

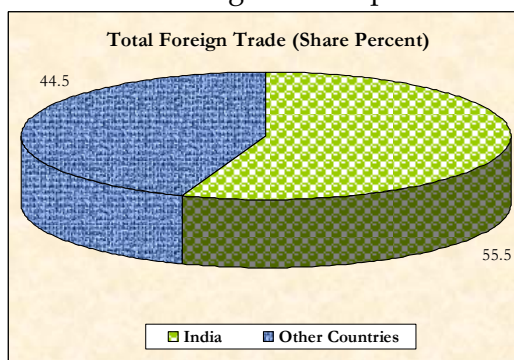
6. External Sector

Structure of the External Sector

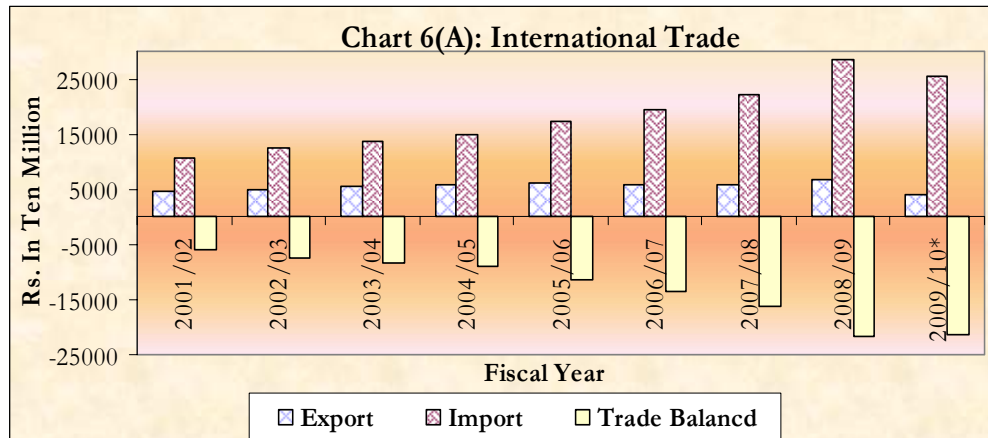
- 6.1. Current Account transaction, the very critical component of Balance of Payments that used to remain surplus in the past years, started declining continuously since the beginning of this fiscal year. This trend seems to continue throughout the remaining period of the fiscal year with no sign of improvement in the situation. Even in previous years, trade of goods, services, and other incomes in the external sector used to suffer losses but offset by other elements of the sector like inflow of remittance, pension, and foreign grants turning the current account into notable surplus. It failed to happen during the review period. Similarly, in aggregate the balance of payments used to remain surplus in the past with comfortable foreign exchange reserve, situation has reversed with negative balance of payments and decrease in the level of foreign exchange reserve also.
- 6.2. Current account is convertible though, capital account is not. Nepal has made policy decision on allowing foreigners making portfolio investments, but extensive arrangement for implementation of such policy is yet to be made. Similarly, there is the absence of instrument allowing Nepalese citizens invest overseas.

Foreign Trade

- 6.3. Total export increased by 33.6 percent to Rs 294.15 billion during first eight months of FY2008/09 against 24.2 percent increase during the same period of the previous fiscal year. Total exports during the review period decreased by 8.0 percent while imports rose by 43.9 percent. Shares of imports and exports on aggregate foreign trade during this period remain at 86.3 percent and 13.7 percent respectively. Shares of these components of foreign trade in the corresponding period of the previous year stood at 79.9 percent and 20.1 percent respectively. Trade deficit expanded notably due to decrease in exports and steep rise in imports. Trade deficit during first eight months of FY 2009/10 has increased by 61.5 percent as compared to 30.1 percent during the corresponding period of the previous fiscal year. The ratio of country-wide foreign trade statistics show India's

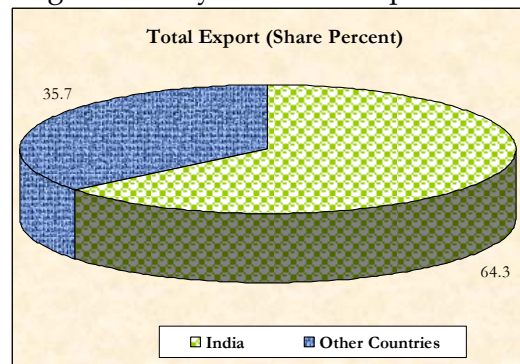


share increase to 55.5 percent from 54.7 percent in the previous fiscal year while that of other countries decrease from 45.3 percent to 44.5 percent during the period.



