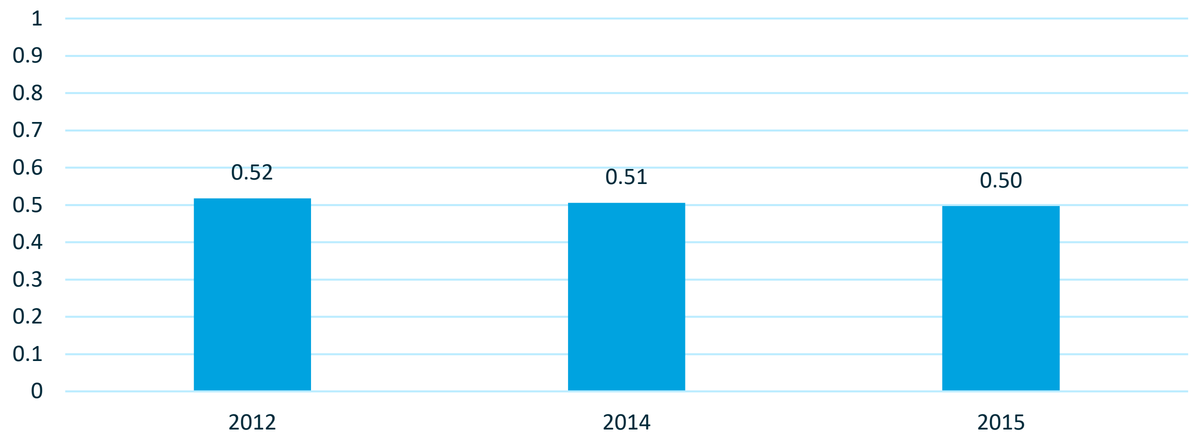
In this sense, remittances have had a type of 'Dutch Disease' impact on the economy. It could also be argued that the 'cushioning' provided by remittances has weakened the urgency for implementation of policies that would enhance productivity and opportunities within the country.

Gender and structural transformation

Growth and structural change can often have a differential effect on the livelihoods of men and women. In Nepal, the majority of women are employed in agriculture, a sector which has mostly stagnated in terms of growth and productivity in the past two decades. As illustrated by data, 73% of women are employed in subsistence agriculture, in contrast to 53% of men. The rural sector in Nepal is also the source of large migration, both to cities and overseas.

A high proportion of these migrants are male, and recent research has shown that the absence of men in farming has led to a feminisation of agriculture. This, however, has had an adverse effect on women's livelihoods and earnings. The exodus of men has meant a shortage of labour on farms and this has reduced efficiency and investment, leading to lower output and earnings from crop cultivation. In addition, wages earned by women in Nepal are markedly lower than those of men in both agriculture and non-agriculture, exacerbating the economic vulnerability of women. Slow and erratic growth in manufacturing and services has also worked to trap women in underperforming agriculture. The gender inequality index improved only marginally between 2012 and 2015.

Figure 10: Gender inequality index (0=perfect equality; 1=extreme inequality)



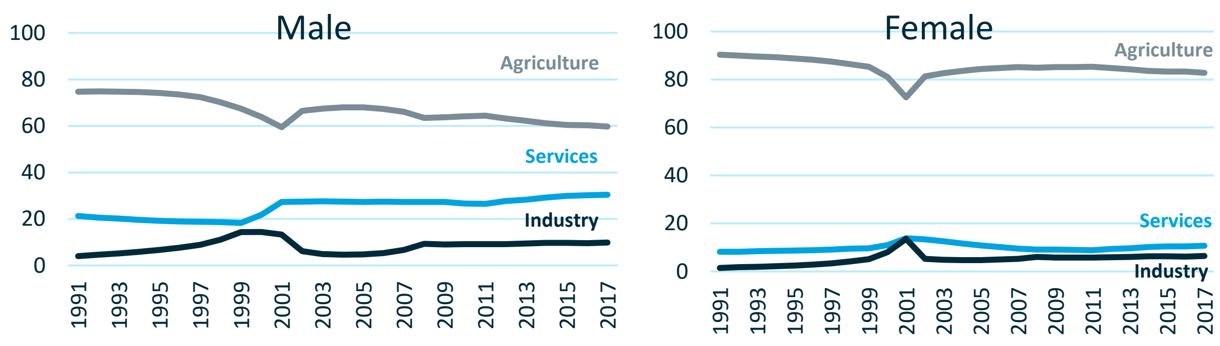
Source: United Nations Development Programme Human Development Data

Table 3: Average daily wage in cash/kind received by wage earners (in Nepalese Rupees)

