

Nepal Development Update

April 2021

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Harnessing Export Potential for a Green, Inclusive, and Resilient Recovery

NEPAL DEVELOPMENT UPDATE

Harnessing Export Potential for a Green, Inclusive, and Resilient Recovery

April 12, 2021



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The Nepal Development Update is produced once a year to report on key economic developments that occurred during the year, placing them in a longer-term and global perspective, and to examine (in the Special Focus section) topics of particular policy significance. The Update is intended for a wide audience including policy makers, business leaders, the community of analysts and professionals engaged in economic debate, and the general public.

This Update was produced by the World Bank Macroeconomics Trade and Investment (MTI) team for Nepal consisting of Kene Ezemenari (Senior Economist, MTI), Nayan Krishna Joshi (Economist, MTI), Florian Blum (Economist, MTI); with a Special Focus Section prepared by Gonzalo Varela (Senior Economist, MTI) and Federico Ganz Carulla (Consultant, MTI). Inputs were also received from Nethra Palaniswamy (Senior Economist, POV), Alen Mulabdic (Economist, MTI), Shaun Mann (Senior Operations Officer, FCI), Erik Nora (Senior Operations Officer, FCI), Sabin Raj Shrestha (Senior Financial Sector Specialist, FCI), and Peter Mousley (Lead Private Sector Specialist, FCI). The report also benefitted from consultations with the following private sector representatives: Mr. Vijay Kumar Dugar (President, Nepal Pashmina Industries Association), Mr. Chandi Prasad Aryal

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The cutoff date is March 15, 2021, and includes data released up until that date.

Abbreviations

BFI	Banking and Financial Institutions
CCD	Credit-to-Core Capital and Deposit
CISE	Cash Incentive Scheme for Exporters
DoC	Department of Customs
DoFE	Department of Foreign Employment
DoI	Department of Industry
DoT	Department of Tourism
GSP	Generalized System of Preferences
IRC	Interest Rate Corridor
JOCEX	Jobs Content of Exports
KYC	Know-your-Customer
LDC	Least Developed Country
MoF	Ministry of Finance
NRB	Nepal Rastra Bank
RPS	Retail Payment Strategy
SAR	South Asia region
SPS	Sanitary and phytosanitary standards
WITS	World Integrated Trade Solution
UNCTAD	United Nations Conference on Trade and Development
TRAINS	Trade Analysis and Information System
WTO	World Trade Organization

Table of Contents

Acknowledgments	i
Abbreviations	ii
Executive Summary.....	vi
A. Recent Economic Developments.....	1
B. Outlook, Risks, and Challenges.....	15
C. Special Topic: Trade as a platform for resilience and recovery.....	19
C1. Nepal's export performance: a beyond COVID-19 perspective	20
C2. Challenges and opportunities ahead to build back better.....	25
C3. Challenges to meeting Nepal's export potential	29
C4. Policy options.....	33
References.....	37

Tables

Table ES1. Harnessing Export Potential for a Green, Inclusive, and Resilient Recovery	ix
Table 1. Macroeconomic projections of selected key indicators	16
Table 2. Major markets with multilateral preferential access for LDCs	32

Figures

Figure 1. Daily COVID-19 cases fell sharply by mid-March 2021.....	2
Figure 2. GDP contracted by 1.9 percent in FY20 due to COVID-19-related social distancing and lockdown...	3
Figure 3. ...led by a decline in the investment on the demand side	3
Figure 4. Private consumption remained subdued despite an increase in remittance in H1FY21	4
Figure 5. A declining number of new domestic and foreign businesses indicates anemic private investment	4
Figure 6. Tourism remains at a standstill due to the collapse of international tourist arrivals.....	4
Figure 7. Growth in paddy production has contributed to agricultural output in FY21	4
Figure 8. Mobility to nonresidential places has been increasing since October, indicating recovery in economic activity... ..	5
Figure 9. Headline inflation declined in H1FY21, driven by a fall in both food and non-food inflation	5
Figure 10. Losses in effective employment (percent economically active in 2020).....	6
Figure 11. Policy rates were lowered to enhance credit conditions.....	7
Figure 12. M2 growth still remained below the target	7
Figure 13. Private credit growth picked up in FY21 but remains below pre-pandemic levels	7
Figure 14. Significant amounts of private credit were used for overdraft and margin lending	8
Figure 15. Eased credit conditions amidst weak credit demand contributed to the recent stock market rally..	8
Figure 16. Deposits expanded by 9.2 percent in the first half of FY21.....	8
Figure 17. Imports contracted during the pandemic... ..	9
Figure 18. ...partly reflecting the effects of depreciation in the real effective exchange rate	9
Figure 19. Exports also declined... ..	9
Figure 20. ...but remittance inflows picked up in H1FY21.....	10
Figure 21. Recovery in remittances and the improved trade balance narrowed the current account deficit ...	10
Figure 22. Foreign exchange reserves increased.....	11
Figure 23. Revenues have dropped since the outbreak of the pandemic... ..	11
Figure 24. ...forcing fiscal adjustment especially through reduced capital expenditures	12
Figure 25. Smaller fiscal surplus in H1FY21 reflects tighter fiscal conditions.....	12
Figure 26. Public debt increased to 36.4 percent of GDP.....	12
Figure 27. Compound annual growth rate of exports of goods and services in current US\$, 1999–2019.....	20
Figure 28. Exports and remittances, cross-country comparison, 2019 or last available data	21
Figure 29. Composition of merchandise exports.....	21
Figure 30. Composition of services exports	22
Figure 31. Share of manufactured exports classified as high-tech, last available year.....	22
Figure 32. Price obtained by relevant exports relative to competitors, 2019.....	23
Figure 33. Survival of Nepalese exports, 2007–18.....	23
Figure 34. GDP growth decomposition, 2001–17	24
Figure 35. Per-worker value added (VA), current level and recent growth, Nepal compared to comparators	24
Figure 36. Value added (VA) per worker, by sector, current level and recent growth, Nepal compared to comparators.....	24

Figures

Figure 37. Missing exports	26
Figure 38. Nepal's missing exports, in million US\$, 2010–17	26
Figure 39. Nepal's missing exports per trading partner and their import growth	27
Figure 40. Nepal export performance compared to counterfactual scenarios and its export potential.....	28
Figure 41. Missing jobs in Nepal due to export underperformance, in thousands.....	28
Figure 42. Foreign direct investment, net inflows.....	30
Figure 43. Upstream import duties, by sector.....	31
Figure 44. Preference utilization	32

Boxes

Box 1. Estimating jobs created from US\$1 million of exports.....	27
Box 2. Nepal's Least Developed Country graduation and its potential impacts.....	32

Executive Summary



Recent Economic Developments

Nepal has been hit hard by COVID-19, although the situation has improved more recently. As the outbreak became widespread in mid-2020, a nationwide lockdown was implemented from March to July in 2020, followed by localized lockdowns, including in the Kathmandu Valley up until mid-September. During this time transportation, education and tourism-related activities were significantly restricted. Since October, the number of cases has been declining steadily, allowing a gradual easing of movement restrictions. Nepal launched its vaccination program on January 27, 2021, and

about 5.9 percent of the population (or 1,791,606 people) were inoculated by mid-March 2021. Thus, there are good prospects that further outbreaks of COVID-19 can be contained.

After contracting for the first time in 40 years in FY20-by 1.9 percent-the economy showed signs of moderate recovery in the first half of FY21. Activity resumed in wholesale and retail trade, transport, and financial services, while favorable monsoons drove agricultural growth. However, tourism remained at a standstill and private investment anemic given high levels of

overall uncertainty related to the epidemic as well as political developments. Uncertainty arising from the epidemic has also contributed to fiscal risks due to the degree of fiscal stimulus provided to support individuals and firms and which will need to eventually be rolled back for fiscal sustainability. Political uncertainty also heightened in December 2020 when the Prime Minister dissolved Parliament. The Supreme Court overturned the decision, reinstating Parliament in February 2021 and precipitating the split of the two-party majority coalition in March.

Economic hardship is likely to have an impact on income and employment. The increasing number of unemployment applications and returning migrants could adversely affect progress in poverty reduction. The recent World Bank COVID-19 monitoring survey suggests there were widespread impacts of the pandemic on jobs and incomes, with more than two of every five economically active workers reporting an incidence of job loss or prolonged work absence. Women, young workers, and those engaged in nonagricultural activities have been the most severely affected.

Credit growth recovered in recent months, albeit moderately. In the wake of the COVID-19 crisis, the central bank lowered its policy rate and took additional measures to support credit to the private sector, including refinancing programs for COVID-19-affected firms. As a result, credit to the private sector grew by 11.6 percent in the first half of FY21, still below pre-pandemic levels. Over the same period, deposits increased significantly due possibly to three key factors: higher precautionary savings, repatriation of savings by returning migrants, and reduced consumption amidst social distancing measures.

Muted domestic demand has contributed to an improvement in the current account balance. The current account deficit narrowed by 39.6 percent year-on-year (y-o-y) in the first half of FY21, thanks to a sharp contraction in imports (by 11.8 percent) and a recovery of remittance inflows (which grew by 6.7 percent y-o-y, after

falling by 3.4 percent in FY20). Given limited amounts of foreign direct investment (FDI), external concessional loans have primarily financed the current account deficit. The central bank's foreign exchange reserves increased moderately to US\$11.3 billion by mid-January 2021, equivalent to 11.3 months of imports.

Spending was higher and revenue lower, y-o-y, over the first half of FY21. Higher spending was driven by purchases of COVID-19-related health equipment and investments at the subnational levels, which offset a significant reduction in capital spending at the central level. Meanwhile, revenues fell slightly. Tax revenues declined by 2.1 percent y-o-y, with trade and consumption taxes, as well as corporate income taxes performing poorly. Non-tax revenues continued to suffer from the near standstill in tourism. Consequently, public debt increased by 8.2 percent over the first half of FY21, relative to the end of FY20, to 36.4 percent of the projected FY21 gross domestic product (GDP). Despite these changes, Nepal remains at low risk of debt distress.

Outlook, Risks, and Challenges

The economy is expected to recover steadily but gradually from FY21 onward. Assuming a successful vaccination rollout domestically and globally, and a gradual resumption of international tourism, real GDP is projected to grow by 2.7 percent in FY21 and 3.9 percent in FY22. Growth is expected to be driven by services as social distancing eases up further, and by agriculture, on the back of recent favorable monsoons. However, the pandemic is expected to have lasting effects. Without reforms to readjust towards a post-COVID-19 tourism market that includes improvements to nature-based tourism, enhanced infrastructure for better access, environmental management and tourism diversification, the sector may not fully recover. This would stall the growth recovery, limiting its resilience. Tepid exports of goods, and services, matched against increasing imports, as consumption returns to normal, would widen the current account deficit to 3.2 percent of GDP by FY22.

The fiscal deficit is projected to remain elevated but to stabilize gradually over the medium term. Revenue performance is expected to remain weak, and additional spending will be required for economic relief measures, vaccinations, and the resumption of project implementation. As a result, the fiscal deficit is expected to widen to just under 8 percent of GDP in FY22 and public debt is projected to reach 46.7 percent of GDP by FY22. However, the country's debt will remain sustainable.

The economic outlook is subject to significant downside risks. The recent political uncertainty, if prolonged, may further undermine investment sentiment. On the upside, effective vaccination campaigns could facilitate a resumption of tourism and hospitality services. A resilient recovery could be further supported by investments, to enhance quality, market access, and livelihood opportunities for local communities in tourism and related value chains.

To mitigate downside risks to the outlook, it will be critical to address structural weaknesses in the economy that have been exacerbated by the pandemic. Over the years, remittance inflows have supported private consumption, poverty reduction, government revenues, and foreign exchange reserves. However, this heavy reliance on remittances has come at a cost, driving a real appreciation of the exchange rate, and undermining export competitiveness while encouraging imports. In turn, weak job creation has fueled further outmigration, while high imports have resulted in a heavy reliance on trade taxes, further weakening firm productivity. Developing exports to drive job creation and firm productivity is therefore central to a quick and resilient recovery. This will require higher levels of much needed FDI to leverage technical know-how and skills from abroad. Complementary reforms to promote exports would also be needed, including investments in resilient infrastructure to close existing gaps that undermine growth. Investments could also go to develop high value tourism targeted at the mid-range segment and focused on nature-based tourism to support community

livelihoods and conservation. This in turn would support greener growth, resilience, and inclusion.

Special Focus— Harnessing Export Potential for a Green, Inclusive, and Resilient Recovery

The Special Focus section of this report explores options to promote trade, particularly through exports, as a transformative pathway to support Nepal's resilient recovery. Over the past two decades, Nepal's export growth has been stagnant. Indeed, with export growth at 4 percent on average since the turn of the century, Nepal features among the 20 countries in the world with the least dynamic exports. Stronger exports could help increase Nepal's economic resilience, and accelerate recovery from the devastating shock that the COVID-19 pandemic has posed for the private sector. Exports can not only bring foreign currency into the economy to finance well-needed imports, but also spur the creation of “good jobs” in higher value-added activities. Indeed, export orientation tends to drive productivity gains through increased scale and exposure to sophisticated global clients.

This report estimates Nepal's untapped export potential or “missing” exports at around US\$9.2 billion, 12 times its actual annual merchandise exports. Realizing that potential is achievable in the medium term. Had Nepal's exports grown at the average of the South Asia region since 2000, the unrealized export potential would have been reduced by 73 percent. This export potential represents an opportunity to create an estimated 220,000 new jobs, with significant implications for productivity growth.

For Nepal to achieve its export potential, six key priorities need to be tackled (Table ES1). First, Nepal will need to reform the tourism sector to meet the expected changes to demand and preferences, following the pandemic. A quick and resilient recovery of the sector could come about through investments to improve planning, conservation, and resilient infrastructure. It would also entail coordination with the private sector to upgrade skills and develop nature-based tourism

that is environmentally sustainable, with potential to support jobs creation and inclusive growth. Second, to attract FDI, crucial for integration into regional and global value chains, it will be important to simplify and streamline processes for multinationals setting shop in Nepal, as well as actively engage in economic diplomacy to attract FDI. Third, modernizing export promotion will require links to digitization, simplification of processes, skills development, and incentives for exporters. Fourth, a reduction of trade costs will be critical, particularly given the country's landlocked location and the mountainous terrain. This would entail reducing border crossing congestion through upgraded infrastructure and

streamlined procedures and processes. Similarly, reducing import duties – particularly on raw materials and intermediates – is crucial to ensure exporters have access to the most efficient inputs at world prices. Fifth, investments to improve phytosanitary infrastructure will be needed for increased standards and safety of exports. Sixth, measures to boost digital trade, and e-commerce in general – could potentially be a game changer for Nepal – through adopting a robust policy framework. This would include, inter alia, efficient domestic and cross-border digital payment systems, and consumer protection and data privacy regulations aligned with international good practices.

Table ES1. Harnessing Export Potential for a Green, Inclusive, and Resilient Recovery

Priorities	Key recommendations
1. Reform the tourism sector for a quick and resilient recovery	<ul style="list-style-type: none"> • Coordinate with the private sector to strengthen market analysis and development • Build back better through investments and adoption of reforms that promote green tourism and community livelihoods • Provide skills development and improve access to credit for communities engaged in nature-based tourism
2. Simplify and streamline processes to attract more FDI	<ul style="list-style-type: none"> • Reduce the minimum threshold for FDI and streamline the approval process • Actively engage in economic diplomacy
3. Modernize export promotion and upgrade exporters' capabilities	<ul style="list-style-type: none"> • Digitize, automate, and simplify the process for availing the Cash Incentive Scheme for exporters • Base export promotion investments on evidence • Support exporters and potential exporters to upgrade their capabilities
4. Reduce trade costs	<ul style="list-style-type: none"> • Continue improving customs operations • Increase digitization through promoting greater transparency and simplifying processes • Gradual rationalization of import duties
5. Invest in phytosanitary- and quality control-related infrastructure	<ul style="list-style-type: none"> • Increase the capacity for plant pest surveillance and diagnostics and food safety testing • Adopt a risk-based sanitary and phytosanitary system • Negotiate mutual recognition agreements with India and other key trading partners
6. Boost digital trade and e-commerce for more opportunities linked to global value chains	<ul style="list-style-type: none"> • Develop an e-commerce framework reflecting international good practices

A. Recent Economic Developments



A.1 Context

The pandemic has brought about major disruptions in the global economy and trade. Global growth is estimated to have contracted by 4.3 percent and world trade to have declined by 9.6 percent in 2020.¹ South Asia has also felt the devastating impacts of the pandemic, amidst stringent lockdowns and a standstill in tourism. Regional output is estimated to have contracted by 6.7 percent² in 2020. In 2021, ongoing vaccination campaigns and declining numbers of COVID-19 cases give ground to cautious optimism. At the same time, the lingering possibility of a resurgence of outbreaks, especially given the incidence of more transmissible variants and uneven progress

in vaccination between advanced and developing economies, remains a cause for concern.

