Foreign Direct Investment in Nepal : Issues and Problems

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Abstract

In this paper, I have attempted to identify the issues and problems associated with Nepal's current foreign direct investment regime, and more importantly the other associated factors responsible for Nepal's unattractiveness as an investment location. Despite Nepal offering a domestic market, complicated rule of law, low labor costs, and not well working democracy, her performance in attracting FDI flows has been far from satisfactory. A restrictive FDI regime, high import tariffs, exit barriers for firms, stringent labor laws, poor quality infrastructure, centralized decision-making processes, and lack of export processing zones and Export Trading House make Nepal an unattractive investment location. FDI in Nepal as of July 16, 2011, amounted to NPR 6,804 billion creating over 155,432 jobs through about 2,100 projects. Of these projects, 712 are in manufacturing, 650 in service, 561 in tourism, 42 in construction, 60 in agriculture, and 36 in mineral sector.

Keywords: Economic policy reform, FDI, BIPPA, Opportunities, FDI trends.

1. Introduction

FDI is a more encompassing term. Moreover, the integration of global economy is enhanced by the flow of FDI across the globe. Besides the flow of capital or foreign exchange, FDI is a composite package of multinational dimension gains for the receiving country which includes the elements like financial transfer and foreign exchange, production technology, management skill, physical resources, like machinery and tools, institutional systems, information and databases, research and development, training sources, and trade channels. FDI is required for economic reconstruction and development.

Besides, FDI is also believed to contribute to the foreign exchange of the host countries.

The wave of FDI swept across the world particularly after the end of the second world war in 1945.

According to UNCTAD, the volume of FDI grew many folds over the year from 207 Billion dollars in 1990 to 1,697 billion in 2008(World Investment Report, 2009).

Since 1980, the policy environment worldwide has been far more conducive to the growth of FDI. Over the 1990's, the number of countries adopting significant liberalization measures towards FDI increased little by little. Despite the rapid growth of FDI flows to developing countries, investment remains highly concentrated in limited countries. It is widely accepted that the key characteristics of globalization have been the liberalization of international trade, the expansion of FDI, migration and the emergence of massive cross-border financial flows. The term globalization began to be used

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more commonly since the 1980s. Since the 1980s, there has also been a global trend towards financial liberalization. One of the underlying factors behind increasing globalization was a shift in economic thinking that becomes pronounced in the 1980s.

Nepal's economic policy reforms have played a critical role in the performance of the Nepalese economy since 1991. Among other things, the reforms have involved opening the economy, making it more competitive, getting the government out of the huge morass of regulation, empowering the states to take more responsibility for economic management and thereby creating a kind of competition between the states for foreign investors.

India is the largest contributor (47%) to Nepal's FDI with approved investments of NPR. 32.39 billion in 501 projects providing employment to over 56,000 individuals.

China is Nepal's second largest source of FDI with total approved investment of NPR 7.03 billion in 401 projects providing employment to over 23,000 individuals.

The United States takes position in Nepal's third largest investor with total approved investments of NPR 4.95 billion in 174 projects providing employment to over 12,000 individuals.

The GDP growth rate and **FDI: FDI**(???) increased from 6.5 percent of world GDP in 1980 to 31.8 percent in 2006.

2. FDI Advantages in Nepal

Nepal is located in between the world's largest a markets: China and India. A trade treaty signed in 2009 has provided Nepalese manufactures duty free access to India's market. Another advantage in that Nepal has lower tariffs on imports, as compared with India's which can make Nepal an attractive location. Other advantages, according to investors already in Nepal, are a low–cost and non- hostile workforce and a small and accessible bureaucracy.

Despite Nepal's proximity to China and India, these are not the only markets to Nepali exports. As a least developed country, Nepal has been entitled to preferential treatment in a number of developed –country markets. The EU's everything but arms initiative is particularly relevant in this context.

3. Opportunities of FDI

The natural and cultural assets of Nepal offer very substantial opportunities to investors. It has a range of climatic conditions –from tropical to **sub-artic** –within a relatively narrow corridor of 250 KM. Many positioned agricultural products can thus be grown in Nepal. There is also huge potential for hydropower investment. Tourism is another area with enormous potential. FDI can also be done in specialized tourism. Manufacturing industries like readymade garments industry is prominent sector for FDI. Developing IT based services for export is another sector where FDI is suitable.

