

NEPAL

ECONOMY IN DISARRAY: CHALLENGES AND CONCERNS

SUBODH CHANDRA BHARTI

INTRODUCTION

Nepal, influenced by domestic imperatives and global trends, underwent significant transformations towards democratisation and economic liberalisation in the 1990s. It marked the beginning of a transition that has spanned over three decades.¹ Over the course of the past 34 years, Nepal has experienced frequent changes in government, characterised by numerous coalition shifts and short-term Cabinets. Additionally, the nation has grappled with social unrest, including ethnic agitations, and endured natural disasters such as floods, earthquakes, and the recent global pandemic COVID-19. Despite pursuing economic

Dr **Subodh Chandra Bharti** is a Research Associate at the Indian Council of World Affairs, New Delhi.

1. Nepal has navigated multiple shifts, including the restoration of multi-party democracy in 1990, accelerated economic liberalisation during the 1990s and 2000s, the Maoist insurgency from 1996 to 2006, the abolition of the monarchy and the establishment of a federal republic in 2008, Constituent Assembly elections in 2008 and 2013 along with Constitution-making processes. This culminated in the establishment of a federal Parliament and seven provincial governments in 2018 after the federal elections in 2017-18.

liberalisation and reforms, Nepal has struggled to achieve sustained progress due to persistent social and political instability. In recent years, Nepal's economy has shown signs of distress and potential disarray. This write-up aims to explore the challenges and concerns surrounding Nepal's economic situation and the underlying factors contributing to the current state of the economy.

NEPAL'S ECONOMY AND THE MAJOR SECTORS OF GROWTH

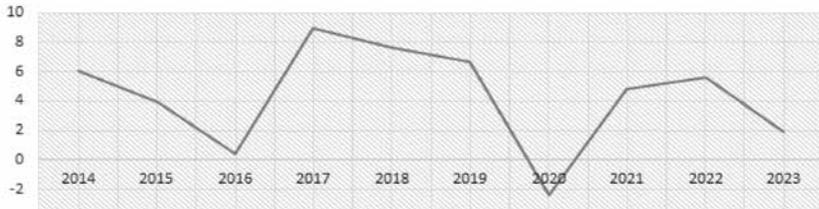
Nepal's economy has historically been reliant on agriculture, with approximately 90 per cent of its population engaged in the agricultural sector during the 1950s. According to the Agriculture Census of 2021/22, at present, around 67 per cent of Nepal's population is dependent on agriculture.² However, despite this high level of engagement, the agricultural sector's contribution to the Gross Domestic Product (GDP) stands at a modest 24.12 per cent, while the industry and service sectors contributed 13.45 per cent and 62.43 per cent respectively in Fiscal Year (FY) 2022-23.³ Nepal's economy underwent a gradual shift towards services, particularly remittances and tourism, following accelerated economic liberalisation since the 1990s.⁴ The industrial sector, however, has not played a significant role in the country's economy in terms of its GDP contribution. This stagnation in the agricultural sector and slow growth in the industrial sector can be attributed to persistent political instability, leading to policy volatility in Nepal.

In the recent past, Nepal has encountered fluctuating GDP growth rates. This is evidenced by data obtained from the World Bank (see Fig 1). Over the past ten years, the Nepalese economy has been significantly impacted by various events, including persistent political instability leading to policy volatility, the April 2015 earthquake, the September 2015 ethnic uprising and economic blockade, and the unprecedented challenges stemming from the

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2. National Statistics Office (Government of Nepal), "National Sample Census of Agriculture Nepal 2021/22", August 2023, [https://agricensusnepal.gov.np/upload_file/files/post/1694250757_1312300734_National%20Sample%20Census%20of%20Agriculture%202021_22%20\(National%20Report\).indd.pdf](https://agricensusnepal.gov.np/upload_file/files/post/1694250757_1312300734_National%20Sample%20Census%20of%20Agriculture%202021_22%20(National%20Report).indd.pdf). Accessed on July 11, 2024.
 3. Nepal Rastra Bank, "Annual Report Fiscal Year 2022-2023", 2024, <https://www.nrb.org.np/contents/uploads/2024/03/Annual-Report-2022-23-English.pdf>. Accessed on July 7, 2024.
 4. Subodh C. Bharti, "Economic Liberalisation and Shifts in Foreign Policy of Nepal", PhD thesis, Jawaharlal Nehru University, 2023.

COVID-19 pandemic. These occurrences have notably disrupted trade, tourism, and Nepal’s overall economic environment, resulting in a noticeable decline in the GDP growth rate, as depicted in Fig 1.