Nepal has also been hit hard by the pandemic, but infection rates were tapering off in March. As of mid-March 2021, 275,210 COVID-19 cases (0.9 percent of the total population) have been reported, with 271,401 recovered (a recovery rate of 98.6 percent) and 3,014 dead. Around 50 percent of cases have been reported in Kathmandu Valley which is the most densely populated and economically important part of the country. As the pandemic first unfolded in March 2020, a strict nationwide lockdown was imposed through

1 World Bank 2021.

2 World Bank 2021.

July. It was followed by localized lockdowns in various municipalities including the Kathmandu Valley in late August, with restrictions on land and air transportation, educational institutions, and tourism. Lockdowns and social distancing measures helped to bring down the number of daily cases from 3,000 in October 2020 to less than 100 cases in mid-March 2021 (Figure 1), which in turn allowed for a gradual easing of movement restrictions. As of January 27, 2021, vaccination has also started, adding to the prospect of further containing the outbreak. As of mid-March 2021, 1,791,606 people, or 5.9 percent of the total population, have received the first dose of vaccine, with administration of the second doses planned in late April.

The COVID-19 pandemic has tested Nepal’s young federal system. With the adoption of the 2015 Constitution, seven provincial and 753 local governments have been placed at the frontline of service delivery, with direct

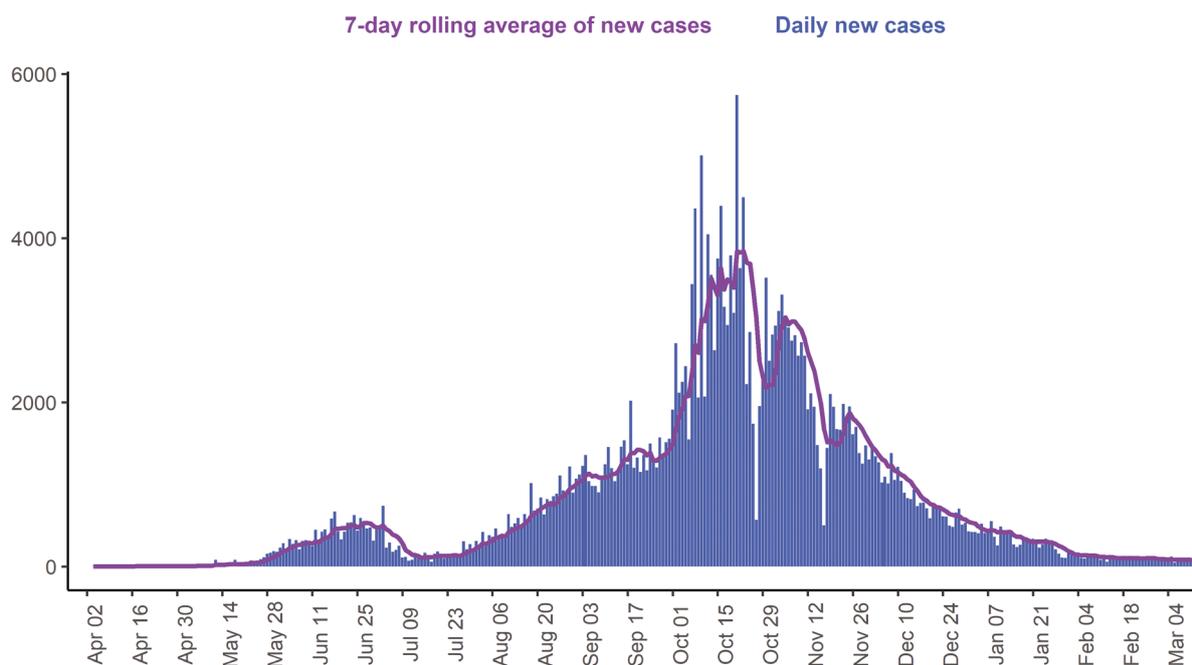
responsibility for managing substantial amounts of public resources. Significant achievements have been made, such as the establishment of a legal framework for federalism and the allocation of expenditure responsibility across the three tiers of government. However, concurrent areas of responsibility still needed to be clarified. By placing increased demands on service delivery and relief, the pandemic has tested the nascent federal system and exposed weaknesses at the local level in terms of human and financial resources, technical capacity, and infrastructure. It has also brought to light weaknesses in coordination across the different levels of government.

A.2 Real Sector

The shock from the pandemic caused an economic contraction in FY20

The pandemic struck at a time when growth was already decelerating. Growth had already

Figure 1. Daily COVID-19 cases fell sharply by mid-March 2021

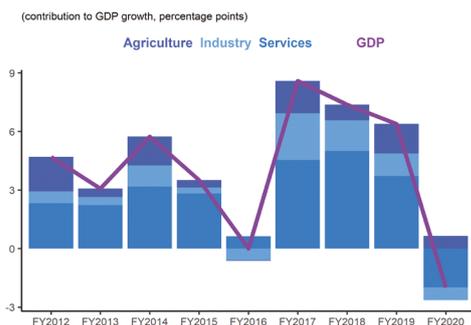


Sources: Ministry of Health and Population and World Bank staff calculations.

begun to moderate in the first half of FY20³, with depressed tourist arrivals and a slowdown in remittance inflows –due to restrictions in outmigration and shocks to migrant receiving economies. Agricultural activity had also been affected by delays in the monsoons and crop damage from army worms and fake seeds.

Against this backdrop, the pandemic caused the first economic contraction in 40 years. Real GDP contracted by 1.9 percent in FY20, as prolonged nationwide mobility restrictions from March to July 2020 significantly impacted all sectors of the economy. Their effect was pronounced on service sector activities, whose output contracted by 3.6 percent (Figure 2): tourism activity ground to a halt (with ripple effects on tourism-linked activities) and transport and wholesale and retail trade were also deeply hampered. About 1 million jobs are believed to have been lost in services linked to tourism and transport.⁴ Meanwhile, industrial output contracted by 4.2 percent as manufacturing and construction were affected by shortages in inputs and restricted labor mobility and constrained market access. Agriculture remained the single driver of growth, expanding 2.2 percent despite shortages in fertilizer supply and disruptions in production distribution channels.

Figure 2. GDP contracted by 1.9 percent in FY20 due to COVID-19-related social distancing and lockdown...



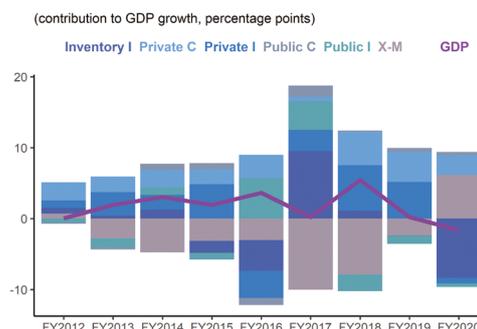
Sources: Central Bureau of Statistics and World Bank staff calculations.

3 Nepal’s fiscal year runs from mid-July to mid-July

4 Overseas Development Institute 2020.

Aggregate demand was weighed down by a decline in investment and depressed consumption (Figure 3). Investment contracted by 3.5 percent in FY20, as construction activity came to a halt and government capital expenditures fell in the second half of the year. Private consumption grew y-o-y, but at a three-year low of 3.7 percent. This was mainly due to a decline in remittance inflows (by 3.4 percent) in FY20 as approvals for foreign employment were halted in March and borders were subsequently closed. The only mitigating factors were higher public spending on wages and COVID-19-related expenditures on health and social assistance as well as net exports (reflecting a sharp fall in imports).

Figure 3. ...led by a decline in the investment on the demand side



Sources: Central Bureau of Statistics and World Bank staff calculations.

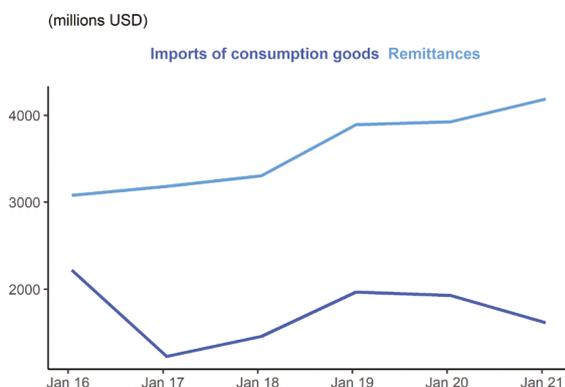
Note: I, C, X, and M stand for investment, consumption, exports, and imports.

Economic activity was subdued in early FY21 but there are early signs of moderate recovery

Domestic demand remained subdued in H1FY21. The persistence of social distancing measures and the effect of income losses incurred at the peak of the crisis (whether linked to permanent jobs losses or temporary shocks) are believed to have depressed private consumption over the festival season (mid-October to mid-November 2020), despite an increase in

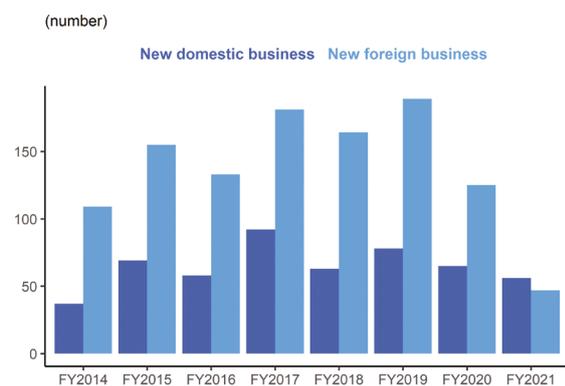
remittances during H1FY21 (Figure 4). Meanwhile, private domestic investment and FDI fell by 7.8 percent and 36.7 percent (y-o-y), respectively. These trends were reflected in the fact that the number of new domestic and foreign businesses fell y-o-y by 13.8 and 61.6 percent, respectively (Figure 5). Lastly, government investment also fell by 19 percent (y-o-y) as current spending increased to meet COVID-19 related needs.

Figure 4. Private consumption remained subdued despite an increase in remittance in H1FY21



Sources: DoC, NRB, and World Bank staff calculations. Note: Data are for the first six months of the FY.

Figure 5. A declining number of new domestic and foreign businesses indicates anemic private investment

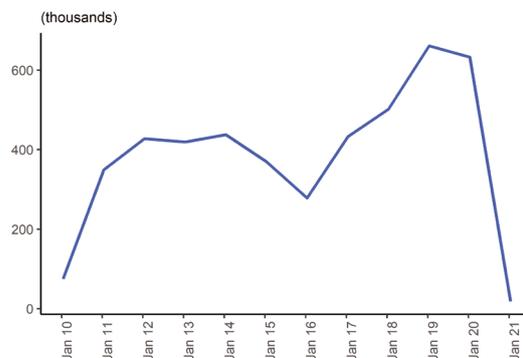


Sources: DoI and World Bank staff calculations. Note: Data are for the first six months of the FY.

Nonetheless there are incipient signs of a moderate recovery in consumer sentiment and economic activity. Since October 2020,

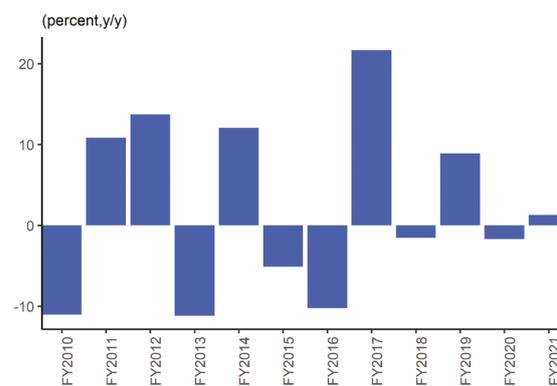
increasing mobility for shopping, recreation, and work (Figure 8) indicates that economic activity has resumed, including in wholesale and retail trade, transport, and financial services, as social distancing measures are being relaxed, even if tourism and tourism-related activities are still almost completely frozen (Figure 6). Moreover, mobility indicators improved again in February

Figure 6. Tourism remains at a standstill due to the collapse of international tourist arrivals



Sources: DoT, DoFE, and World Bank staff calculations. Note: Data are for the first six months of FY.

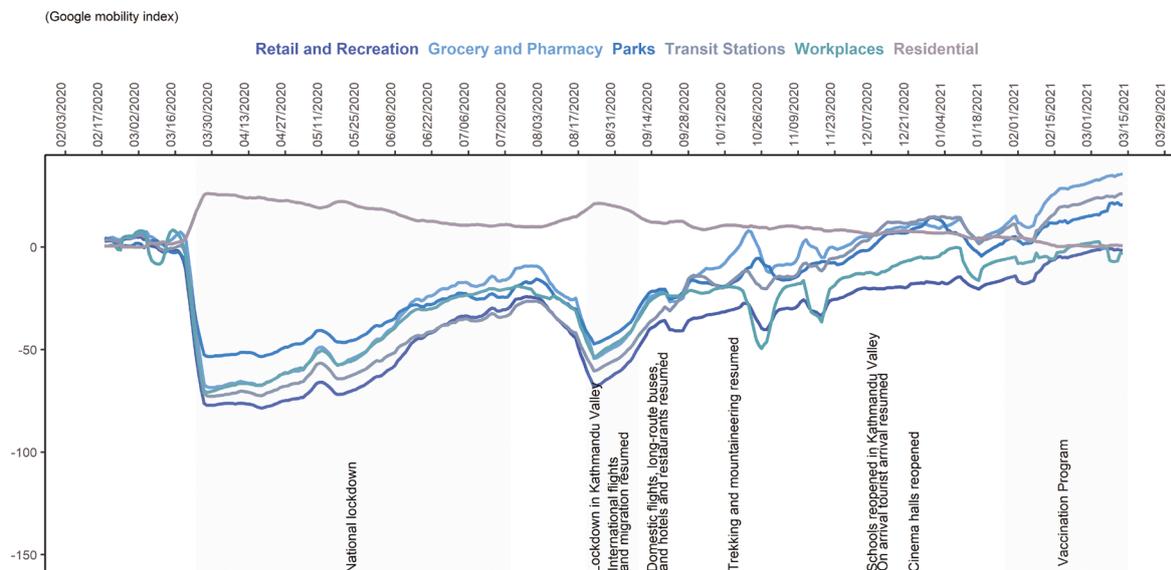
Figure 7. Growth in paddy production has contributed to agricultural output in FY21



Sources: Ministry of Agriculture and Livestock Development and World Bank staff calculations.

(Figure 8), coinciding with the rollout of vaccine, which suggests that further improvements could take place in FY21, assuming a smooth vaccination rollout for the remainder of the fiscal year. Meanwhile, on the side of the rural economy, paddy production grew by 1.3 percent, suggesting a continued expansion of

Figure 8. Mobility to nonresidential places has been increasing since October, indicating recovery in economic activity...



Sources: Ministry of Agriculture and Livestock Development and World Bank staff calculations.

agricultural output in FY21 (Figure 7).

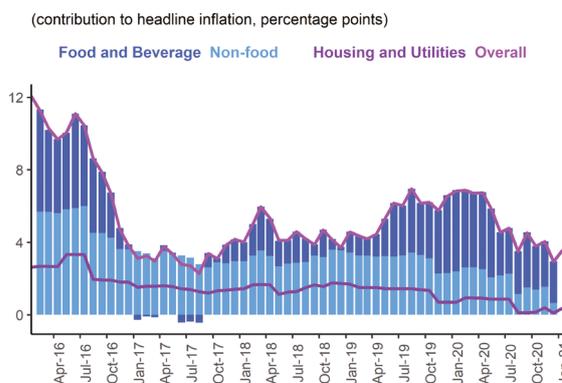
Inflation has decelerated recently

In FY20, average inflation rose to 6.1 percent from 4.6 percent in the previous year. The uptick inflation was mostly driven by higher food inflation (8.6 percent), caused partly by a ban on exports of onions by India (between September 2019 to March 2020), as well as COVID-19-related supply and trade disruptions in the agriculture sector since mid-March. Weaker domestic demand, on the contrary, put downward pressure on non-food inflation, which fell to 4.6 percent in FY20 (from 5.9 percent in FY19).

Over the first half of FY21, inflation fell to a three-year low of 3.7 percent (y-o-y) (Figure 9). Food price inflation slowed to 5.5 percent (y-o-y) (from 8.2 percent in the same period of FY20) thanks to an increased supply of vegetables, meat, and fish, as the national lockdown was lifted in July 2020. Non-food prices rose moderately by 2.3 percent (y-o-y) in the same period, the lowest price increase since H1FY08, mostly on account of subdued prices of housing and utilities (which

grew by only 0.2 percent y-o-y).

