

Enhancing FDI Flows to Nepal during the Period of Post-conflict Transition and Global Recession

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FDI is much sought after in conflict-stricken countries such as Nepal as it can play a crucial role in the development process. However, the process of attracting and promoting FDI is complex, in particular as most developing countries, including Nepal, are competing for similar types of FDI. Although a number of efforts have been made in the past to boost FDI flows to the country, they have not had any striking impact. The country has not been able to draw on the potential technological and other contributions that FDI can make to the process of development. This underlines the need for effective policy interventions with a view to maximizing the benefits of FDI for Nepal's development in an open environment. Nepal also needs policy framework to enhance national and regional infrastructure, in areas such as transport, energy and communications services, and to generate domestic employment and skills transfer. The main policy conclusion that can be drawn from this paper is that the economic benefits of FDI are real, but they do not accrue automatically. To reap the maximum benefits, a healthy enabling environment for business is paramount, which encourages domestic as well as foreign investment, provides incentives for innovation and improvements of skills and contributes to a competitive investment climate.

I. BACKGROUND

Foreign direct investment (FDI) in developing countries has a long history. It has fluctuated over time, as investors have responded to changes in the environment for investment, including government policies toward FDI and the broader economic policy framework. Hence, trends in FDI have reflected changes in policy stances by developing countries, from import substitution in the 1950s and 1960s through natural resource-led development in the 1970s, structural adjustment and transition to market economies in the 1980s, and an increased role for the private sector in the 1990s.

Sudden and sharp capital inflow reversals have been a salient feature of recent emerging market crises. Among the different types of capital flows, short-term bank flows and portfolio flows, especially, have been most volatile. Longer-term capital flows such as FDI, on the other hand, have generally been more stable. Thus, FDI is viewed as a “desirable” form of capital inflow compared with other more volatile flows. Again, beyond providing additional financial resources (when not financed locally), FDI can facilitate the transfer of intangible assets such as technology, skills, and management know-how, thus helping to directly raise productivity and growth; in addition, FDI could

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assist in securing foreign market access. In short, FDI seems to offer a bundle of “good” characteristics ranging from a high degree of stability, financial resource augmentation, positive productivity effects and, perhaps, access to foreign markets.

Analogous to other economic activities, FDI has been going through dramatic changes since the end of 2008. The atypical magnitude of the ongoing economic and financial crisis—the worst in the last 60 years—provokes major apprehensions about the propensity and capability of multinational corporations (MNCs) to continue investing and expanding abroad. Faltering profits, reduced access to financial resources, declining market opportunities, coupled with the risk of a possible worsening of the current global economic downturn are some of the factors responsible for a fall in FDI flows.

The current global crisis has largely affected FDI flows, after their steady upward trend between 2003 and 2007, with FDI inflows touching a historic figure of \$1.9 trillion in 2007. Because of the financial crisis, global FDI inflows are estimated to go down from \$1.7 trillion in 2008 to below \$1.2 trillion in 2009, with a slow recovery in 2010 (to a level up to \$1.4 trillion) and gaining momentum in 2011 (approaching \$1.8 trillion). The crisis has altered the FDI landscape: investments to developing and transition economies soared, increasing their share in global FDI flows to 43 percent in 2008. This was partly attributed to a concurrent large decline in FDI flows to developed countries (29 percent) (UNCTAD, 2009). However, in 2009 FDI flows to all regions will experience a setback.

The decrease in FDI flows, together with a surge in corporate restructurings and divestments, emanates from two main factors. One, the capability of firms to invest has been reduced by a reduction in access to financial resources, both internally—owing to a decline in corporate profits—and externally—owing to lower availability and higher costs of finance. Two, the propensity to invest has been diminished by negative economic prospects, especially in developed countries that have been the worst affected (UNCTAD, 2009a).

With respect to Nepal, so far the country does not seem have witnessed an adverse impact in terms of FDI inflows due to the global recession. Nepal’s foreign investment rules and regulations are based on the *Foreign Investment and Technology Transfer Act 1992*, which was amended in 1996 in line with open and liberal economic policies. One of the major policies of the Three-Year Interim Plan (2007/8-2009/10) is the promotion of domestic and foreign investment for the development of the economic sector of the country. Again, in the case of Nepal, as a conflict-stricken economy, FDI is more sought since it has an even more instrumental role in buttressing the building-up process. Though many attempts were made in the past to boost FDI flows to the country, they did not have any noteworthy impact.

On the basis of the above background, this paper is organized as follows. Section II examines the determining factors and benefits of attracting more FDI. The following section reviews some theories of FDI while Section IV assesses the problems encountered by post-conflict economies in promoting FDI. Nepal’s experiences in attracting FDI are highlighted in Section V. Some policy measures are also suggested. The last section provides the concluding observations.

II. DEFINITION, DETERMINANTS AND BENEFITS

Definition

FDI occurs when an investor based in one country (the home country) acquires an asset in another country (the host country) with the intent to manage that asset. The management dimension is what distinguishes FDI from portfolio investment in foreign stocks, bonds and other financial instruments. In most instances, both the investor and the asset it manages abroad are business firms. In such cases, the investor is typically referred to as the “parent firm” and the asset as the “affiliate” or “subsidiary”.

