

# Nepal Sector Competitiveness Notes

DECEMBER 2018



**THE WORLD BANK**  
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## Executive Summary<sup>1</sup>

**The Government of Nepal (GoN) needs to foster new drivers of economic growth and competitiveness if it is to meet its objective of achieving middle-income status by 2030.** Over the past decade, Nepal has been growing at an average of 4 percent—the slowest rate in the South Asia region—and has a relatively low rate of participation in regional and global value chains (GVCs) compared to peers. Yet, Nepal sits strategically between two of the world's fastest growing economies, China and India, enjoys preferential access to many of the world's top importing countries, and boasts a country image famed for its natural beauty and rugged landscapes. This provides opportunities for greater participation and integration into global markets.

**The GoN laid out an ambitious plan for economic development in the 2016 Nepal Trade Integration Strategy (NTIS).** The NTIS prioritized twelve sectors positioned or with the potential for export-led growth. Objectives and priority actions were identified for each sector, including for cross-cutting issues affecting all sectors. At the request of the GoN, three of these sectors were selected for analysis. Sector notes have been prepared for Footwear and Information and Communication Technology (ICT), and a detailed strategic segmentation analysis was undertaken for Medicinal and Aromatic Plants (MAPs). The sector studies informed the *Nepal Country Private Sector Country Diagnostic* (CPSD), which was recently published in November 2018.

**The sectors chosen for the study are representative, to a large degree, of a wider range of industries.** The analysis on Footwear is illustrative of the broader sector of light manufacturing, and similar industries can draw from the findings and recommendations of this study. Similarly, the ICT study is useful for understanding the competitiveness of modern services including business services in Nepal, while the MAPs value chain analysis highlights the many constraints and opportunities for other agribusiness value chains in general in Nepal.

**The three sectors analyzed vary in terms of their current levels of competitiveness.** Nepal's footwear industry is small (worth about US\$278.1 million) but growing at a rate of roughly 20 percent a year. Total footwear exports by value were just US\$11.1 million in 2017, accounting for just 1.5 percent of the country's total exports and less than one-hundredth of one percent of the global footwear market by value. Most domestic firms are currently very small with low productivity and using dated production processes. Nepal's ICT services are nascent and largely located in Kathmandu with only a few firms operating formally. While most firms offer outsourced software development services to international clients (such as back office business process outsourcing (BPO) functions, data analytics, document digitization services, web and mobile applications development), some ICT firms also provide product-based solutions in financial technology solutions, digital marketing and specialized software.

**Nepal has the potential to tap into growing world demand for MAPs given the natural endowments in terms of endemic MAPs and the country's long history of traditional medicine.** While Nepal currently does not hold a significant share of global markets for MAPs, MAPs are relatively more important in Nepal's export basket compared with other countries. The number of processors located in Nepal has grown significantly in the past decade, but establishing long-term trade relationships in export markets has proven to be a challenge. Presently, Nepal primarily competes in the segment of raw and unbranded MAPs for the non-discerning user. This segment has minimal value addition and a high degree of global

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competition. The MAPs sector analysis identifies two segments where Nepal has the potential to compete successfully in the medium term: (i) lightly processed products for the discerning and conscientious consumer, specifically personal care products; and (ii) heavily processed, mass-produced products for non-discerning buyers, specifically Ayurvedic and traditional medicine products.

**The sectoral analysis suggests that there are several cross-cutting constraints faced by firms in Nepal across sectors that need to be addressed.** Foreign Direct Investment (FDI) inflows in Nepal are amongst the lowest in the region and are hindered by restrictive policies on entry and operation as well as complex procedures and inadequate investment facilitation.<sup>2</sup> High tariffs on inputs, along with other supply side constraints, have limited firm participation in global value chains. One of the most pressing constraints faced by businesses in Nepal is the poor infrastructure as the country has a relatively low road density, limited air and land connectivity and inadequate energy infrastructure. Firms in Nepal also operate under a weak regulatory environment. Nepal ranks 110 out of 190 countries in the 2019 edition of the Doing Business Report and scores particularly low on the ease of getting electricity, dealing with construction permits, paying taxes, enforcing contracts and starting a business. There is a scarcity of medium- to high-skilled technical and managerial workers in Nepal and this poses a problem for firms seeking to move up the value chain. Legal constraints, poor land records and weak institutions have made it difficult to deploy land for productive uses. Firms also have difficulty accessing finance as gaps in Nepal's financial infrastructure limit the system's ability to provide credit, particularly long-term finance. The legal framework for e-commerce, specifically international payment gateways requires updating. Establishing the infrastructure for digital signatures and updating the legal framework could help in opening new market access opportunities for small and medium-enterprises (SMEs).

**In addition to cross-cutting challenges, firms face sector specific constraints that inhibit their growth and competitiveness.** Production facilities of firms in the footwear industry are ill-suited for manufacturing and distribution, and conditions in many factories are poor, sometimes dangerous. There is a need to upgrade quality standards and modernize production facilities to become safer and more efficient in this industry. In the ICT sector, the supply of skilled manpower is not well-oriented to the needs of firms because of gaps in the course curricula at the university level, the migration of graduates, and a limited pool of middle-managers with higher-level IT skills and managerial capabilities. While telecom infrastructure and connectivity have improved in recent years, infrastructure-sharing policies are not enforced and there is limited availability of licensed bandwidth, which inhibits the growth of ICT firms. In the MAPs sector, sustainability is a major concern, especially in higher elevation areas, and requires continued conservation efforts. There are inter-district trade frictions for suppliers providing MAPs raw materials to domestic manufacturers that need to be eased. Due to the public health aspect of MAP products, firms in Nepal face non-tariff barriers to trade (quality and SPS standards) in destination markets. They face difficulties proving compliance with buyer requirements and require support in this area.

**The GoN has several ongoing initiatives to improve the investment climate and enhance competitiveness.** The three notes provide policy recommendations to address the cross-cutting as well as sector-specific constraints that concern trade costs; export promotion; investments in skills and firm capabilities; the quality infrastructure; improve the business climate and the regulatory environment for FDI.

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<sup>2</sup> These restrictions include foreign ownership limitations, sector caps, a long negative list and restrictions in non-equity modes of investment, cumbersome processes on the repatriation of funds and the lengthy processes needed to hire foreign workers