Figure 9. Headline inflation declined in H1FY21, driven by a fall in both food and non-food inflation



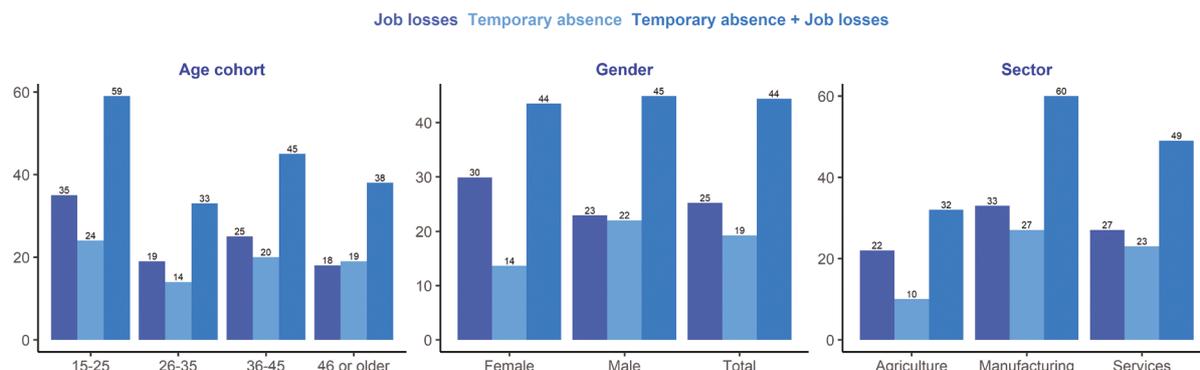
Sources: NRB and World Bank staff calculations.

Economic hardship has a disproportionate impact on the most vulnerable house holds

The pandemic has adversely impacted employment and income, particularly for the most vulnerable. With roughly a third of the population living close to the poverty line

Figure 10. Losses in effective employment (percent economically active in 2020)

(Losses in effective employment, percent of economically active in 2020)



Source: World Bank's Random Digital Dialing Survey.

before the pandemic, widespread jobs and earning losses are likely to have increased poverty, even if temporarily. Women, younger age cohorts, and workers in non-agricultural sectors will be most adversely impacted. A precise estimate of the poverty impact is difficult to estimate given that the last available official estimate of poverty was based on 2010/11 data. However, the pandemic is likely to increase the poverty rate since a large share of the population was close to the poverty line before the pandemic (about a third of all Nepali earning between US\$1.90 and US\$3.20 a day).

There were widespread losses in jobs and income. According to a World Bank COVID-19 monitoring survey, more than two in every five economically active workers reported a job loss or a prolonged work absence in 2020. An estimated 44 percent of all workers who were economically active at any point in 2020 experienced a loss in effective employment⁵, and 25 percent of the economically active population lost their jobs. In addition, 19 percent reported a prolonged absence, with an average absence of 4.4 months and a gap of 4 months since they were last paid. More women reported permanent job losses (30 percent compared to 23 percent for male workers). Among those who did not lose a job, 46 percent

still reported earnings losses. These job-related losses were the largest measured in monitoring surveys in the South Asia region. They affected women, younger age cohorts, and nonagricultural workers disproportionately (Figure 10).

A.3 Monetary and Financial Sector Developments

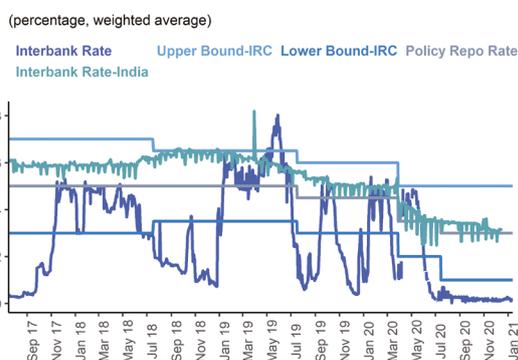
Money supply growth remained below target despite an accommodative monetary policy

The central bank lowered its policy rate and took additional measures to support the real economy. The Nepal Rastra Bank (NRB) has been using an interest rate corridor (IRC) since FY17 to manage volatility in short-term interest rates (weighted average interbank rate). In FY21, the lower limit of the IRC and the policy rate were lowered by 1 percentage point (to 1 percent) and 0.5 percentage point (to 3 percent), respectively, to enhance liquidity (Figure 11). The central bank also took additional credit relief measures for the ailing private sector. Major actions included (i) refinancing programs for COVID-19-affected firms; (ii) concessional lending to the agriculture sector; (iii) the requirement that at least 15 percent of credit from commercial banks should go to the agriculture sector by FY23; and (iv) more directed lending to micro, small, and medium-

⁵ The economically active population in 2020 is defined as the current labor market participants (either working for pay or unemployed in the past seven days prior to the interview), or those who were ever employed in 2020.

sized enterprises by FY24.

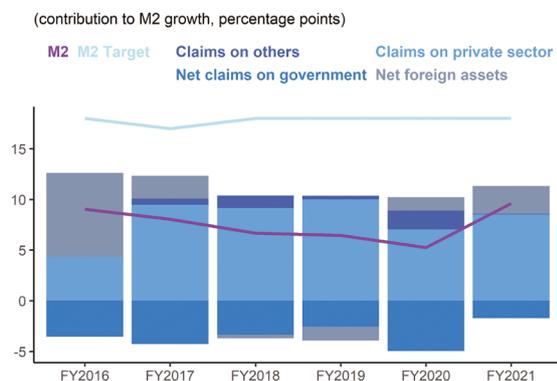
Figure 11. Policy rates were lowered to enhance credit conditions



Sources: NRB and World Bank staff calculations.

Despite the NRB’s accommodative stance, M2 growth remained below the FY21 monetary policy target. M2 grew by 9.6 percent in H1FY21, at a rate below the annual FY21 target of 18 percent, reflecting subdued economic activity (Figure 12). This was despite an increase in foreign exchange reserves and government deposits which contributed to M2 growth through higher net foreign assets and lower negative net claims on the government.

Figure 12. M2 growth still remained below the target

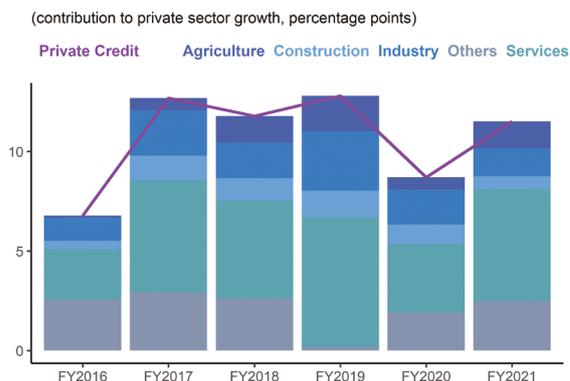


Sources: NRB and World Bank staff calculations.
Note: Data are for the first six months of FY.

Private sector credit growth has picked up recently

In FY20, private sector credit growth slowed to 12.4 percent from 19.3 percent in FY19, due to a combination of weak demand on the borrowing side and risk aversion on the lending side in the second half of the fiscal year. The decline was particularly steep during the lockdown, with net issuance of private sector loans plummeting by 57.5 percent year-on-year between mid-March and mid-July 2020. It was also concentrated in specific sectors. Credit to activities that were directly hit by the pandemic – such as construction, tourism, and import businesses – declined sharply, while credit growth in retail and agriculture sectors remained relatively robust. In contrast, deposits increased by 18.6 percent in FY20, reflecting increased precautionary savings and the deferment of tax payments.

Figure 13. Private credit growth picked up in FY21 but remains below pre-pandemic levels

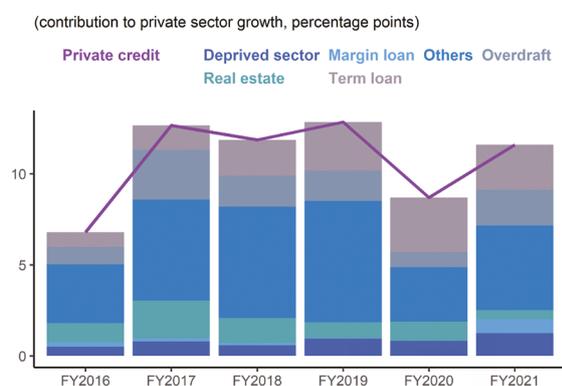


Sources: NRB and World Bank staff calculations.
Note: Data are for the first six months of FY.

Private credit growth has recovered to 11.6 percent (y-o-y) in H1FY21 from a contraction in H2FY20. The observed sequential recovery in credit is consistent with the gradual resumption of economic activity, thanks to the relaxation of movement restrictions and the effects of credit relief measures (Figure 13). However, the composition of credit growth suggests that

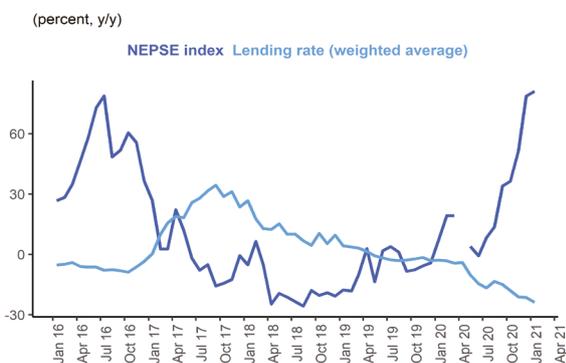
much of it has been on account of overdrafts,⁶ likely to provide economic relief to businesses whose earnings were adversely impacted during the pandemic, and for margin lending for stock market investments⁷ (Figure 14). Indeed, the stock market reached a historic high in mid-January 2021, supported by excess market liquidity and lower borrowing costs amidst subdued investment demand and higher risk aversion from lenders (Figure 15).

Figure 14. Significant amounts of private credit were used for overdraft and margin lending



Sources: NRB and World Bank staff calculations.
Note: Data are for the first six months of FY.

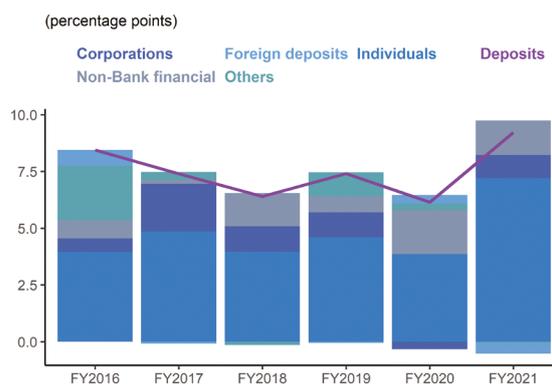
Figure 15. Eased credit conditions amidst weak credit demand contributed to the recent stock market rally



Sources: Nepal Stock Exchange, NRB, and World Bank staff calculations.

Deposits further increased in H1FY21 (Figure 16). Deposits grew by 9.2 percent in the first half of FY21, primarily driven by individual deposits. The robust expansion of deposits can be attributed to three key factors: (i) increasing official remittances, (ii) higher precautionary savings by households (reflecting heightened uncertainty about future economic prospects), and (iii) a temporary and “forced” increase in savings by high-income households who remain unable to consume high-value services such as international travel and restaurant meals.

Figure 16. Deposits expanded by 9.2 percent in the first half of FY21



Sources: NRB and World Bank staff calculations.
Note: Data are for the first six months of FY.

The banking sector’s prudential indicators remained generally within the regulatory targets in H1FY21. The NRB introduced several measures to increase the availability of loanable funds in H1FY21. These included (i) an increase in the Credit-to-Core Capital and Deposit (CCD) ratio to 85 percent (from 80 percent); (ii) an increase in the existing refinancing fund by up to five times; and (iii) the suspension of the countercyclical capital buffer requirement. As a result, the volume of loanable funds has risen even though credit uptake remains low. In turn, this has resulted in sound banking sector indicators. The ratio of net liquid assets to total deposits (26.8

6 On December 1, 2020, the NRB issued a circular to Banking and Financial Institutions that would require them to lower the individual overdraft loan to NPR 5 million. Borrowers do not have to state the purpose of loan when the overdraft loan is provided.

7 Margin lending is provided against the collateral of stocks and bonds.

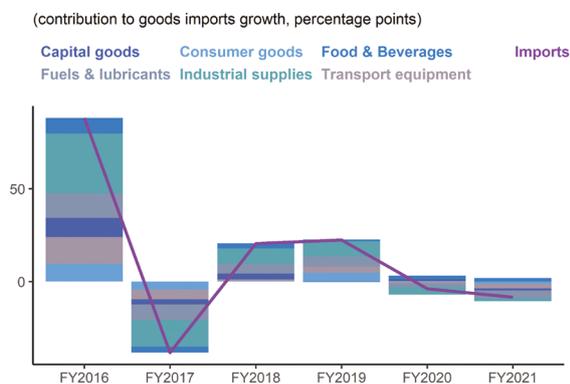
percent), remained above the regulatory threshold of 20 percent; the CCD ratio (74.9 percent) also stayed well below the 85 percent regulatory limit, and; banking and financial Institutions (BFIs) remained well capitalized, with sound asset quality. The capital adequacy ratio was above the requirement of 11 percent, and nonperforming loans to total loans – defined as the ratio of loans that are overdue by 90 days or more to total loans – was in the low single digits (2 percent).⁸

A.4 External Sector

Imports have plummeted given demand shocks and trade disruptions

Imports of goods and services dropped sharply in the first half of FY21. Goods imports contracted by 17.6 percent in FY20 in nominal terms, reflecting the impact of subdued demand, sectoral dynamics (particularly the halt in reconstruction activities), and policy initiatives (including an import ban on energy and flavored synthetic drinks, and a ban on onion exports by India). These trends continued in H1FY21, with imports goods falling by 8.4 percent (y-o-y) in nominal terms, the sharpest drop since FY16 (Figure 17).

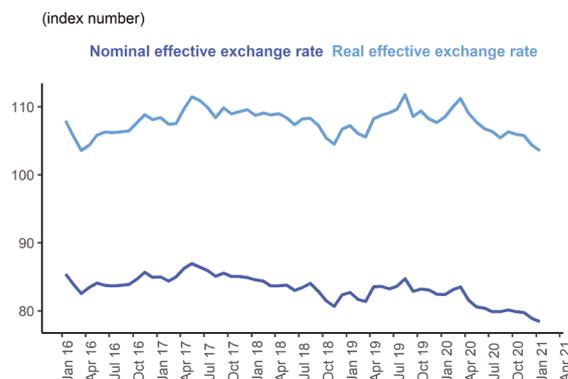
Figure 17. Imports contracted during the pandemic...



Sources: DoC and World Bank staff calculations
Note: Data are for the first six months of FY.

Service imports fell by 24.3 percent in FY20 and again by 32.4 percent in H1FY21 year-on-year, as international travels for leisure and outmigration for study and work ground to a halt. Meanwhile, real effective exchange rate depreciation (Figure 18), from April 2020 onward also disincentivized imports.

Figure 18. ...partly reflecting the effects of depreciation in the real effective exchange rate

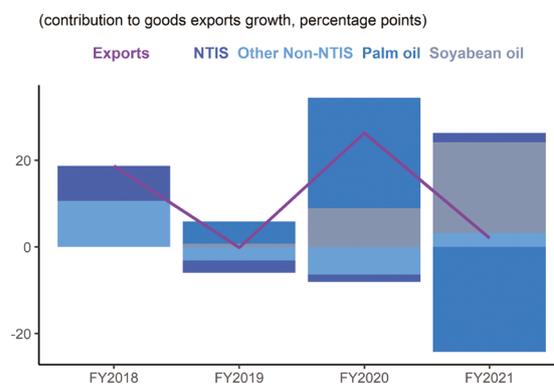


Sources: IMF and World Bank staff calculations.

Exports also declined, but to a lesser extent.

Goods exports declined by 1.8 percent in FY20 but increased moderately by 2 percent in H1FY21

Figure 19. Exports also declined...



Sources: DoC and World Bank staff calculations.
Note: Data are for the first six months of FY.

⁸ The low nonperforming assets could be due to the NRB’s policy that allow BFIs to restructure and reschedule loans, which were in the performing category in mid-January 2020 after collecting 10 percent of the accrued interest, by mid-January 2021. As per the policy, loans amounting to NPR 94.7 billion were restructured in H1FY21. The NRB extended the period for restructuring and rescheduling loans to mid-July 2021 through the FY21 midterm monetary policy review.

(y-o-y) (Figure 19) as increased exports of refined soybean oil largely offset lower exports of refined palm oil to India. The products supported by the Nepal Trade Integration Strategy (NTIS) 2016 – for which exports grew by 6.7 y-o-y in H1FY21 – also contributed to the export recovery, thanks to strong growth of tea exports (60.8 percent y-o-y). However, predictably, services exports plummeted by 18.6 percent in FY20 and a further 56.8 percent in H1FY21 year-on-year due to the shutdown of tourist arrivals.