But some of the difficulties are: low FDI flow, too much ups and down in FDI within 3 years, administrative weakness, unevenness and increased transaction cost, lack of proper labor law, and others.

4. FDI Trends

FDI flows in Nepal is very low. In the 1990's, there was significant improvement. After peaking in 1997, FDI declined sharply but rose again in 2000.

FDI could play a crucial role in Nepal by supplying capital and know how and enhancing employment prospects for Nepali workers. Its worth noting in prospects lies for Nepalese worker.

Nepal for the first time, signed BIPPA with France on May 2,1983, and anohter such agreement was signed with Germany on October 20,1986 during the Panchayat regime. After restoration of democratic system(1990), first such agreement was signed with UK on March 2,1993 and another was signed with Mauritius on August 3,1999. After becoming Republic, first such agreement was signed with Finland on February 3,2009 and another signed with India on October 21, 2011. BIPPA agreements will flow FDI in future years.

5. Results and Analysis

In 1992, the Government of Nepal introduced a new policy on foreign direct investment (FDI) and instituted a 'One Window' system to facilitate and encourage it. FDI has been welcome through reservation express of investors. FDI regime has been liberalized by South Asian Standards. Foreign investment has been widely seen as being helpful to investors. FDI in the country represents a wide range of companies and countries.

The restoration of Multiparty system in 1990 not only brought political change in the country but also introduced new trends in the areas of economic liberalization. FDI began to be considered as a vital force for stimulating the economy of the country. FDI and TT Act 1992, Industrial enterprises Act 1992 and Privatization Act 1994 are the major trade related Acts in Nepal.

In the Three-Year Interim Plan FDI has been invited in the form of joint venture.

Despite all these, Nepal has some remarkable challenges. They include high transit costs caused by the country's landlocked position, underdeveloped infrastructures, technological backwardness, and requirements imposed by WTO.

Some measures can be highly recommendable for FDI promotion in Nepal: create conducive environment in politico-economic stability, HRD, good governance; more openness to trade; linkages between different sectors; and paradigm shift from manufacturing to high-tech products.

Despite the tremendous increment in the overall volume of FDI, its flow has not been smooth for LDCs including Nepal.

To enhance the flow of productive capital, Nepal needs to continue her efforts to achieve a transparent, stable and predictable investment climate with proper contract enforcement and respect for property rights, fixed in sound economic policies and institutions.

The emergence of global production systems that drove the increasing flows of FDI has created new opportunities for growth and industrialization in developing countries. Some 65,000 MNEs with around 850,000 foreign affiliates are the key actors behind these global production systems.

One of the major implications of globalization is flow of FDI and emergence of MNCs. Different attempts to cope with globalization have been made to attract foreign investment through liberal policies that provides a priority to privatization in Nepal. After the restoration of democracy in 1990 and especially after 2006, reforms in industrial sector to attract FDI were made. The **industrial policy 206(???)**, Industrial Enterprises Act, Foreign Investment and Technology Transfer Act, and New Trade Policy 2065**B.S. (???)** have been implemented in this regard.

Nepal has been encouraging FDI since the 6th Development plan(1980/81-1984/85). The following table shows FDI enter since the beginning to F.Y. 2010/1.

Table of category-wise FI projects in Nepal

(Rs. in Million)

Category	No of industries	Total project cost	Total fixed cost	Foreign investment	Employment
Agriculture	60	1674.42	1095.61	893.29	3497
Construction	42	3605.34	2683.10	2762.81	3016
Energy Based	47	40759.24	40381.02	14518.77	7947
Manufacturing	712	54611.18	40355.50	25595.87	78409
Mineral	36	5162.62	4223.60	2904.24	5574
Service	650	25955.40	21220.18	12974.65	32127
Tourism	561	20413.55	19157.38	8400.34	24862
Total	2108	152181.75	129116.39	68049.97	155432

Source: Department of Industry, Industrial Statistics, F.Y 2010/11

The Department of industry granted permission to 70 countries for the establishment of joint venture projects. On the basis of the number of the projects, India stood first(501) followed by China(401), USA(174), Japan(154), and South Korea(149). On the basis of foreign investment, India stood first(Rs. 32.4 billion) followed by China(Rs. 7.0 billion) , USA(Rs.4.95 billion) and South Korea(Rs. 4.3 billion). These projects were expected to generate employment opportunities for 155,432 people.

