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ABBREVIATIONS

BFI — banks and financial institutions
CA — Constituent Assembly
CPI — consumer price index
FDI — foreign direct investment
FTA — Free Trade Agreement
FY — fiscal year
GDP — gross domestic product
LPI — Logistics Performance Index
NRB — Nepal Rastra Bank
NRs — Nepalese Rupees
NTIS — Nepal Trade Integration Strategy
OECD — Organisation for Economic Co-operation and Development
SEZ — Special Economic Zone
US — United States

NOTE

(i) The fiscal year (FY) of the Government ends on 15 July. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2014 ends on 15 July 2014.

(ii) In this report, “$” refers to US dollars.
Executive Summary

1. The positive political outlook, expected increase in agriculture production following the favorable monsoon, modest improvement in capital expenditure following the timely full FY2014 budget, and a strong services sector performance supported by remittance income are expected to boost gross domestic product (GDP) growth (at basic prices) to 4.5% in FY2014, up from 3.6% in FY2013. The forecast is lower than the government’s 5.5% target in view of the less than expected increase in capital spending and a slightly lower services sector. In addition to the improvements in agriculture production, both domestic and foreign investment commitments increased remarkably in the first half of FY2014.

2. Despite the timely full budget, expenditure performance was not satisfactory in the first half of FY2014. Of the total planned expenditure of NRs 517.2 billion, only 30.3% was spent largely due to the lower than expected capital spending. The slow pace of spending so far indicates that the capital budget will likely continue to be underspent as in the previous years. If the utilization of the capital budget remains at the same level as in FY2013 (81% of total planned capital expenditure), the total capital spending in FY2014 is projected to be about 3.5% of GDP, lower than the 4.4% of GDP projected in the budget but slightly higher than 3.1% of GDP in FY2013. There is an urgent need to ramp up both the quantum and quality of capital spending as it not only ‘crowds in’ private investments, but also helps create the foundations for the lackluster growth to take off on an employment-centric, high, inclusive and sustainable growth path.

3. Even though the NRs 163.4 billion revenue mobilized in the first half of FY2014 is 21.5% higher than the revenue mobilized in the corresponding period in FY2013, it still is lower than the half year target set for this fiscal year. As a share of total targets, customs, value added tax (VAT), excise, land registration and income tax mobilization up to mid-year stood at 46.8%, 46.6%, 47.6%, 52.3% and 44.4%, respectively. Since import-based tax revenues account for around 45% of total revenue, the yearly revenue target may not be met as the depreciation of the Nepalese rupee against the dollar is slowing down import demand.

4. Inflation averaged 9.1% in the first half of FY2014, down from 10.7% in the corresponding period in FY2013. Inflation moderated in all the six months of FY2014 compared to their corresponding months in FY2013. The decline in prices is mainly driven by the sharp slowdown in non-food and services prices. However, the persistence of the high inflation level is supported by rising food and beverage prices, which averaged 11.5% in the first half of FY2014 against 9.8% in the same period in FY2013. Despite the expected improvement in agriculture harvest, the wage pressures, the persistently high price level in India, the rise in administered fuel prices, lower interest rates, the persistently weak Nepalese rupee and the supply-side constraints, average annual consumer price index (CPI) inflation in FY2014 is forecast at 10.0%, higher than the government’s target of 8.5%.
5. Money supply increased by 9.0% in the first half of FY2014, higher than 4.8% in the corresponding period in FY2013, due to the large increase in remittance inflows and foreign assistance, which boosted net foreign asset holdings. The increase in money supply was reflected in the 8.9% growth of narrow money (M1) and 5.5% growth of time deposits. The increasing remittance inflows and the election related expenditures increased deposit mobilization by 8.0% in the first half of FY2014, up from 5.3% in the corresponding period of FY2013. However, lending growth slowed to 7.3%, from 10.7% in mid-January 2013, as credit to private sector fell given the lack of immediate bankable investment projects and the cap on lending to certain sectors. The large liquidity surplus in the banking system led to lower interest rates compared to the level in mid-January 2013. Proper management of excess liquidity is essential to ensure that hasty and risky lending does not fuel bubbles in key sectors, including the residential housing market. As investor’s confidence rebounded and excess liquidity prevailed, the Nepal Stock Exchange (NEPSE) index increased sharply by 143.2% (787.1 points) in mid-January FY2014, up from a decrease of 19.7% (323.6 points) in mid-January FY2013.

6. The country’s external situation strengthened on the back of a large increase in remittance inflows, gains in exports and a slowdown in imports. In the first half of FY2014, the balance of payments surplus increased to $788.1 million, up from $89.3 million in mid-January in 2013. The merchandise trade deficit widened to $2.8 billion, up from $2.6 billion in mid-January 2013. However, the surge in remittance inflows pushed the current account surplus to $554.6 million, sharply up from $50.7 million in the first half of FY2013. Gross foreign exchange reserves increased from $5.5 billion in FY2013 to $6.3 billion in mid-January 2014, sufficient to cover 10.2 months of import of goods and non-factor services.

7. This edition of Macroeconomic Update’s Issue Focus explores the various dimensions of Nepal’s export competitiveness. Given the country’s poor export performance so far, it is clear that Nepal has been unable to fully utilize the market access and tariff concessions offered by trading partners, primarily due to crippling supply-side constraints. These include the lack of adequate and quality infrastructure; political instability and strikes; recurring labor disputes; lack of skilled human resource; deficient research and development; and policy inconsistencies and implementation paralysis. The country needs to properly utilize the technical assistance offered through various financing windows by multilateral and regional trading blocs, and development partners. This will help boost private sector activities in export-oriented sectors, which is mostly dominated by small and medium enterprises. In the long term, along with improvements in the investment climate, the government will need to substantially increase investment in energy, transport corridors, skills development, technology transfer and adoption, supportive regulatory and institutional frameworks including Special Economic Zones (SEZ), and overall stable macroeconomic environment. These are critical for product and market diversification as well as product sophistication to stay competitive and to make exports an important driver of inclusive growth, which is essential to absorb an estimated 633,000 new entrants annually to the job market by 2020.
MACROECONOMIC UPDATE

A. Real Sector

I. Performance in FY2013

1. Adversely affected by the unfavorable monsoon, the shortage of chemical fertilizers during the peak summer crops planting season, continued slowdown in industrial activities, and the delay in introducing a full budget, gross domestic product (GDP) growth dipped to an estimated 3.6% in FY2013, down from 4.5% in FY2012. Services sector contributed about four-fifths of the GDP growth, up from about two-fifths in FY2012, largely due to the rise in remittances-induced consumption demand. Agriculture sector’s contribution dropped to less than one-fifth of the GDP growth in FY2013 (from two-fifths in FY2012), due to the decline in the production of major crops, including paddy, maize and millet (Figure 1). The industrial sector’s contribution remained below one-fifth in the last three years, reflecting the slowdown of manufacturing and construction activities.

2. The agriculture sector, which comprises almost 35% of GDP and provides livelihood to about 76% of households, grew at a mere 1.3%, down from 5.0% in FY2012 and 4.5% in FY2011. The industrial sector, which comprises only 15% of GDP, continued the lackluster performance, registering an estimated growth of 1.6%, down from 3% in FY2012 and 4.3% in FY2011. The remittances-induced consumption demand propelled the services sector growth to an estimated 6%, up from 4.5% in FY2012. Within the services sector, wholesale and retail trade—whose share in GDP is 14.4%, nearly equal to that of the industry sector—grew sharply by 9.5%, up from 3.1% in FY2012 (Figure 2).

3. Consumption accounted for an estimated 90.7% of GDP, up from 88.5% in FY2012 and 85.5% in FY2011, reflecting the increasing consumption demand stimulated by the growing remittance income. While capital formation hovered around an average of 37% of GDP, gross fixed capital formation (GFCF) has been around 21% of GDP. The private sector accounted for the largest share of GFCF (17.2% of GDP in FY2013). Net exports jumped to a negative 28.5% of GDP in FY2013, up from a negative 23.4% of GDP in FY2012, reflecting a significant rise in import of goods and non-factor

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1 R and P denote revised estimate and provisional estimate, respectively. Any reference to GDP for FY2012 and FY2013 in this Macroeconomic Update refers to revised and provisional estimates, respectively.
2 It may be noted that even though final consumption with respect to GDP is very high, the actual domestic consumption expenditure made up only 62.2% of GDP in FY2013, down from 65.1% in FY2012. This is due to the surge of net exports (or, export minus import) in FY2013, i.e. the consumption expenditure on import of goods and non-factor services.
3 It is measured by the total value of a producers’ acquisitions, less disposals, of fixed assets during the accounting period plus certain additions to the value of non-produced assets (such as land or subsoil assets) realized by the productive activity of institutional units. See CBS. 2013. National Accounts of Nepal 2012-13. Kathmandu: Central Bureau of Statistics.
services—38.8% of GDP from 33.4% in FY2012 (Figure 3). While high remittance income supported imports, the slowing exports are a result of the persistent supply-side constraints affecting both production and competitiveness.