There are three main categories of FDI:

- Equity capital is the value of the multinational corporation's (MNC) investment in shares of an enterprise in a foreign country. An equity capital stake of 10 percent or more of the ordinary shares or voting power in an incorporated enterprise, or its equivalent in an unincorporated enterprise, is normally considered as a threshold for the control of assets. This category includes both mergers and acquisitions and “greenfield” investments (the creation of new facilities).
- Reinvested earnings are the MNC's share of affiliate earnings not distributed as dividends or remitted to the MNC. Such retained profits by affiliates are assumed to be reinvested in the affiliate.
- Other capital refers to short or long-term borrowing and lending of funds between the MNC and the affiliate.

These three main categories of FDI described above are those used in balance-of-payments (BoP) statistics.

The available statistics on FDI, which are far from ideal, come mainly from three sources. First, there are statistics from the records of ministries and agencies that administer the country's laws and regulations on FDI. The request for a license or the fulfillment of notification requirements allows these agencies to record data on FDI flows. Typically, re-invested earnings, intra-company loans, and liquidations of investment are not recorded, and not all notified investments are fully realized in the period covered by notification. Second, there are the FDI data taken from government and other surveys, which evaluate financial and operating data of companies. While these data provide information on sales (domestic and foreign), earnings, employment and the share of value added of foreign affiliates in domestic output, they often are not comparable across countries because of differences in definitions and coverage. Third, there are the data taken from national BOP, for which internationally agreed guidelines exist in the fifth edition of the IMF's *Balance of Payments Manual* (IMF, 1993).

Determinants

How FDI impacts growth and development depends, to a large degree, on the type and volume of FDI. Hence, it is crucial to understand what attracts FDI, how this has changed over time, and what these changes in determinants and types of FDI mean for differential growth prospects.

The major determinants of inward FDI can be divided into many categories, and link to a) general policy factors (e.g. political stability, privatization); b) specific FDI policies (incentives, performance requirements, investment promotion), c) macro economic factors (human resources, infrastructure, market size and growth); and d) firm specific factors (technology).¹

General Policy Factors

Theory indicates that long-term investment benefits from stability as it lowers the risks for the long-term investor. This has been supported by investor surveys and evidences. Politically unstable countries appear to attract relatively small amounts of FDI.²

Countries that provide a welcoming ‘investment climate’ attract more investment. A welcoming investment climate is governed by many factors determining investment. Stricter regulation of business entry is associated with higher corruption and thus weaker governance, deterring investment. Even though countries have begun to understand what a welcoming investment climate involves, with some reductions in red tape, there is still a wide variation in administrative and regulatory practices.

FDI Policies

Renewed confidence in the advantages of FDI has led many countries that were restricting FDI in the 1960s, 1970s and 1980s to be more open towards FDI in the 1990s and beyond (Lall, 2000).

Much of the FDI potential in developing countries was not acknowledged a few decades ago as many countries had stringent restrictions on foreign ownership, and many of what are now regarded as conducive factors (for instance, a competitive environment and good quality local capabilities) were not in order. This is slowly changing. Almost all countries are now actively and aggressively welcoming FDI.

Investment liberalization has coincided with an increased focus on FDI protection and promotion. Countries now actively try to attract FDI and have set up FDI promotion agencies. Tools included for FDI promotion comprise incentives, export processing zones and science parks, among others.

Macro-economic Factors

General and specific FDI policies have become less restrictive to inward FDI. With fewer policy barriers, other factors have become more crucial as determinants. Among these are basic economic pull factors like good quality and appropriate human resources and infrastructure on the supply side, and market size and market potential on the demand side. Macro-economic policies that shape the underlying fundamentals of cost-competitiveness have become more crucial over time in attracting FDI. Lall (2000a)

¹ For instance, ICT developments have had a significant impact on the way companies structure their international activities. Most importantly, it has facilitated a more specialized production attracted to those locations that can offer the most competitive environment for any given activity. Details are given in Velde (2006).

² The major exception to this rule are countries rich in natural resources which have managed to attract huge amount of FDI despite often unstable environment.

argues that FDI location decisions will, to a large extent, depend on economic factors and not on temporary policy interventions.

Firm Specific Factors

Since the 1950s, researchers have attempted to understand the evolution of FDI through micro-economic factors. International business studies have had a long tradition studying MNCs and use an eclectic paradigm for FDI, the Ownership-Location-Internalization (OLI) framework (Dunning, 1993).³ Economists such as Caves (1974) and Dunning have emphasized that MNCs need to possess some firm-specific asset that differentiates them from domestic firm to compensate for the extra costs in terms of local knowledge that a foreign firm must incur to operate in foreign markets. The firm-specific asset is called an ownership (O) advantage. As the firm-specific asset is often related to access to some superior technology or to specific knowledge of production processes, foreign affiliates require the right skill-mix to use the specific technology and to undertake a complex production process in usually large-sized plants. MNCs should also have an internalization (I) advantage to internalize business contacts, and not to outsource. Finally, the reason why a multinational invests in one country but not in another depends on the country's locational advantage (L).

It is suggested by Markusen (1995) that technology or the firm-specific asset (ownership advantage) is the primary reason for FDI. The claim that technology rather than different factor endowments and prices underpin FDI can also explain why trade and FDI can be complements rather than substitutes.