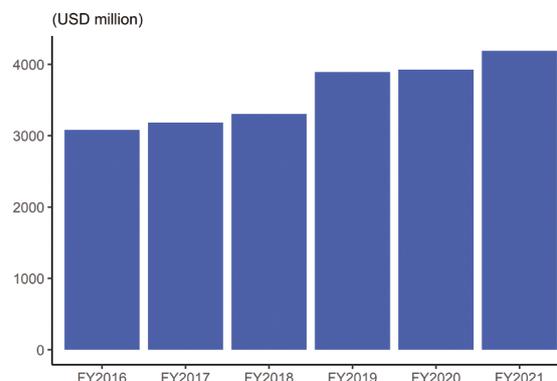
The current account deficit has narrowed

The trade deficit has narrowed in H1FY21, given the sharp contraction in imports. Total exports and imports of goods and services fell by 36.6 percent (y-o-y) and 11.8 percent (y-o-y), respectively, in H1FY21. With the contraction in imports far outweighing the decline in exports in absolute terms (given the large imbalance between the two to begin with). As a result, the trade deficit narrowed to 14.8 percent of projected GDP in H1FY21 from 15.7 percent of GDP in the same period of the previous year.

Remittance inflows have picked up in H1FY21 after declining the previous year. Remittances declined by 3.4 percent in FY20, reflecting the standstill in outmigration and economic shocks in the destination countries. However, remittance inflows showed signs of recovery in H1FY21, increasing by 6.7 percent (y-o-y), as remittances were increasingly routed via formal channels⁹ and returnees repatriated their savings (Figure 20).

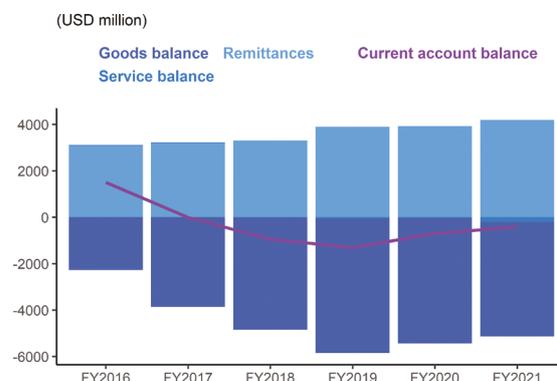
As a result of the lower trade deficit and higher remittances the current account balance improved slightly (Figure 21). In FY20, the current account deficit narrowed to 0.9 percent of GDP (US\$341 million) from 6.9 percent of GDP (US\$1,036 million) in FY19, as the contraction

Figure 20. ...but remittance inflows picked up in H1FY21



Sources: NRB and World Bank staff calculations.
Note: Data are for the first six months of FY.

Figure 21. Recovery in remittances and the improved trade balance narrowed the current account deficit



Sources: NRB and World Bank staff calculations.
Note: Data are for the first six months of FY.

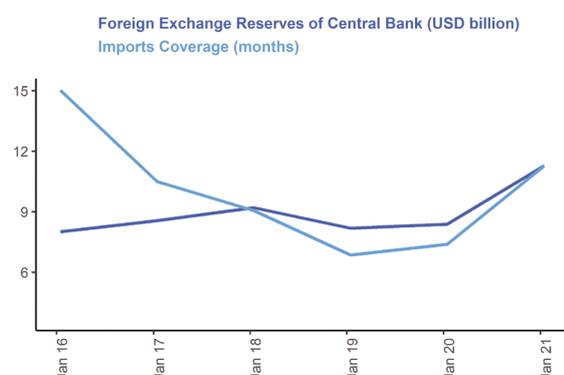
in imports largely offset the reduction in remittances and exports. The current account deficit further narrowed in H1 FY21 on a y-o-y basis to 1.2 percent of projected FY21 GDP (US\$422 million), 39.6 percent lower than in the same period in FY20. With foreign direct investment comparatively low (reaching US\$64.8 million in H1FY21) and portfolio inflows nonexistent, the

⁹ This could be partly due to the new policy introduced from September 2019 that made it mandatory for migrant workers to have a bank account in Nepal in order to obtain a work permit to work abroad. It could also be that the increase in remittances captures the decrease in positive net errors and omission of 6.6 percent y-o-y, (compared to the increase of 18.8 percent, y-o-y, in the same period of FY20), which primarily reflects the informal transactions that are not captured by workers’ remittances and compensation of employees.

current account deficit was primarily financed through external concessional loans.

The improved balance of payments conditions was reflected in increased external buffers. The foreign exchange reserves of the NRB increased to US\$11.3 billion at mid-January 2021, equivalent to 11.3 months of imports (Figure 22).

Figure 22. Foreign exchange reserves increased



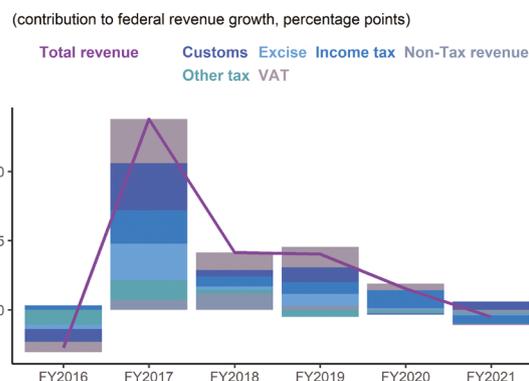
Sources: NRB and World Bank staff calculations
Note: Data are for the first six months of FY.

A.5 Fiscal Sector

The pandemic has triggered a revenue shock

Tax revenue collection decreased by 5 percent in FY20, to 17.8 percent of GDP from 19.1 percent of GDP in FY19. Specifically, trade-related taxes fell by 15.7 percent in FY20 given widespread trade restrictions, supply chain disruptions, and weak demand. The value-added tax – over 60 percent of which is collected at the border – and excises declined by 7.3 and 18.8 percent, respectively. However, direct tax revenues increased by 13.2 percent in FY20, largely reflecting higher incomes taxes from government wages and the payment of tax arrears from a large taxpayer. Subnational government own-revenues dropped mostly due to lower tourism royalties.

Figure 23. Revenues have dropped since the outbreak of the pandemic...



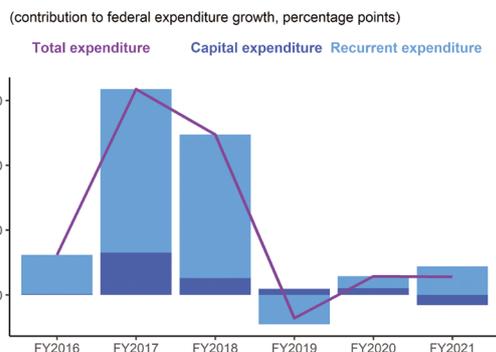
Sources: NRB and World Bank staff calculations.
Note: Data are for the first six months of FY.

During the first half of FY21, total revenue continued to fall by 2.1 percent (y-o-y). Income tax revenue declined by 12.2 percent (y-o-y) due to reduced corporate income tax receipts (Figure 23). Revenue collection from other taxes also declined, except for customs. Given that the travel and tourism sector remained anemic non-tax revenues (including tourism-related royalties and visa and passport fees) fell by 13.5 percent (y-o-y).

Expenditure was adjusted in FY20 to contain the fiscal deficit

In response to the abrupt revenue shock, the Government of Nepal (GoN) took steps to contain discretionary spending toward the end of FY20. Tighter expenditure directives, together with practical difficulties in executing budgets under the lockdown, led to a shortfall in budget execution in FY20. Only 71.4 percent of the total budget and 47 percent of the capital budget were executed. The capital expenditures of the federal government were the main variable of adjustment (declining to 4.9 percent of GDP in FY20, from 6.3 percent of GDP in the previous year), while recurrent expenditures increased slightly due to higher health-related expenses as well as wages (Figure 24).

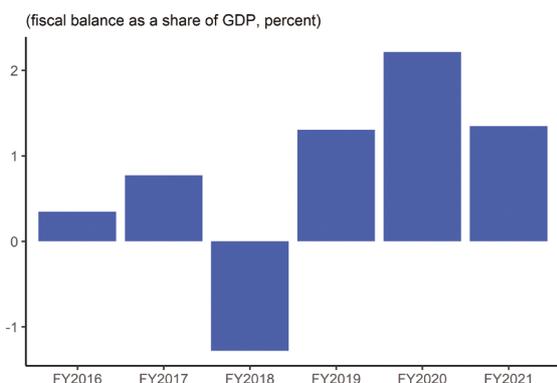
Figure 24. ...forcing fiscal adjustment especially through reduced capital expenditures



Sources: NRB and World Bank staff calculations.

Note: Data are for the first six months of FY.

Figure 25. Smaller fiscal surplus in H1FY21 reflects tighter fiscal conditions



Sources: MoF and World Bank staff calculations.

Note: Data are for the first six months of FY.

However, the federal fiscal deficit widened slightly in FY20 (Figure 25). This was largely due to the decline in revenues coupled with a slight increase in total spending. As a result, the fiscal deficit reached an estimated 5.2 percent of GDP in FY20, up marginally from 5 percent of GDP, in the previous year.

Budget performance remained weak in the first six months of FY21

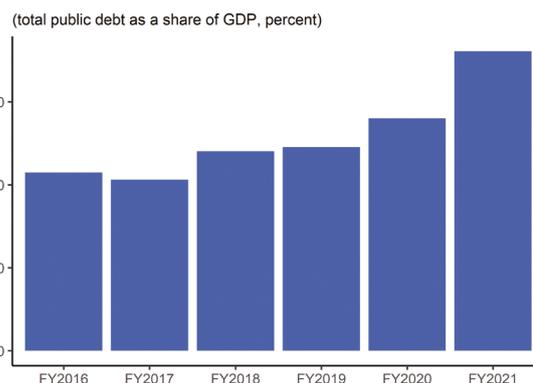
Total federal expenditures increased by 5.6 percent (y-o-y) in H1FY21 due mostly to higher recurrent expenditures for health-related measures. Notably, these took the

form of higher and faster disbursing conditional grants to provincial and local governments to procure COVID-19-related equipment and health infrastructure investments (although they are recorded as current transfers in the budget of the federal government). However, government delayed some capital spending causing it to decline by 19 percent (y-o-y) in H1FY21, while current spending increased to support relief measures. Some large capital projects were stalled by the absence of skilled foreign workers. As a result, only 14.4 percent of the annual amount budgeted for capital was spent in the first six months of the year.

The bunching of expenditures over the second half of the fiscal year (and the resulting positive fiscal balance in the first half of the fiscal year) is a recurrent problem in Nepal. This pattern has been repeated in H1FY21, albeit to a lesser extent than usual, given the recurrent spending push and weak income tax revenue collection. Indeed, the H1FY21 fiscal surplus was lower compared to the same period of the previous year, by 35.6 percent.

Public debt has been rising in recent years. In H1FY21, total public debt is estimated to have increased to 36.4 percent of GDP, from 27.2 percent of GDP in FY19 (Figure 26). The increase

Figure 26. Public debt increased to 36.4 percent of GDP



Sources: MoF and World Bank staff calculations.

Note: Data are for the first six months of FY.

of total public debt reflects a number of factors: the widened fiscal deficit in FY20; increased domestic financing in H1FY21 mobilized to cope with high uncertainty over revenue projections; and increasing spending needs expected in the second half of the fiscal year due to delayed spending and bunching. A medium-term debt strategy is under preparation to guide debt management. In addition, all three tiers of government adheres to debt ceilings set by the National Natural Resource and Fiscal Commission.

The GoN has sought to address the perennial issue of poor budget execution

Poor budget execution undermines the credibility of fiscal planning. It reflects weaknesses in the selection and preparation of public investment projects, along with deficiencies in procurement. It has resulted in expenditure bunching, in the last months of each fiscal year, especially in public investment projects, and to repeated midyear downward revisions of the budget. The problem is also acute at the subnational level, particularly given the current crisis. In H1FY21, only 14.1 percent of the capital budget, 15.8 percent of the recurrent budget, and 14.9 percent of the total budget of provincial governments have been executed. For local governments, only 21.5 percent of total budget was spent.

The poor budget performance reflects institutional weaknesses and technical capacity gaps. Nepal has guidelines for project preparation, but their implementation is poor. In some instances, budgets are allocated to projects that lack detailed cost estimates, realistic timelines, and procurement plans. Consequently, projects are often selected that are not adequately prepared or ready for implementation. Poor budget execution also reflects the lack of staff with adequate technical capacity, and weak coordination across the three tiers of government, which have been

magnified by COVID-19. For example, some local municipalities still do not have their full staff on board, due to delayed enactment of the Federal Civil Service Act¹⁰.

However, the GoN sought to improve public investment management. A national project bank has been established to improve the process of project selection and preparation, and all projects above NPR 500 million are required to be appraised, prior to their inclusion in the project bank and prior to inclusion in the inclusion into the budget.

¹⁰ In the absence of the Act, the government recently developed the Staff Adjustment Standards that would allow federal staff with at least three years of service remaining to be transferred to the local and provincial level, partly addressing the staff shortage.

B. Outlook, Risks, and Challenges



The economy is expected to continue to recover, with growth projected to reach 2.7 percent in FY21. Services are expected to lead the recovery, driven initially by the easing of domestic confinement measures even if the most impacted subsectors (such as tourism and hospitality) will only recover fully from FY22 onward. Agriculture is also projected to perform well with continued government programs to invest in irrigation, promote the use of improved seeds and fertilizer, and support commercialization. Industrial activities are expected to rebound in FY21, but only gradually as manufacturing and construction output is expected to remain below pre-pandemic levels until FY22.

On the demand side, consumption will drive economic recovery in FY21, reflecting improved consumer sentiments, modest remittance growth,

and high government expenditure for COVID-19 testing and vaccines. Private consumption growth is expected to pick up over time as the economy stabilizes and employment conditions improve. Private investment should start recovering in FY21, supported by low interest rates and government relief programs, but is expected to return to pre-pandemic levels only in FY22 due to weak firm balance sheets and lingering political uncertainty.

However, inflation is projected to remain stable as food supply improves. In FY21, an increase in food supply against higher demand is expected to moderately increase inflation to 5 percent by FY22. Over the medium term, inflation is expected to accelerate gradually due to a rise in global oil prices and recovery in domestic demand, stabilizing at around 6 percent, as the exchange rate peg with the Indian rupee provides a sound nominal anchor.

Table 1. Macroeconomic projections of selected key indicators

	FY18	FY19	FY20 e	FY21 f	FY22 f
Real GDP growth, at constant market prices	7.6	6.7	-1.9	2.7	3.9
Private Consumption	6.2	5.6	3.7	4	4.2
Government Consumption	2.1	7.3	6.2	11.8	15.4
Gross Fixed Capital Investment	11.8	11.3	-3.5	4.2	9.2
Exports, Goods and Services	7.7	5.5	-16	-18	11.1
Imports, Goods and Services	19	5.8	-15.3	4.5	12.4
Real GDP growth, at constant factor prices	7.4	6.4	-2	2.7	3.9
Agriculture	2.6	5.2	2.2	2.5	2.7
Industry	10.4	7.4	-4.2	3.1	4.6
Services	9.3	6.8	-3.6	2.7	4.4
Inflation (Consumer Price Index)	4.1	4.6	6.1	4.8	5.1
Current Account Balance (% of GDP)	-7.1	-6.9	-0.9	-1.2	-3.2
Fiscal Balance (% of GDP)	-5.8	-5	-5.2	-6.9	-7.7
Debt (% of GDP)	26.5	27.2	36	41.9	47.9
Primary Balance (% of GDP)	-5.4	-4.5	-4.5	-6.2	-6.8

Sources: MoF, NRB, and CBS for history and estimates. World Bank staff for forecasts.

Note: e = estimate; f = forecast.

The monetary policy stance should remain accommodative. The NRB, through its monetary policy, aims to maintain price and external stability and support the economic growth target set out in the government's fiscal policy statement. To minimize volatility of interbank rates, the NRB is expected to maintain the existing lower bound (1 percent), upper bound (5 percent), and policy rates (3 percent) of the Interest Rate Corridor and continue credit relief programs through FY21.

The current account deficit should widen gradually over the medium term. In FY21, the current account deficit is projected to remain close to its FY20 level as a share of GDP (1.2 percent). Remittances are forecasted to increase to 23 percent of GDP in FY21 and stabilize around that level in FY22. The trade deficit is expected to widen modestly in FY21 as imports recover faster than remittances and exports. Over the medium term, import growth will accelerate as consumption and investment return to normal, while service exports will remain subdued until

a full resumption of international tourism is possible. As a result, the current account deficit is projected to widen to 3.2 percent of GDP in FY22. However, foreign exchange reserves are expected to remain at a comfortable level.