4. Gross domestic savings declined to an estimated 9.3% of GDP from 11.5% in FY2012 and 14.5% in FY2011. This indicates that a majority of the residents’ income is spent on consumption, which is mostly met by imported goods. Meanwhile, the high national savings (38.4% of GDP in FY2013) reflects the high remittance inflows. It has also contributed to a positive savings-investment gap (computed as the difference between gross national savings and gross capital formation) in the last two years.

5. Though per capita GDP increased to $713 in FY2013 from $709 in FY2012, it is still lower than $720 in FY2011 (Figure 4). The fluctuation in per capita GDP is partly attributed to the depreciation of Nepalese rupee against the US dollar. The overall economy marginally expanded to an estimated $19.4 billion in FY2013, from $19.0 billion in FY2012.

II. FY2014 Investment

6. Domestic investment commitment: Investors’ confidence improved following the formation of an election government in March 2013 and the successful election to the second Constituent Assembly (CA) in November 2013. As a result, total domestic capital investment (fixed plus working capital) commitment reached NRs 182.7 billion in the first six months of FY2014, a remarkable increase by 383% from mid-January 2013. The domestic investment commitment by mid-January 2014 was 52.8% higher than the commitment in the whole of FY2013. Energy sector alone accounted for 95.4% of the total investment commitment in the first half of FY2014, indicating the increasing interest of domestic investors to invest in small to medium scale hydro power projects (Figure 5).

7. Foreign direct investment commitments: In the first six months of FY2014, foreign direct investment (FDI) commitment of approved projects reached NRs 14.6 billion, a notable increase by 49.9% from mid-January 2013\(^4\). The FDI commitment by mid-January 2014 was 55.9% of the total FDI commitment in the whole of FY2013. As in the case of domestic investment commitment, energy sector received the highest FDI commitment, reaching NRs 10.3

\(^4\) 1 $ = NRs 87.7 in FY2013 and 1 $ = NRs 80.7 in FY2012.

\(^5\) Note that actual FDI inflows, as recorded in the balance of payments, were just 16.5% of total FDI commitments in the first half of FY2014. In FY2013, actual FDI inflows were 65.5% of total FDI commitments.
Though the Agriculture Inputs Corporation Ltd. supplied only about a quarter of the total fertilizer demand, farmers did not face a shortage during the planting season. This is probably due to imports from India by the private sector and individuals through informal channels.

It is largely based on strong agriculture sector performance and 6% services sector growth. But less than expected increase in capital spending and lower services sector growth (due to lower real estate, and retail and wholesale activities) are likely to lower GDP growth below the government’s forecast.

Financial provision includes internal loan investment, domestic share investment, and external and domestic debt repayments.

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3. FY2014BE, nominal GDP at producers’ prices estimate is assumed to be 14.7% (average of FY2012 and FY2013) higher than FY2013 provisional data.
The budget set a revenue growth target of 19.9% for FY2014, slightly lower than the 21% revised estimate in FY2013. Overall, gross budget deficit is expected to be 4.5% of GDP (to be financed by foreign loans and domestic borrowing equivalent to 2.2% and 2.3% of GDP, respectively). However, the net foreign and domestic borrowings are estimated at 2.4% of GDP.

II. Expenditure Performance

10. Despite the timely announcement of the full FY2014 budget, overall expenditure performance during the first half of FY2014 was still low. Only 30.3% of the total budget was spent (NRs 156.1 billion), slightly higher than the 29.6% budget utilization in the corresponding period in FY2013 (Figure 8).\(^{10}\) Though the utilization of recurrent and financing budgets was higher than last year, capital spending has remained low, with just 13.5% of total allocation spent in the first half of FY2014 (NRs 11.5 billion)\(^{11}\), down from 14.9% utilization in the corresponding period in FY2013 (Figure 9).

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Box 1: Economic Agenda of Major Political Parties*

The economic agenda of the main three political parties — Nepali Congress, Communist Party of Nepal Unified Marxist-Leninist, and Unified Communist Party of Nepal (Maoist) — have a lot of similarities. Overall, they agree on a strong economy based on three pillars — namely public, private and cooperatives sectors — and are committed to liberal economic principles with a greater role of the private sector. There is also agreement on the special role of cooperatives in agriculture sector, and the need for foreign direct investment (FDI) and foreign aid to bridge the financing gap, particularly in physical and social infrastructures. The political parties have underscored the importance of a favorable investment climate to facilitate investments in the priority sectors, particularly energy, tourism, agriculture and industry.

In energy sector, the political parties’ focus is on meeting the growing energy demand and ending load-shedding in the short term. In agriculture sector, the focus is on modernization, commercialization and diversification of production. In tourism sector, the political parties accentuate the need to build vital tourism infrastructures and to attract domestic as well as foreign visitors. In industry sector, they have committed to promote an investment friendly environment, including cessation of bandhs/strikes. Human resources development with a focus on critical skills to sustain a high growth rate and to generate employment opportunities is also a common feature in the political manifestos. The other common priorities include transport and communications, road and rail networks, and completion of national pride projects.

* For more details, see Appendix 1.

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\(^{10}\) FY2013 budget utilization figure pertains to two-thirds budget. FY2013 full budget was introduced in April 2013. With respect to full FY2013 budget, the mid-year budget utilization for total, recurrent, capital and financing were 25.7%, 31.3%, 11.6% and 16%, respectively.

\(^{11}\) In the first seven months of FY2014, 17.3% of total capital budget allocation was spent.
As in the previous years, capital expenditure can be expected to pick up in the last quarter of FY2014. Of the actual capital spending in FY2013, 43% was spent in the last month and 64% in the last three months. Even then, the slow pace of spending so far this year indicates that planned capital budget will likely be continued to be underspent. In FY2013, actual capital expenditure was 81% of total capital budget. If the utilization of capital budget remains at the same level, total capital spending in FY2014 will be about 3.5% of GDP, lower than the 4.4% of GDP projected in the budget but slightly higher than 3.1% of GDP in FY2013 (Figure 10). The main reasons for low capital spending are: (i) lack of project readiness, in terms of timely preparatory activities such as land acquisition, establishment of project management offices, and preparation of procurement plans; (iii) inherent weaknesses in the government’s budget execution processes, including delays in budget approval and release processes at various stages; (iii) delays in procurement process; and (iv) overall weak project planning and implementation capacity. There is an urgent need to ramp up both the quantum and quality of capital spending as it not only ‘crowds in’ private investments, but also helps create the foundations for the lackluster growth to take off on an employment-centric high, inclusive and sustainable path.

III. Revenue Performance

The mid-year revenue mobilization stood at NRs 163.4 billion, which is 46.1% of the total revenue target for FY2014 (Figure 11). It is about 21.5% higher than the revenue mobilized in the first half of FY2013. As a share of total targets, customs, value added tax (VAT), excise, land registration, and income tax mobilization up to mid-year stood at 46.8%, 46.6%, 47.6%, 52.3% and 44.4%, respectively. The depreciation of the Nepalese rupee against the dollar is slowing down import demand, which in turn is affecting revenue mobilization. It could potentially lower total revenue mobilization below the FY2014 target, as import-based revenues account for around 45% of the total revenue. For instance, vehicle tax increased by a mere 1.8% in the first half of FY2014 when compared to a growth rate of 12.0% in the corresponding period in FY2013.

The 35.2% increase in land registration fee indicates a gradual rebound of real estate and residential housing market from a slump since FY2011. The FY2014 budget has targeted to raise NRs 4.5 billion as land registration fee in FY2014, of which NRs 2.4 billion has already been raised in the first half of the year. Lending for
personal housing is picking up as the liquidity surplus is benefiting borrowers in terms of low lending rates.

14. The largest contribution to total revenue came from VAT (28.2%), followed by income tax (22.6%), customs duties (19.2%), and excise duty (12.4%) (Figure 12). Revenue from all sources (except vehicle tax) increased by over 10%.

IV. Budget Balance
15. During the first six months of FY2014, the Nepal Rastra Bank’s (NRB) data shows that government budget surplus increased to NRs56.1 billion from NRs40.4 billion in the corresponding period in FY2013, reflecting higher revenue growth and slower than expected expenditure growth.

C. Monetary Sector

I. Inflation
16. Inflation averaged 9.1% in the first half of FY2014, down from 10.7% in the corresponding period in FY2013. Inflation, as measured by month-on-month (m-o-m) consumer price index (CPI), moderated in all the six months of FY2014 compared to corresponding months in FY2013 (Figure 13). The decline in prices is mainly driven by the sharp slowdown in non-food and services prices (Figure 15). However, the still persistently high inflation is supported by rising food and beverage prices, which averaged 11.5% in the first half of FY2014 against 9.8% in the same period in FY2013.

17. Compared to the corresponding months of FY2013, although food inflation (m-o-m CPI) slowed down in the first two months of FY2014, it inched up to double-digits in the next four months (Figure 14). The double-digit increase in the prices of cereals, vegetables, meat and fish, fruits, spices, restaurants, tobacco, and hotels pushed up overall average food prices to over 10%. Higher international oil prices and still high food inflation in India passed through imports, affecting domestic wholesale and retail prices. Furthermore, since Nepal is a net food importing country, the depreciation of the Nepalese rupee against convertible currencies increased import costs and ultimately domestic prices.

