

Nepal:

A Himalayan Corridor of Economic Potential

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Background: Transition from Turbulence

EVERY TIME A FLIGHT LANDS SAFELY AT LUKLA, NEPAL, a sense of relief is palpable in the joy that erupts among its passengers. Lukla is one of the most dangerous airports in the world, situated at a height of 2,860 meters above sea level. Planes have to squeeze in between the Himalayas and through obscuring clouds before they can land on the narrowest of strips on top of the mountain. Incidentally, Lukla is also the airport serving Everest Base Camp – the gateway to the world's highest peak.

The landing at Lukla is comparable in many ways to events that have shaped Nepal's recent history. Tumultuous, unpredictable, and yet, promising. Nepal's ongoing transition toward a stable democracy holds the promise of enabling a sound business environment amid its many legacy issues. With each successful election and peaceful transition of power between premiers, there builds hope. And a round of applause. Just like each successful landing at Lukla.

For a young democracy in a country one-fifth the size of Texas¹, Nepal has endured painful changes: overcoming a bloody civil war, steering its governance from a monarchy toward a shaky democracy, outlasting disasters, sustaining peace, and standing its ground, flanked by India and China.

The message is simple. Nepal exhibits a doughty resilience for development and economic growth. It is expected to provide investors and businesses with an environment of stability and peace in the future if it continues on its current path of political consolidation.

¹ <https://mapfight.appspot.com/nep-vs-texas/nepal-texas-size-comparison>

Nepal's Potential for Resilience: The Recovery from Twin Disasters

With its mountain ranges and high peaks' underlying seismic movements, Nepal has often been exposed to natural disasters. In April 2015, Nepal endured multiple deadly earthquakes measuring up to 8.1 on the Richter scale.² The earthquakes left behind a trail of destruction. Nearly 9,000 lives were lost³, and significant infrastructure damage stressed the economy, especially tourism, which traditionally has been a major revenue generator. Local experts say that while the earthquake was splashed across newspapers all over the world, what went unnoticed was the local community's resilience and teamwork in recovery, despite the absence of a formal government.⁴

The Blockade

Nepal undertook a process to promulgate its constitution, which was drafted over a period of seven years. The new constitution triggered internal political discontent as political parties from the southern plains of Nepal, also known as Terai region, protested, alleging that the constitution was unfair to the Terai people. The dissenting political parties blocked border points between Nepal and India, which accounts for more than 90 percent of Nepal's trade, including essential goods such as fuel and medicines. The government of Nepal blamed the Indian government for supporting the blockade. The blockade ended after five difficult months, with disastrous consequences for the Nepali economy. The GDP growth, reported at 5.7 percent in 2014, had dropped to 2.3 percent in 2015, and 0.8 percent in 2016.⁵



² <http://www.thehansindia.com/posts/index/2015-04-25/Nepal-earthquake-measures-81-on-Richter-scale-146822>

³ <http://nationalpost.com/features/aftershock-heres-how-nepal-is-coping-after-two-earthquakes-left-nearly-9000-dead-16800-injured>

⁴ <https://thewire.in/135055/two-years-earthquake-nepal-failed-recover/>

⁵ <https://www.adb.org/countries/nepal/economy>



On the Cusp of Change and Growth: Why Elections Can Change Nepal's Economy Forever

Unstable Political Atmosphere

Despite adopting a democratic system in 2008, Nepal had not held local elections for over 20 years. Absent local regulatory bodies, tentative governance and an ineffective executive setup has meant that recovery and reconstruction has always been sluggish. After several delays and uncertainty, Nepal finally held local elections spread over three phases between May and June 2017.