Exports

6.4. Total exports that rose by 16.2 percent during the first eight months of FY2008/09 fell by 8 percent totaling Rs. 40.41 billion in the same period of FY2009/10. Overall export (India and other countries) did not grow notably in the review period with just a nominal increase seen in export to India (by 3.4 percent) from 60.9 percent to 64.3 percent. Ratio of export to import that stood at 24.9 percent in the review period of the previous fiscal year decreased to 15.9 percent in the corresponding period of this year due to significant rise in imports and steep fall in exports. In US Dollar terms, total export fell by 7.1 percent as compared to 1.9 percent decrease in the previous year. Such a shrink in export receipts (in terms of US Dollar) is also due to 7.8 percent appreciation of Nepalese currency vis-a-vis US Dollar between mid-July 2009 and mid-March 2010.



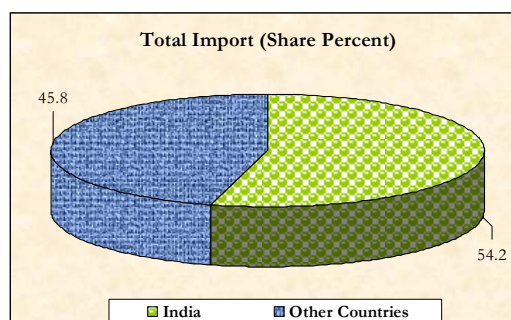
6.5. Exports to India, which had grown by 3.7 percent during first eight months of the previous fiscal year shrunk to Rs. 25.96 billion during the same period of this year with a decrease of 2.9 percent. During this period, export of items like Polyester yarn, jute bags, jute cutting, textile, M.S. Pipe, herbs, oil cakes, Chyavanpraas, Haajmola, Pashmina, and copper wire rods has increased while exports that of vegetable ghee, lentils, yarn, tooth paste, G. I. Pipe, noodles (chow chow) has

decreased. Observation of the group-wise structure of commodity exports to India reveals that proportion of primary and manufactured goods in first eight months of the previous fiscal year stood at 30.0 and 70.0 respectively remains at 27.5 percent and 72.5 percent in the corresponding period of this fiscal year.

- 6.6. Export to other countries during the review period of this fiscal year dropped to Rs. 14.44 billion with a decrease of 16 percent, which had expanded by 42.9 percent in the same period of the previous year. Exports especially of cardamom, handmade paper and paper made items, and handicraft goods rose while those of lentils, woolen carpets, herbs, readymade garments, ornaments and Pashmina goods fell during this period. Observation of group-wise structure of commodity exports to other countries reveals proportion of primary and manufactured goods in first eight months of the current fiscal year remains at 25.5 percent and 74.5 percent respectively as compared to 35.1 percent and 64.9 percent respectively in the same period of the previous fiscal year.

Imports

- 6.7. Total imports in the review period grew by 43.9 percent in the review period touching Rs. 253.74 billion figure as compared to 26.3 percent growth in the corresponding period of the previous fiscal year. Of the total imports, the share of India shrunk slightly from the previous year's 56.3 percent to 54.2 percent while that of other countries grew from 43.7 percent to 45.8 percent during this period. In US Dollar term, growth of imports, which stood at 6.6 percent in the previous fiscal year grew by 45.4 percent this year.