	Agriculture sector		Non-agriculture sector	
	Cash	Kind	Cash	Kind
Male	145	68	234	92
Female	97	63	143	86

Source: CBS, 2011

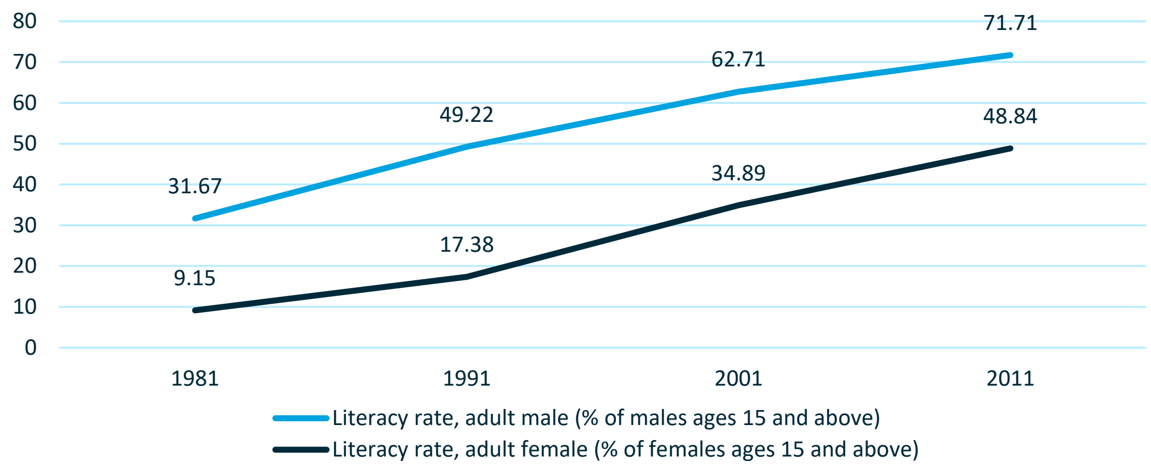
Figure 11: Labour force participation rate in agriculture, industry and services (% of male or female employment)



Source: World Bank

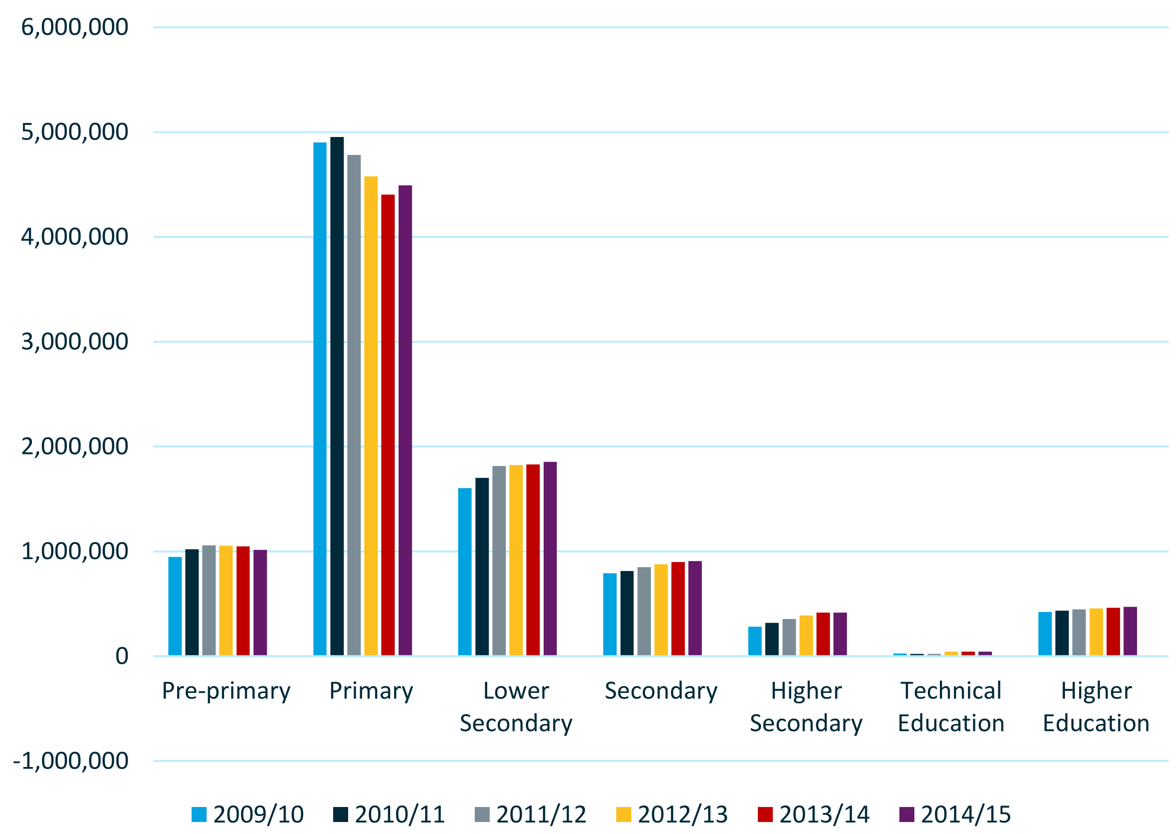
Human capital acquisition and improvements in education are strong enablers of structural transformation and economic diversification. Nepal has made progress in building human and educational capital in the past decades and educational expenditure as a proportion of total GDP has increased over time. Econometric research has shown that education investments have a significant and positive effect on productivity in Nepal, both in the agricultural and non-agricultural sectors (Bhattarai and Shrestha 2015). Overall, however, Nepal requires significantly higher levels of investment in education to produce the quality necessary for the transition to a middle-income country.