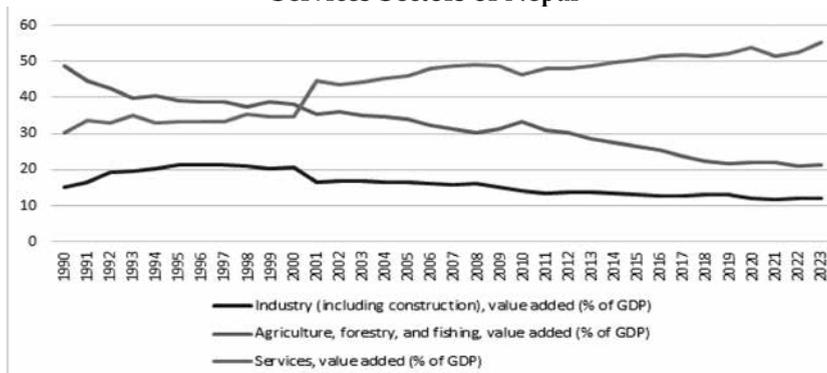
Fig 1: GDP Growth (Annual %)



Source: Prepared by the author based on the data retrieved from the World Development Indicators, World Bank, n.d.

According to data retrieved from the World Bank, over the past 34 years, there has been a noticeable decline in the contribution of the agricultural sector to Nepal’s GDP, accompanied by a significant rise in the services sector. Concurrently, the industrial sector has experienced fluctuations, declines, and stagnation in its growth, as depicted in Fig 2.

Fig 2: GDP % Share of Agriculture, Industry and Services Sectors of Nepal



Source: Prepared by the Author based on the data retrieved from the World Development Indicators, World Bank, n.d.

The Asian Development Bank (ADB) forecasts an acceleration in Nepal's economic growth for FY 2024 and 2025. This growth is expected to be driven by increased domestic demand, amplified hydroelectric output, and a sustained recovery in the tourism sector.⁵ However, the outcome is contingent upon political and policy stability, as well as Nepal's capacity to capitalise on the hydropower and tourism sectors.

UNDERSTANDING THE ECONOMIC CHALLENGES AND CONCERNS IN NEPAL

In the recent past, Nepal has encountered an array of daunting challenges and issues within its political economy, contributing to a state of disarray. These challenges encompass persistent political instability, leading to policy fluctuations due to frequent changes in governance and leadership. The resultant instability has effectively impeded long-term economic planning and development.

Financial Sector

According to the International Monetary Fund (IMF) report, the potential weaknesses in the Nepalese financial sector are growing as banks experience capital challenges caused by the surge in post-pandemic borrowing. Lending practices are evolving, leading to a shift towards term lending and a review of client connections, but also resulting in a rise in gross Non-Performing Loans (NPLs). The decline in the real estate market has affected loan performance and the banks' ability to sell repossessed assets, contributing to higher NPLs and decreased bank profitability.⁶ In addition, according to the IMF report, despite some recovery, tax collection remains below pre-pandemic levels, limiting fiscal space for development spending.⁷

5. Asian Development Bank, "Asian Development Outlook April 2024", 2024, <https://www.adb.org/sites/default/files/publication/957856/asian-development-outlook-april-2024.pdf>. Accessed on July 7, 2024.

6. International Monetary Fund, "Nepal Fourth Review Under The Extended Credit Facility Arrangement—Press Release; Staff Report; And Statement by the Executive Director For Nepal", IMF Country Report No. 24/225, July 15, 2024, <https://www.imf.org/en/Publications/CR/Issues/2024/07/15/Nepal-Fourth-Review-Under-the-Extended-Credit-Facility-Arrangement-Press-Release-Staff-551887>. Accessed on July 17, 2024.

7. Ibid.

Furthermore, in recent years, Nepal has witnessed a sustained escalation in its external debt, particularly since 2018. As of mid-July 2023, Nepal's external debt amounted to NPR (Nepalese Rupee) 1170.25 billion, signifying approximately 22 per cent of the GDP.⁸ This presents another concern for the Nepalese economy.