**Table 6(a): Status of Foreign Trade
(First eight months)**

Description	Percentage Change			
	2006/07	2007/08	2008/09	2009/10*
Exports: FOB	-6.6	-2.9	14.2	-8.0
- India	-6.4	-6.9	6.4	-2.9
- Other Countries	-7.0	6.9	28.9	-16.0
Imports: C.I.F.	-1.1	19.2	28.2	43.9
- India#	2.3	24.9	14.1	38.5
- Other Countries	-6.4	10.5	53.4	50.9
Trade Balance	2.0	30.2	33.3	61.2
- India	8.6	45.2	17.0	53.8

Description	Percentage Change			
	2006/07	2007/08	2008/09	2009/10*
- Other Countries	-6.2	11.7	62.0	70.1
Total Trade	-2.6	37.7	25.2	33.6
- India	-0.3	15.0	12.4	29.7
- Other Countries	-6.6	9.8	48.3	38.7
Share in Total Trade				
- India	63.2	64.4	57.2	55.5
- Other Countries	36.8	35.6	42.8	44.5
Share in Total Exports				
- India	71.1	68.2	60.9	64.3
- Other Countries	28.9	31.8	39.1	35.7
Share in Total Imports				
- India	60.5	63.4	56.3	54.2
- Other Countries	39.5	36.6	43.7	45.8
Share in Total Trade Balance				
- India	55.2	61.6	54.7	52.2
- Other Countries	44.8	38.4	45.3	47.8

* Unprocessed

Petroleum products included in India from FY1999/2000

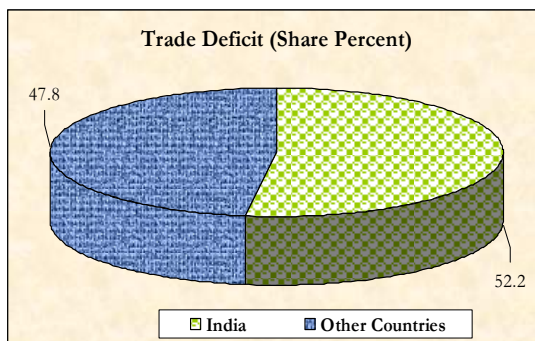
Source: Nepal Rastra Bank

- 6.8. Imports from India recorded an increase of 38.5 percent in first eight months of current fiscal year reaching Rs. 137.41 billion. Imports had recorded a normal growth of 12.1 percent in the same period of the previous year. Imports especially of chemical fertilizers, M.S. wire rods, M.S. billets, means of transportation, aluminum ingots, hot rolled sheets, and agricultural tools and their parts recorded significant rise while imports of petroleum products, electrical goods, yarn, tobacco, medicines, other machines and their spares, and textiles recorded a normal growth during this period. Import of cold rolled sheets in coils, however, appears to be the only item recording a decrease. Total value of goods imported from India through payments of convertible foreign currency during the review period reached Rs. 18.26 billion with a recorded growth of 40.0 percent. Imports during first eight months of the previous year had decreased by 5.4 percent and remaining at worth Rs. 13.05 billion. Number of items allowed for import from India under this provision was 165 at mid-March 2008, which has been raised to 137 in the review period. Analysis of group-wise structure of imports of primary and manufactured items from India in the first eight months of the previous fiscal year stood at 42.2 percent and 57.8 percent, which remains at 36.9 percent and 63.1 percent respectively in the same period the current fiscal year.
- 6.9. The total import from countries other than India remained at previous year's level of 50.9 percent, reaching Rs. 116.33 billion during the review period. There has been a substantial growth in import of goods like flash lights, chemical fertilizers, steel rods and sheets, storage batteries, gold, office equipments and stationary

goods, and synthetic carpets. Similarly, imports of x-ray films, computer and parts, aircraft spare parts, telecommunications equipment, medicine, tools and equipment, powder milk, tallow, bags, raw wool, pipe and pipefitting recorded very high growth. But, imports of cameras, coconut oil, cosmetic goods, M. S. Billets, dry cell batteries, toys, cloths, electrical goods, unprocessed palm oil, and textile dyes has decreased during this period. Analysis of group-wise structure of imports of primary and manufactured items from countries other than India in the first eight months of the previous fiscal year stood at 16.7 percent and 83.3 percent, which remains at 14.8 percent and 85.2 percent respectively in the same period the current fiscal year.