The fiscal deficit will remain elevated but gradually decline over the medium term. While revenue performance is expected to remain weak, additional spending on economic relief measures, vaccinations, and the resumption of project implementation should contribute to an increase in the fiscal deficit to close to 7 percent of GDP in FY21 and 8 percent of GDP in FY22. Given this rapid rise in spending and slower improvement in revenues, public debt is projected to reach 41.9 percent of GDP in FY21 and 47 percent of GDP in FY22. Still, the recent debt sustainability analysis indicates Nepal should remain at low risk of debt distress, even in the extreme shock scenario.

The outlook is tilted to the downside. Delays in the deployment of vaccines and new outbreaks

domestically or globally would dampen the nascent recovery momentum, with a particularly detrimental impact on tourism. Also, widespread or global outbreaks could cause a return to travel restrictions, leading to a reduction in outmigration and remittances. Shocks in migrant receiving countries would also reduce remittances. Finally, should there be another dissolution of Parliament or similar level of political incident as occurred recently, this could dampen investor sentiment.

The government has outlined a program to address the impact of COVID-19, to mitigate the risks to the outlook. The government's program lays the foundation for sustained, inclusive, and green growth,¹¹ phased over three stages: from crisis relief, to restructuring for recovery, to reforms that support greater resilience. So far, the government's relief efforts have focused on containing the outbreak through lockdowns and travel restrictions. Declining infection rates suggest that the country is now transitioning to the recovery phase. Fiscal and monetary measures, which were announced in March and April 2020 and extended as part of the FY21 budget speech and monetary policy statement, have provided some economic and social relief. Many of these measures will continue into FY22, supported by additional fiscal space provided by Nepal's participation in the G-20 Debt Service Suspension Initiative. During the restructuring and resilient recovery stages, the government plans to focus on reforming the health system and prioritizing job creation in a greener and more digital economy.

However, improving export competitiveness will be critical for a resilient economic recovery. Strong remittances have supported private consumption and poverty reduction, as well as government revenue (through import taxes) and also raised foreign exchange reserves. However, this has come at the cost of appreciating the exchange rate, eroding export competitiveness, and reducing

firm growth. In turn, the lack of private sector dynamism has depressed job creation and spurred outmigration. Also, over-reliance on revenues from import taxes has led to fiscal volatility, further undermining the competitiveness of domestic firms (through high input prices). Meanwhile, inefficient public investment management has prevented the government from decisively addressing significant infrastructure gaps that constrain growth. The COVID-19 crisis exacerbated these structural weaknesses as returnee migrant workers contributed to unemployment, and the sharp drop in import-related taxes strained the fiscal space. Against this backdrop, the Special Focus of the Nepal Development Update presents Nepal's huge export potential or "missing exports", and highlights the equally great potential for jobs creation. The Special Focus identifies the main constraints underlying stagnant export growth and proposes policy options to harness Nepal's untapped export potential.

11 Green growth is a growth pattern that is efficient in its use of natural resources, clean in that it minimizes pollution and environmental impacts, and resilient in that it accounts for natural hazards and the role of environmental management and natural capital in preventing disasters (World Bank 2012).

C. Special Topic: Trade as a platform for resilience and recovery



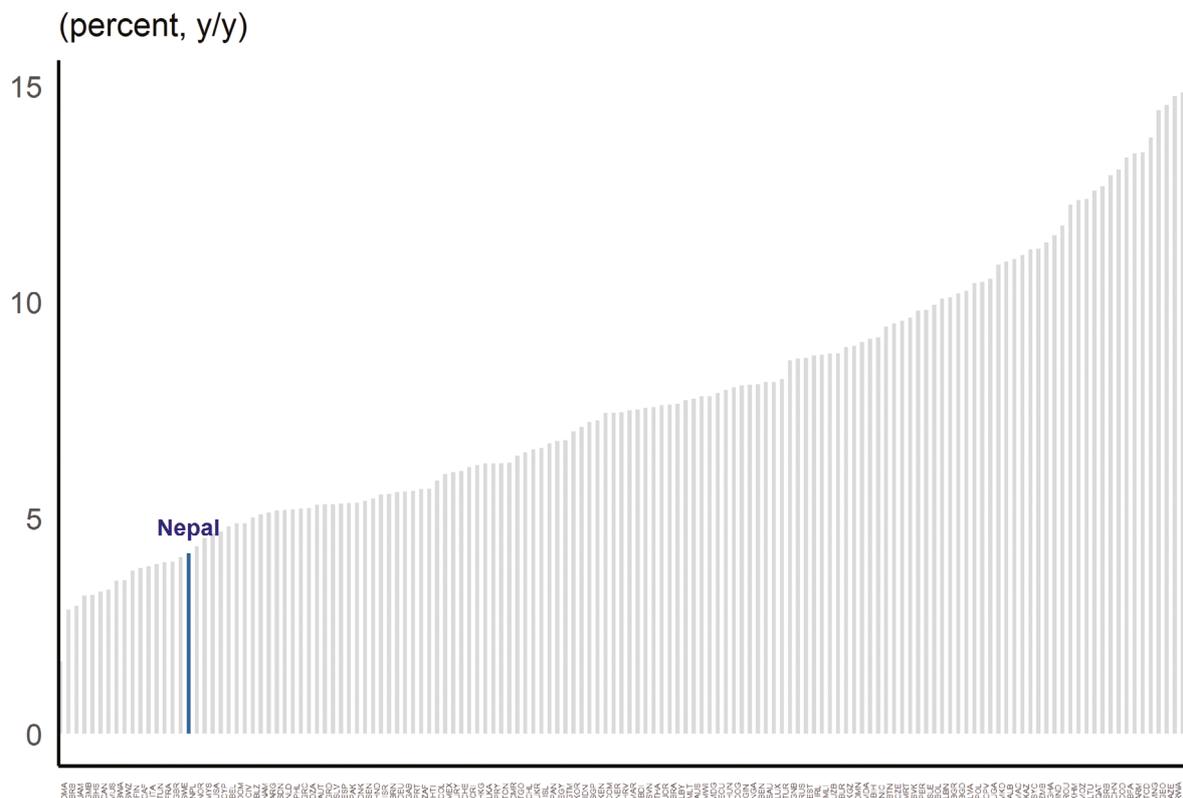
Exports could be a powerful platform to increase Nepal’s economic resilience and accelerate the recovery from the devastating shock to the private sector caused by the COVID-19 pandemic. Exports bring foreign currency into the economy, which is essential to finance much-needed imports and to reduce macro risks. They can help create good-quality jobs to pull labor out of low-productivity informal activities. And, importantly, exports are associated with productivity gains through increased scale and exposure to sophisticated global clients. Exports can therefore be a means to accelerate growth.

Over the past two decades, Nepal has failed to tap into exports as a platform for accelerating

growth and job creation. This contrasts with other countries that have used exports to leapfrog to higher productivity, better jobs, and more foreign exchange inflows. Instead, Nepal has relied on remittances, which have fueled consumption growth and lowered productivity. The related exchange rate appreciation has helped stimulate imports, causing a heavy reliance on import taxes as a revenue source, which has resulted in higher inputs cost for firms and lower exports.

Nepal can change this dynamic and use exports as a platform for resilience and recovery from COVID-19. This would entail investments and reforms to address the key challenges, taking advantage of opportunities, and

Figure 27. Compound annual growth rate of exports of goods and services in current US\$, 1999–2019



Source: Based on World Development Indicators data.

adopting the needed policies to make exports an engine of recovery and a source of resilience for Nepal. A key focus would need to be on reducing trade costs that undermine firm competitiveness, increasing investments in infrastructure, and promoting the digital economy.

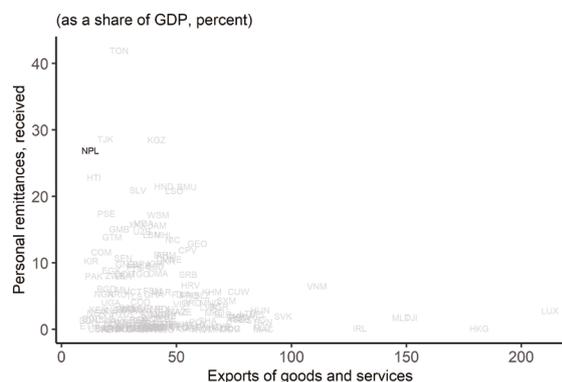
C1. Nepal’s export performance: a beyond COVID-19 perspective

The COVID-19 pandemic and its associated shock to Nepal’s export sector exacerbated long-standing structural challenges. Specifically, Nepal’s exports have been low, concentrated in only a few countries, and with export flows that are short in duration. The export performance of Nepal can be assessed based on its export growth, diversification, quality and sophistication, and survival.

Over the past two decades, Nepal’s export growth has been stagnant. During that period, many developing countries tapped into exporting as a platform for productivity upgrading, job creation, and securing inflows of foreign exchange. Nepal has not. With export growth at 4 percent on average since the turn of the century, Nepal features among the 20 countries in the world with the slowest export growth in the past two decades (Figure 27). Rather than exporting goods and services, Nepal exports its talent (Figure 28). Since 2010, over 4.2 million workers have left Nepal, accounting for nearly 22 percent of the country’s working-age population. These migration outflows are at the basis of a remittance-dependent external financing model: large inflows of remittances (Nepal ranks fifth in terms of received remittances as a share of GDP) that finance (and to some extent contribute to) one of the highest trade deficits in the world, at 37 percent of GDP as of

2018.¹²

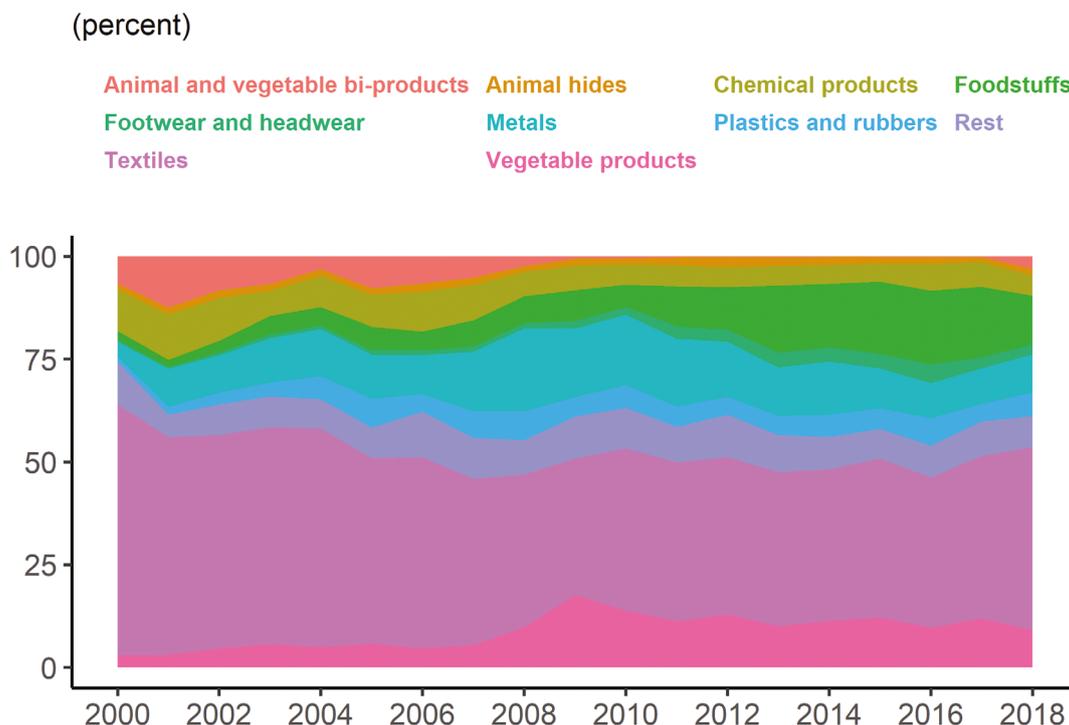
Figure 28. Exports and remittances, cross-country comparison, 2019 or last available data



Source: Based on World Development Indicators data.
 Note: Countries with more than 100 percent of GDP in exports are excluded.

Diversification has also been elusive. Nepal’s export basket has not substantially changed, revealing the stagnation of innovative capabilities (Figure 29 and Figure 30). Even within broadly defined sectors, there has not been substantial innovation, in terms of introduction of new products. In 2009, Nepal exported 1,167 product varieties, while in 2017 it exported 1,093, which places Nepal in the 125th position among 154 countries in terms of number of product varieties exported. Diversification in terms of destinations is key for building resilience through the reduction of risks, but has also been limited. In 2009, Nepal’s exports reached 146 countries, while by 2017 they reached only 124, placing Nepal in 101st position among 154 countries by this metric.

Figure 29. Composition of merchandise exports

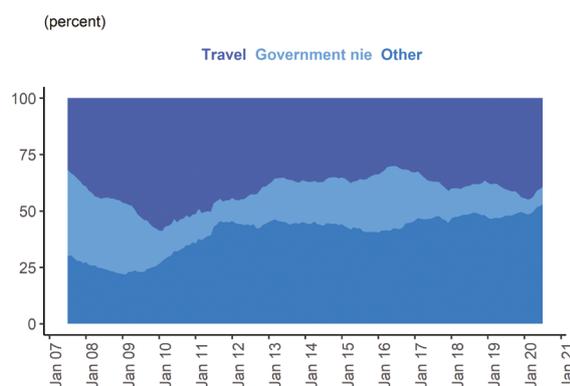


Source: Based on Atlas of Economic Complexity data.

The sophistication and quality of exports is also relatively low. In terms of technological sophistication, only 1 percent of exports of Nepal qualify as high-tech, a level comparable to

12 Portugal and Zildzovic (2016) show that in Nepal, increases in remittance inflows are associated with an increase in the trade deficit, by contributing to the appreciation of the real exchange rate. They estimate that a 10 percent nominal increase in remittances leads to a 0.5 percent real exchange rate appreciation in the long run, eroding export competitiveness.

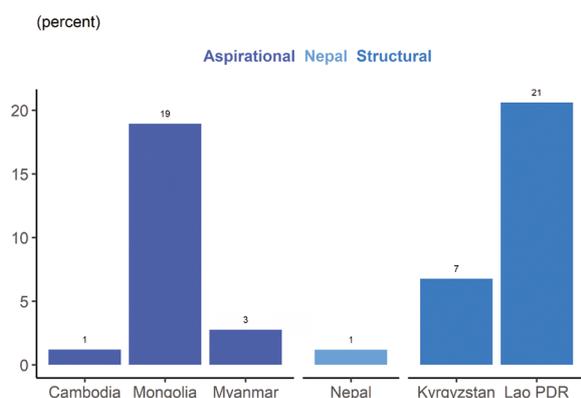
Figure 30. Composition of services exports



Source: Based on data from Ministry of Finance, Balance of Payments, Nepal.

Note: Monthly data, accumulated 12 months. Last included datum corresponds to March 2020.

Figure 31. Share of manufactured exports classified as high-tech, last available year



Source: Based on World Development Indicators data.

Note: Last available year for Nepal is 2017; for Kyrgyz Republic, Lao PDR, Cambodia, Myanmar, and Mongolia it is 2019.

Cambodia but far from comparators such as Lao PDR and Mongolia (Figure 31).¹³ Another metric to measure quality and sophistication is the price products fetch in international markets, relative to those of competitors. Nepal’s underperformance becomes clear when we analyze two of the largest and most paradigmatic export products: shawls and cardamom. For cardamom, Nepal fetches prices slightly below the median across all competitors. For shawls, it fetches prices in the lower quartile of the distribution (Figure 32, Panel b).

Export flows also show low survival. The average export spell¹⁴ lasts less than two years, and only four out of 10 export flows that start each year survive past the first year. This is about 20 percent lower than in Cambodia. The average length of an export spell is about 2.7 years, 10 percent shorter than in Cambodia (three years).¹⁵ The rapidly declining probability of survival after the first year is a feature of Nepal’s exports: it occurs regardless of the proximity and income of the trading partner, and of the initial value of exports and type of product exported (Figure 33).

Slow export growth is both a cause and consequence of low productivity growth in Nepal. Exporting requires a minimum threshold of productivity of firms. At the same time, as firms export, their productivity increases through more exposure to competition, and knowledge transfers (“learning by exporting”).¹⁶ Thus, the lack of

13 A caveat is in order: in an era of global production sharing, technological groupings of high-tech and medium-tech products may be misleading, as a country may export supposedly high-tech goods (like computers), but its role may simply be in the final stages of low-value-adding assembling operations.