Figure 12: Literacy rate among the population aged 15 years and older (in %)



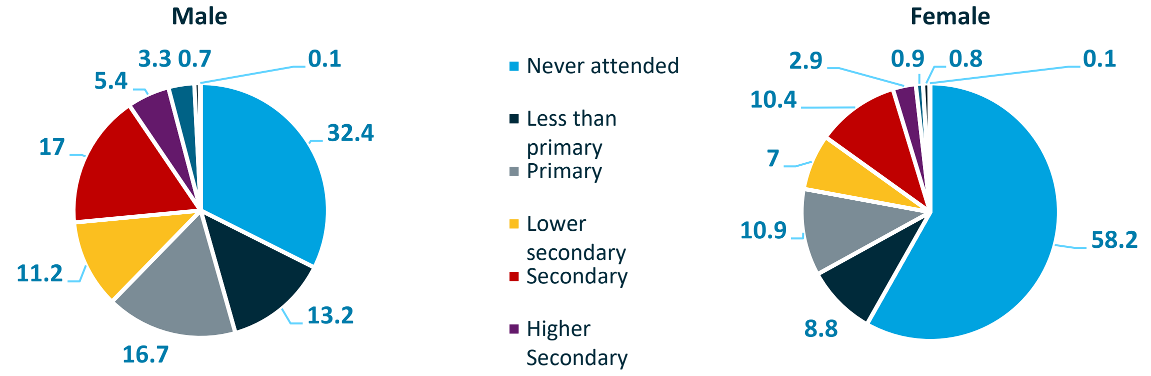
Source: World Bank, World Development Indicators (most current data available)

Figure 13: Enrolment at all levels of education



Source: UNESCO

Figure 14: Education (Male vs Female)