Trade Balance

6.10. Exports during the first eight months of the current fiscal year dropped significantly while imports surged notably. Besides, total trade deficit expanded by almost double to 61.2 percent totalling Rs. 213.33 billion due to broader base of imports. Such deficit had expanded by 30.1 percent totalling 132.35 billion in the previous year. Trade deficit with India in the review period totalled Rs. 111.44 billion with increase of 53.8 percent while such deficit with other countries totalled Rs. 101.89 billion with deficit growth of 70.1 percent. Such deficit with India had increased by 15.6 percent while that with other countries had increased by 53.4 percent in the same period of the previous year.



Balance of Payments

6.11. The Current Accounts and overall Balance of Payments is in deficit as the receipts from private sector remittance and increase in pensions, and the foreign currency flows from direct investments could not sustain the notable expansion of trade deficit in the first eight months of the current fiscal year.

Box 6(a): Nepal-India Trade Agreement

Nepal and India have entered into a new Trade Agreement on 27 October 2009 (10 Kartik 2066) replacing the 1996 Agreement (reviewed in 2002). The Salient Features of this Agreement are as follows:

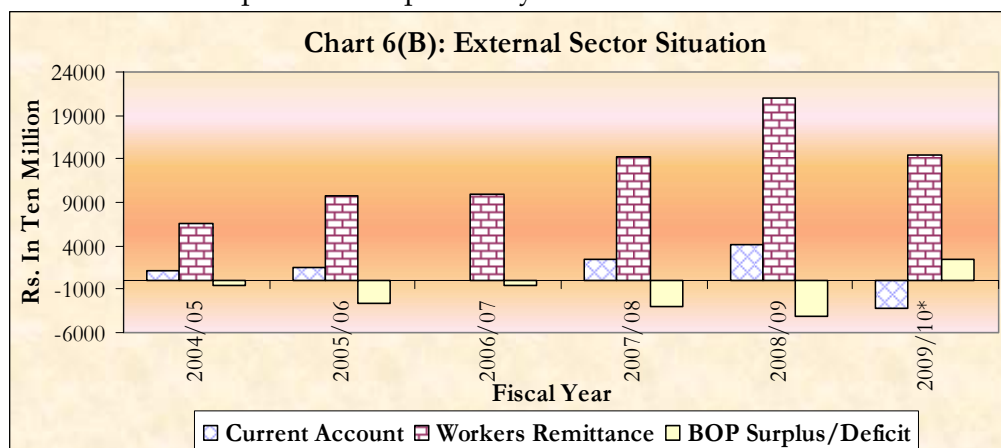
- This Agreement is for seven years with the provision of automatic renewal

for another term thereby ensuring stability to trading provisions.

- The provision of providing US Dollar equivalent facility to bilateral transactions conducted in the Indian currency has freed the (bilateral) trading regime from DRP hassles.
- Tariff free facility is accorded to exports of primary goods, and provision is made for addition of numbers in the list of tariff exempt quantitatively restricted items.
- India has agreed to avail the port at Visakhapattanam for trade facilitation.
- Agreement is reached to open up additional four customs points for trade facilitation making total number of points to 26.
- A new arrangement is made for conducting bilateral trading from cities connected by air services.
- The Government of India has agreed to enhance the trading capacity of Nepal. India will support to upgrade the level of quarantine and examination facilities under such arrangement.
- India will exempt the additional tariff levied on Nepalese products on special request of the Government of Nepal.
- Nepalese products unable to receive favourable status will be accorded the most favourable status, but certificate of origin would be necessary for such products.
- Provision is made to form an Intergovernmental Committee at to resolve trading related issues that may emerge.

