

COUNTRY REVIEW

Nepal



8 April 2010

ANALYST: Andrew Atkinson

EULER HERMES COUNTRY RISK GRADE: D

**Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.**

COUNTRY PROFILE

Capital city:	Kathmandu
GDP:	USD12.61bn (2008e)
Population:	28.8mn (2008e)
GDP per capita:	USD438 (2008e)
Currency:	Rupee (NPR)
Form of state:	Republic
Head of government:	PM Madhav Kumar Nepal
Next elections:	To be scheduled; a draft constitution is expected in May 2010

Following the twin attacks from a prolonged rebellion of militant Maoist insurgents and sometimes violent pro-democracy street protests, the country became largely ungovernable under its traditional monarchy. King Gyanendra was forced to relinquish the throne and ceded power to a seven-party interim government in April 2006. The transition to a new government—which had to encompass negotiations between the Maoist rebels, political parties and individuals and organisations loyal to the monarchy—has been problematic, engendering an economic and business environment unsuitable to effective development. Elections for a constituent assembly in April 2008 were the first of any sort in nine years and indicated that the **Maoists would have a strong determining voice in the creation of a new political system**. A coalition government led by the Unified Communist Party of Nepal (Maoist)—UCPN (M)—collapsed in May 2009 and the current government is an unwieldy 22-party coalition led by the Communist Party of Nepal (Unified Marxist-Leninist)—CPN (UML)—and the Nepali Congress (NC). Against this background, there is **little evidence that politicians have the administrative capacity to govern or that they can forge regional harmony** with neighbouring states. India, the regional superpower, has its own Maoist insurgents and is concerned that their success in Nepal may foment further internal troubles.

Successive weak governments have failed to tackle successfully structural weaknesses and 30% of the population remains below the poverty line according to the World Bank. Nepal remains a largely agrarian economy (**farming accounts for over 30% of GDP**), but is reliant on expansion in non-agricultural sectors to fuel overall growth. However, a combination of deteriorating internal security and external shocks has limited growth in **tourism and workers' remittances, the other significant economic drivers**, and hampered GDP expansion. **Real annual GDP growth increased by 5% in 1991-2001 but we estimate that it averaged below 2% in 2002-08**. Subject to improved political stability and security, the economy could expand by **around 4% this year and in 2011**.

Economic development will remain subject to political uncertainties and structural deficiencies—in addition to high transport costs because of the landlocked nature of the country, **oil accounts for almost 20% of the import bill** and periods of high energy prices result in overall external deficits and drawdowns on limited FX reserves. There is also concern that the small (but significant for the country's FX generation) domestic clothing sector has been unable to compete with major producers (such as China) following expiry of the Multi-Fibre Arrangement at the beginning of 2005.

The business environment is weak. Transparency International's Corruption Perceptions Index for 2009 ranks Nepal 143 out of 180 countries surveyed, below Pakistan, Philippines and Azerbaijan. The Heritage Foundation's 2010 Index of Economic Freedom (IEF) classifies Nepal as "mostly unfree" and ranks it 130 out of 179 countries covered, below Papua New Guinea, Tajikistan and Niger. The IEF suggests that restrictions on foreign investment deter private sector development and inward capital flows, while regulations are enforced by a perceived inefficient and corrupt bureaucracy. Moreover, property rights are generally not supported by the judiciary, which is considered to be subject to political influence. Financial regulation is rudimentary and does not meet international standards. State-controlled banks account for over 30% of total bank assets and over half of the number of bank branches and such institutions are reported to have a large number of NPLs.

Andrew Atkinson

London: +44 (0)20 7860 2577