Benefits

In general, FDI inflows can contribute to the growth and development of the economy in host countries by generating employment and expanding the supply of goods. FDI associated with MNCs can create spillover effects, providing new skills, technologies, and marketing networks for local producers. Foreign firms also can provide training for workers—not only in manufacturing processes but also in management. Such training can make local workers more productive, particularly when technology transfer is involved, and increase their wages (ADB, 2004).

FDI can help earn foreign currencies for host countries by increasing the manufacture of goods and services that are exported. The earning of foreign currencies is critical for developing countries to generate a current account surplus to finance the import of necessary inputs, among other things. If a current account surplus is not available to finance imports, the country's capital account must be relied upon, which can lead to debt accumulation. FDI focused on export-oriented industries can positively affect the volume of trade in the host country, and stimulate economic growth. In addition, the global marketing network of MNCs that invest in export-oriented industries can be used to market products of local affiliates and other worthy local firms in the host country.⁴

³ This is further discussed in Section III.

⁴ In India, for instance, FDI from the US has been observed to positively and significantly affect the export intensities of domestic firms operating in the nontraditional export market. See Banga (2003) for further elaboration.

If the domestic market of a prospective host country is expected to be large in the future, especially in countries with large populations, MNCs may use FDI to establish large domestic production bases in those markets. Purchasing power and consumption can expand quickly in developing economies with rapidly expanding economies. Countries with large populations can thus provide rich business opportunities for MNCs for the production of goods for domestic markets at local production bases. Such production can replace imports and reduce the burden of foreign borrowing. This type of FDI can also expand consumer welfare in the host country if local consumers are provided a wider range of products of better quality at lower prices.

Technology transfer and knowledge spillovers often can be expected from FDI inflows. Spillovers are indirect effects of FDI, and can be defined as circumstances where FDI improves the technology or productivity of domestic firms. Spillover effects can have both vertical and horizontal impacts on host economies. Vertical spillovers refer to inter-industry impacts.⁵ Horizontal spillovers occur when FDI promotes intra-industry competition in local markets through imitation effects and positive effects on human capital, industrial relations, market competition, and technology transfer. Vertical and horizontal effects can help local firms raise productivity as a result of improvements in human capital and industrial management skills, competition and efficiency, production processes, technological capabilities, and research and development (R&D). Through these linkages, FDI can help diversify local industries and thus diminish the economic vulnerability of host economies to external shocks that result from a narrowly based industrial structure.

FDI can play an important role in the overall development process, and in meeting the MDGs (Addison and Mavrotas, 2004). First, FDI is a source of capital accumulation, both physical capital and human capital. Provided that the FDI projects are well-designed, their rate of return will raise economic growth, thereby adding to the growth of employment, an indirect effect which is additional to the jobs created by FDI projects themselves. Second, FDI can generate much-needed revenues for governments to spend on MDG-focused infrastructure and services. These revenue effects are both direct (through corporate taxes paid by the enterprises themselves as well as revenue from FDI in the natural resource sectors) and indirect (when FDI raises economic growth and therefore the economy's total tax base).

To sum up this section, FDI's development benefits are potentially strong, but whether this potential is realized or not largely depends on the host country having a clear vision of how FDI fits into its overall development strategy. Thus, FDI can be used to diversify the economy thereby reducing over-dependence on a few commodity-based sectors, for example by creating new manufacturing and service-sectors, particularly in exports and in services which use the new information and communication technologies (ICTs).

⁵ For example, when foreign manufacturing firms tap local suppliers for procurement of inputs, the demand for local inputs expands production possibilities in the host country through backward linkages.

III. THEORIES

Market Imperfections

One of the earliest attempts to introduce market imperfections in the theory of FDI was made by Hymer (1976). He argued that the investing firm must have some advantages specific to its ownership which are sufficient to outweigh the disadvantages they faced in competing with indigenous firms in the host country. These exclusive advantages imply the existence of some kind of market failure. This is because in a perfectly competitive world, all firms are competing equally and have no advantage over others. FDI cannot take place in such a world.

However, as other writers (Hood and Trijuens, 1993; Dunning, 1988, 1993) have pointed out, the existence of ownership advantages does not necessitate production abroad, for the foreign firm can exploit its advantage through licensing or through producing at home and exporting. To explain the choice of FDI over producing at home and exporting, it is necessary to take into account local-specific factors such as trade barriers and market characteristics.

Internalization Theory

Internalization theory also focuses on market imperfections. But these imperfections are in the markets for intermediate inputs and technology. Intermediate inputs in this context are not just semi-processed materials but more often are types of knowledge incorporated in patents and human capital, among others (Hood and Young, 1984). Imperfections in markets for intermediate inputs create difficulties and uncertainty for the firm to fully exploit its advantages. A profit-maximizing firm faced with such imperfections will try to overcome these in the external market by internalizing them in their operation, either through backward or forward integration.

There are a number of such imperfections that are considered important in stimulating internalization. An example is government intervention in the form of tariff, taxation, and exchange rate policies that create difficulties in the firm's sourcing activities and in exploiting location-specific advantages. All these factors stimulate firms to internalize.