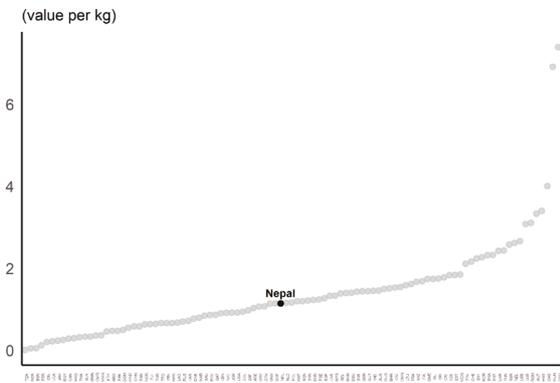
14 An export spell from Country A to Country B of product X is the number of consecutive calendar years that product X is exported from Country A to Country B. If the exporting of the product stops for one or more years and is then revived, it constitutes a new spell even though the product-country pair is identical.

15 A spell death is not necessarily a poor export achievement, especially if it occurs more frequently in product categories that are dynamic with characteristic short life cycles (for example, components that are part of global production networks). However, in the case of Nepal, such types of manufacture hold a small share, so poor longevity of its traditional exports adds urgency to the need for diversification. Well-diversified economies outperform less successful ones not in introducing new exports or entering new markets, but in sustaining exports after they have been introduced.

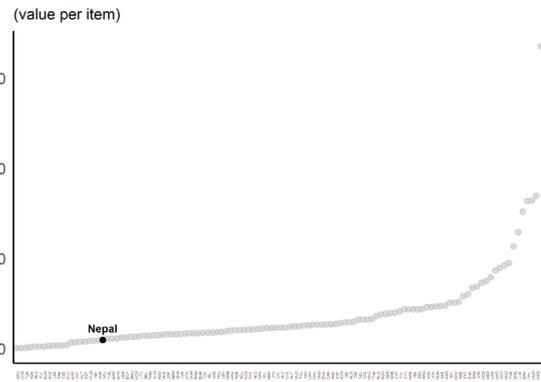
16 Atkin et al. (2017) provide the most direct evidence on productivity gains through exporting. They randomly provide opportunities to export to Egyptian rug manufacturers. They find that several years after the initial export opportunity, firms that receive the opportunity (the treated firms) display higher quality-adjusted productivity. Treated firms produce higher-quality rugs while the time it takes to manufacture them does not change. The authors document productivity improvements that come in part from knowledge flows between foreign buyers, local intermediaries, and producers (exporters).

Figure 32. Price obtained by relevant exports relative to competitors, 2019

Panel A. Cardamom



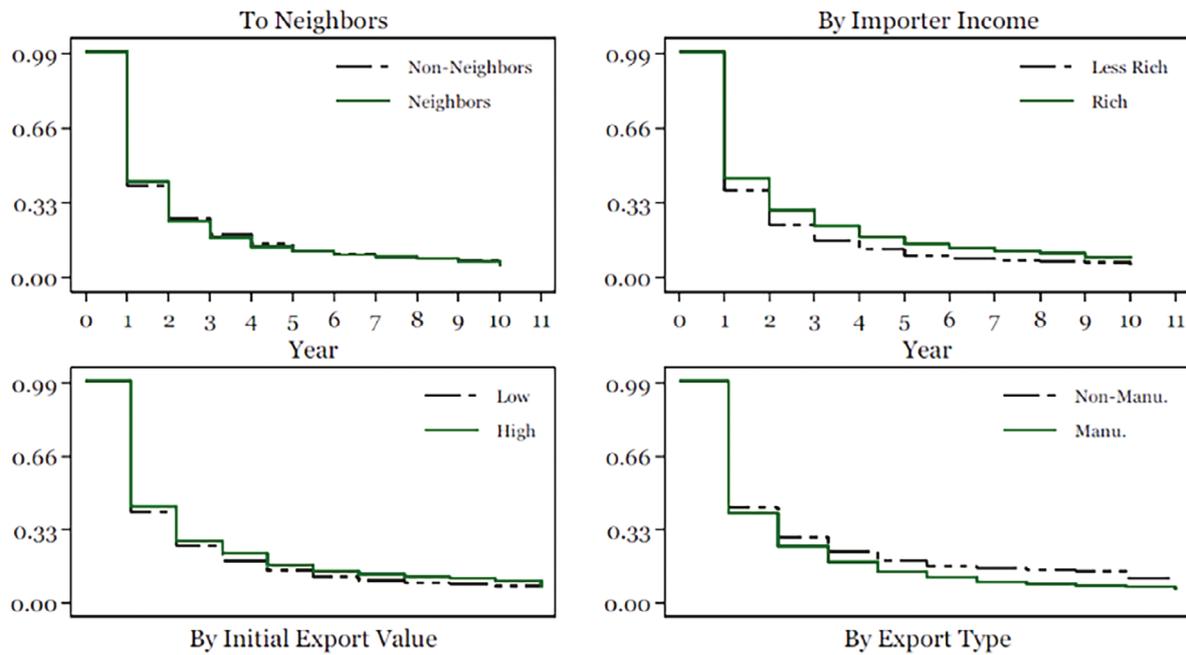
Panel B. Shawls, price per unit



Source: Based on data from WITS UNCTAD TRAINS.

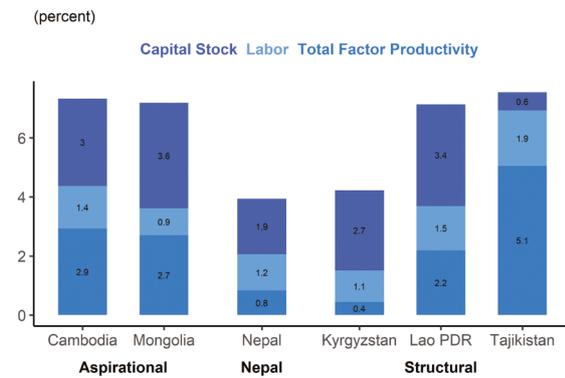
Note: Singapore excluded from the right-hand side graph (value per unit of 34).

Figure 33. Survival of Nepalese exports, 2007–18



Source: Neopané and Waglé 2020.

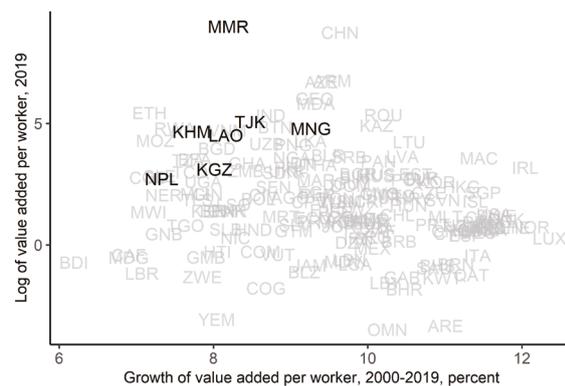
Figure 34. GDP growth decomposition, 2001–17



Source: World Bank staff calculations using the World Bank Growth Accounting Tool.

Note: Solow model. Growth rates are weighted according to the income share of capital (%) = 40%. Selected growth rate formula: Natural Log (continuous compounding). Decomposition for Tajikistan corresponds to 2001–13 and for Mongolia to 2005–17

Figure 35. Per-worker value added (VA), current level and recent growth, Nepal compared to comparators



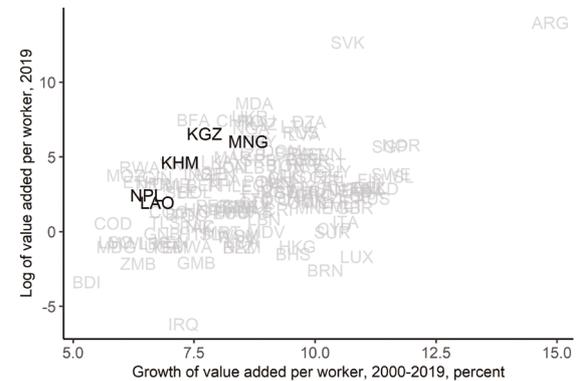
Source: Based on World Development Indicators data.

competitiveness observed in Nepal’s exports also reflects on poor productivity performance.¹⁷ In the past two decades, total factor productivity contributed only 0.8 percentage points to overall annual growth, substantially below the 2.3 and 3.2 percentage-point contributions, respectively, observed in structural or aspirational comparators

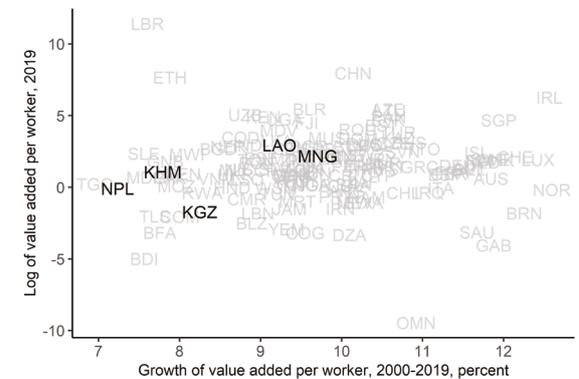
(Figure 34). A similar picture emerges when examining patterns of productivity per worker. Nepal lags its comparators both in level and growth rates of labor productivity (Figure 35). This is generalized across sectors and is particularly salient in agriculture, the country’s largest employing sector (Figure 36).

Figure 36. Value added (VA) per worker, by sector, current level and recent growth, Nepal compared to comparators

a. Agriculture

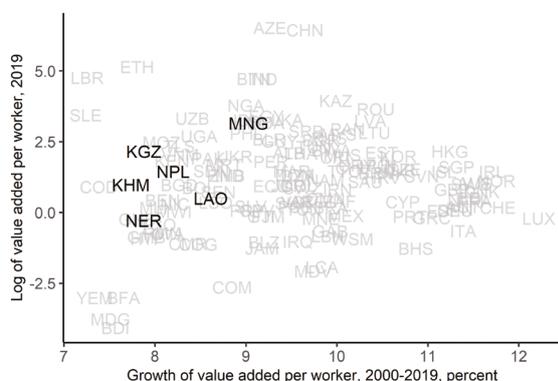


b. Industry



17 Neopane and Waglé (2020) point to the perverse regulatory incentives, poor institutions and infrastructure, and inadequate trained workforce as the main drivers of the lack of export dynamism and the poor export performance.

c. Services



Source: Based on World Development Indicators data.

C2. Challenges and opportunities ahead to build back better

Nepal’s export potential is substantial, but so are the challenges ahead to tap into it. Recovering from the COVID-19 shock and building a more resilient economy will require addressing these challenges. By using the necessary policy levers to increase its export orientation, Nepal can both create more and better jobs at home and move into a path of productivity-based growth.

Nepal’s untapped export potential or “missing exports” are estimated at US\$9.2 billion. Taking into account the characteristics of Nepal, including size, geographic location and land-lockedness, level of development, and factor endowments, and relying on a gravity model of international trade, it is estimated that Nepal’s untapped export potential (or “missing exports”) are equivalent to 12 times its actual annual merchandise exports.¹⁸ Indeed, across a sample of 104 countries, Nepal ranks first in terms of the index of missing exports (Figure 37, Panel a). Moreover, the comparison of this index across two periods, 2000–07 compared to 2010–17, reveals little change in recent decades for Nepal (Figure 37, Panel b).

Nepal’s “missing exports” are generalized across destinations and products. From the perspective of destinations, Nepal’s largest missing exports are with China (by over US\$2.2 billion), followed by India (US\$1.2 billion), the United States (US\$800 million), and Japan (US\$700 million) (Figure 38, Panel A). From a sectoral perspective, except for final textiles and intermediate apparel, missing exports are substantial across all sectors. Of note is the high level of missing exports in final apparel products (over US\$1.2 billion), as well as intermediate and final processed food (US\$800 million and US\$500 million, respectively) (Figure 38, Panel B).

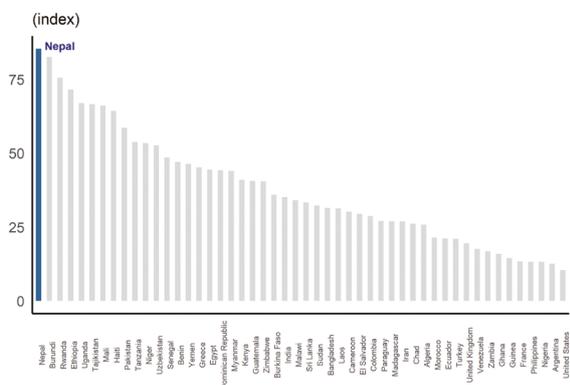
A large share of Nepal’s “missing exports” corresponds to countries that are geographically close and have fast-growing imports. Figure 39 shows export destinations of Nepal according to the value of the untapped export potential of that destination (vertical axis) and according to the destination’s import dynamism (horizontal axis). It also identifies those destinations that offer “large markets” (bold black circles, for destinations with average import levels above the world’s median). “Attractive” destinations from an export promotion perspective are those in the top-right quadrant: they exhibit high untapped potential for Nepal, and their imports have been growing fast. The bottom-left quadrant instead features the least attractive destinations: low untapped export potential for Nepal, and stagnant imports. Nepal has substantial missing exports with regional partners such as China, Bangladesh, the Philippines, and Vietnam, while there is still room to further expand trade with India. All these Asian markets are large (above the world median in terms of import value) and are growing fast.

Tapping into the export potential is achievable in the medium term. Nepal could create a significant number of additional jobs from new exports (Box 1). Had Nepal’s exports grown at

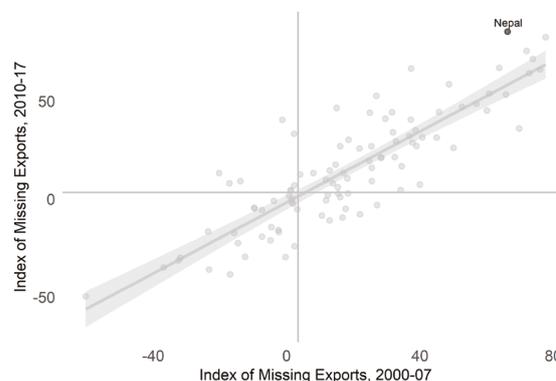
18 The characteristics included to define the bilateral potential exports include geographic distance, the existence of regional trade agreements, common colonial past, common language, GDP, GDP per capita, whether the importer or exporter is a mineral producer, a remoteness indicator (GDP weighted distance to the rest of the countries), the capital intensity per worker, and tariffs. The estimates are based on the methodology developed by Mulabdic and Yasar (2021).

Figure 37. Missing exports

a. Cross-country comparison, average 2010–17



b. Cross-country comparison, average 2000–07 compared to average 2010–17



Source: Based on Mulabdic and Yasar (2021).

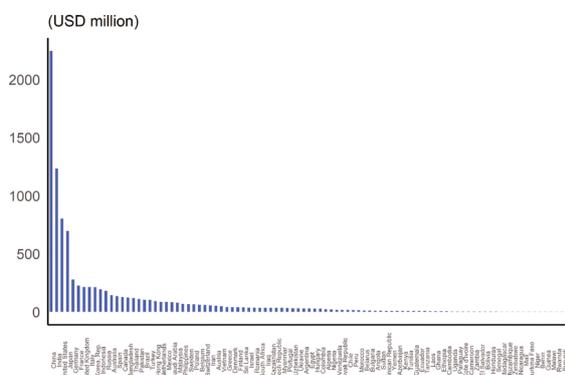
Note: The Missing Export Index for country i in year t is calculated using the following equation, where $X_{ij,t}$ is the predicted exports from country i to country j at year t according to the gravity model, and $X_{ij,t}$ is the observed exports:

$$MEI_{it} = \left(\frac{\sum_j \hat{X}_{ij,t} - \sum_j X_{ij,t}}{\sum_j \hat{X}_{ij,t} + \sum_j X_{ij,t}} \right) \times 100$$

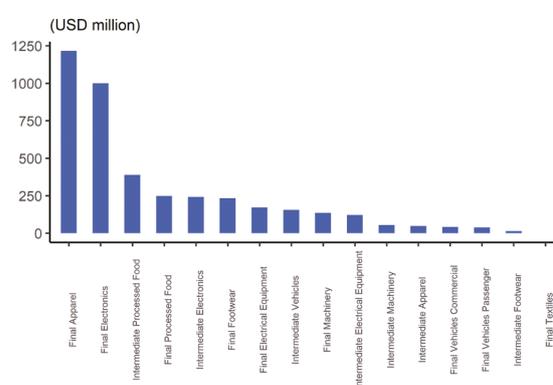
The Missing Export Index varies between 100 and -100. The maximum value of the index (that is, 100) is obtained when observed bilateral trade flows are equal to zero, but the model predicts positive exports to destination market, while the minimum value (that is, -100) is obtained when the predicted value is equal to zero and we observe positive values.