Remittances

Nepal's heavy dependence on remittances from Nepali workers abroad plays a significant role in supporting many households. However, this reliance reflects a potentially unstable and unsustainable dependency. Notably, Nepal's GDP has seen a marked increase in the proportion of remittances, accounting for approximately 26 per cent of the total GDP.⁹ The increase in migration from Nepal presents initial benefits but raises concerns regarding the country's growing reliance on remittances. This reliance is not conducive to long-term sustainability and makes the country vulnerable to external shocks. It has also contributed to a phenomenon known as brain drain, where numerous young individuals are departing from the nation in pursuit of opportunities overseas. Additionally, educated and highly skilled individuals are increasingly seeking work abroad.¹⁰ The negative impact of losing skilled individuals is a real concern. This trend could create a dangerous cycle where a poor domestic business and investment climate drives high-skilled people abroad, while the lack of high-skilled workers contributes to the poor climate, limiting the potential for reform and growth.¹¹

8. Nepal Rastra Bank, "Nepal Survey Report on Foreign Direct Investment in Nepal (2021/2022)", September 2023, <https://www.nrb.org.np/contents/uploads/2023/09/FDI-Survey-2021-22-2.pdf>. Accessed April 16, 2024.

9. International Organisation for Migration, "Nepal on the Right Track to Achieve Cost-effective Remittance Transfers", June 14, 2024, <https://roasiapacific.iom.int/news/nepal-right-track-achieve-cost-effective-remittance-transfers#:~:text=For%20instance%2C%20in%202023%2C%20Nepal,assistance%20and%20foreign%20direct%20investment>. Accessed on July 15, 2024.

10. Paras Kharel, "Remittance as Development Resource: Experience of Nepal", n.d., <https://www.unescap.org/sites/default/d8files/Remittance-as-development-resource.pdf>. Accessed on July 7, 2024.

11. Ibid; and Aashiyana Adhikari, "Exporting Talent, Importing Cash: Nepal, Youth Migration and Remittances", May 13, 2024, blogs.lse.ac.uk/southasia/2024/05/13/exporting-talent-importing-cash-nepal-youth-migration-and-remittances/. Accessed on July 07, 2024.

The substantial dependence on remittances has steered Nepal towards a consumer-driven economy, leaving it vulnerable to abrupt crises, as demonstrated during the challenging period of the COVID-19 pandemic, when the Nepalese economy exhibited signs of strain.

Trade

Nepal's trade is crucial to its economy, accounting for around 49 per cent of the GDP in 2022. However, the country's trade deficit remains significant due to political instability and policy inefficiency. This has led to a lack of investment and weak implementation of export-oriented policies in key sectors.¹² Recently, concerns have been raised about Nepal's declining exports compared to imports in recent decades, attributed to a "collapse in its top export products".¹³ According to the Nepal Rastra Bank (NRB) report, in FY 2022-23, Nepal's exports decreased by 21.4 per cent to NPR 157.14 billion.¹⁴

The fluctuations in Nepal's exports suggest historical trade policy challenges. Nepal faces a significant trade deficit and has yet to fully leverage its expertise in products such as woollen carpets, pashmina, and medicinal plants. The country's size and limited resources are key factors contributing to its trade deficit in goods. However, there is potential for expansion in the services sector, which could help mitigate the trade imbalance.¹⁵

Notably, Nepal's primary export destinations include India, the USA, Germany, Türkiye, and the UK, while the country mainly imports from India, China, Indonesia, the United Arab Emirates, and Argentina.¹⁶

Foreign Direct Investment

The Foreign Direct Investment (FDI) data of the past decade indicates that despite the liberal reforms in the investment sector of Nepal, it

12. Bharti, n. 4, pp. 125, 171.

13. Rishi R. Sharma, "An Anatomy of Nepal's Remarkable Export Decline: A Note", *Journal of Asian Economics*, vol. 89, December 2023, 101663, <https://doi.org/10.1016/j.asieco.2023.101663>.

14. n. 3.

15. Bharti, n. 4, p. 122.

16. Department of Customs, Ministry of Finance (Government of Nepal), "Nepal Foreign Trade Statistics: Fiscal Year 2022/23 (2079/80)", 2023, Annual Foreign Trade Statistics Book 2079-80.pdf (customs.gov.np). Accessed on July 17, 2024.

could not achieve the desired goal of attracting foreign investments. FDI's GDP share could not even cross 1 per cent of the total GDP of Nepal ever.¹⁷ The latest FDI survey report published by the NRB points to a significant gap between FDI commitments and actual net inflows. As per the NRB data, between FY 1995–96 and 2021–22, the total actual net FDI inflow stood at around 36.2 per cent of the total approval.¹⁸ The FDI environment in Nepal is unfavourable due to a lengthy approval process, time-consuming profit repatriation, and weak copyright laws. Additionally, and most importantly, the everlasting political instability has majorly hampered foreign investors from investing in Nepal.¹⁹

According to data spanning FY 2012-13 to 2020-21, the primary source countries of foreign investment in Nepal were China, India, the USA, South Korea, Japan, the UK, the Netherlands, Bangladesh, Australia, and Russia. However, a notable downturn in foreign investment occurred due to the global impact of the COVID-19 pandemic²⁰ and the uncertainty created by the constant political jolts in Nepal.