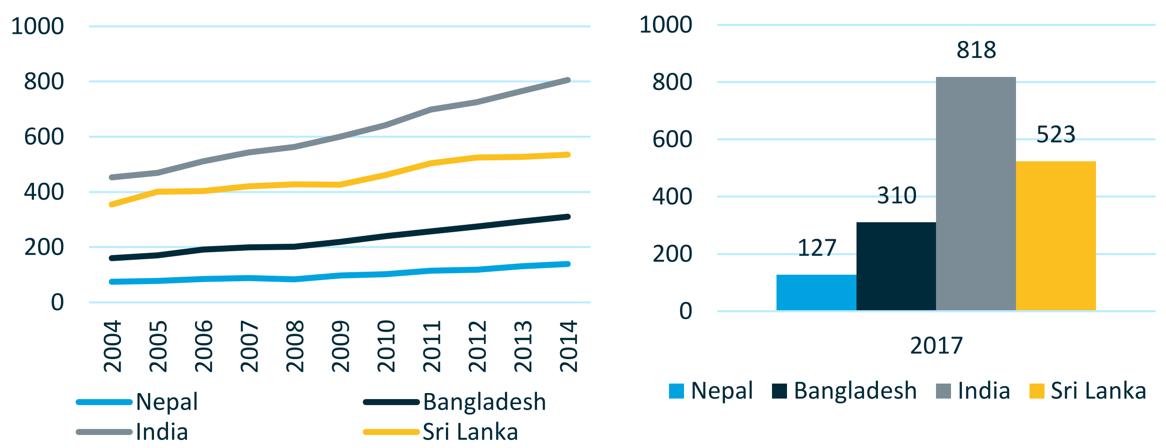


Source: ILO Labour Force Survey Nepal 2008

Infrastructure, structural change and diversification

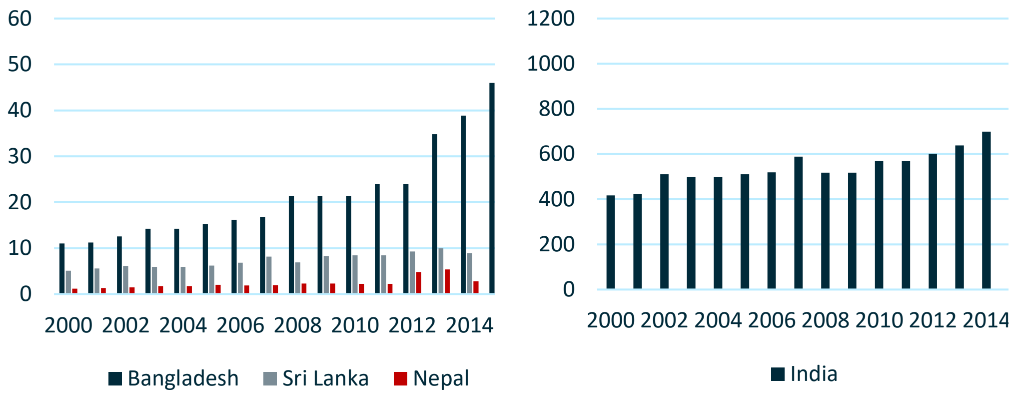
Limited structural transformation and diversification of the Nepalese economy is linked to its historical infrastructure deficit, and partly linked to and exacerbated by its landlocked situation. Per capita electricity consumption is well below other South Asian countries. Estimates show that Nepal needs infrastructure investment worth least 8-12% of GDP until 2020 to adequately develop its infrastructure.

Figure 15a: Electric power consumption (kWh per capita)



Source: CIA World Factbook

Figure 15b: Overall electricity consumption to 2018 (billion kWh)



Source: CIA World Factbook

Apart from a lack of 'hard' infrastructure, Nepal also has an inadequate supply of 'soft' infrastructure such as transport service and IT services. Recent World Bank estimates (2017) show that transport inputs constitute 40% of all inputs for the processed food export sector and 30% of inputs for leather exporters. (World Bank TIS document).

World Bank data shows the average time taken for exporting in Nepal is significantly longer than that for comparator countries and that this is partly the result of an infrastructure and service input deficit. This deficit also makes it difficult for Nepal to diversify its export product mix.

Table 4: Yearly infrastructure investment needs (as % of GDP, 2010-2020)

World Bank Estimates	Transport	Electricity	ITC	Water & and Sanitation	Irrigation	Total
Nepal (percent of GDP)	2.3-3.5	3.3-4.5	0.3-0.4	1.1-1.6	1.0-1.5	8.2-11.8
USD billion by 2020	3.7-5.5	5.3-7.0	0.4-0.6	0.4-0.5	1.6-2.3	13-18
ADBI Estimates	**Transport**	**Electricity**	**ITC**	**Water & and Sanitation**	**Irrigation**	
Nepal (percent of GDP)	1.65	0.58	5.14	1.10	8.48	
South Asia (Including India)	5.55	3.03	2.02	0.39	11.00	

Source: Andres, et al., 2014, Bhattacharya, 2010, Ahmed, et al., 2012

Exploring policy measures (national policy documents)

Macroeconomic policy

Nepal is often cited as one of the best performing developing countries in terms of achieving macroeconomic stabilisation. Macroeconomic policy in Nepal has mainly consisted of tight fiscal policy, money supply control, and inflation targeting. It could be argued, however, that macroeconomic policy in Nepal has been stabilisation-centric, and that this has been at the expense of growth and structural change. In particular, the fiscal balance has been maintained at the cost of government-led investment that could have promoted productivity-enhancing growth and development.

In recent years, there has been more explicit recognition of the need for policy to move beyond stabilisation and deregulation, especially in the sphere of international trade. The Nepal Trade Integration Strategy was developed to deal specifically with the challenge of diversification and transformation.

Nepal's Trade Integration Strategy (NTIS)

Nepal's National Trade Integration Strategy 2015 (NTIS 2015) was developed with the objective of enhancing the contribution of the trade sector to growth and to overcome the constraints and challenges associated with trade development and export promotion. The assumption underlying this strategy is that trade integration can encourage diversification and structural transformation.