Figure 38. Nepal’s missing exports, in million US\$, 2010–17

Panel A. By country of destination

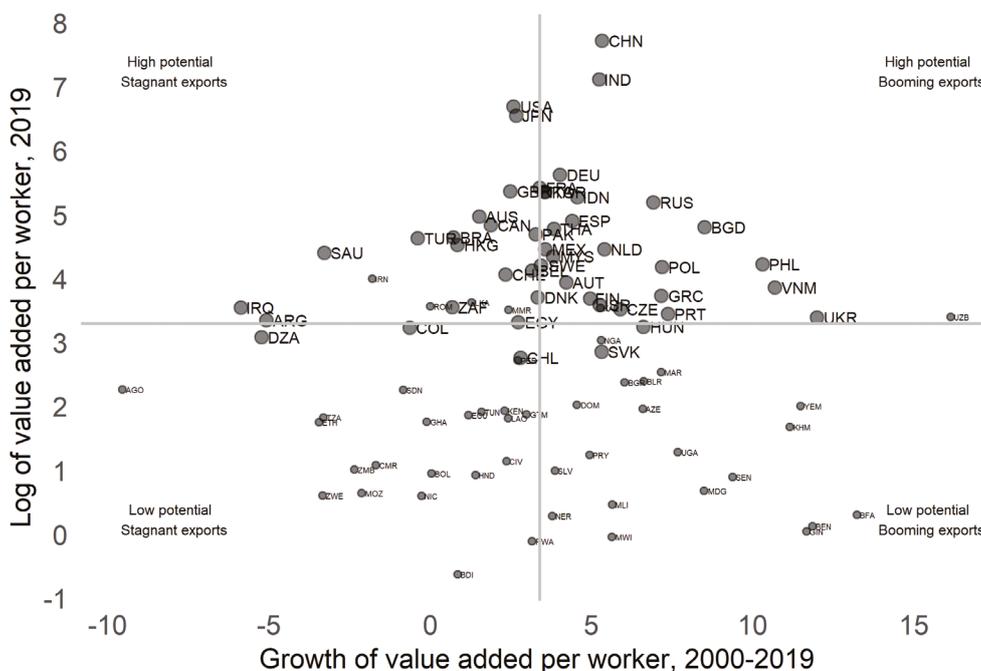


Panel B. By product



Source: Based on Mulabdic and Yasar (2021). Note: Top 30 destinations in terms of missing exports are reported.

Figure 39. Nepal’s missing exports per trading partner and their import growth



Source: Based on World Development Indicators data.

Note: The small and big circles represent destinations with imports below the world median and the destinations with imports above the world median, respectively.

Box 1. Estimating jobs created from US\$1 million of exports

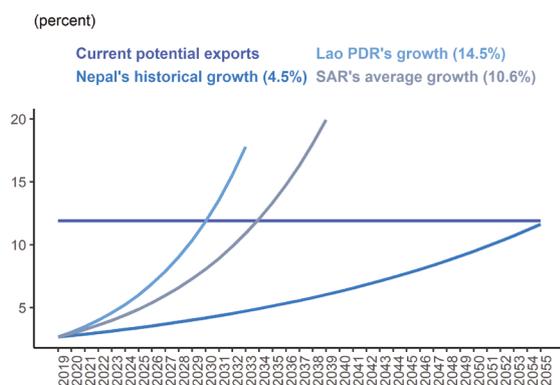
Nepal could potentially create an additional 38 jobs in agriculture and 13 additional jobs in manufacturing for every US\$1 million worth of new exports. Based on this estimate, if Nepal were able to increase exports to their full potential, an additional 220,000 jobs could be created. This estimate draws on the elasticity of jobs creation to exports derived from the “Jobs Content of Exports” (JOCEX) dataset, which captures the variation in elasticities according to the country and sectors concerned.

The JOCEX dataset, developed by Calí et al. (2012), uses global input-output tables and aggregate data from the Global Trade Analysis Project to calculate the number of jobs embedded in exports for 65 countries and 11 sectors. While in advanced economies such as Luxembourg, Norway, or Singapore, US\$1 million of exports embed less than four jobs, for countries more comparable to Nepal, such as Guatemala, Ethiopia, and the Philippines, they embed more than 100 jobs. The median across countries is 14.6 jobs per US\$1 million of exports, with the first- and third-income quartile of countries generating 7.3 jobs and 35.5 jobs, respectively. At the sector level, mining and energy exports have the smaller job content per US\$1 million (a median of four jobs), while service exports, such as commercial services and trade and sales, have a much larger jobs content (median above 50 jobs).

Agriculture is the third-highest sector in terms of job content per value exported (38 jobs), while manufacturing (generally more capital intensive and with more intermediate consumption than agriculture) is the third lowest (13 jobs). In the case of Nepal, to estimate the “missing” jobs associated with “missing exports,” the median jobs-to-exports elasticity is assumed (38 additional jobs per US\$1 million of agricultural exports and 13 additional jobs per US\$1 million of manufacturing exports) across comparable countries.

the average rate of the South Asia region since 2000, the gap between the actual and potential exports would have been 73 percent smaller than it currently is. Had exports grown at the same rate as Lao PDR’s, the gap would have been closed by 2016. Tapping into the export potential would bring the ratio of exports to GDP from the current 9.5 percent (average 2015–19) to 46 percent, moving Nepal from being the sixth least-export-oriented economy in the world to 64th out of 188 countries. Looking forward, if Nepal manages to achieve the export growth rate of Lao PDR, it would reach its potential within 10 years (Figure 40).

Figure 40. Nepal export performance compared to counterfactual scenarios and its export potential

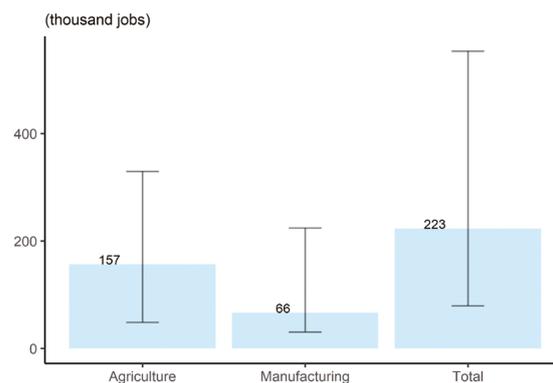


Source: World Bank staff calculations.
 Note: “Lao PDR’s growth” corresponds to the evolution of Nepal’s exports if they had grown, since 1999, at Lao PDR’s average period pace (14.5 percent). Same criteria are applied to SAR (10.6 percent growth). Current potential exports of goods and services is the sum of 2019 exports of goods and services (US\$2.7 billion) and the missing merchandise exports (US\$9.2 billion). SAR = South Asia region.

“Missing exports” imply “missing jobs” estimated at over 220,000. The opportunity cost in terms of forgone jobs of not tapping into the export potential is large. Given the current export structure, and if Nepal’s exports matched their

potential (or no missing exports), Nepalese firms could create an additional 223,000 jobs in export-related industries (Figure 41).¹⁹ This would have meant retaining about two-thirds of the Nepalese

Figure 41. Missing jobs in Nepal due to export underperformance, in thousands



Source: World Bank staff calculations.
 Note: US\$9.2 billion of missing exports are assumed to have the same composition as 2019 exports (44 percent agriculture, 56 percent manufacturing). First quartile, median, and third quartile sector (Agriculture/Manufacturing) elasticities are used.

workers that migrate in a given year, or about 6 percent of those who emigrated in the past decade.²⁰ The dynamism these potential workers could have added to the domestic economy is an additional missed opportunity.

Closing the gap between actual and potential exports will also impact informality, wages, and poverty. In a study of South Asian countries, Artuc et al. (2019) identify a positive impact of exports on wages and informality. Exporting firms tend to pay higher wages than non-exporting ones. In addition, exporting pulls workers out of informal activities, often also displaying lower productivity levels, which in turn leads to aggregate productivity growth. The impact is heterogeneous across groups: the benefit is greater

19 See Box 1 for details on the methodology used to estimate ‘missing jobs’.
 20 If Nepal had full employment, then tapping into the export potential would have required labor to be reallocated from the non-export sector to the export sector. However, given the substantial outflows of migrant workers, the creation of these job opportunities in the export sector at home are not likely to put pressure on other sectors of the economy, but rather to reduce the outflow of migrant workers.

for highly educated males in urban areas than for workers with low levels of formal education, females, and those working in rural areas. In addition, Nepal could accelerate inclusive growth and poverty reduction by raising exports in those sectors where the poor are employed. The Nepal Country Economic Memorandum 2017 and the Nepal Jobs Diagnostic 2020 indicate that the poor are primarily engaged in subsistence agriculture and low-value and informal urban services and tourism. Increased exports from these sectors coupled with increased value addition would be key to raising productivity, promoting rapid structural transformation, and generating inclusive growth.

C3. Challenges to meeting Nepal's export potential

Tapping into Nepal's potential requires overcoming substantial challenges related to developing higher value-added tourism, low levels of foreign direct investment, high trade costs, inadequate trade phytosanitary- and quality-control-related infrastructure, and inadequate digital infrastructure.²¹

Investing for high-value and sustainable tourism

Indications are that the tourism sector is likely to be different post-COVID-19, reflecting changes in tourist preferences and origins. For Nepal, domestic and neighboring tourism markets (i.e., China and India) may bounce back, but preferences and the type of tourism could change, requiring adaptation of tourism offerings. Concerns over health are likely to increase demand for solo and small group travel and crowd avoidance. More tourists might prefer opportunities to connect with nature and engage in activities to improve wellbeing. To compete internationally, Nepal's tourism will need to adapt to this new reality.

Nepal will need to improve planning, conservation, infrastructure improvement and private sector upgrading to develop nature-based tourism and environmental sustainability. Most protected areas and nature-based tourism destinations have limited connectivity, basic services (water, waste management and electricity), and climate resilient infrastructure. Nepal faces climate change and disaster risks, which require enhanced infrastructure resilience, particularly in mountainous areas where trekking and mountaineering is the main occupation and the main source of income of the local people.

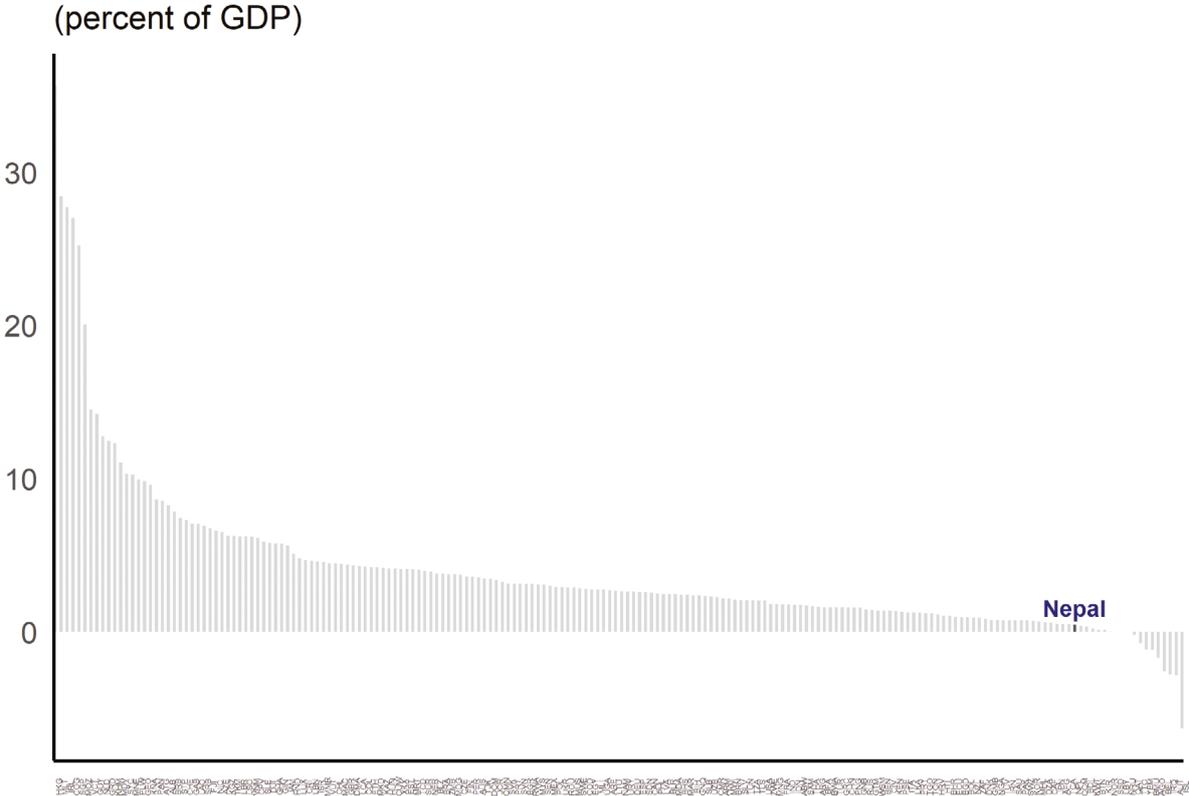
Equally important are investments in higher value potential tourism targeted at the midrange tourist segment. Midrange tourists require higher levels of comfort, convenience, and service quality. This requires more investments, training and knowledge sharing for local communities who derive their livelihoods from tourism. These local communities often derive their livelihood through homestays and sale of agricultural products, with limited revenues due to the poor facilities for hygiene and heating, and limited access to tourism training and assistance. The central bank has issued directives to banks and financial institutions to lend at least 5 percent of their total loan portfolio to the tourism sector. However, the loans remain concentrated in urban areas and large corporate clients, due to high collateral requirements and the low capacity of the local small and medium enterprises to conceptualize and develop bankable projects for the midrange tourist segment.

Leveraging foreign direct investment to better integrate into global value chains

Nepal has not leveraged foreign direct investment (FDI) for promoting exports and productivity upgrading (Figure 42). Attracting FDI has been a crucial platform for many developing countries to integrate into

²¹ The list of challenges is not exhaustive. For example, energy costs, access to finance, and the complexity of the business environment also affect the competitiveness of exports. Yet, these are factors that affect domestic and exporting firms alike. In this section the focus is placed on the factors that predominantly affect exporters.

Figure 42. Foreign direct investment, net inflows



Source: Based on World Development Indicators data.
 Note: Cayman Islands (533%), Liechtenstein (396%), and Cyprus (64%) are not shown.

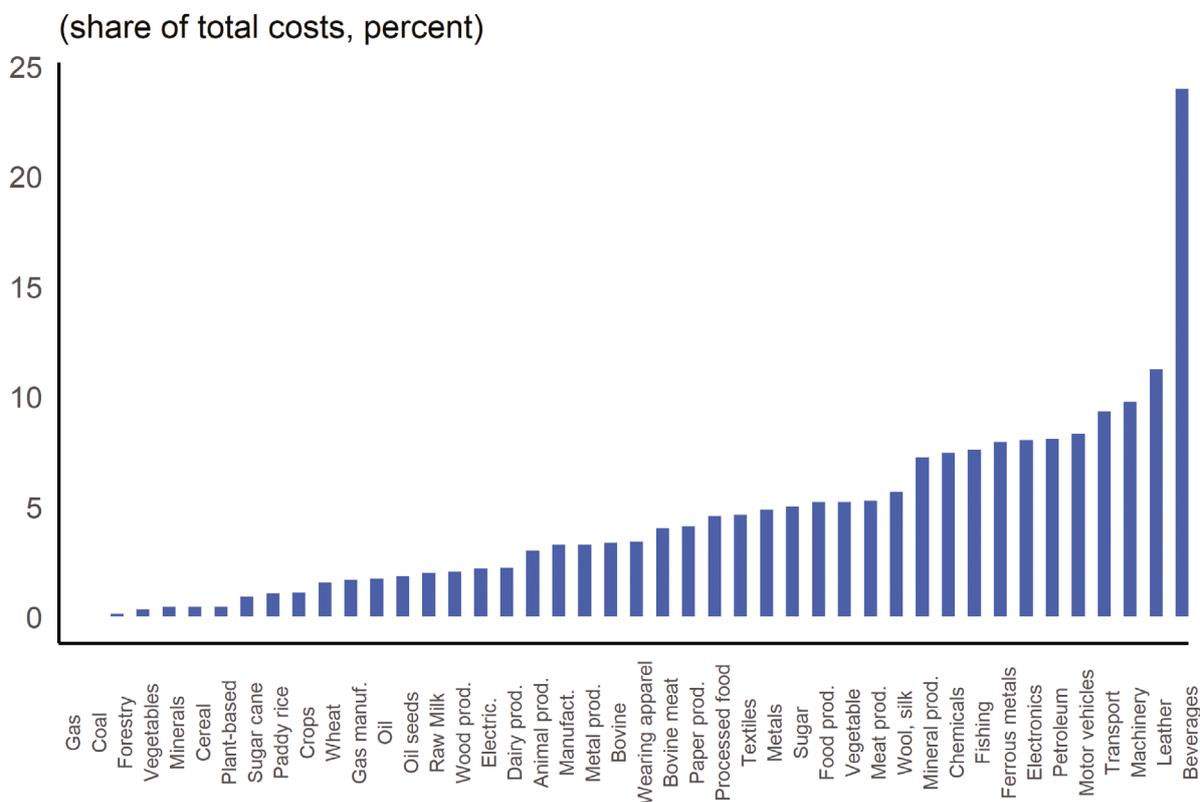
global value chains (GVCs) and become export powerhouses. Vietnam, Cambodia, and Lao PDR are examples. However, Nepal’s FDI inflows as a share of GDP have been low, at 0.4 percent in FY19, which puts Nepal in the bottom decile of the distribution internationally. To a large extent, low FDI inflows are related to restrictive policies. Foreign investments are subject to both negative and positive lists, a high minimum investment threshold, foreign equity caps, duplicate screening processes, and discretionary assessment procedures.