18. Non-food and services inflation remained in a single digit in all the six months of FY2014. (Figure 15). Compared to the prices in mid-January 2013, except for the double-digit increase in prices of clothing and footwear in mid-January 2014, prices of other items under non-food and services basket remained in single digit levels. The slowdown in credit to the private sector (despite the reduction of...
lending rates) as well as the lower than expected pass-through of high prices (via imported goods, whose demand moderated) might have contributed to keeping non-food and services prices at low levels.

19. Primarily, inflation in Nepal is driven by prices in India—the largest trading partner, to whose currency the Nepalese rupee is pegged, and with which Nepal shares an open border. Other factors influencing Nepal’s inflation include agriculture harvest, oil price movements, domestic wage revisions, exchange rate against convertible currencies, monetary tools (mainly interest rates), and domestic supply-side constraints such as power outages, transport bottlenecks, lack of raw materials leading to high import content of manufacture products, inadequate supply of key agricultural inputs, and market distortions by middlemen, cartels and syndicates.

II. FY2014 Inflation Outlook
20. Despite the expected improvement in agriculture harvest, the wage pressures, persistently high price level in India, the rise in administered fuel prices, lower interest rates, the still weak Nepalese rupee, and supply-side constraints, CPI inflation in FY2014 is forecast at 10.0%, higher than the government’s revised target of 8.5% but a half a percentage point lower than the August 2013 Macroeconomic Update forecast (Figure 16). The government increased civil service salaries by 18% and allowances by NRs 1,000 per month in the FY2014 budget. Meanwhile, the non-agriculture sector workers’ minimum wage was revised upward by 29%. Prices of petroleum fuel were revised upward on 11 August 2013 and again on 12 September 2013 (Table 2). While the good harvest will help lower food price pressures (which has a 46.8% weight in the CPI), the overall impact might be lower because the domestic supply is insufficient to meet total domestic demand (making Nepal a net food importing country), and supply-side constraints still remain stubbornly persistent.

III. Money Supply
21. Despite the slowdown in net domestic assets, the large increase in net foreign assets of the banking sector increased money supply (M2) by 9.0% in the first half of FY2014 (NRs 118.1

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17 The balance sheet of monetary authorities is composed of assets and liabilities. Assets consist of net foreign assets and net domestic assets (net claims on government and claims on the private sector). Liabilities consist of currency issued and deposits. Both net foreign assets and net claims on government affect reserve money and hence the money supply. A decline in net foreign assets, denominated in local currency in the monetary survey, and the banking sector’s net credit to government reduces the money supply. Net foreign assets are associated with the fluctuations in foreign exchange reserves (in the balance of payments account).

18 It is the difference between the value of assets owned abroad and the value of domestic assets owned by non-residents.

19 M2 is the sum of net foreign assets and net domestic assets. Also called broad money, M2 is equal to narrow money (M1) and saving and time deposits. M1 is equal to currency in circulation and demand deposits.
billion), up from 4.8% in the corresponding period in FY2013 (NRs 54.4 billion). Net foreign assets grew by 16.5% (NRs 77.2 billion), up from a 2.0% growth rate (NRs 7.8 billion) in mid-January 2013 (Figure 17). The higher rate of remittance inflows and increased foreign assistance boosted the growth in the net foreign asset holdings. The increase in money supply was reflected in the 8.9% growth of narrow money (M1) and 5.5% growth of time deposits.

22. Net claims on government—direct loans and government securities held by the central bank—decreased by 44.1% (NRs 40.9 billion), lower than the 26% fall recorded in mid-January FY2013. It reflects the large increase in government deposits compared to the bank and financial institutions’ (BFI) claims on the government. The overall credit to private sector grew by 8.9% (NRs 86.6 billion), down from 12.3% growth (NRs 99.3 billion) in mid-January FY2013, reflecting the lack of immediate bankable investment opportunities despite the offer of low lending rates by BFIs, which now have excess liquidity.

IV. Deposit and Credit

23. The BFIs mobilized NRs 95.4 billion (reaching a total of NRs 1,283.5 billion) in deposits in the first six months of FY2014, higher than the NRs 54.1 billion mobilized in the corresponding period in FY2013. This translates into a growth of 8.0%, up from 5.3% in the first half of FY2013. Deposit mobilization of commercial banks, development banks and finance companies increased by 7.2%, 13.9%, and 8.4%, respectively (Figure 18). The acceleration of government spending in the last quarter of FY2013, the election related expenditures, and a higher growth of remittance inflows boosted deposits.

24. Total credit (loans and advances) of BFIs increased by 7.3% (NRs 83.7 billion) in the first half of FY2014, down from 11.2% growth in corresponding period in FY2013 (NRs 108.2 billion). Credits of commercial banks grew by 7.0% (NRs 65.3 billion), down from a rate of 10.7% in mid-January FY2013. Similarly, credits of development banks and finance companies grew by 12.1% (NRs 21.2 billion) and 6.5% (NRs 5.8 billion), respectively (Figure 19). During the review period, credit to the private sector (by category A, B and C BFIs) increased by 9.0% (NRs 86.8 billion), down from 12.3% growth rate (NRs 98.9 billion) in the first half of FY2013, with commercial banks, development banks, and finance companies registering growth.

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20 To facilitate the analysis of the central bank’s financing of government operations, claims on the government are recorded in net basis. The net credit to the government means creation of high-powered money, i.e. monetary base (currency in circulation plus reserves of banks in the central bank).
rates of 9.1%, 11.8% and 2.0%, respectively. Despite the positive political outlook and declining lending rates, the growth rate of credit to the private sector fell due to the low demand emanating from the lack of immediate bankable investment projects and the cap on lending to certain sectors (particularly the property market) that had seen bubbles in the previous years. Cumulatively, 21.6% of the total lending went to wholesale and retail traders, followed by 20.5% to industry, 10.2% to construction, and 8.4% to finance, insurance and fixed assets (Figure 20).

25. On a sectoral basis, 31.6% of the increase in credit by BFI’s in the first half of FY2014 was absorbed largely by wholesale and retail traders (NRs 26.4 billion), followed by industry (NRs 22.4 billion), construction (NRs 9.6 billion), services sector (NRs 7.8 billion), and agriculture (NRs 4.1 billion). Consumable loans shrunk by NRs 187.3 million (Figure 21). While lending to the construction sector increased in the first half of FY2014, lending to real estate declined (Figure 22). It reflected the uptake in residential housing and infrastructure related activities, but the continued slowdown in real estate market.

V. Liquidity Management

26. In the review period, NRB mopped up NRs 8.5 billion through open market operations (outright sale auction) and NRs 118.5 billion through reverse repo auction—the two monetary tools actively used to manage liquidity in the banking sector. This amount is higher than that (NRs 8.4 billion) in the first half of FY2013. NRB mopped up NRs 8.5 billion in mid-October 2013 (at a weighted average interest rate of 0.05%). The weighted average interest rate on reverse repo auction has been between 0.05% and 0.68%. The acceleration of public expenditure in the last quarter of FY2013, the election related spending, and the higher growth of remittance

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21. It comprises of productive sectors such as food production, agriculture, handicrafts, textiles, paper, medicine, processing plants, plastic, cement and metals, among others.
inflows have led to a surplus liquidity, which the BFIs are finding hard to lend given the lack of investment-ready projects and the cap on lending to certain sectors. Consequently, the BFIs are investing in treasury bills carrying negligible interest rates. They have also not utilized the standing liquidity facility (SLF) so far. In mid-January 2013, they utilized a SLF of NRs 1.6 billion, which carried an 8% interest rate. A proper management of excess liquidity is essential to ensure that hasty and risky lending do not fuel bubbles in key sectors, including the personal housing market.

27. To finance the burgeoning imports from India, NRB sold $1.4 billion in the Indian money market and purchased Indian currency equivalent to NRs 143.1 billion in the first half of FY2014. In the same period in FY2013, NRB had sold $1.4 billion to purchase Indian currency equivalent to NRs 122.0 billion.

VI. Interest Rates

28. Short-term interest rates remained lower than the corresponding months in FY2013, indicating the excess liquidity in the banking sector (Figure 23). The 91-day treasury bills weighted average interest rate was substantially lower than in the corresponding months in the previous year. It reached 0.47% in mid-January 2014, down from 0.7% in mid-January 2013. Starting this year, NRB introduced a market-based mechanism to auction government bonds. The BFIs are showing increasing appetite to purchase them at lower interest rates than what was offered by NRB when the interest rate on such bonds was fixed administratively. Meanwhile, interbank rates also remained substantially lower than in the corresponding months in the previous years. The weighted average inter-bank transaction rate among commercial banks was as low as 0.21% in mid-January 2014, much lower than the 0.9% in mid-January 2013. The existing high demand for government bonds and low interbank rates are driven by the excess liquidity in the banking sector.

29. In the first half of FY2014, weighted average deposit and lending rates fell as the BFIs struggled to increase lending amidst the liquidity surplus (Figure 24). The weighted average deposit rate of commercial banks was as low as 4.7% in mid-January 2014, down from 5.2% in mid-January 2013. Similarly, the weighted average lending rate fell to 11.5% from 12.6% in mid-January 2013.