In a broad sense, the NTIS is consistent with the aim of structural transformation articulated by the Vienna Programme of Action. It covers four cross-cutting areas and three "priority export potential sectors." The cross-cutting areas are:

- transport and trade facilitation;
- standards and technical regulations;
- sanitary and phyto-sanitary measures; and
- intellectual property rights.

The priority export sectors are set out in the table below (Table 5).

Table 5: NTIS 2016 priority export potential sectors

Priority export potential sectors	
Agro-based products	**Cardamom** **Ginger** **Tea** **Medical and aromatic plants**

Craft and manufacturing products	**All fabrics, textile, yarn and rope** **Leather** **Footwear** **Pashmina** **Carpets**
Services	**Skilled and semi-skilled professionals at various categories (remittance generating services)** **IT and BPO and IT engineering** **Tourism (leisure, business, education and medical)**

Source: Government of Nepal. 2016. "Nepal Trade Integration Strategy".

The NTIS proposes that in order to benefit from trade integration, firms in Nepal need to make good use of available platforms for integration. These include:

- regional and global value chains both for goods and services;
- services trade in activities of marked comparative advantage; and
- e-commerce for high-quality, low-volume segments.

Regional and global value chains (R&GVCs) are seen as offering opportunities for firms in Nepal to access markets and benefit from productivity-enhancing technology as well as skills transfers and know-how.

Shortcomings and challenges of the NTIS

While the NTIS is an important step towards formulating explicit industrial and agricultural policy and linking this to trade integration, it has several shortcomings. The key ones are highlighted below. These limitations mean that the NTIS in some ways falls short of the policy regime articulated by the Vienna Programme of Action for enabling structural transformation in LLDCs.

Insufficient attention to the productivity-trade integration nexus

The key limitation of the NTIS is that it pays insufficient attention to productivity. Productivity improvement should be seen as integral to trade integration in a landlocked country such as Nepal. More specifically, the following issues relating to productivity need to be addressed with more focus in the NTIS.

- Productivity in the agricultural sector should be improved through mechanisation and commercialisation.
- Special attention should be given to promoting the manufacturing and service sectors, which can generate employment and exhibit high productivity.
- There should be a focus on developing human capital necessary for a knowledge-based, high-yielding economy.

– The construction of physical infrastructure and adequate supply of energy should be ensured for promoting economic activities in the economy.

Prioritising low quality products in the NTIS

The quality of most agricultural products prioritised by the NTIS 2015 is average or low. For products such as coffee and tea, Nepal's exports are positioned halfway through the quality distribution with an average unit price that is approximately 40% of that of the top exporting country.

However, focusing an export strategy that aims to participate in global value chains but at the lower quality spectrum of the market carries with it the significant risk of unfavourable price trends and demand conditions in the medium term, due to substitution effects and the tendency to cut costs and reduce prices at times of recession.

More focus needed on infrastructure

Given its tight fiscal policy, Nepal has some capacity to increase investment in infrastructure. Again, this could be linked more explicitly to integration and economic diversification in the NTIS.

The first stepping stone towards sound infrastructure governance is to improve project prioritisation in order to optimise the infrastructure portfolio. Reports have shown that eliminating poor performing contracts and the selection of improved alternatives could save up to 15-35% of new capital spending. In Nepal's case, even if the country saves just 10% of capital expenditure, which amounts to NRS 8 billion, this could provide sufficient cushioning to finance large scale infrastructure projects.

In Nepal, important infrastructure projects have been suffering from implementation delays caused by the lack of a sophisticated procurement system and a failure to streamline permit approvals and land acquisition in order to reduce bottlenecks.