- 6.12. Total exports in first eight months of the current fiscal year, with adjustment made for trading bypassing the customs, has totalled Rs. 41.90 billion with a decrease of 9.5 percent. Imports during the same period totalled Rs. 247.98 billion with, a whopping growth of 43.5 percent. As a result, trade deficit this year grew by 62.9 percent reaching Rs. 206.07 billion as compared to 29.5 percent increase in the same period of the previous fiscal year.
- 6.13. During the review period, income from tourism and incomes not included elsewhere has decreased by 0.3 percent and 57.0 percent respectively while income from other services has increased by 25.1 percent. Consequently, gross income from service sector declined by 11.3 percent and came down to Rs. 30.56 billion. The growing trend of Nepali students going abroad for higher education has resulted in an increase in the expenditure on education by 21.4 percent leading to increase in travel expenses during the review period by 7.3 percent. Despite increased expenditure on payment for other services, gross services payments decreased by 10.4 percent bringing down the level of payments to Rs. 39.24 billion due to notable decrease in travel expenses. Still, net services income remained negative by Rs 8.67 billion during the review period.

6.14. Concerning transfers, remittance incomes of the private sector grew by 9.9 percent during the review period totalling Rs. 143.96 billion. Grants decreased by 11.9 percent during this period while pension and other transfers increased by 74.9 percent and 20.7 percent respectively. Despite increase in net transfer income by 11.4 percent totalling Rs. 175.51 billion as compared to the corresponding period of the previous year, the current accounts still remained deficit by Rs. 32.58 billion in the review period of the current fiscal year, which stood at surplus by Rs. 28.94 billion in the same period of the previous year.



6.15. During the review period, the Capital Account received capital transfers totalling Rs. 8.96 billion as compared to Rs. 4.63 billion in the corresponding period of the previous year.

6.16. In Financial Accounts, other investment assets of Rs. 7.50 billion is added during the first eight months of the current fiscal year compared to Rs. 3.41 billion of the previous fiscal year. Concerning other investments and liabilities, the government floated the debt totalling Rs 4.20 billion, with repayment of the principal amounting to Rs 5.94 billion. The total foreign deposit liability decreased by Rs 3.98 billion during the review period. The Balance of Payments during this period recorded a deficit of Rs. 23.53 billion which stood at surplus by 34.81 billion in the corresponding period of the previous year.

Foreign Exchange Reserves

6.17. The total foreign exchange reserves of the banking sector has declined by 15.6 percent between July 2009 and March 2010 and contained to Rs. 236.34 billion against the rise of 27.4 percent in the corresponding period of the previous year. Foreign liabilities during the same period, however, decreased by 7.5 percent totalling Rs. 55.01 billion, against the notable growth of 30.9 percent during the

corresponding period of the previous year. In this way, the net foreign assets, which grew by 27.4 percent in the first eight months of the previous fiscal year has decreased by 15.1 percent to Rs. 187.67 billion.

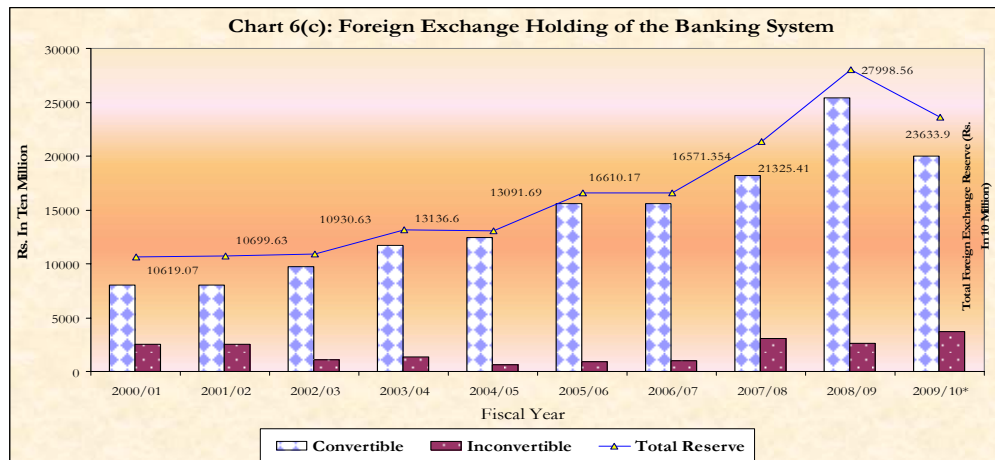
Table 6(b): Gross Foreign Exchange Reserves