Product Cycle Hypothesis

The above explanations of FDI have been based upon static advantages, either specific to firms or specific to a location. However, the relative importance of these advantages will change over time as the product develops through its life cycle. As a consequence the firm's choice between export, FDI and licensing might also change. Vernon (1966) developed the product cycle model to deal with such dynamic aspects of FDI activities. Initially, Vernon attempted to explain US investment in Europe during the post-war period by answering two questions. The first concerns why innovations occur in developed countries and the second concerns why they are transferred abroad. Vernon tried to answer these questions by relating the product life cycle, which is divided into three stages progressing from the 'new' to the 'mature' and ultimately the 'standardized'

product, to the location decisions made by firms and the choice between exports and overseas production.⁶

Although the product cycle hypothesis has several weaknesses and might be an oversimplification of reality, it has provided an explanation of why innovations occur mostly in developed countries, while at the same time it explains both trade and investment flows.

Eclectic Paradigm

According to Dunning (1979), the product cycle hypothesis is only a partial explanation. He developed an eclectic approach to the problem. The principal hypothesis of this eclectic theory is that a firm will engage in FDI if the following three conditions are met:

1. It possesses ownership advantages over firms of other nationalities in serving particular markets. These advantages are specific to the firm.
2. Given (1) is satisfied, it must be more beneficial to the firm to exploit the advantages itself rather than to sell or lease or license them to foreign firms, that is to internalize its advantages through an extension of its activities rather than externalizing them.
3. Given (1) and (2) are satisfied, it must be profitable for the firm to combine these advantages with some factors in the foreign country.

The key point of the eclectic theory is that any one of these advantages may be necessary but not sufficient to give rise to FDI. It is necessary to consider all three conditions together. Dunning (1993) concludes that all forms of FDI can be explained by the above three conditions.

Investment Development Path Theory

The Investment Development Path (IDP) theory was introduced by Dunning (1981) as an extension of Eclectic Paradigm, to explain the net outward investment position of countries in relation to their development stages. The Eclectic Paradigm suggests that the direct investment stock of countries is determined by three factors: ownership, location and internalization (OLI) advantages. According to the IDP theory, the country passes through five main development stages determined by the changes in the OLI parameters

⁶ In the first stage, market conditions in developed countries, particularly in the US, facilitate the innovation of new products. The second stage is when the product is maturing, and potential competitors appear. Some degree of standardization has been introduced in the design and production process. Faced with the resultant competition, producers are more concerned with the cost of production. In the final stage of this model, namely the standardized product, developing countries are at a comparative advantage as a production location. At this stage, market knowledge and information are less important; therefore, the priority is for the least-cost location. The net result is that the production facility or assembly is moved to developing countries to take advantage of low labor costs.

of domestic firms of the country (Dunning and Narula 1996).⁷ These changes affect the international investment position of the country with respect to its development.

Recent Empirical Studies

According to Blomström & Kokko (2003) and Borenzstein, De Gregorio & Lee (1998), the contributions of FDI to the development of a country are widely recognized as filling the gap between desired investment and domestically mobilized saving, increasing tax revenues, and improving management and technology, as well as labor skills in host countries. These could help the country to fight its way out of poverty.

Empirical studies suggest that FDI provides a source of capital and complements domestic private investment. Some studies (Blomström & Kokko, 2003, and Chen & Démurger, 2002) conclude that FDI contributes to total factor productivity and income growth in host economies, over and above what domestic investment would trigger. These studies find, further, that policies that promote indigenous technological capability, such as education, technical training, and R & D, increase the aggregate rate of technology transfer from FDI and that export promoting trade regimes are also important prerequisites for positive FDI impact. For instance, the study by Borenzstein, De Gregorio, and Lee (1998) using data on FDI received by developing countries tested the effect of FDI on economic growth in a cross-country regression framework. They found some indications that FDI has a positive effect on economic growth, but this impact was dependent on the human capital stock in the host economy.

However, there is growing empirical evidence suggesting that the impact of FDI on economic growth is not automatic. Borenzstein, De Gregorio, and Lee (1998) show that for FDI to contribute to economic growth, the host country must have achieved a minimum threshold level of development in education, technology, infrastructure, financial markets, and health. Thus, FDI contributes to economic growth only when the host country has reached a developmental level capable of absorbing the advanced technology that it brings.

Excessive FDI may not be beneficial. Through ownership and control of domestic companies, foreign firms know more about the host country's productivity, and they could overinvest, at the expense of domestic producers. Possibility exists that the most solid firms will be financed through FDI, leaving domestic investors stuck with low-productivity firms. Such "adverse selection" is not the best economic outcome.⁸

⁷ In the first stage of IDP, outward FDI of the country is at a negligible level or zero because of insufficient ownership advantages of domestic firms. In the second stage of IDP, outward direct investments remain still at a negligible level but inward FDI begins to rise as the location advantages of the country improves, particularly with the help of government policies. Eventually, the rate of outward FDI begins to increase in the third stage of IDP. In the fourth stage, outward FDI of the country becomes equal to or greater than its inward FDI. Finally, the net outward investment level of a country fluctuates at the zero level in the fifth stage of IDP while the growth rate of both inward and outward FDI continues to rise.

⁸ The impact of too much FDI is discussed in Kumar (2007).

IV. FDI IN POST-CONFLICT ECONOMIES

Post conflict transition countries cannot be considered as normal economies. The majority of them are burdened by substantial market failures, relative small market size, severe economic constraints and weak institutions necessary for a well functioning economy. Many of them fall into the category of countries described as least developed; some of them are landlocked, such as Nepal. These countries are also afflicted by a number of risks and capacity deficits including political instability and security problems. Physical infrastructure is often destroyed or unavailable, including electricity, water, transport and access to land. Corruption is often rife, while transparency and the rule of law are very weak. These economies are also normally deprived of skilled labor as they struggle to cope with the effects of brain drain and capital flight.