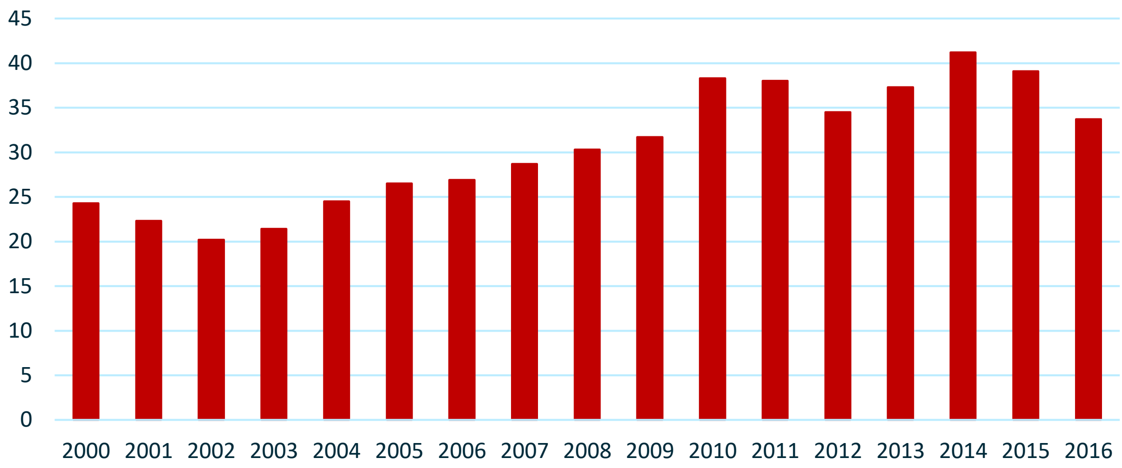
It is also necessary to better utilise existing infrastructure assets. Adding more roads, constructing hydropower dams and fitting pipelines will not resolve problems if the existing infrastructure is not properly maintained. Nepal should move away from the build, neglect, and rebuild mentality and implement an adequate infrastructure management system. It has been argued that the deployment of information technology in establishing an intelligent transport system (ITS) for roads would enable the utilisation of the existing road capacity to double or even triple (World Bank 2017).

Clearly all these points go in the same direction – more clarity on objectives and a strong focus on achieving the key aims is essential if Nepal is to work through what has been a rather muddled and patchy approach towards improving growth and development.

Investment

Historically, investment rates in Nepal have been low as illustrated in Figure 18. Over the past 16 years, fixed capital formation as a percentage of GDP has averaged 22%, although there have been some recent increases due to post-earthquake reconstruction. This underinvestment has resulted in lower growth rates and very limited structural transformation.

Figure 16: Gross capital formation (% of GDP)



Source: World Bank

Insufficient public investment in basic infrastructure in key areas such as energy and transport (around 4% of GDP in 2017, which is below average among both the South Asian and low-income countries) is a major cause of limited economic diversification in Nepal. The Asian Development Bank estimates that this needs to increase to a sustained rate of 7-8% for Nepal to reach the status of a middle-income country by 2030.[1]

In addition, the efficiency of investment in Nepal is low. With a low (public) investment rate and capital stock, the return on marginal investment should be high, with many projects expected to have a high return. But this is not the case in Nepal, as shown by the incremental capital output ratio (ICOR), or the units of required capital needed to increase output by 1 additional unit. In other words, the higher the ICOR, the more inefficient is public investment. From 2001 to 2007, the ICOR for Nepal was 5.7, the highest among comparator countries. The ICOR has not improved in recent years, and the Fourteenth Plan of the National Planning Commission estimates the ICOR to be 5.2 between the fiscal years 2016 and 2019, with an unacceptable level of 29 for energy and 9 for transport.

This public investment deficit limits the ability of the private sector to perform well and to scale up investments. The country's inadequate and unreliable supply of electricity is repeatedly noted as having a crippling effect on private sector investment and activity.

Adequate levels and appropriate types of public investment in a low-income country like Nepal can have the effect of 'crowding in' by creating the conditions that enable private investment

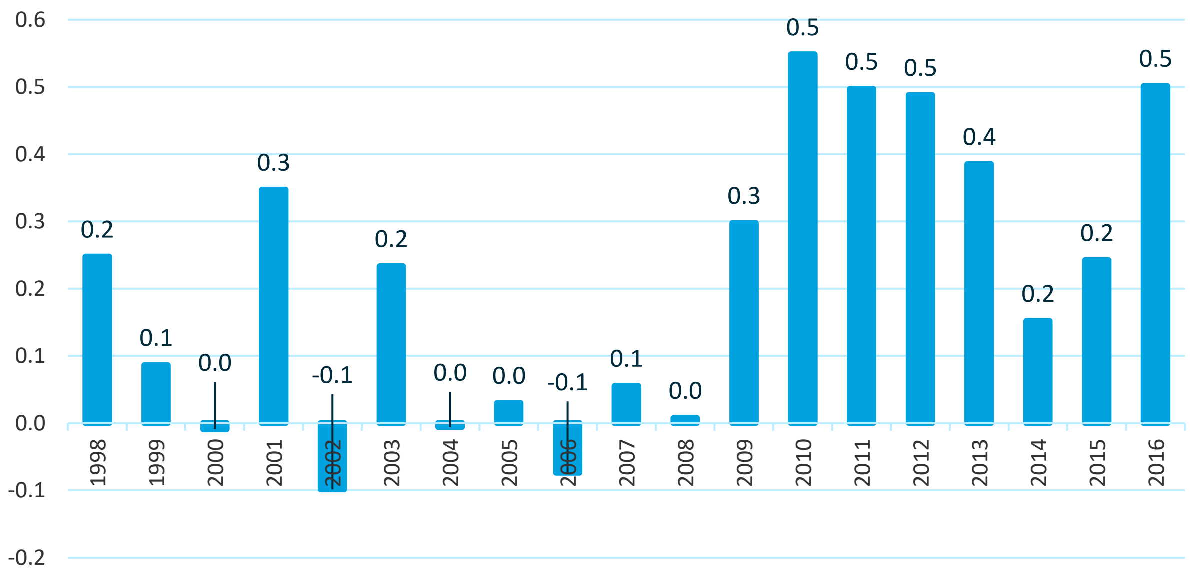
[1] https://www.adb.org/news/speeches/key-enablers-accelerating-infrastructure-investments-nepal-wencai-zhang