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22 This was one of the recommendations, under Component 1, of the ongoing ADB supported Grant 0252-NEP: Capital Market and Infrastructure Capacity Support Project.

23 In its Monetary Policy for FY2014, the NRB mandated commercial banks to lower spread rate to 5% by mid-July 2014.
Consequently, the interest rate spread (lending rate minus deposit rate) fell to 6.8% in mid-January 2014 from 9.4% in mid-January 2013. The average weighted base rate of commercial banks also came down to 8.6% from 9.4% in mid-January 2013.

VII. Securities Market

30. As investor’s confidence rebounded following the successful second CA elections and excess liquidity prevailed in the banking sector, the stock market turnover increased by NRs28.3 billion in mid-January 2014, significantly up from NRs10 billion in mid-January 2013 (Figure 25). The turnover amounted to 3.5% of total market capitalization as of mid-January 2014. Of the total turnover, the commercial banks’ share was 58.9% in mid-January 2014 (NRs 16.7 billion), followed by insurance companies (11.2%) and hydropower companies (7.8%). A higher share turnover indicates more liquid shares of a listed company.24

31. The Nepal Stock Exchange (NEPSE) index increased sharply by 143.2% (787.1 points) in mid-January FY2014, up from a decrease of 19.7% (323.6 points) in mid-January FY2013. Similarly, stock market capitalization surged by 166.2% to NRs 799.8 billion (40.3% of GDP) in mid-January FY2014, following a negative growth rate of 14.0% in mid-January FY2013 (market capitalization of NRs 300.4 billion, 19.0% of GDP) (Figure 26).

D. External Sector

I. Exports

32. Export increased as competitiveness improved due to the depreciation of the Nepalese rupee, production picked up with the improvement in political situation, and external demand improved on account of the optimistic growth outlook in the major export destinations. Merchandise exports (free on board [fob]) registered a growth of 1.8%, in US dollar terms, by mid-January 2014, up from a negative growth of 1.2% in mid-January 2013. Exports in mid-January 2014 totaled $506.3 million, equivalent to 51.6% of total exports in FY2013.25

33. Overall, in the first half of FY2014, the top export items were woolen carpets, yarns, textiles, readymade garments, and cardamom. The top five exports to India were zinc sheet ($38.5 million), textiles ($28.9 million), cardamom ($25.6 million), polyster yarn ($24.6

24 Note that Nepal’s stock market is still developing and does not always respond meaningfully to policy changes and political developments.

25 Overall, merchandise exports declined to 5.1% of GDP in FY2013 from 5.3% of GDP in FY2012.
million), and jute goods ($21.7 million). Meanwhile, the top five exports to other countries were woolen carpets ($36.8 million), readymade garments ($20.0 million), pashmina ($11.8 million), pulses ($9.7 million), and herbs ($6.1 million). The increase in Nepalese rupee competitiveness has boosted manufacturing price competitiveness, particularly exports of garments and textiles (Figure 27).

II. Imports

34. Merchandise imports (cost, insurance and freight [cif]) in dollar terms grew by 8.1%, down from the 11.8% growth in the first half of FY2013. Of the total imports of $3.3 billion by mid-January 2014, 18.7% was oil imports. This is equivalent to $615.3 million, higher than the total value of total merchandise exports. The high oil import reflects the rising demand for petroleum products largely due to the persistent and long hours of power cuts, and the depreciating Nepalese rupee.

35. Overall, in the first six months of FY2014, the top imports were petroleum products, iron and steel, transport and vehicle parts, machinery and parts, and electronic and electrical equipment. The five top imports from India were petroleum products ($612.0 million), vehicle and spareparts ($170.2 million), steel billets ($104.9 million), medicine ($74.7 million), and other machinery and parts ($74.4 million). Top imports from other countries were gold ($122.9 million), crude soybean oil ($94.1 million), telecommunication equipment ($64.2 million), silver ($52.9 million), and other machinery and parts ($45.1 million) (Figure 28).

III. Remittances

36. Remittance inflows have continued to grow along with the increase in the number of labor migrants and the incentives to remit more money back home due to the depreciation of the Nepalese rupee against the major convertible currencies (Figure 29). In US dollar terms, remittance inflows grew by 17.9% in mid-January 2014, up from a growth of 9.2% in mid-January 2013, reaching $2.7 billion. It is equivalent to 54.0% of the $4.9 billion (25.5% of GDP) remittance inflows in FY2013. Labor migration (those who obtained permits from the Department of Foreign Employment) grew by 12.7%, higher than 1.5% growth in the first six months of FY2013. An average of 1,237 workers left the country legally each day in the first six months of FY2014.

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26 In FY2013, oil imports accounted for 19.6% of total imports. Overall, merchandise imports increased to 32.2% of GDP in FY2013 from 29.6% of GDP in FY2012.

27 In FY2012, remittance inflows amounted to $4.4 billion (23.4% of GDP).
IV. Balance of Payments

37. The country’s external situation strengthened on the back of a large increase in remittance inflows, gain in exports, and slowdown in imports. In the first half of FY2014, the balance of payments surplus increased to $788.1 million, up from $89.3 million in mid-January in FY2013 (Figure 30). Merchandise trade deficit widened to $2.8 billion, up from $2.6 billion in mid-January 2013. However, the surge in remittance inflows pushed current account surplus to $554.6 million, sharply up from $50.7 million in the first half of FY2013. The capital account and financial account registered significant growth rates as opposed to the negative growth in the first half of FY2013. Actual foreign direct investment stood at $12.9 million, much lower than the $42.9 million in the first half of FY2013. Gross foreign exchange reserves increased from $5.5 billion in FY2013 to $6.3 billion in mid-January 2014, sufficient to cover 10.2 months of import of goods and non-factor services.

V. Exchange Rate

38. The Nepalese rupee has been continuously depreciating against the US dollar since October 2012 (Figure 31), closely following the currency movement of the Indian rupee, to which it is pegged. Overall, the Nepalese rupee depreciated by 11.0% between 15 January 2013 and 15 January 2014.

39. The concerns over the economic slowdown in India, its large current account deficit, and the gradual curbing of quantitative easing by the US Federal Reserve Bank triggered the weakening of the Indian rupee. NRB has little traction on the US dollar-Nepalese rupee exchange rate movement. The sharp
depreciation of the Nepalese rupee has a number important macroeconomic implications: (i) weaker financial health of Nepal Oil Corporation due the persistent gap between its import cost and selling price, (ii) increased overall import bill as Nepal’s major imports are relatively price inelastic, leading to a wider trade deficit; (iii) increased inflation as higher import prices get reflected in retail prices; (iv) increase in Nepal Electricity Authority’s payments to independent power producers whose prices are denominated in foreign currency; and (v) increase in external debt service payments. On the positive side, remittance inflows will increase as migrant workers will have more incentives to remit money back home.28 Similarly, exports rise to some extent (but subject to recovery of external demand and increase in domestic industrial capacity utilization, which currently stands at only around 60%).

Figure 31: Daily nominal exchange rate (NRs per $)

Source: Nepal Rastra Bank.

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28 It may be noted that almost 80% of remittances flowing to households is used for daily consumption and just 2.4% in capital formation.
Box 2: Major Highlights of the Declaration of Nepal Economic Summit 2014

The Federation of Nepalese Chamber of Commerce and Industry (FNCCI) and the Government of Nepal, supported by development partners including ADB, organized Nepal Economic Summit (NES) 2014 on 24-26 February. Following the deliberations on the investment opportunities and needed short-term reforms in energy, tourism and agriculture sectors, the NES came up with a joint declaration, which is proposed to be a basis for ‘minimum common economic agenda’ of Nepal. Some of the major highlights are as follows:

Overall Reform Agenda
- Improve the overall investment environment by prioritizing entry/exit procedural reforms and eliminating costly regulatory processes.
- Create at least 50,000 additional jobs by the private sector in agriculture, energy and tourism sectors by 2015.
- Execute at least four different large scale projects in agriculture, energy and tourism sectors.
- Draft legislations related to agriculture, energy and tourism sectors and work on getting them passed.
- Adopt Energy Development Strategy, Tourism Development Strategy and Agriculture Development Strategy within the next six months with appropriate action plans for respective stakeholder agencies.
- Create a high level mechanism, including members from the civil service and the private sector, to identify regulatory burdens and propose solutions to move up 10 positions in the ‘Doing Business’ ranking by 2016.
- An Implementation Monitoring Committee comprised of the Secretaries of the concerned Ministries to be formed under the chairmanship of the Chief Secretary.

Agriculture Sector
- Review the existing land management systems and come up with a regulatory framework for contract farming and effective utilization of land, particularly focusing on value chain development.
- Assess existing policies and programs on their effectiveness in terms of costs and reach to the targeted beneficiaries. High priority to be given to the review of programs, policies and regulatory framework in agricultural inputs and produce market.
- Increase public spending in agricultural infrastructure development.
- Develop human resource capacity needed for commercialized agriculture.
- Develop and implement incentives for production of high value goods with competitive advantage.