Other Challenges and Concerns

Corruption is a major concern in Nepal, eroding trust in institutions, distorting economic decision-making, and obstructing development efforts. The integrity of political and social-institutions has been significantly impacted, leading to an increase in dishonest practices. Media reports have revealed numerous scandals and financial irregularities over the past decade, including substantial kickbacks linking diplomats, political leaders, and individuals to the financial support of corrupt politicians and parties. Prominent figures such as prime ministers, Cabinet ministers, bureaucrats and businessmen, have frequently been implicated in these improper activities.

Additionally, Nepal is susceptible to natural disasters such as earthquakes, landslides, and floods, which have the potential to devastate communities and disrupt economic activities. Nepal has

17. Bharti, n. 4, p. 111.

18. Nepal Rastra Bank, "Nepal Survey Report on Foreign Direct Investment in Nepal (2021/2022)", 2023, <https://www.nrb.org.np/contents/uploads/2023/09/FDI-Survey-2021-22-2.pdf>. Accessed on April 16, 2024.

19. Bharti, n. 4, p. 111

20. *Ibid.*, 112.

experienced numerous catastrophic natural events, such as the 2015 earthquake, annual heavy flooding in the southern plains, and ensuing landslides in the hills. These events have caused significant damage to infrastructure, loss of human lives, and depletion of resources, consequently hindering Nepal's development. The need to build resilience against these disasters remains a formidable challenge. Substantial disparities in income, access to services, and opportunities persist among different segments of Nepali society, highlighting the imperative to address these inequalities for sustainable development.

Moreover, Nepal's geopolitical position between India and China exerts influence on its economic and political dynamics, presenting the delicate challenge of balancing relations with these major powers while asserting its sovereignty. Nepal's endorsement of China's ambitious and strategic Belt and Road Initiative (BRI) framework agreement in 2017 has strengthened China's influence in Nepal concerning political and strategic objectives. The implementation plan for the BRI is pending ratification. Nepal has expressed hesitancy in participating in BRI projects that require funding through loans²¹ due to apprehensions about accumulating unsustainable debt. The current unease is supported by the challenges encountered in Sri Lanka, an economic crisis in Lao PDR, and concurrent studies and reports indicating that Pakistan may confront similar issues.

Likewise, more recently, there has been an increase in the United States' engagement with Nepal, partly influenced by China's expanding presence in the South Asian region. The endorsement of the Millennium Challenge Corporation (MCC) serves as a manifestation of this heightened engagement. Additionally, there are some prevalent political perspectives in Nepal suggesting that the US is actively pursuing Nepal as a key component of its Indo-Pacific Strategy and aims to establish military engagement.²²

21. Purushottam Poudel, "Congress Insists on Grants, not Loans for Funding BRI Projects", *The Kathmandu Post*, July 2, 2024, <https://kathmandupost.com/politics/2024/07/02/congress-insists-on-grants-not-loans-for-funding-bri-projects>. Accessed on July 12, 2024.

22. Naresh Kumar, "Nepal, MCC and the US' Indo-Pacific Strategy", *Indian Council of World Affairs*, October 29, 2021, https://www.icwa.in/show_content.php?lang=1&level=3&ls_id=6519&lid=4480. Accessed on July 29, 2024

Lastly, Nepal is making strides towards its projected graduation from the Least Developed Country (LDC) category in 2026. This transition has been a key focus for the government since 2010. Currently, Nepal is in the transition period spanning from 2021 to 2026 and retains its status as an LDC, and is entitled to receive all associated benefits. However, after graduation, Nepal will no longer be eligible for the preferential treatment and privileges accorded to LDCs, such as lower or zero tariffs on exports, concessional loans, and grants.