In the process of post-conflict recovery, reconstruction and development of physical and institutional infrastructure are the prime goals. The two major avenues of such development are foreign aid and FDI. Development aid alone cannot transform devastated economies into vibrant, self-sufficient systems—FDI can bring added advantages, and can eventually even abolish the need for foreign aid (Turner *et. al*, 2008). FDI generates employment opportunities, which are crucial in the attainment of long-term economic stability. It provides capital to raise the productive capacity of the host economy, access to international markets, helping countries to shift from aid-dependent to investment-driven post-conflict reconstruction. The presence of foreign investment can also provide a type of 'peace dividend', instilling the people with a stronger sense of hope and providing incentives to consolidate peace.

Attracting a form of FDI that is beneficial to post-conflict countries depends upon prioritizing quality of investment, rather than focusing solely on the size of investment flows. FDI can only be justified if it is high value and makes a genuine contribution to the host economy, with respect to employment generation and spillover of knowledge or technology. Any investment regime must acknowledge that foreign investment is part of economic development within a reconstruction and peace-building process, and not an end in itself.

Hence, in order for FDI to transform post conflict transition countries, some positive and proactive steps need to be initiated to ensure that FDI fits into some domestic investment demand systems, such that FDI creates the necessary spill-over effects and internal linkages with the local economy.

With regard to the impact of internal conflict in FDI in conflict-ridden countries, limited literature exists in both theoretical and research form. Vadlamannati (2007) showed how internal state conflict affected FDI inflows in Sri Lanka from 1980 to 2006.⁹ The claims

⁹ The methodology included generating econometric models based on linear approach which takes into account both FDI presence and actual FDI inflows into the country to estimate the impact of civil war. Also examined are the role of internal conflict and economic performance on volatility in FDI inflows and intensity of volatility in FDI inflows. Vadlamannati's paper brought into play these empirical models using conflict variables and other key macroeconomic variables, which would allow obtaining some general characterization of the effects of internal state conflict on FDI inflows in Sri Lanka.

rought forward by Vadlamannati's study are that foreign investor, while choosing an investment destination keenly observe whether the investment destination is war free or not and do not take into account the issues like number of terror events. However, once the investment is made in the country, foreign investors are likely to react to the extremities of the civil war in the form of the number of terror events. Besides, this study also shows that ongoing civil war in the country coupled with poor economic performance in the past are the prime reasons for volatility in FDI inflows.

Overall, experiences demonstrate clearly that investors will often invest in locations with suboptimal investment climates, as long as there is a clear business case and as long as they believe that the location satisfies certain minimum business environment standards. They often also invest when things are moving in the right path and the government is committed to reform. Hence, once reform is perceived to be underway, it would become more feasible to consider promoting selectively for investment in key sectors. In this perspective, experiences from a number of post-conflict countries show that investment promotion agencies (IPAs) have a number of responsibilities to fulfill in building credibility (Box 1).

Box 1: Experience from Post-Conflict Countries

Experiences in post-conflict countries such as the Balkans, Sub-Saharan Africa and Indonesia (Aceh) suggest that investment promotion agencies (IPAs) face three key challenges in building credibility:

- Building the country's image as a stable and peaceful place for investors to locate their businesses;
- Building the country's "promotional product", in other words the IPA needs to build effective "arguments" to sell the country as location for investment. These include being able to point to a good investment environment, strong business-related infrastructure, labor skills, power and water supply, among others; and
- Building a targeted marketing strategy and creating a network of business contacts that will get the country back on to investors' "radar screens"; in other words, IPAs face a real challenge in letting potential investors know that the country is open and ready to do business with them.

Source: IFC (2007).

V. NEPAL'S EXPERIENCES

Background

Development priorities of Nepal include achieving sustained economic and human development to reduce poverty by strengthening technological capacities and skills, improving access to world markets, and creating more and better employment opportunities. To pursue these strategies, the country needs significantly increased flow of investment capital, especially FDI. However, globalization has led to an increase in competition for FDI among developing countries thereby making it even more difficult for Nepal to attract new investment flows. Hence, one of the development challenges facing Nepal is how to attract and retain FDI on a sustainable basis. It is true that in the present context of global economic recession, it could be difficult for Nepal to attract FDI

inflows as most developing countries are competing for similar types of FDI. Still, FDI is highly preferred in this post-conflict economy as it can play a key role in facilitating the building-up process.

A direct investment enterprise is defined as "an incorporated or unincorporated enterprise in which a direct investor, who is resident in another economy, owns 10 percent or more of the ordinary shares or voting power (for an incorporated enterprise) or the equivalent (for an unincorporated enterprise)" (IMF, 1993, p. 86). However, Nepal does not apply the current 10 percent rule. According to the *Foreign Investment and Technology Transfer Act 1992*, foreign investment means the following investment made by a foreign investor in any industry: a) investment in share (equity); b) reinvestment of the earnings derived from the investment in share (equity); and c) investment made in the form of loan or loan facilities. The minimum investment needs to be equivalent to US\$ 20,000.