Energy Sector
- Priority to be given to demand side management of electricity and specific incentives to be offered in FY 2016 budget to industries practicing energy efficient processes and technology.
- Work on setting up an independent power trading company. Introduce ‘open access’ on existing transmission lines with a ‘wheeling charge’ to use these facilities.
- Construction of cross border transmission lines and preparation of a framework for cross border power trade to be given priority.
- Expedite the passage of electricity related legislations in the legislature.
- Revise existing incentives given to efficient biomass energy production to make them technology neutral.

Tourism Sector
- Up-gradation of Tribhuvan International Airport, and construction of regional airports in Lumbini, Nijgadh and Pokhara under PPP model.
- Improve air safety through regulations and upgrading infrastructure facilities at existing airports.
- Promote private sector can participate in developing high value tourism products in the conservation areas.
- Choose five strategic locations (Lumbini, Janakpur, and three locations from Far Eastern and Far Western Development Regions) to develop them as tourist destinations by the end of 2016 with an aim to increase per capita tourism receipts from $36 to $60.

Source: Adapted from ‘Nepal Economic Summit 2014: Declaration – A Commitment to Economic Reform’
ISSUE FOCUS

Nepal’s Export Competitiveness

I. Introduction

40. Despite being a member of multilateral and regional trade blocs, and having entered into bilateral free trade agreement with India, Nepal’s export performance has remained weak. Nepal has been unable to fully utilize the market access and tariff concessions offered by trading partners, primarily due to crippling supply-side constraints. These have become strong and persistent constraints to export competitiveness. As a land-locked country and with its currency pegged to the Indian rupee, Nepal’s trade concentration (and deficit) with India is notably high. Over the years, the composition of its export basket has hardly changed. Given its strategic location between India and the People’s Republic of China (PRC), and the market access concessions received so far, there exists a huge opportunity to not only reduce trade deficit by increasing exports and substituting imports, but also to stimulate economic activities and create jobs by promoting export-oriented industries.

Figure 32: Evolution of export, FY1976- FY2013

Source: Nepal Rastra Bank.

Note that the growth rates are computed after converting exports and imports into US dollars using the yearly average buying exchange rate.
II. Export Performance and Structure

41. Nepal’s export performance has been dismal, with the export growth lagging far behind import growth and its share in GDP shrinking. While merchandise exports grew by an average of 0.7%, merchandise imports grew by 13.6% over FY2009-FY2013. Exports reached as high as 13.1% of GDP in FY2000. Since then, it has declined consistently, reaching just 4.5% of GDP in FY2013 (Figure 32). The export basket is dominated by light manufactured and agriculture goods (66% and 23.5%, respectively, of total exports in FY2013). Export of manufactured goods also peaked in FY2000 (9.8% of GDP). It has declined since then, bringing down total exports. Export of manufactured goods was a mere 3% of GDP in FY2013. Nepal exported US$633 million of manufactured products in FY2011. The main manufacturing exports are textiles and fabrics, iron and steel, readymade garments, and non-ferrous metals (Figure 33). Exports to India account for about 60% of Nepal’s total export (Figure 34).

42. The degree of production specialization is declining. While the level of overall specialization has been low for a long time, a particularly worrisome aspect is the rapid decline of specialization in producing labor-intensive and resource-intensive manufactured goods, which was positive up until FY2007 (Figure 35). Furthermore, Nepal’s existing export capabilities are not advanced as the export basket is dominated by low-value added agriculture and manufactured products. Assets and capabilities (embedded knowledge) required to produce a particular good are normally imperfect substitutes for producing another good of similar nature (differentiated in some aspects only). Hence, the probability that Nepal produces a new export item is closely related to the closeness (or proximity) of that product with another product it is already producing. In this sense, given that Nepal’s installed capabilities are concentrated in the production of low-value added manufactured and agriculture products, the potential comparative advantage in the production and export of new products is also linked to the existing capabilities. With the existing set of infrastructures and other pre-requisites for export competitiveness, the new export products will likely be somewhat similar, in terms of value addition and production capabilities, to the existing ones. There is hardly any substantive change in the composition of the export basket and market diversification (Figure 36).

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30 It is also indicative of two things: (i) the export-oriented firms have failed to add much new capabilities, and (ii) the government’s initiative on this front is insufficient.
43. A jump from the existing basic production capability (low-value added manufactured and agriculture products) to a more complex production capability (high-value added manufactured and agriculture products, electronics, and equipment) will require greater provision of critical infrastructures, technology transfer and adoption, competitive environment and innovation, enhancement of skills, supportive regulatory and institutional frameworks, and overall macroeconomic stability. These will also contribute to a meaningful structural transformation that is characterized by a high and inclusive growth together with an equitable rise in per capita income.

**Figure 36: Composition of export basket in 2003 and 2010**

Source: The Growth Lab, Center for International Development, Harvard University; http://www.hks.harvard.edu/centers/cid/programs/growthlab

Note: The charts are called “Tree maps”. The total area represents total exports of Nepal in a given year. The smaller rectangular areas represent the share of each product in total export. The exported products are grouped according to the broader commodity group they belong to (SITC rev.4 code) and are colored accordingly. For instance, red color shows the group of manufacturing goods. The percentage shows the share of trade represented by that good.
III. Treaties and Policies

44. Nepal is the first Least Developed Country (LDC) to become a member of the World Trade Organization (WTO) (on 23 April 2004) through a full working party process. Its membership was approved at the Cancun Ministerial Conference in September 2003. Nepal is also a member of two regional trade agreements (RTAs), namely the Agreement on South Asian Free Trade Area (SAFTA) and the Bay of Bengal Initiative for Multi-sectoral Technical and Economic Cooperation (BIMSTEC) Free Trade Agreement (FTA). Similarly, Nepal has signed a FTA, which is reviewed and renewed every seven years, with India. Nepal’s exports are also getting preferential access under Generalized System of Preferences (GSP) to developed countries’ markets. Furthermore, the European Union has offered duty-free, quota-free access to all export items under its ‘Everything but Arms’ initiative. Regarding trade promotion and investment, Nepal signed the Trade and Investment Framework Agreement with the United States (US) in 2011, and bilateral investment protection and promotion agreements with France, Germany, the United Kingdom (UK), Mauritius, Finland, and India.

45. In addition to these treaties, Nepal has initiated a number of export promotion programs and policies. Nepal’s medium and long term plans and policies highlight the need to boost exports by enhancing value addition, mainstreaming trade, and increasing employment in trade-related sectors. The approach paper for the new Three-Year Plan (FY 2014-2016) sets targets of NRs 100 billion worth of exports by FY 2016, NRs 1 billion of export of each product listed in the Nepal Trade Integration Strategy (NTIS) 2010, and reduction of the trade deficit to 20% of GDP (from the existing 27% of GDP). The government also rolled out an updated trade policy in 2009 with an objective to reduce the trade deficit by promoting exports, and to boost income and employment opportunities in trade related activities. Consistent with the main objectives of Trade Policy 2009 and to formulate an export-led inclusive growth strategy, the government adopted the NTIS 2010. It identified 19 key commodities and services with ‘export potential’, the major export destinations for them, and product-specific promotion strategies.
46. The Industrial Policy 2010 emphasizes high-value added production, employment generation, promotion of domestic industries, and facilitation of forward and backward linkages in the industrial sector. It specifies the provision of additional facilities and incentives such as customs and excise duty refund on imported raw materials and intermediate goods if they are used in the production of export items. It also aims to promote Special Economic Zones (SEZs) and institute a ‘one-window’ policy for all industrial activities.

47. Given the export performance so far, Nepal has not been able to fully utilize the benefits that come with being a member of the multilateral and regional trading blocs, and the market access concessions offered by the developed countries. Furthermore, the trade and investment promotion policies are not effectively implemented to boost exports. Both external and internal factors have contributed to this, but the latter one seems to be more crippling than the former.

IV. Crippling Constraints

48. External constraints include non-tariff barriers (NTBs) such as rules of origin, and technical, sanitary, and phyto-sanitary standards related barriers. Even if tariff barriers are coming down and almost 97% of export items are accorded duty free, quota-free access to the developed countries’ markets, the NTBs are somewhat negating the potential gains by increasing fixed costs, thus eroding cost competitiveness. Nepal faces sanitary and phyto-sanitary barriers to market entry in the OECD countries, India, and PRC. Similarly, technical barriers and hassles at customs point are more prevalent in the region, including PRC. Government support in the form of subsidies to key sectors such as agriculture in OECD countries and India has reduced relative competitiveness of Nepal’s agricultural exports.

49. Internal constraints are more crippling than external constraints as they negatively impact production capacity of domestic firms and erode cost competitiveness of export items. Market access concessions (exogenous factor) alone will not promote Nepal’s exports. A key to boosting Nepal’s exports is to enhance its production and supply capacity, which currently continues to fall short of demand. In FY2013, the average capacity utilization of industries was just 58% (Figure 37). The major factors that affect supply capacity and erode export cost competitiveness are: (i) lack

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66 Among other commitments and provisions, the industrial policy also promises flexible labor policy, including the ‘no-pay-for-no-work’ policy. It allows for easy exit from business for promoters, freeing them from long-term labor and other liabilities. Tax and income rebate incentives and easy credit are offered to export-oriented firms. It promises tax holiday for 10, 7, and 5 years to firms that invest respectively in highly underdeveloped (21 districts), undeveloped (15 districts) and less developed (24 districts) areas, respectively.

of adequate and quality infrastructure, (ii) political instability and strikes, (iii) recurring labor disputes, (iv) lack of skilled human resource, (v) deficient research and development investment and innovation in the private sector, and (vi) policy inconsistencies and implementation paralysis.