(Rs. in million)

Description	Mid-July 2007	Mid-March 2008	Mid-July 2008	Mid-March 2009	Mid-July 2009	Mid-Mar 2010	Percentage change (July-March)	
							2009	2010
Nepal Rastra Bank	12962	14429	16968	21846	22419	18591	28.7	-17.1
Commercial Bank	3550	3769	4294	5234	5580	5042	21.9	-9.6
Total Reserves	16512	18198	21262	27080	27999	23633	27.4	-15.6

Source: Nepal Rastra Bank

- 6.18. Gross foreign exchange reserves declined by 15.6 percent to Rs. 236.33 billion in first eight months of current fiscal year. In the review period reserves at Nepal Rastra Bank, out of the total foreign exchange reserves, with the banking sector decreased by 17.1 percent whereas that of commercial bank by 9.6 percent. Such fall in the foreign exchange reserves is especially due to notable rise in trade deficit.



- 6.19. Nepal Rastra Bank has made special arrangement for curbing the unexpected rise in gold imports during the first eight months of the current fiscal year, which caused the rise in trade deficit (Rs. 37.47 billion) and correspondingly affecting the balance of payments.

Box 6(b): Special Arrangements made for import of gold and silver

- Banks can import gold through normal Letter of Credit. For this purpose, banks should compulsorily deposit 40 percent cash margin in the 'gold import earnest money account at banking office of Nepal Rastra Bank.
- Only the banks are eligible to import gold. While importing gold, 10 kilograms of gold can be imported on the recommendation of the Bankers Association.
- Gold importing member banks should sell gold only to the traders recommended by the Gold and Silver Dealers Association and registered in VAT/PAN.
- Silver can be imported only through normal Letter of Credit with a margin of 100 percent cash deposit. Only the members of the Gold and Silver Dealers' Association can, on the Association's recommendation, import up to 100 kilograms of silver each day. The importer can sell more than a kilogram of silver only to VAT/PAN registered businessmen/traders.

- 6.20. Based on the trend of imports for the first eight months of the current fiscal year 2009/10, the present foreign exchange reserve level is sufficient to cover import of goods for the 7.6 months and goods and services for 6.6 months. Based on the trend of imports by mid-March 2008, foreign exchange reserves with the bank in the same period was sufficient to cover the imports of goods for 12.3 months and goods and services for 9.9 months.

Box 6(c): Procedural Reforms in External Sector

External Sector related procedural reforms made by Nepal Rastra Bank in the fiscal year 2009/10 are as follows:

- The existing level of foreign exchange facility is raised up from US\$ 4,000 to US\$ 6,000 to persons and agencies/organizations for different purposes directly from class 'A' and 'B' banks and financial institutions on producing relevant documents.
- Goods from countries other than India now can be imported on FOB through Draft/TT payments in addition to the existing arrangement of importing through Letter of Credit.
- As transactions of a number of goods and services through electronic medium is getting global recognition with the development and expansion of electronic system, arrangement is made for accepting payments in convertible currencies through the internet by using international debit/credit cards by agreeing conditions as laid out.
- Earlier goods could be imported by using the existing system of Documents Against Payment (D/P) under the Documentary Collections procedure, which has been extended to Documents Against Acceptance by remaining under the procedures and conditions as laid out.
- Nepal Rastra Bank licensed 'A' and 'B' class banks can conduct various derivative tools related transactions operating in the market to manage their convertible foreign currency investments, and also safeguard them against the risk emanating from fluctuations in foreign exchange rates. In the process, banks can make investments as follows remaining within standards and measures as stipulated by their respective boards:

- a. Can invest on Bonds, Savings Certificates of various types and durations, issued by International Financial Institutions and foreign governments.
- b. Investments can be made out of income receipts from the convertible currency deposits and foreign exchange with the self.
- c. Borrowing from any International or foreign bank and financial institution is not allowed for such purpose.
 - The limit of making payment in US Dollar through Draft/TT at a time is reduced from USD 50,000 to USD 25,000. Under this system, such payment facility within the limit of UD 25,000 cannot be availed to a single beneficiary within seven working days.
 - Arrangement is made for collecting 2 percent customs deposit against L/C, Draft/TT and collection issued for import of raw wool. Similarly, raw wool and other goods should be imported directly from the Tibetan supplier and the payment deposited in his/her account in Tibet for goods imported into Nepal through the Tatopani Customs Point from the Tibetan autonomous region of China for payments made through Draft/TT and credit facility. Arrangement is made for providing foreign exchange facility for goods imported under the existing arrangement. As per such an arrangement, the bank will certify of the exchange facility provided on the back of the customs receipt and retain it, acknowledge and certify the original being retained, and give a copy of it to the concerned importer.
 - Foreign exchange facility of US Dollar 2,000 against the passport should not be provided more than two times a year. Amount and the date of such facility availed should be compulsorily mentioned in the related section of the passport. A Nepalese citizen travelling for foreign employment with approval from the concerned entity, however, will be entitled to the exchange facility not exceeding US Dollar 500.

Exchange Rate

- 6.21. Mixed trend is seen in the exchange rate of Nepalese currency vis-a-vis major international currencies during the first eight months of current fiscal year. Nepalese Currency has appreciated by 7.8 percent against the US dollar between the period of July 2009 and March 2010 and stood at Rs 72.40. Nepalese currency had depreciated by 17.02 percent in the corresponding period of the previous fiscal year. Nepalese currency appreciated against Sterling Pound, Euro, and Japanese Yen by 16.32 percent, 9.98 percent, and 5.01 percent respectively. Nepalese currency had depreciated against the Japanese Yen while it had appreciated against the Sterling Pound and Euro in the corresponding period of previous year.

Table 6(c): Foreign Exchange Trend

Currency	Buying Rate (Rs.)					Appreciation (+) Depreciation (-)	
						(percentage)	
	Mid-July 2007	Mid-July 2008	Mid-March 2009	Mid-July 2009	Mid-March 2010	Mid-March 2009	Mid-March 2010
1 US Dollar	64.85	68.50	82.55	78.05	72.40	-17.02	7.80
1 Pound Sterling	131.43	135.89	114.17	126.78	108.99	19.02	16.32
1 Euro	89.27	108.72	105.27	109.07	99.17	3.28	9.98
10 Japanese Yen	5.30	6.42	8.57	8.39	7.99	-25.09	5.01

Crude Oil and Gold Prices

6.22. Price of Petroleum Products (Crude Oil Brent) in the international market has shot up from US\$45.18 per barrel to US\$79.43 between mid-March of 2009 and 2010 with an increase of 75.8 percent.

6.23. Price of gold in the international market between mid-March of 2009 and 2010 has increased by 19.2 percent reaching US\$ 1,106.00 per ounce. Price of gold had declined by 6.7 percent in the corresponding period of the previous year.

Table 6(d): Prices of Oil and Gold in International Market

	Mid-July			Mid-March			Percentage Change			
							<i>Mid-July</i>		<i>Mid-March</i>	
	2007	2008	2009	2008	2009	2010	2008	2009	2009	2010
Oil (US\$/Barrel)*	79.73	143.25	61.53	110.75	45.18	79.43	79.7	-57.0	-59.2	75.8
Gold (US\$/Ounce)#	666.0	986.0	938.0	995.0	928.0	1106.25	48.0	-4.9	-6.7	19.2

* Crude Oil Brent

Based on London Rate

Source: Nepal Rastra Bank