FDI in Policy-making

For the first time, the Sixth Plan (1980/81-1984/85) incorporated a policy for utilizing foreign capital and technology as a useful supplement. The Plan mentioned that foreign investment and technology was primarily required in large-scale industries and mineral industries. As an upshot, the *Foreign Investment and Technology Transfer Act 1982* was introduced. Presently, however, Nepal's foreign investment rules and regulations have been formulated on the basis of the *Foreign Investment and Technology Transfer Act 1992* that was amended in 1996 in line with open and liberal economic policies.

According to *Foreign Investment and Technology Transfer Act, 1992*, foreign investors are equally treated as local investors and the same act prevails regarding incentives and facilities to foreign investors. Incentives and facilities are designed to make investment viable and products competitive. Some of them include the following: a) foreign investors are allowed to hold 100 percent ownership in industries, except the cottage scale enterprises and a few restricted activities such as security related ones; b) technology transfer is allowed in all types of industries even in the areas where foreign investment is not allowed; c) full repatriation of the amount received from the sale of equity, profits, or dividends and interest on foreign loan and the repatriation of the amount received under an agreement for the transfer of technology is permitted; d) foreign investors will be granted a business visa until their investment is retained; e) the resident visa will be provided to foreign investors, who at a time, makes an investment in excess of US \$ 100,000 or equivalent; and f) only nominal import duty is levied on raw materials. Despite the implementation of most of the policy measures of the *Foreign Investment and Technology Transfer Act, 1992*, the country has not been able to attract FDI for its development benefits.

One of the major policies of the Three-Year Interim Plan (2007/8-2009/10) is the promotion of domestic and foreign investment for the country's economic development (NPC, 2008). The main objectives of foreign investment include raising of the foreign investment level by broadening the industrial base, seeking foreign aid to supplement resources needed for a sustainable high economic growth and employment generation, and augmenting technology and management skill transfer.

Some policies pertaining to FDI in the Three-Year Interim Plan include the following:

- Foreign investment in the form of joint ventures would be encouraged in hydropower production; components of tourism development such as airport construction and its management; airlines, star hotels and recreational facilities construction; agriculture and non-timber based high value products; development of education and health related facilities. Financial services, information technology, and biotechnology related industries, would also be incorporated in the field of such investments.
- With respect to the medium and large-scale production industries, 100 per cent share-based investment would be permitted. Similarly, that list would also comprise export-oriented industries, natural resources excavation, construction of toll roads and construction of goods management terminal.
- Individuals wishing to invest in the development of the basis for the dissemination of employment technology making compatible with the existing economic structure would be encouraged. Investors that seek to invest in joint venture with the Nepalese, with management skills and technology transfer package, would also be welcomed.
- Suitable policy would be formulated to attract capital, skills, efficiency and technology of the non-resident Nepalese.
- Nepalese diplomatic missions abroad would be mobilized for the promotion of foreign investment.
- A high-level investment promotion board would be set up to facilitate foreign investment. This board would operate as a "one window" shop for satisfying the requirement of project approval, licensing, tax facilities and infrastructure management as necessary, for the large-scale investors.

Whether the objectives of FDI as delineated in the Three Year Interim Plan will be realized or not is yet to be seen.

One of the objectives of the *Budget Speech for 2008/09* is investment promotion (MOF, 2008). A policy has been initiated to guarantee industrial and investment security, reform in legal and organization structure for creation of investment climate, procedural simplification, additional provision for sick industry rehabilitation and opportunities for foreign, non-resident Nepalis and private sector investment. A law related to Special Economic Zone is to be enacted for development and management of industrial estates, export processing zones and special commercial areas. A Garment Processing Centre is to be set up in Simara. An Investment Board with full authority would be established for industrial investment promotion.

Institutional Arrangements

As per *the Industrial Enterprises Act, 1992*, there existed a provision to establish the One Window Service (OWS) whose aim was to provide all services required by foreign investors under one roof. Specifically, the policy listed two types of services to be provided by the OWS: a) permission, facilities, and other administrative services under

the *Foreign and Technology Transfer Act, 1992* and b) other infrastructural facilities (such as registration, land, electricity, telecommunication, water) and other services as required by the investors. However, the One Window Committee set up to provide infrastructure facilities under the one-window system for industries to be established with foreign investment was not successful in addressing the true needs of the investors.

An Industrial Promotion Board was formed under the chairmanship of the Minister of Industries on the basis of the *Industrial Enterprises Act, 1992*. The principal objectives of the Board were a) providing necessary co-operation in developing and implementing policies, laws and regulations pertaining to industrial development of the country; b) developing guidelines in meeting the aims of liberal, open and competitive economic policies undertaken by the country in order to make the industrial sector competitive; c) coordinating between the policy level and the implementation level of the industrial policy; and d) suggesting to the Government for including any other industry in the classification of industries. An evaluation of the functions, duties and powers of the Industrial Promotion Board depicts that they are confined to a large extent to policy-related matters.

Nepal formed a Board of Investment (BOI) under the chairmanship of the Prime Minister in December 2001. The BOI was established for promoting investment and making it more transparent and reliable. The other objectives of the Board were, among others, a) formulating new policies by reviewing the existing investment policy, b) maintaining coordination between various government and non-government organizations for the promotion of investment, c) pinpointing the areas of priority sector for investment promotion, d) monitoring the activities associated with investment promotion and e) providing directives to the concerned department to boost up investment. However, it is disappointing to note that the BOI has not been functioning smoothly as per its objectives. In this respect, as indicated earlier, the announcement of the formation of an Investment Board in *Budget Speech for 2008/09* with full authority for promoting industrial investment seems a positive step. However, just the formation of the BOI is not adequate. It needs to accord priority to implementation of a focused and targeted investment promotion and facilitation policy.