50. **Lack of adequate and quality infrastructure:** The inadequate supply of electricity has severely constrained both production and potential comparative advantages of Nepal’s exports. Firms are not able to operate manufacturing plants and machines at full capacity due to the shortage of electricity. They are compelled to depend on generators that use petroleum fuel to power machines, increasing cost of production and eroding cost competitiveness of goods. According to the Enterprise Survey 2013, the percentage of firms owning or sharing a generator jumped to 50.5% in 2013 from 15.8% in 2009. Furthermore, generators met, on an average, 34% of electricity demand. About 69% of firms identified electricity as a major constraint in 2013.

51. Similarly, the inadequacy of existing transport infrastructure and logistical hassles has also increased production costs and lowered export competitiveness. The major trade routes need upgrading as it is choking the flow of traffic and increasing the cost of transportation. About one-third of the manufacturing firms identified bad transport facility as a major constraint in 2013. Furthermore, the lack of adequate facilities for warehousing, handling equipment, scanning machines, testing laboratories, and basic information and communication technology (such as harmonized automated customs management systems) have restrained trade flows.

52. Nepal consistently stands out as a country with one of the poorest logistical and enabling trade infrastructures in the world. In fact, Nepal slipped to 151 position out of 155 countries in the Logistics Performance Index (LPI) 2012. It ranked 147 in 2010 and 130 in 2007. On the specific components of LPI, while there has been an improvement in the customs score and ranking, it has deteriorated in the case of infrastructure and logistics competence (Figure 38). Similar is the case with Global Enabling Trade Ranking (GETR), which shows that the enabling environment, including trade-related infrastructure and customs, for trade has deteriorated over in the last couple of years. Nepal’s ranking deteriorated from 110 in 2009 to 118 in 2010 and 124 in 2012.

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38 The situation is even worse for large firms with 100 plus employees. About 99% of large firms owned or shared generators and they supplied 36.4% of total electricity demand.
39 This is slightly lower than 75.6% in 2009 probably because more firms were resorting to using generators to bridge the gap between demand for and supply of power.
40 The total number of countries included in LPI in 2012, 2010 and 2007 was 155, 155 and 150, respectively.
53. **Political instability and strikes**: Over the past few years, frequent political and union related strikes along the main trade routes have disrupted production and distribution of goods and services. This has led to an increase in the ‘lead time’ (the amount of time between the placing of an order and the receipt of the goods ordered), which together with the natural high trading costs of being a land-locked country have contributed to an increase in delivery costs. In South Asia, Nepal has the highest export lead time (days) for land supply chain\(^41\) (Figure 39), largely due to the 777 km of land supply chain\(^42\), which is the longest and the most expensive when compared with other countries in the region. According to Doing Business 2014, it still takes 11 documents, 42 days and US$2,295 to export a container (Figure 40 and Figure 41). Furthermore, the business community has repeatedly complained about the high costs imposed by truck syndicates, leading to rise in cost of production.\(^43\)

54. **Recurring labor disputes**: The recurring labor disputes, especially after FY2006, have been one of the thorniest issues in the industrial sector. It has not only disrupted production, but also contributed to the loss of established markets abroad and the closure of domestic firms. The garment industry has been hit the hardest. Once the highest foreign currency earner, the industry is now struggling to maintain and fulfill orders in time, especially after the end of the Multi-fiber Agreement (MFA) in 2005. By abolishing the quota regime, the end of MFA created a level playing field for all garments exporters to the US, resulting in the loss of market share to low-cost yet competitive exports from other countries. Nepal has one of the highest minimum wages in South Asia (Figure 42), but also one of the lowest labor productivities.\(^44\) On an average, the annual labor productivity growth contracted by 6.8% in 2013, much larger than the 4% dip in 2009.

55. **Lack of skilled human resource**: The lack of qualified human resources as well as the shortage of workers due to large-scale migration has affected production. Garment and pashmina productions are hit by the shortage of workers of all skills range. The exodus of youths has put pressures on wages, increasing industrial sector wages by an average annual rate of 10% since FY2006. The gap between the demand for and supply of workers of all skills range has hampered production, operations, management and marketing of goods and services.

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\(^{41}\) For port or airport supply chain, the export lead time is the highest (6 days) in Nepal when compared to other countries in the region.

\(^{42}\) According to LPI 2012, this includes ‘the point of origin (the seller’s factory, typically located either in the capital city or in the largest commercial center) to the buyer’s warehouse.’

\(^{43}\) Some traders also argue that the fixed transportation cost (trucks mainly) set by syndicates/cartels is higher than the combined cost of vehicle operation and transport bottlenecks.

\(^{44}\) In 2011, the productivity of Nepalese a garment worker was 9.6 pieces of shirt in an 8-hour shift, whereas it was 25.5, 18.6 and 16 for Chinese, Bangladeshi and Indian worker, respectively. See:http://ceslam.org/index.php?pageName=newsDetail&nid=1109
56. **Deficient research and development:** The private sector itself has not been able to scale up research and development investment and training of staff, resulting in hardly any major product innovation in the entire production chains. The Nepalese exporters seem to be more reliant on market concession abroad than promoting efficiency gains and innovation within their own factories. In 2013, 26.1% of firms on average had their own website and only 8.2% had an internationally recognized quality certificate. Furthermore, only 31.9% firms offered formal training to staffs.

57. **Policy inconsistencies and implementation paralysis:** While the government has introduced elaborate policies, their implementation remains weak. The trade policy introduced in 1983 was updated in 1992 and 2009, along with the formulation of elaborate sectoral promotion strategies for export potential goods (Diagnostic Trade Integration Study [DTIS] in 2004 and NTIS in 2010). For example, after two decades of delay, the establishment and operationalization of the special economic zone (SEZ) in Bhairahawa has finally been initiated without the passage of the SEZ Act. Similarly, the ‘one window’ facility for exporters and provisions like ‘no work, no pay’ remain unimplemented. Several institutional arrangements envisaged in the trade and investment policies have not been formed. In a way, there has been policy inconsistencies (instability) and policy implementation paralysis. There is a possibility that the existing set of policies and sectoral promotion strategies may be termed ineffective without first fully implementing them and taking adequate time to evaluate the actual output.

V. Export Opportunities

58. Due to the nature and scope of the FTA with India and the pegged exchange rate, there exists tremendous potential for Nepal’s exporters to cater to the increasing demand for goods and services in India. The five border Indian states—namely Uttarakhand, Uttar Pradesh, Bihar, West Bengal and Sikkim—have a combined population of over 400 million, average real GDP growth of over 7%, and average real per capita income growth of over 6% (except in Uttar Pradesh, which had 5% growth over FY2008-FY2012). Furthermore, along with the agreement to upgrade trade infrastructure at new customs points and to provide assistance to enhance technical skills, a number of outstanding tariff, para-tariff and non-tariff barriers were resolved in December 2013 during the Inter-Governmental Committee meeting between Nepalese and Indian commerce secretaries. This was followed by the ‘Bali package’ agreed during the Ninth Session of the Ministerial Conference of the WTO in January. The Bali package, as a part of the agreement on trade facilitation measures, includes provision for assistance to LDCs to enhance their infrastructure and build capacities of customs administration. On top of

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Footnote: Furthermore, the bilateral trade cost of Nepal with India is the lowest. Compared to the trading cost with India, the bilateral trade cost with Bangladesh, PRC, the UK and the US is 2.9, 2.1, 2.5, 2.3 times higher, respectively. For more on bilateral trade costs, see International Trade Costs by ESCAP and World Bank.
these, PRC and several developed countries, including the US, have accorded duty-free, quota-free entry to almost 97% of exported items.

59. Against this backdrop and the recent weakening of Nepalese rupee against convertible currencies, which makes Nepal’s exports relatively cheaper, there exists opportunities for Nepal to boost exports by addressing some of the supply-side constraints even in the short term. Nepal could better coordinate and utilize Aid for Trade (AfT) offered by development partners to boost not only software but also hardware aspects of trade. Similarly, other trade related technical assistance (TRTA) and the support from Enhanced Integrated Framework (EIF) to enhance sectoral technical, marketing, branding and processing capacities could be fruitful.  

60. To tackle some of the supply-side constraints in the short term, the government needs to ensure proper implementation of some of the provisions outlined in trade and industrial policies, especially those related to the promotion of export-oriented sectors and the 19 sectoral support strategies elaborately detailed in the NTIS 2010.