Reducing trade costs to make Nepalese firms more competitive

Nepal faces high trade costs due to geography

and policies. Being a landlocked country with a mountainous terrain, geography naturally makes trade costs high. Yet, policies and infrastructure also play a role. Border crossings are congested due to inadequate infrastructure and lack of streamlined procedures and processes. These constraints increase product losses and raise logistics costs, both for the transportation of final products and of raw materials and intermediates, thus reducing Nepal’s export competitiveness. It is worth mentioning, however, that notable progress has been made in recent years in reducing border crossing time at key land borders with India. For example, clearance time at the Birgunj-Raxhaul Integrated Check Post (ICP) for imports and exports declined from 1.5 days and 1 day to 1.1 days and 0.24 days, respectively.

Figure 43. Upstream import duties, by sector



Source: Based on Nepal’s customs data and Upstream Tariff Simulator (UTAS) under product homogeneity assumption.

Note: Only industries that produce goods are shown.

Import duties, particularly those on raw materials and intermediates, further increase trade costs. Import duties on intermediates and raw materials increase the relative price of the imported input, altering a firms’ technological choice and reducing their productivity.²² The burden imposed by import duties on inputs (or upstream duties), measured as the ratio of these upstream duties to total costs varies considerably among industries, from over 24 percent in the case of beverages, to 7 percent for food production and textiles (Figure 43). This heterogeneous impact on production costs across industries has negative implications in terms of efficiency and on

the firms’ capacity to compete in world markets. Estimates suggest that a 10 percent reduction in upstream import duties would result in increases in exports by approximately 5 percent, all else being equal.²³ Tariffs imposed by partner countries on Nepalese exportable products also reduce their international competitiveness. Yet, with major trading partners, Nepal enjoys preferences due to its least-developed-country status. The extent to which Nepalese firms take advantage of these preferences depends on, among other factors, their ability to certify that their product complies with the set rules of origin (see Box 2).

Investing in quality control infrastructure

22 Studies for Indonesia (Amiti and Konings 2007), China (Yu 2015), Pakistan (Lovo and Varela 2020), and India (Khandelwal and Topalova 2011), for example, have found that input tariff reductions positively affect the efficiency of firms that use those inputs in downstream sectors

23 Based on Mulabdic and Varela (2021).

Box 2. Nepal’s Least Developed Country graduation and its potential impacts

What advantages does Nepal have as a Least Developed Country (LDC) in terms of access to markets? Preferential market access for LDCs for exports of goods: mainly provided through duty-free, quota-free (DFQF) market access or preferential tariffs, and preferential origin of trade (Table 1).

Table 2. Major markets with multilateral preferential access for LDCs

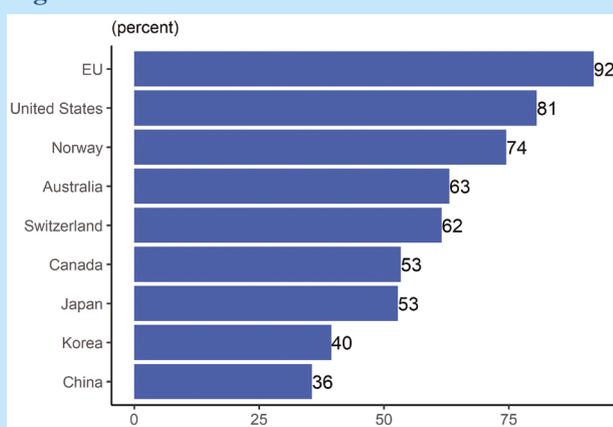
Market	Description	Duty-free tariff line coverage and major exclusions
China	Duty-free treatment for LDCs, adopted July 1, 2010.	96.6 percent (exclusions: chemicals, transport vehicles, machinery and mechanical appliances, electrical machinery, paper).
European Union	GSP everything but arms initiative, adopted: March 5, 2001.	99.8 percent (exclusions: arms and ammunitions).
United States	Generalized System of Preferences (GSP) for least developed countries. Currently expired, but can be potentially renewed with a retroactive effect on paid duties. ^a In addition, the Nepal Trade Preference Program (NTPP) provides duty-free access to about 77 products and runs until 2025.	82.2 percent (exclusions: apparel and clothing, cotton fibers, footwear, dairy and other animal products).

Sources: Authors’ elaboration based on Nepal Human Development Report 2020, and on Nepal Trade Preference Program. Note: a. “GSP was first authorized for 10 years, until 1985. Since then, 14 more reauthorizations have generally lasting 2 to 3 years. Congress most recently extended the program until December 31, 2020, in Division M, Title V of the Consolidated Appropriations Act, 2018 (P.L. 115-141). Congressional practice has been to extend the program retroactively from the original expiration date, so that importers are refunded (without interest) for the duties incurred during the lapse” (Congressional Research Service, January 6, 2021).

Is Nepal currently tapping into these preferences?

Nepal is not fully exploiting preferences. Preference utilization varies according to the destination of exports. It is highest in the European Union (92 percent), followed by the United States (81 percent), Norway (75 percent), and Australia (63 percent). It is particularly low in large Asian markets, such as the Korean (40 percent) and Chinese markets (36 percent) (Figure 44). This last fact reinforces the idea that there are potentially large benefits from improving export channels with China, the largest untapped export destination for Nepal. According to the Nepal Human Development Report 2020, the reasons behind low exports and low preference utilization are supply-side constraints that affect productive capacity and trade and production costs and market access conditions in export markets.

Figure 44. Preference utilization



Source: Nepal Human Development Report 2020. Note: Preference utilization is the proportion of trade eligible for preferences that receives them.

Will Nepal graduate from the LDC group?

Nepal has improved in the three dimensions considered for LDC definition – gross national income per capita, the Human Assets Index, and the Economic Vulnerability Index – and is above the threshold in the latter two.^a This implies that Nepal is eligible for graduation from the LDCs at the 2021 triennial review of the United Nations Capital Development Fund (UNCDF). However, given the negative impacts of the COVID-19 pandemic, the decision on graduation demands a detailed assessment of socioeconomic fallout.

Note: a. The Human Assets Index consists of four indicators, three on health and nutrition (the percentage of the population undernourished, the under-five mortality rate, and the maternal mortality ratio) and two on education (gross secondary enrolment ratio and adult literacy rate). The Economic Vulnerability Index threshold is a composite index encompassing exposure and shock indexes. It consists of an indicator of size (logarithm of population); geographic exposure to shocks (index of remoteness); human exposure to shocks (share of population living in low-lying coastal areas); economic exposure to shocks (share of agriculture, forestry and fisheries in GDP; index of merchandise export concentration); natural shocks (share of victims of natural disasters in the population; index of the instability of agricultural production); and trade-related shocks (index of instability of exports of goods and services) (Nepal Human Development Report 2020).

for higher value-added agricultural exports

Quality control infrastructure is crucial to increase Nepal’s exports of value added, particularly in agriculture. However, the lack of accredited trade laboratories to certify agricultural exports undermines Nepal’s opportunities to upgrade the value of its exports. Existing laboratories are not internationally accredited and therefore Nepal’s trading partners, including India, do not recognize their certifications. This results in traders having to undergo costly and time-consuming rounds of inspections in accredited labs in India. Currently, samples of Nepalese export products are sent for testing to laboratories in India, which takes a minimum of nine days but often up to three to four weeks. For Nepal to increase agricultural exports, investments are needed in infrastructure, equipment, and human resources to certify that its goods achieve the various sanitary and phytosanitary standards (SPS) requirements of key regional and global export markets.

Increasing digitization for upgrading services trade

The service sector faces challenges and opportunities moving forward. On the one hand, tourism, currently the largest foreign currency source in the country, is likely in the short run to continue facing a decline in demand due to COVID-19 restrictions. On the other hand, the information and communications technology sector, which had been showing dynamism prior

to the outbreak of the global pandemic, will face increased demand. In the same way that people discovered they can run their meetings from their living rooms, firms are increasingly opting for remote suppliers for many enabling services such as telemarketing, IT support, accounting, and other professional services.²⁴ Leveraging these opportunities can help Nepal weather the negative tourism shock and increase opportunities to retain skilled talent at home. Yet, the sector faces several challenges related to (i) an inadequate digital connectivity infrastructure – for example, broadband access across the country, (ii) slow implementation of an e-payments gateway that pushes e-commerce users to rely either on the banking sector (with associated high costs) or on informal payment methods, (iii) lack of an e-commerce framework that could spur digital trade, (iv) lack of skilled manpower, and (v) difficulties securing work visas for foreign talent.²⁵

C.4 Policy options

Addressing the challenges requires a coordinated effort by different government agencies with mandates in areas that directly affect export competitiveness. Developing high-value tourism and attracting FDI are critical areas that could bring about a faster recovery. The following should be considered as priorities.

Reform the tourism sector for a quick recovery and greater resilience

Coordinate with the private sector to

24 To be sure, this trend had started substantially prior to the outbreak of the COVID-19 pandemic, but it was exacerbated by it.

25 See Joshi and Antoni (2019) for a detailed assessment.

strengthen market analysis and development.

Recovery of the tourism ecosystem, in the aftermath of the COVID-19 pandemic, will likely be heterogeneous across the sector. In the short term, setting up a National Response, Communications and Recovery Task Force with high-level representation from the public and private sector is crucial to position the destination as responsible, inspiring trust and confidence among stakeholders. Destinations that are clear in their messaging around health and safety and that prioritize easy and streamlined access will likely be more successful. This will in turn require investing in regulation and policy to open air routes, increasing visa openness, supporting peer-to-peer (P2P) accommodation, and increasing health and hygiene in hotels and along the entire visitor experience.

Build back better through investments and adoption of reforms that promote green tourism.

Measures to increase preparedness for future shocks, while improving competitiveness and resilience, should be a priority. These include, for example, defining zoning policies to assure sustainable development, particularly in areas of natural and cultural heritage sites; supporting sector sustainability through greening of the tourism sector and protecting against increased single-use plastics and improper disinfectant use; diversifying geographically, considering the mid-hills, which offer wide diversity for tourism, and which is open year-round; and improving data collection to identify future market demand and new product development to enable a fast recovery.

Simplify and streamline processes to attract more FDI**Reduce the minimum threshold for FDI and streamline the approval process.**

The reduction of the minimum threshold, which can be achieved through a directive issued by Ministry of Industry, Commerce and Supplies, will contribute to facilitating entry of FDI. In addition, the approval of the new Foreign Investment and Technology Transfer Rules, which will introduce

the automation for FDI approvals in some sectors, will further facilitate FDI inflows.

Actively engage in economic diplomacy to attract FDI.

Active pursuit of linked export and FDI promotion is a needed to complement regulatory reforms.

Modernize export promotion and upgrade exporters' capabilities**Digitize, automate, and simplify the process for availing the Cash Incentive Scheme for Exporters (CISE).**

First, introduce a trust-based system for certification of value addition through cooperation with exporters associations and through random audits. Second, increase digitization and automation for the application process. Third, ensure the allocation of funds for the CISE is enough for all eligible exporters to avail it.

Base export promotion investments on evidence.

Consider high-potential destinations for export promotion support, and increasingly rely on automated matchmaking platforms to support new exporters in the search of global clients.

Support exporters and potential exporters to upgrade their capabilities.

Coordinate with exporters' associations to support exporters, particularly the small and new ones, to build capabilities. One particular area in which evidence points to the need for support is on input-traceability systems so that exporters can better use trade preferences that many developed countries offer to Nepal, such as the Generalized System of Preferences or the Nepal Trade Preference Program, and that require compliance with rules of origin.

Reduce trade costs**Continue improving customs operations to reduce trade costs.**

A risk management approach for cross-border cargo movements can significantly

increase the facilitation of legitimate trade across Nepal's borders. Around 30 percent of low-risk consignments are currently allowed to proceed without any Customs interaction, also known as “green lane” facilitation. The Government of Nepal recognizes the value of improved trade facilitation and has set a target to achieve green lane utilization in line with good international practice (over 90 percent). However, a recent gap assessment on Nepal's alignment with the World Trade Organization (WTO) Trade Facilitation Agreement suggests that risk management is not improving clearance times for low-risk traders. In fact, there is little difference between green and yellow lanes as both require documents to be submitted and endorsed, with additional approvals and documentary checks for commodities moving through the yellow lane. Therefore, reformed procedures need to be implemented that will result in immediate clearance on arrival at the border control post for all green lane transactions. More rigorous risk profiling and selectivity criteria, that are validated and continuously monitored and updated based on Revised Kyoto Convention good-practice approaches, will also be required. Furthermore, risk management approaches need to be expanded by other border agencies with appropriate coordination among them to maximize the benefits to low-risk traders.

Increased digitization through promoting greater transparency and simplifying processes can contribute to significantly lower trade costs. Nepal has made great strides toward digitizing and automating trade processes. The Nepal Trade Information Portal, a single source for trade-related information, will help improve regulatory transparency. The Nepal National Single Window, a common digital platform for fulfilling import and export procedures (expected to become fully operational by the end of 2021), will significantly reduce manual processes. Furthermore, close to 100 percent of customs declarations and supporting documents are submitted digitally under the UNCTAD Automated System for Customs Data (ASYCUDA). However, there remains much greater scope for further

digitization and automation. For example, digital signatories are not mandatory, and hard copy documents must be submitted at border crossing points, which dilutes the value of automation.

A gradual rationalization of import duties is needed to reduce costs to exporters. It is crucial to commit to an import duty rationalization plan and communicate the timeline transparently to the private sector to reduce policy uncertainty. This plan needs to be consistent with the government's financing needs, as well as with the objective of increasing trade and productivity. In the short run, the strategy could focus on import duty reductions on raw materials and intermediates, and capital goods will increase the competitiveness of domestic firms and facilitate productivity gains. In the long term, the strategy should aim at reducing the anti-export bias of tariff policy by focusing on tariff reductions on final goods.

Invest in phytosanitary- and quality control-related infrastructure

The Government of Nepal has given priority to achieving compliance with the SPS Agreement under the WTO's Trade Facilitation Agreement. Short-term priorities include (i) increasing the capacity for plant pest surveillance and diagnostics and food safety testing in microbiology, pesticide residues, and other pollutants and mycotoxins; (ii) adopting a risk-based SPS system, shifting attention from routine controls to prevention and targeted controls; and (iii) negotiating mutual recognition agreements with India and other key trading partners.

Boost digital trade and e-commerce for more opportunities linked to global value chains

Develop an e-commerce framework reflecting international good practices. Data privacy, consumer protection, and intellectual property regulation are crucial elements in an e-commerce framework that need to be carefully addressed, as do the following:

(1) Digital signatures. Digital signatures are crucial to reduce costs, and regulations are needed in this area. A digital signature framework will contribute to advancing customs reforms around digitization and automation, with its corresponding savings for traders and firms and households in general, through seamless movements of goods, lower inventory costs, and optimal use of logistics infrastructure.

(2) Digital payments infrastructure. Boosting e-commerce requires facilitating the flow of payments within and in and out of Nepal. For these purposes, improving the digital payments infrastructure is crucial. The Nepal Rastra Bank has developed jointly with the International Finance Corporation a Retail Payment Strategy (RPS) to unlock the potential and move toward safe and efficient payment systems in Nepal. A crucial step in this direction is the adoption of the RPS, along with action plans on (i) achieving interoperability for payment transactions using transaction accounts, (ii) enabling new models for digital payments (notably the standardization of QR codes), (iii) enabling the growth of agent networks and explicitly banning exclusivity arrangements for agent networks, and (iv) rationalizing customer fees and charges.

In addition, and to complement the above-mentioned steps, it is crucial to comply with “Know-your-Customer” (KYC) standards. The following policy actions will contribute to this objective. First, remove restrictions in government rules that allow transfer of government-to-person (G2P) payments only to bank accounts and open it up for all types of transaction accounts operated by licensed financial service providers. Second, allow sharing of KYC-related information on customers among licensed entities with adequate and robust customer data protection measures to facilitate immediate activation of accounts and opening of transaction accounts remotely. Third, establish government payment systems, including an interface that connects various government systems, with the aim of leveraging the national payment system, to enable a choice of payment mechanisms to users, for receiving payments from and making payments to government.

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