Experiences indicate that most successful investment regimes in a number of countries have been driven with a single-minded goal at the highest level of Government. A powerful institutional arrangement with all necessary powers will command respect and authority and enable the country to put foreign investment at the top of the development agenda. This type of arrangement is essential in promoting and attracting FDI and also in facilitating the post-approval process. In this respect, as the Board of Investment kind of institutional arrangement in Sri Lanka and Bangladesh have been found quite successful

in carrying out its functions, Nepal could draw many lessons from the experiences of these two countries (Pant and Sigdel, 2004).¹⁰

Data Limitations

In Nepal, the *Foreign Investment and Technology Transfer Act, 1992* empowers the Department of Industries (DOI) to administer, implement and evaluate all foreign investment projects. The compilation, maintenance and publishing of statistical data related to industrial sector of Nepal (including FDI) are generally made by the DOI. The DOI approves direct investment applications and the Foreign Exchange Management Department of the Nepal Rastra Bank (NRB) approves principal and interest repayments by these enterprises.

The FDI figures for Nepal are based on data provided by the DOI and are linked to the number of projects approved. There are often significant time lags between approval and actual investment; the actual investment may not take place at all. For instance, in 2008/09, the number of approved FDI projects was 230. The foreign investment tied with these projects amounted to Rs. 6.25 billion. However, it is believed that the actual disbursement of FDI in Nepal is much lower than the approvals.¹¹ Information on reinvested earnings and on withdrawals of investment (disinvestments) is generally not captured. Although the DOI requires all FDI-related enterprises to submit their financial statements every three months, this practice has not been followed.

In 2002 and 2003, a survey was undertaken by the NRB in an attempt to improve the recording of FDI data. Direct investment surveys forms were provided to 158 previously-identified direct investment enterprises. However, completed survey forms were received from just 78 enterprises. A number of problems were encountered: a) some enterprises had ceased operations and/or changed their locations with no known forwarding address; b) data reported by the enterprises did not relate to the requested period; and c) most of the responding enterprises reported net losses from operations in Nepal.

¹⁰ In the case of Sri Lanka, for instance, investor friendly policies, simplified systems and procedures and business-like attitudes adopted by the BOI over the last few years led to phenomenal growth of FDI inflows. The country has achieved the highest ever growth of FDI inflow in 2008, which reached US\$ 889 mil. This was achieved in a year when worldwide FDI inflows were down by 15 percent. Sri Lanka was able to attract such FDI inflows introducing innovative measures such as simplified application and approval procedures where the investment approval could be granted within a day. The investor was freed of the burden of filing and lodging a large number of documents. In addition there was a reduction of bureaucracy, of cumbersome practices, a reduction of waiting time, a simplification of the process of company formation and registration. The long-term effect was an improvement of the doing business index of Sri Lanka. The setting up of the Cabinet Sub-Committee on Investment Facilitation (CSIF) headed by the President to resolve the major policy issues faced by the investors is further proof of importance Sri Lankan authorities accord to and of their commitment to the promotion and facilitation and retention of FDI (*The Colombo Times*, May 11, 2009). These measures are worth emulating by Nepal in pursuit of attracting FDI under severe competitive conditions.

¹¹ According to the balance of payments (BoP) data, however, FDI amounting to only Rs. 1.83 billion flowed into the country in 2008/09. It should be noted that this figure is an underestimation since not all the FDI

To resolve the problem pertaining to the compilation and monitoring of FDI data, the formation of a Foreign Direct Investment Supervision Committee is being initiated comprising members from the Department of Industries, the Federation of the Nepalese Chamber of Commerce and Industry, and the Foreign Exchange Management Department and Research Department of the NRB. The proposed Committee would regulate the data reporting by direct investment enterprises and the systematic compilation of such data.

Again, for proper recording of FDI data, Nepal is participating in the Coordinated Direct Investment Survey (CDIS) that is being conducted by the IMF.¹² In a country where data on FDI has not been properly recorded, participation in this Survey would greatly facilitate in the improvement of the country's recording system.

Other Impediments

Nepal faces multiple challenges such as inadequate development of macroeconomic environment, unsatisfactory physical and economic infrastructure development, level of technology development, disadvantaged geographical situation and lack of entrepreneurship and managerial capacity in its efforts for attracting FDI. Administrative instability, lack of consistent planning, insufficient institutional capacity, reliance on unsolicited proposals and a lack of government support arrangements are other obstacles.

The absence of supporting infrastructure such as telecommunication, transport, power and water supply and skilled labor discourage foreign investors since it increases transaction costs. Investment comes along with the need to communicate with clients at ease, operate efficiently under reliable utilities. Such factors include proper infrastructure and utilities that would make investing in Nepal a pleasure with no hassles. The constant cuts in power and water supply make it hard for international businesses to manufacture and produce efficiently. Moreover, the cost of transport is very high in the country.

Political instability denotes that Nepal presents mainstream foreign investors with an unacceptably high level of political risk. Significant prospective investors will delay the identification and implementation of projects until the risk profile becomes acceptable.