and improving the potential profitability of this investment. This can be an important source of economic diversification and there is much scope for better policy emphasis on this in Nepal.

Foreign direct investment

FDI can enable a country to access new markets, upgrade the quality of its export basket and increase innovation and productivity, but FDI inflows to Nepal are very low compared with comparator countries. In 2016, FDI inflows constituted just 0.5% of GDP. Although the HH index for FDI concentration (for source country) in Nepal shows diversification of FDI sources over time, the very low volumes of FDI entering the country means that the overall impact of this diversification is not likely to be significant.

Figure 17: Foreign direct investment, net inflows (% of GDP)



Source: World Bank, World Development Indicators

The low volumes of FDI flowing into Nepal are the consequence of several factors, including the cumbersome process for repatriating funds, the time required to complete the hiring of foreign workers, and the entry barriers to foreign investment in certain industries (World Bank 2015).

Private sector

Nepal's private sector is dominated by small- and medium-scale enterprises, which comprised more than 90% of the total registered businesses. The World Bank's Nepal Enterprise Survey 2013 shows that about 60% of the formal non-agricultural private sector is in wholesale and retail business, followed by 15% in hotels and restaurants, and 12% in manufacturing.

The competitiveness of Nepal's private sector is also limited in the global economy. This is largely due to poor infrastructure (electricity and transport), political uncertainty, and limited bureaucratic capacity which constraint private sector performance in Nepal.

The government of Nepal now recognises the private sector as one of the key pillars of the economy and considers its role crucial to achieving higher growth. It is promoting private sector participation in infrastructure development of hydropower plants, irrigation, roads, and airports (through Public Private Partnerships).

As noted in this report, infrastructure development is key to economic diversification in Nepal, and therefore such policy could make the private sector a key player in the diversification process. In the fiscal year 2017, the private sector's investment in fixed capital assets, such as plants, machinery and infrastructure increased by 41.6%, partly reflecting the impact of these policy measures

Integrating the principles of the Vienna Programme of Action

The Vienna Programme of Action is specifically designed to mobilise national, regional and international action in support of the development efforts of the landlocked developing countries, focusing on six interrelated priority areas: (a) fundamental transit policy issues; (b) infrastructure development and maintenance; (c) international trade and trade facilitation; (d) regional integration and cooperation; (e) structural economic transformation; and (f) means of implementation.

Nepal is of course severely constrained in all five areas of VoP priorities. Infrastructure and international trade constraints have been discussed in detail above. In terms of transit issues, Nepal has persisting limitations: Kolkata is the nearest sea-port for Nepal. The transit arrangements between India and Nepal are governed by two main legal instruments: the India-Nepal Treaty of Trade and Transit, and the India-Nepal Rail Services Agreement.

The transit treaty has a number of inadequacies with issues related to documentation requirements, trans-shipment procedures, sensitive items, arbitrary bank guarantees, and poor infrastructure further increasing the transaction costs for transit cargo. Although the value of the total transit trade through India has been increasing, its share in Nepal's total trade with the world has seen a decline during 2009-13.

Nepal policy on structural change

The VPoA posits that structural transformation is central to promoting growth and development in landlocked LDCs. Nepal aims to become a middle-income country by 2030, and structural transformation is key to this. Policy emphasis on priorities of the VPoA in Nepal, however, have several limitations.

Policy initiatives and documents relating to structural transformation and diversification in Nepal fall into two categories:

- NTIS (discussed above); and
- Periodic Plans presented by the National Planning Commission which is the primary planning body in Nepal.

The Periodic Plans fail to address the sustained structural transformation of the economy as they are essentially short-term policy documents. Nepal has implemented nine five-year plans and five three-year plans since the process of planned economic development began in 1956. Although these plans provide a basis for the government to frame the annual budget and guide development work in the country, they are an ad hoc scheme and fail to provide a unified and well-coordinated strategy for promoting long-term growth and diversification.