6. Major constraints to larger FDI inflows in Nepal:

In addition to Nepal's poor performance in terms of competitiveness, quality of infrastructure, and skills and productivity of labor, there are several other factors that make Nepal a far less attractive ground for direct investment than the potential she has.

Given that Nepal has a huge domestic market and a fast growing one, there is every reason to believe that with continued reforms that improve institutions and economic policies, and thereby create an environment conducive for private investment and economic growth that substantially large volumes of FDI will flow to Nepal.

We list some of the major hindrances below:

6.1 Restrictive FDI regime

The FDI regime in Nepal is still quite restrictive. In our view, there does not seem to be any justification for continuing with this rule. This rule should be scrapped in favor of automatic approval for 100-percent foreign ownership except on a small list of sectors that may continue to require government authorization.

The banking sector, for example, would be an area where Nepal would like to negotiate reciprocal investment rights. Besides, the government also needs to ease the restrictions on FDI outflows by non-financial Nepalese enterprises so as to allow these enterprises to enter into joint ventures and FDI arrangements in other countries. Further deregulation of FDI in industry and simplification of FDI procedures in infrastructure is called for.

6.2. Lack of clear cut and transparent sectoral policies for FDI

Expeditious translation of approved FDI into actual investment would require more transparent sectoral policies, and a drastic reduction in time-consuming red-tapism.

6.3. High tariff rates by international standards

Nepal 's tariff rates are still among the highest in the world, and continue to block Nepal's attractiveness as an export platform for labor-intensive manufacturing production.

Most importantly, tariff rates on imported capital goods used for export, and on imported inputs into export production, should be duty free, as has been true for decades in the successful exporting countries of East Asia.

6.4. Lack of decision-making authority with the state governments

The reform process so far has mainly concentrated at the central level. Nepal has yet to free up government sufficiently so that they can add much greater dynamism to the reforms. In most key infrastructure areas, the government remains in control, or at least with veto over state actions. Greater freedom to the states will help foster greater competition among themselves.

The government in Nepal need to be viewed as potential agents of rapid and salutary change.

6.5. Limited scale of export processing zones

The very introduction of Nepal's export processing zone act to attract FDI and overall export development has been waited.

6.6. No liberalization in exit barriers

While the reforms implemented so far have helped remove the entry barriers, the liberalization of exit barriers has yet to take place. In our view, this is a major deterrent to large volumes of FDI flowing to Nepal . An exit policy needs to be formulated in such a way that firms can enter and exit freely from the market. While it would be incorrect to ignore the need and potential merit of certain safeguards, it is also important to recognize that safeguards if wrongly designed and/or poorly enforced would turn into barriers that may adversely affect the health of the firm. The regulatory framework, which is in place, does not allow the firms to undertake restructuring.

6.7. Stringent labor laws

Large firms in Nepal are not allowed to retrench or lay off any workers, or close down the unit without the permission of the state government. While the law was enacted with a view to monitor unfair retrenchment and lay off, in effect it has turned out to be a provision for job security in privately owned large firms. This is very much in line with the job security provided to public sector employees. Most importantly, the continuing barrier to the dismissal of unwanted workers in Nepalese establishments with 100 or more employees paralyzes firms in hiring new workers. With regard to labor regulations and hiring and firing practices, labor-intensive manufacturing exports require competitive and flexible enterprises that can vary their employment according to changes in market demand and changes in technology, so India remains an unattractive base for such production in part because of the continuing obstacles to flexible management of the labor force.

6.8. Financial sector reforms

Reform of Nepal's financial sector is crucial for large FDI flows into Nepal . However, only some partial steps have been undertaken and these are by no means going to make any meaningful changes to the existing system. India's banking and insurance companies were nationalized more than two decades ago. While a number of countries had undertaken such actions in the 1970s and early 1980s, for instance Mexico, France, and Chile, however, they have almost completely reversed this policy by now. Be that as it may, Nepal still continues to rely on a state-owned, state-run banking system and the insurance sector till very recently remained a government monopoly. This, as one would expect, has had highly adverse results, both in terms of availability of funds for investment and a negligible presence of foreign banks and no presence of foreign insurance companies in the country.

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