ECONOMIC RELATIONS WITH INDIA

India plays a crucial role in the economic initiatives of Nepal, helping as a key partner in development cooperation across diverse sectors. Since the late 1940s, Nepal has actively sought economic and technical support from India.²³ In addition, it has also been seeking assistance from India in its planned development.²⁴ India's development cooperation in Nepal largely encompasses manufacturing, infrastructure, hydropower, and tourism.²⁵ Furthermore, India represents a significant market for Nepalese agricultural and manufacturing goods and serves as a destination for labour migration.²⁶ Notably, a burgeoning partnership in the hydropower sector has emerged between the two countries in recent times. Nepal's developmental collaboration with India is distinct from its engagement with other nations due to its particular nature.²⁷ The pegging of the Nepalese currency to the Indian currency has brought stability to the value of Nepal's currency, acting as a protection against fluctuations.²⁸ Besides, Nepal's proposed hydropower export to Bangladesh necessitates a transmission line through Indian

23. Subodh C Bharti, "Nepal Investment Summit and the Development Aspirations of Nepal", Indian Council of World Affairs, May 3, 2024, https://www.icwa.in/show_content.php?lang=1&level=3&ls_id=10817&lid=6881#_edn19. Accessed on July 19, 2024; and Bharti, n. 4, p. 96.

24. Hari Bansh Jha, "India's continuing role in Nepal's economic development", Observer Research Foundation (ORF), July 31, 2020, <https://www.orfonline.org/expert-speak/india-continuing-role-nepal-economic-development>. Accessed on July 29, 2024.

25. Bharti, n. 4, pp. 128-132

26. Bharti, n. 23.

27. Ibid.

28. Jha, n. 24.

territory. There is a trilateral power exchange agreement in the pipeline.²⁹ The signing of the trilateral agreement will facilitate cross-border energy trade in the South Asia and Bangladesh-Bhutan-India-Nepal Initiative (BBIN) subregions, making it a unique, first-of-its-kind initiative.

In addition, India provides duty-free, quota-free access to its market for almost all Nepalese goods and also provides access to its two seaports, Haldia (Kolkata) and Vishakhapatnam, to Nepalese overseas trade.³⁰ The majority of Nepal's third-country trade passes through Indian land, with access via Kolkata (Haldia) and Vishakhapatnam ports.

Besides, India is Nepal's largest trading partner, accounting for more than 60 per cent of the country's trade. The recent commencement of hydropower exports to India, as well as its potential for growth, could help alleviate Nepal's trade deficit with India. India's developmental collaboration with Nepal plays a pivotal role in Nepal's efforts to attract foreign investment and expand its foreign trade and commerce. Given that foreign investors typically seek accessible markets for their investment ventures, India appears to be the largest market and transit provider to most of Nepal's overseas trade. Significant aspects of Nepal's economic development, including trade, investment, tourism, hydropower, agriculture, and services, are reliant on its relationship with India and the infrastructure connecting the two countries.

India's commitment to its 'Neighbourhood First Policy' underscores Nepal's paramount importance in its diplomatic and strategic pursuits, positioning it as a key priority in the region. This approach seeks to establish harmonious, stable, and forward-looking environments that foster mutual prosperity and development. India has consistently extended support to Nepal in its development endeavours, providing aid and assistance as needed and being the first to respond in times of necessity.

29. South Asia Subregional Economic Cooperation (SASEC), "Landmark Bangladesh-India-Nepal Energy Agreement in Final Discussion", June 29, 2023, <https://www.sasec.asia/index.php?page=news&nid=1509&url=bin-trilateral-energy>. Accessed on April 17, 2024.

30. Subodh C Bharti, "Nepal's Accession to the WTO: Challenges and Implications for Trade Policy and Trends", M. Phil. Dissertation, Jawaharlal Nehru University, 2018.

Amidst the frequent coalition changes and political instability, all the governments formed in Kathmandu have consistently underscored India's significance for Nepal's economic growth and overall development. Consequently, they have made concerted efforts to maintain positive relations and seek developmental support. Given the new coalition government formed in July 2024, the recent high-level visit of Nepalese Foreign Minister Arzu Rana Deuba to India in August 2024 underscores Nepal's dedication to enhancing its ties with India. The visit particularly emphasised the pursuit of development cooperation and an eagerness to broaden the scope of collaboration.³¹

CONCLUSION

Nepal's economy is confronted with a multitude of challenges and issues that have contributed to its current state of disarray. The ongoing and protracted transitions have significantly impacted the nation. Addressing these challenges necessitates a concerted focus on governance and policy reforms, infrastructure development, anti-corruption measures, promotion of inclusive growth, and building resilience against natural disasters. Political stability and effective leadership are imperative for navigating these intricacies and guiding Nepal towards sustainable development. Further, Nepal must strategically realign and actively engage with its reliable international development partners. Doing so is crucial to mitigate further adverse effects of economic challenges.

31. Subodh C Bharti, "The Recent High-Level Visit: Revitalising India-Nepal Relations", Indian Council of World Affairs, September 11, 2024, https://www.icwa.in/show_content.php?lang=1&level=3&ls_id=11780&lid=7171. Accessed on September 12, 2024.