61. In the long term, an important export product as well as a stimulant to export-oriented sector is energy, particularly hydropower export to India. Nepal’s immense water resource endowment and the potential to sustainably harness them make it a unique export item in itself. Furthermore, the adequate supply of hydroelectricity may substantially reduce the cost of production and also give rise to firms that could operate at various stages of the supply chains. Similarly, tourism is another export service whose further promotion may increase not only visitor inflows, but also revitalize hotel industry and associated businesses. However, this would require adequate upgrading of necessary tourism related infrastructure and services at various key destinations. Nepal ranked 112 out of 140 countries in the Travel & Tourism Competitiveness Report 2013, with even lower ranking in air transport infrastructure (121), ground transport infrastructure (137), tourism infrastructure (130), and ICT infrastructure (127). Encouragingly, Nepal ranks sixth in the world terms of price competitiveness in travel and tourism industry.

62. The other long-term measure to boost export competitiveness includes investment in either construction of new or upgrading of existing road network along the major trade corridors. Also equally important is the strategy to retain workers and develop their skills so that the export-oriented sectors do not face shortage of workers of all skills range. The increase in the cost of production due to high wages could be partially offset by enhancing operational efficiency and productivity of workers. The upgrading of skills could also benefit migrant workers, who would be able to secure semi-skilled to skilled jobs overseas, allowing them to earn more income and remit more money back home. Properly matching skills development to the structure of industry as they evolve according to the

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46 Currently, EIF is supporting value chain development of ginger and pashmina in Nepal.
47 Except for Sikkim, all other four bordering Indian states faced an estimated peak time deficit of 1.200 MW of electricity. Specifically, the peak time deficit in Uttarakhand, Uttar Pradesh, Bihar and West Bengal were approximately 24.3%, 19.1%, 20.2%, and 1.7%, respectively in FY 2013.
48 McKinsey & Company noted that Bangladesh’s garment industry, despite the recent tragedies, has been successful in offsetting rising wage costs by enhancing efficiency and boosting supply capacities. Readymade garment export of Bangladesh accounts for over 10% of GDP and 75% of total exports revenue. See: http://www.mckinsey.com/insights/consumer_and_retail/bangladesh_the_next_hot_spot_in_apparel_sourcing
pace of global value chain development and competition is a key to sustaining manufacturing sector growth in the medium to long term.

63. Regional economic cooperation in areas such as cross-border connectivity, regional trade facilitation measures, and energy trade will help reduce the cost of trade and bring about efficiency gains throughout the production cycle and value chains. Furthermore, more cooperation in trade and investment, and monetary and financial services will help promote exports by facilitating investments in priority sectors and credit flows to high-return sectors. The South Asia Subregional Economic Cooperation (SASEC) initiative—a regional economic cooperation investment-oriented partnership between Bangladesh, Bhutan, India and Nepal—is already working on building multi-modal transport networks and logistics hubs to facilitate trade. Similarly, SASEC is also working on developing a regional energy market, increase energy availability, improve energy trade infrastructure, and create a harmonized legal and regulatory frameworks.

VI. Conclusion

64. To fully utilize the substantial market access concessions it already has and to boost exports, Nepal needs to significantly improve its supply-side capacities. This will require adequately addressing the crippling constraints—lack of adequate and quality infrastructure; political instability and strikes; recurring labor disputes; lack of skilled human resource; deficient research and development; and policy inconsistencies and implementation paralysis—to industrial activities, and a timely and effective implementation of the policies and sectoral strategies that are already in place.

65. The country also needs to properly utilize the technical assistance offered through various financing windows by multilateral and regional trading blocs, and development partners. This will also help boost private sector activities in export-oriented sectors, which is mostly dominated by small and medium enterprises. In the long term, along with improvements in the investment climate, the government will need to substantially increase investment in energy, transport corridors, skills development, technology transfer and adoption, supportive regulatory and institutional frameworks including SEZs, and overall stable macroeconomic environment. These are critical for product and market diversification as well as product sophistication to stay competitive and to make exports an important driver of inclusive growth, which is essential to absorb an estimated 633,000 new entrants annually to the job market by 2020.50

49 For instance, the applied ad valorem tariff on Nepal's iron and steel export to India is zero while India's bound tariff on such imports is, on an average, 25%. Even with this attractive market concession, Nepal's share of iron and steel export in India's total import was just 1.2% in 2010, i.e. India imported US$8.3 billion worth of iron and steel in 2010, but Nepal's share was just US$102 million. Note that this included all iron and steel export of Nepal, meaning that Nepal is unable to fully utilize the existing market concession without boosting its supply capacity of those products in which it has comparative advantage (usually denoted by revealed comparative advantage greater than unity). For more, see: R. Adhikari and C. Sapkota. 2012. A Study on Nepal India Trade. Kathmandu: South Asia Watch on Trade Economics and Environment.

Appendix 1: Highlights of Economic Agenda of Major Political Parties

Prior to the second Constituent Assembly (CA) election on 19 November 2013, the major political parties published their election manifestos, which among others included their economic vision and plans for an accelerated and inclusive economic growth. Following the peaceful election, Nepali Congress (NC) emerged as the party with the highest number of CA representatives, followed by Communist Party of Nepal Unified Marxist and Leninist (CPN-UML), and Unified Communist Party of Nepal (Maoist) [UCPN-M].

The economic agenda of the main three political parties have a lot of similarities. Overall, they agree on a strong economy based on three pillars— namely public, private and cooperatives sectors— and are committed to liberal economic principles with a greater role of the private sector. There is also agreement on the special role of cooperatives in agriculture sector, and the need for foreign direct investment (FDI) and foreign aid to bridge the financing gap, particularly in physical and social infrastructures. The political parties have underscored the importance of a favorable investment climate to facilitate investments in the priority sectors, particularly energy, tourism, agriculture and industry. In energy sector, the political parties’ focus is on meeting the growing energy demand and ending load-shedding in the short term. In agriculture sector, the focus is on modernization, commercialization and diversification of production. In tourism sector, the political parties accentuate the need to build vital tourism infrastructures and to attract domestic as well as foreign visitors. In industry sector, they have committed to promote an investment friendly environment, including cessation of bandhs/strikes. Human resources development with a focus on critical skills to sustain a high growth rate and to generate employment opportunities is also a common feature in the political manifestos. The other common priorities include transport and communications, road and rail networks, and completion of national pride projects.

The highlights of the economic vision and agenda of the three largest political parties are as follows.

**Nepali Congress (NC)**
- Achieve 8-10% GDP growth by creating favorable investment climate and by initiating second phase of industrial reforms. Uplift Nepal to a middle income country within 20 years.
- Raise average per capita income to NRs100,000 per annum (US$1000) in the next five years.
- Reduce agriculture dependent population to 55%. Increase manufacturing sector’s share to 10% of GDP in next five years. Ensure an inclusive economic growth by promoting energy, infrastructure, agriculture, tourism, and industrial sectors.
- End load-shedding in the next three years. Additionally, end load-shedding in industrial areas and Kathmandu in the next two years. Develop national energy security by consulting with all political parties. Generate 5,000 MW of electricity in the next five years.
- Develop a competitive and globally integrated economy. Promote export-oriented and import substituting industries, and construct dry ports inside industrial zones itself. Ensure good industrial relations and promote industries to utilize domestic raw materials and generate employment opportunities.
- Establish at least one chemical fertilizer company under a PPP model in the next five years. Increase year-round irrigated land from 36% of agricultural land to 50% in the next five years. Develop tourism sector as the main foreign currency earner and employment generator, and ensure adequate funding for the development of Lumbini area.
- Develop 20 modern secondary towns along the Mid-hill Highway. Develop Biratnagar, Hetauda and Nepalgunj as industrial cities; Birgunj as a commercial city; Bharatpur as a medical city; Butwal-Bhairahawa as tourist cities; Dhangadi as a green city; Pokhara as a film and tourist city; and Dhulikhel-Banepa as educational and medical cities.
• Address barriers constraining access to education/skills, and access to financial and capital markets.
• Guarantee 100 days of employment per year a member of a household living below the poverty line.
• Build modern, 21st century infrastructure through reliable road, railway, airport and communication networks. Connect each Village Development Committee with all-weather roads. Complete Postal Highway, Mid-hill Highway, and Kathmandu Niijgarh Fast Track roads in the next five years.
• Gradually reduce dependence on foreign aid by strengthening internal revenue system. Foreign aid to be mobilized in national pride projects and infrastructure development, commercialization of agriculture and development of skilled human resources as well as technology transfer.

Communist Party of Nepal (CPN-UML)
• Uplift Nepal from Least Developed Country (LDC) category to a developing country status in the next five years by making substantial progress in per capita income, social and infrastructure development, and human development indicators.
• Distribute NRs5 million grant to each Village Development Committee.
• Guarantee housing to 0.5 million homeless people in the next five years and ensure zero homeless people in 10 years’ time.
• Absorb at least 300,000 new entrants to the job market by creating employment opportunities.
• Reduce maternal mortality rate to zero in the next five years.
• End load-shedding, ensure universal access to energy, and connect all district headquarters with electricity grid in the next five years.
• Connect all district headquarters with blacktopped all seasons road and ensure road access to at least 95% of settlement in the next five years. Complete Upper Karnali, West Seti, Budi Gandaki, Upper Marsyangdi, Lower Arun, Tamakoshi III, Arun III, and Upper Tamor hydropower projects in the next 10 years by involving the private sector.
• Develop one model village and ensure facilities at par with those available in developing countries.
• Initiate construction of an international airport in Niijgarh, and finish construction of regional airports in Bhairahawa and Pokhara in the next five years. Increase the number of visitors to two million.
• Ensure good industrial relations and ensure labor security through contribution based Social Security Fund. Promote domestic and foreign investment, and develop export-oriented industries that use domestic raw materials.
• Human resources development through technical and scientific education, and integrated skills development training.