Nepal's unstable political landscape, held together by a fragmented people's verdict in the last election in 2013, has led to a lack of accountability and corruption. None of the three major political parties — Nepali Congress ("NC"), Communist Party of Nepal Unified Marxist-Leninist ("CPN-UML"), and Communist Party of Nepal-Maoist ("CPN-M") — could form a government on its own and consequently depended on one of the other two major parties for support. In the two years since the earthquake, Nepal has already had four different prime ministers, with a new prime minister expected to be elected in 2018. The constant changing of the guard has slowed down reconstruction activities after the earthquake, despite the overwhelming response from the international community, which donated nearly USD 4.4 billion for reconstruction activities.⁶ In fact, according to a report dated April 2017, two years after the earthquake, only 12 percent of the funds have been utilized and only 20,889 homes have been rebuilt (824,000 homes were destroyed).⁷ The absence of governance at local levels did not help matters. According to a media report, "Since the earthquake, it has not been uncommon for very small NGOs to be receiving donations of \$100,000 or more."⁸ The large funds that arrive from international donors would need accountable local governance to deliver results.

Local Governance: A Hope from the Ballot

A senior Nepali political expert told Kroll that the new constitution is meant to ensure significant devolution of power to municipalities. It is widely expected that reconstruction activities and other civic developments would gather momentum once the local municipalities receive their share of funds for local development. Two other elections, one each at the provincial and national levels, are expected to be held by mid-2018.

⁶ <http://www.ipsnews.net/2015/06/donors-pledge-over-4-4-billion-dollars-to-nepal-but-with-a-caveat/>

⁷ <http://www.aljazeera.com/indepth/opinion/2017/04/nepal-earthquake-disaster-years-41bn-170412110550808.html>

⁸ "Nepal's Political Faultlines", <https://www.crisisgroup.org/asia/south-asia/nepal/nepal-s-constitution-i-evolution-not-revolution>



Business Environment

According to a 2017 World Bank study on ease of doing business⁹, Nepal has fallen from 99th position to 107th in two years. In addition, Transparency International's Corruption Perception Index for 2016 ranks Nepal at 131.¹⁰ Overall, the business environment in Nepal has suffered due to lack of reforms and poor business infrastructure.

The country, including the capital city of Kathmandu, has been affected by frequent energy outages. In 2016, Nepal was forced to import power from India, which provided temporary relief. Recent reports estimate Nepal's commercially viable hydropower generation capacity at 40,000 megawatts ("MW"), but to date Nepal has only been able to develop 680 MW.¹¹ Similarly, the Asian Development Bank financed a project to supply drinking water to the capital of Kathmandu, the Melamchi Project, which has been under development for over 19 years and is expected to be only completed by the end of 2017, missing more than a dozen deadlines. In the past, businesses in Nepal have also grappled with labor issues resulting in lockouts and production inefficiencies.

Opportunities and Challenges

Wedged between two of the fastest growing world economies, India and China, Nepal is strategically located to benefit from the growth of its two large neighbors, which together account for one quarter of the total global population. Recently, Nepal has expressed its willingness to speed up the development of its hydropower potential and has signed an initial agreement with a Chinese state-owned firm to develop a 1,200 MW hydroelectric project, currently the largest project in Nepal.¹²

Despite its vast potential, the Nepali tourism sector only contributes 4 percent to Nepal's national GDP. Crippled infrastructure and poor roads do slow down tourism to the Himalayas, but the natural attraction that the world's highest mountains command will always draw traffic to Nepal. In fact, the inherent appeal of these mountains provides an opportunity for investors to benefit from the potential of developing large-scale tourism. The mushrooming of mid-size hotels in Kathmandu is a testimony to the potential, though high-end business traffic in the city has been elusive.

⁹ <https://mapfight.appspot.com/np-vs-texas/nepal-texas-size-comparison>

¹⁰ <http://www.thehansindia.com/posts/index/2015-04-25/Nepal-earthquake-measures-81-on-Richter-scale-146822>

¹¹ <http://nationalpost.com/features/aftershock-heres-how-nepal-is-coping-after-two-earthquakes-left-nearly-9000-dead-16800-injured>

¹² <https://thewire.in/135055/two-years-earthquake-nepal-failed-recover/>



The financial sector in Nepal has been dominated by local businesses; very few international companies have a presence in this sector in Nepal. Therefore, local banks and financial institutions, including microfinance businesses, have generally not been affected by the ongoing global challenges and have reported strong earnings.