There is limited coordination between the Nepal Trade Integration Strategy (which explicitly recognises the need for diversification) and the Periodic Plans. This means that there is significant scope for placing greater policy emphasis on Priority 5 of the Vienna Program by tightening the coordination between key development policy documents in Nepal.

Challenges, opportunities and policy recommendations

Nepal has opportunities to better utilise geological and cultural diversities to promote the tourism sector, which can enhance foreign currency earnings. There are opportunities to increase public capital expenditure through prioritisation of expenditures, maintaining financial discipline making public expenditure management result oriented, with the explicit objective of addressing Priority 5 of the VPoA.

In particular, there are opportunities to use the remittances to retrain or further train workers who have earned skills abroad. Nepal has opportunities to address the weaknesses of the NTIS by targeting export sectors which have greater potential for productivity increase, and export competitiveness and export diversification.

However, the country also faces the challenges of enabling higher economic growth rates and structural transformation through proper mobilisation of domestic and foreign investment. To achieve this, it will need to develop physical infrastructure and boost technology development aimed at increasing productivity in agriculture and industry.

Providing incentives for the private sector to engage in boosting economic growth, developing infrastructure and increasing productivity is also key. For example, constructing electricity projects with active participation of the private and government sectors will be critical to end the energy crisis in the county.

The effects of a ‘Dutch Disease’ created by the high level of inward remittances from migrant labour working overseas also add to the constraints facing Nepalese policy makers. A concerted policy effort is needed to bring about structural change and target alternative industries and sectors that can earn foreign exchange in a sustained manner.

To mitigate the challenges and capitalise on the opportunities, Nepal could consider policies and initiatives aimed at increasing investment, diversifying its export and dealing more efficiently with migrant remittances.

Policies for increasing investment

Investment rates (both public and private) have been low in Nepal, as has been its efficiency. Therefore, increased investment in infrastructure and in new technologies is essential for diversifying the economy. Investment specifically aimed at economic diversification should be integrated into economic planning. To achieve this, decision makers should consider making Periodic Plans of Nepal (PPN) for the medium term, and not on an ad hoc short-term basis, as is currently the practice.

In order for investment to be specifically directed at diversification, it is important to distinguish between two types of policy options which include:

- **Public sector and public-private infrastructure investment policies:** These are 'general' policies to extend and hasten investment in the transport and energy sectors in particular. While they do not directly target diversification, they create the necessary conditions that enable transformation towards higher productivity activities and sectors.

- **Public investment directed at 'picking winners'**, which will include new activities and sectors in which Nepal has the potential to be internationally competitive. This type of investment policy should be directed at the acquisition and dissemination of new technology and providing incentives to the private sector to enter these specific sectors.

These policy initiatives can be formulated jointly by the National Planning Commission together with individual ministries such as the Ministry of Industry, Commerce and Supplies.

As discussed in this report, Nepal has some scope to increase public investment in the above directions through prioritisation of expenditures, maintaining financial discipline, and making public expenditure management result oriented.

Policies for export diversification and increasing productivity

This report evaluated the Nepal Trade Integration Strategy in terms of its potential to promote export diversification and structural transformation and argued that the NTIS has several shortcomings. Therefore, export and trade diversification policy in Nepal should target productivity improvement in agriculture, manufacturing and service and must move beyond prioritising low quality, low productivity sectors as the NTIS currently does.

While the NTIS is formulated by the Ministry of Commerce, expanding the productivity focus of the strategy may need more specific input from other Ministries – those dealing with agriculture and industry, as well as the broader institutions dealing with Period Plans.

This would enable trade policy to be closely coordinated with investment policies of the types discussed above, and also with policies to develop human capital and skills discussed below.

Policies to deal with migrant remittances

To a certain extent, the Nepal economy has been cushioned against the urgency for structural change, given the high level of inward remittances provided by migrant labour working overseas. To counter the possible impacts of 'Dutch Disease', policy efforts could involve the following initiatives:

(i) **directing a proportion of the substantial earnings from remittances to improve and diversify human capital and training.** In particular, the policies should target the acquisition of industry-specific skills that will enable economic diversification, especially in high productivity sectors and in new export sectors.

(ii) **coordinating between institutions such as the Council for Technical and Vocational Skills, the Nepal Business Forum and the National Planning Commission.** Such coordination can provide strategic direction for this type of policy aimed at educational and skill diversification in Nepal.