United Communist Party of Nepal (Maoist) [UCPN-M]
• Uplift Nepal from LDCs to a middle income country within 20 years and a developed country within 40 years. Increase annual per capita income to $1,400 within 5 years, $3,300 in 10 years, $10,700 in 20 years, and $40,000 in 40 years.
• Employment and production centric double-digit growth and in 15 years attain self-sufficiency with shared prosperity. Achieve 7.9% growth in the first five years, and 11%, 12.4% and 12.2% growth in the next 10, 20 and 30 years.
• Formulate action plan for rapid modernization and commercialization of agriculture sector; develop hydropower and energy with utmost priority and as a national campaign; and develop road, railway, ropeway, airport, canal and large physical infrastructure to achieve double digit growth.
• End load-shedding in the next three years. Develop 10,000 MW, 20,000 MW, and 25,000 MW of electricity in the next 10, 20, and 40 years. The ratio of reservoir to run-of-river projects to be maintained at 30:70. Ensure universal access to electricity within 10 years. Achieve an average 13.2% growth in industry, hydropower and construction sectors.
• Raise Nepal’s Human Development Index score to 0.781 from the current 0.462.
• Ensure two-thirds investments from private sector by attracting domestic and foreign investors. Gradually increase domestic investment to completely substitute foreign loans in 40 years.
• Ensure 180 days of employment to a member of each household living below the poverty line.
Appendix 2: Major Highlights of Agriculture Census 2011/12

The Central Bureau of Statistics (CBS) released the National Sample Census of Agriculture Nepal 2011/12 in December 2013. The decennial census shows the major trends in the agriculture sector and choices of agricultural households. About 83% of farmers’ main source of income comes from agriculture, and there are 3.8 million holdings in the country, up from 3.3 million in FY2002.

The average area of holding is decreasing, indicating a faster rate of increase in total number of holdings than the total area of holdings.

Cropping intensity is increasing as farmers may be using the same piece of land, subject to the planting cycle of crops and cropping season, many times for planting crops.

River/lake/pond is the largest source of irrigation.

The number of households growing vegetables increased by 97.6%. Plantation area of vegetables, potato, other cash crops and spices increased between FY2002 and FY2012.
The number of goats far outpaces the number of all other livestock. The share of agricultural households taking loans to finance farming operations has decreased to 22%.

Credit from non-institutional or informal sources is the main source of loans.

Majority of the agricultural households still use local seeds.

About 41.8% of agricultural households reported the need for agricultural loan primarily to start livestock/poultry farming and to purchase agricultural inputs.

The largest quantity of minerals and chemical fertilizers is used for paddy production.

Source: National Sample Census of Agriculture Nepal 2011/12, Central Bureau of Statistics
# Appendix 3: Country Economic Indicators

<table>
<thead>
<tr>
<th>Item</th>
<th>Fiscal Year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2009</td>
</tr>
<tr>
<td><strong>A. Income and Growth</strong></td>
<td></td>
</tr>
<tr>
<td>1. GDP per Capita ($, current)</td>
<td>498</td>
</tr>
<tr>
<td>2. GDP Growth (% in basic prices)</td>
<td>3.9</td>
</tr>
<tr>
<td>a. Agriculture</td>
<td>3.0</td>
</tr>
<tr>
<td>b. Industry</td>
<td>(0.6)</td>
</tr>
<tr>
<td>c. Services</td>
<td>6.0</td>
</tr>
<tr>
<td><strong>B. Saving and Investment (current and market prices, % of GDP)</strong></td>
<td></td>
</tr>
<tr>
<td>1. Gross Domestic Investment</td>
<td>31.7</td>
</tr>
<tr>
<td>2. Gross National Saving</td>
<td>35.9</td>
</tr>
<tr>
<td><strong>C. Money and Inflation</strong></td>
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</tr>
<tr>
<td>1. Consumer Price Index (average annual % change)</td>
<td>12.6</td>
</tr>
<tr>
<td>2. Total Liquidity (M2) (annual % change)</td>
<td>27.0</td>
</tr>
<tr>
<td><strong>D. Government Finance (% of GDP)</strong></td>
<td></td>
</tr>
<tr>
<td>1. Revenue and Grants</td>
<td>16.7</td>
</tr>
<tr>
<td>2. Expenditure and Onlending</td>
<td>20.0</td>
</tr>
<tr>
<td>3. Overall Fiscal Surplus (Deficit)</td>
<td>(3.3)</td>
</tr>
<tr>
<td><strong>E. Balance of Payments</strong></td>
<td></td>
</tr>
<tr>
<td>1. Merchandise Trade Balance (% of GDP)</td>
<td>(21.2)</td>
</tr>
<tr>
<td>2. Current Account Balance (% of GDP)</td>
<td>4.2</td>
</tr>
<tr>
<td>3. Merchandise Export ($) Growth (annual % change)</td>
<td>(4.7)</td>
</tr>
<tr>
<td>4. Merchandise Import ($) Growth (annual % change)</td>
<td>8.3</td>
</tr>
<tr>
<td>5. Remittances (% of GDP)</td>
<td>21.5</td>
</tr>
<tr>
<td><strong>F. External Payments Indicators</strong></td>
<td></td>
</tr>
<tr>
<td>1. Gross Official Reserves ($ million)</td>
<td>3671.2</td>
</tr>
<tr>
<td>Months of current year’s imports of goods</td>
<td>9.8</td>
</tr>
<tr>
<td>2. External Debt Service (% of exports of goods and services)</td>
<td>10.2</td>
</tr>
<tr>
<td>3. Total External Debt (% of GDP)</td>
<td>27.6</td>
</tr>
<tr>
<td><strong>G. Memorandum Items</strong></td>
<td></td>
</tr>
<tr>
<td>1. GDP (current prices, NRs billion)</td>
<td>988.3</td>
</tr>
<tr>
<td>2. Exchange Rate (NRs/$, average)</td>
<td>76.6</td>
</tr>
<tr>
<td>3. Population (million)</td>
<td>25.9</td>
</tr>
</tbody>
</table>


GDP = gross domestic product

- a Based on FY2013 National Accounts Statistics. Central Bureau of Statistics
- b Based on FY2013 annual data. Nepal Rastra Bank
- c Based on FY2014 Budget Speech. Ministry of Finance
- d Based on FY2013 annual data. Financial Comptroller General Office

## Appendix 4: Country Poverty and Social Indicators

<table>
<thead>
<tr>
<th>Item</th>
<th>1990s</th>
<th>2000s</th>
<th>Latest Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Population Indicators</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Population growth (annual % change)</td>
<td>2.1</td>
<td>2.2</td>
<td>1.4 (2011)</td>
</tr>
<tr>
<td>B. Social Indicators</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Infant mortality rate (below 1 year/1,000 live births)</td>
<td>82.0 (1991)</td>
<td>48.0 (2006)</td>
<td>46.0 (2011)</td>
</tr>
<tr>
<td>4. Life expectancy at birth (years)</td>
<td>55.0 (1991)</td>
<td>62.0 (2001)</td>
<td>68.8 (2011)</td>
</tr>
<tr>
<td>a. Female</td>
<td>54.0 (1991)</td>
<td>63.0 (2001)</td>
<td>70.0 (2011)</td>
</tr>
<tr>
<td>b. Male</td>
<td>55.0 (1991)</td>
<td>62.0 (2001)</td>
<td>68.0 (2011)</td>
</tr>
<tr>
<td>6. Primary school gross enrollment (%)</td>
<td>57.0 (1996)</td>
<td>72.0 (2004)</td>
<td>122.0 (2011)</td>
</tr>
<tr>
<td>8. Child malnutrition (% below 5 years old)</td>
<td>57.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10. Population with access to safe water (%)</td>
<td>45.9</td>
<td>82.5 (2006)</td>
<td>84.0 (2013)</td>
</tr>
<tr>
<td>13. Human development index</td>
<td>0.341</td>
<td>0.429 (2005)</td>
<td>0.463 (2012)</td>
</tr>
<tr>
<td>15. Gender-related development index</td>
<td>0.33 (1995)</td>
<td>0.511 (2003)</td>
<td>0.485 (2012)</td>
</tr>
<tr>
<td>C. Poverty Indicators</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Proportion of poor to total population</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>c. Mountain</td>
<td>57.0 (1996)</td>
<td>32.6 (2004)</td>
<td>42.77 (2011)</td>
</tr>
<tr>
<td>5. Inequality (Theil Index)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Multidimensional poverty index</td>
<td></td>
<td></td>
<td></td>
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</tbody>
</table>

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… = not available, GDP = gross domestic product,

Sources:

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