This year, Nepal has been inundated with investment pledges from Indian and Chinese firms, ranging from investments of USD 317 million to USD 8.3 billion in different sectors, such as airport and roads infrastructure, healthcare hydropower, services sector, and information technology. Six Chinese companies pledged USD 8.3 billion, or around 61 percent of the total investment commitment. Investors from Japan and the United Kingdom have pledged USD 1 billion, according to media reports.¹³ The two-day Nepal Investment Summit 2017 held in Kathmandu attracted investment promises from different countries that see potential in Nepal.¹⁴ Furthermore, 21 Indian firms made commitments to invest in hydropower, the service sector, and information technology. India's finance minister, Arun Jaitley, was of the view that more soft loans will be provided for new infrastructure projects and called for a better regulatory framework.

¹³ <http://www.deccanchronicle.com/business/economy/040317/foreign-investors-intend-to-pour-usd-135-billion-into-nepal.html>

¹⁴ <http://www.hindustantimes.com/world-news/chinese-firms-to-invest-8-3-billion-in-nepal/story-gKW9cDBsW1jhOoBVDtcFM.html>

What Do Businesses Need to Consider While Investing in Nepal?

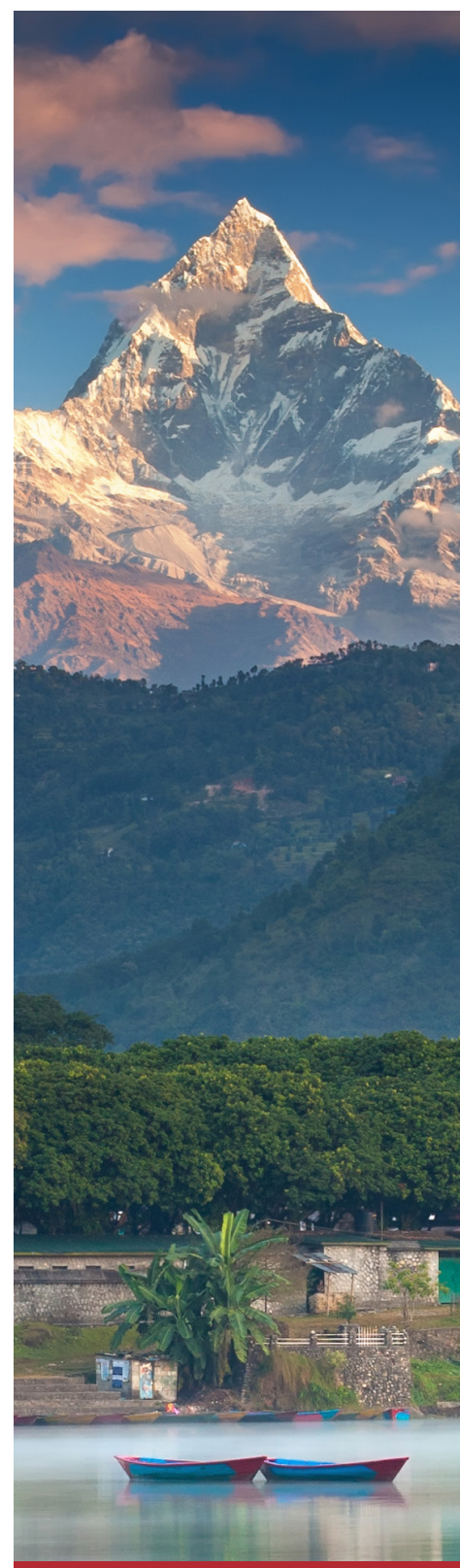
The likely emergence of political stability is linked to a growing business potential, but this could increase corruption in the absence of a sound regulatory bulwark to support it. Apart from the political changes and bureaucratic hurdles to operate in Nepal, businesses need to consider and negotiate aspects such as the uncertainty in the regulatory environment, the associations of their local partners with disreputable or problematic entities, and local issues of legacy links and corporate governance that may not be in line with global expectations or may not have been disclosed fully to investors.

In order to engage long-term business interest, Nepal needs a stable business environment where regulatory provisions are executed consistently. This consistency has been sorely lacking in recent years. For example, in 2014, the government passed an arbitrary law banning casinos and then lifted the ban shortly thereafter. The lack of clarity in the ongoing capital gains tax issue involving the large telecom deal described above raised the question about the stability of government policies. Given the frequent changes in government, there have been charges of nepotism in regulatory appointments¹⁵, vendetta politics, and corruption. For instance, the Supreme Court of Nepal in January 2017 removed Lok Man Singh Karki from the powerful post of Chief of Commission for the Investigation of Abuse of Authority (CIAA), despite the original positive recommendation of the Constitutional Council ("CC") and subsequent appointment by the President. At the time of his appointment, Lok Man Singh Karki had a controversial reputation, which was known to those who appointed him.¹⁶ Lok Man Singh Karki was removed by a sitting Supreme Court Judge, Sushila Karki, who was in turn impeached by opposing politicians. The impeachment attempt on a sitting Supreme Court Judge (which was overturned a few months later)¹⁷ and the recent appointment and subsequent arraignment of an anti-corruption head are examples of the influence of political stakeholders in perpetuating corruption, nepotism, and instability in Nepal. Nevertheless, according to a senior source in a multilateral development organization in Nepal¹⁸, the regulatory institutions are less corrupt than in a few other countries in South Asia and therefore are expected to develop more robustness in due course.

Business leaders in Nepal are still awaiting the revival of liberalization efforts that began in the 1990s. These reforms encouraged foreign investment and eased currency exchange controls. Given the ongoing transition toward democracy, elections held at various levels presage growing political stability and increased participation of foreign investors in the process of economic development. Political analysts that Kroll spoke with in Nepal feel that the government is expected to be more accountable in the future, leading to the passage of more consistent legislation.

Though political stability would help lend comfort to the macro business environment, investors would still need to understand legacy issues in the context of their investments to better evaluate the impact of any prospective changes to their businesses.

As in most emerging countries, business reporting requirements in Nepal are not very high, and hence very limited information is available in the public domain. Also, businesses need to understand their local partners in Nepal to ensure they do not partner with problematic individuals. For example, it is not uncommon for politicians to have varied business interests, which might not necessarily be disclosed.



¹⁵ <http://www.tinepal.org/faulty-appointment/>

¹⁶ <https://thehimalayantimes.com/nepal/supreme-court-disqualifies-lok-man-singh-karki-for-ciaa-chief/>

¹⁷ <http://www.hindustantimes.com/world-news/nepal-s-supreme-court-reinstates-chief-justice-sushila-karki/story-SjXTxi8LmnasdQp1ZpLcsL.html>

¹⁸ Interview with a senior source from a global multilateral development organisation based in Nepal

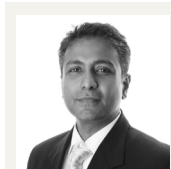


A Corridor to Sow Hope

Nepal, despite its mix of political uncertainties and a volatile past, is a land that may tick a number of positive boxes for an investor. In researching Nepal, chances are that one is likely to read mostly about political tensions, earthquakes, monarchy, and Maoism. What one might miss out on is the manner in which local communities revived the region after devastating earthquakes in the absence of a formal government. It is also easy to forget that Nepal is one of the few places in the region where military conflicts have subsided and peace reigns. What isn't featured anywhere is the local can-do attitude, evidenced in the recently improved traffic situation in Kathmandu after the arrival of a new traffic chief. Likewise, both local Nepalis and Western expats working in Kathmandu increasingly share an optimism about Nepal's future as a promising marketplace nestled between two of the largest economies in the region. In fact, Nepal has been ranked as the third fastest growing economy in the world in 2017.¹⁹ The present and its future, more than its past, make Nepal a corridor with potential for economic growth. And more certain than the landing at Lukla.

¹⁹ <https://www.weforum.org/agenda/2017/06/these-are-the-world-s-fastest-growing-economies-in-2017-2/>

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