Plausible Measures

The current global environment is characterized by an intense “global race” for foreign investment. No doubt, FDI is drawn to different countries for different reasons. Nonetheless, at a general level, in order for a country to be more attractive to investors, there is a need to put in place measures to ensure the existence of an enabling environment, i.e., one that is conducive to doing business. In this respect, the following measures could facilitate in the promotion of FDI in Nepal in this post-conflict era:

- Regional integration could be used as strategy to overcome the limitations of market size of Nepal. Furthermore, since all countries in the South Asian region are trying to

¹² The major objectives of the CDIS include: a) collecting comprehensive and harmonized information, with geographic detail, on the stock of inward FDI as at end 2009; b) for the major investing countries, also gathering comprehensive and harmonized information, with geographic detail, on the stock of outward FDI; and c) exchanging bilateral data among the participating countries.

attract FDI, a great deal of competitive overbidding and unnecessary loss of resources could be avoided through some harmonization of FDI policies among different governments.

- Policies and strategies for the promotion and attraction of FDI should clearly delineate areas in which FDI is desired; FDI should not be attracted indiscriminately but should be geared to the country's needs and requirements while taking investor concerns into full account.¹³ At the same time, countries and regions from which foreign companies are to be attracted, as well as the foreign companies themselves, need to be carefully screened on their suitability and targeted on the basis of solid research and superior marketing techniques. In this context, particular attention could be paid to attracting investment from nationals living abroad as experience shows that in many countries the diaspora has been the pioneer of foreign investment.
- Nepal should strive to improve, in particular: (a) a well-disciplined, relatively cheap, but reasonably well-educated labor force; (b) access to adequate infrastructural and institutional facilities, including information and communications technology (ICT) facilities; (c) a stable legal and financial framework and environment; and (d) a stable political environment with a government committed to economic development and reform and absence of excessive red tape and corruption in the FDI approval and implementation process.
- The country needs to accord priority to improving the rule of law, including transparency in the formulation of the laws and regulations, consistency among them, and due implementation, enforcement as well as proper dissemination and communication of laws and regulations and any changes therein and consistent interpretation by all concerned official entities. Laws and regulations should not change too often while incentives for investors need to be carefully evaluated on their net benefits. All in all, there is a need of a substantial revision of the Foreign Investment and Technology Transfer Act of 1992 in the context of Nepal's entry into the WTO, SAFTA and BIMSTEC.
- Without accurate and reliable FDI data, policy makers in Nepal face difficulties in the formulation of appropriate investment policies. In this context, the formation of a Foreign Direct Investment Supervision Committee that is being initiated for regulating the FDI data reporting by direct investment enterprises and the country's participation in the CDIS are steps in the right direction.

¹³ In this context, an example from India seems worth-mentioning. India's FDI inflows have reached US\$ 42 billion in 2008-09, an 11 percent jump from the previous year. It is being seen among the top five investors' destinations during the next two years, according to UNCTAD's *World Investment Prospects Survey 2009-2011*. The Government has turned pro-active and is instituting measures to attract inflows. Ministries are coordinating with investor countries and enterprises to present investment opportunities across sectors. The Government, for the first time, has established a non-profit company, Invest India, in collaboration with industry body FICCI and state governments for attracting foreign investment focusing on small and medium companies. Invest India is all set to bridge the information gap for small and medium foreign investors via its website with comprehensive knowledge about the policy framework that they seek. For details, see Mukherjee (2009)

- The issue of peace and stability must be addressed with increased urgency. The extra costs of security for firms that wish to invest in Nepal and those who are already present are high. The extra cost from the view of many prospective investors makes such investment efforts not worth it. Hence they stay away. Conflict prevention, peace and stability in Nepal would help create a favorable economic environment, which would allow the implementation of sound investment friendly policies to attract FDI.
- Effective FDI promotion involves image building, investment generation and investor servicing to influence investment decisions.
 - Image-building activities comprise effective communication about the location and include producing and distributing fact sheets, videos, brochures and newsletters, holding briefings and engaging in media relations, public relations and advertising. Image-building techniques must be accompanied by removing administrative obstacles and managerial impediments, investment-generation and investor-servicing activities.
 - Investment-generating activities are necessary where the flow of new investments falls short of national objectives and where the country wants to expand into new areas of investment for reasons of resource availability, comparative advantage or long-term development. To attract new investment, Nepal should engage in in-bound and out-bound overseas missions and seminars, communications (advertising, mail and telephone), campaigns and direct contact with individual investors.
 - Servicing investors usually entails a range of pre-approval, approval and post-approval activities. These entail providing information on doing business, granting approvals and clearances quickly and efficiently, assisting in the implementation of projects, helping with access to essential infrastructure, and supporting and monitoring investor performance.
- The close partnership between the private and public sector is essential to build confidence. In this respect, it is recommended that a forum be established where the private and public sectors could sit together to discuss business promotion-related issues. The forum needs to be composed of the prime minister, all the presidents of the national chambers, top businessmen/industrialists, top bankers, as well as heads of overseas chambers of commerce and relevant ministries' secretaries and ministers. The forum may meet regularly to review the economic situation of the country. The problem faced by the business community can be discussed and decisions could be taken immediately. This kind of partnership between the government and private sector will help restore market confidence.

VI. CONCLUSIONS

Economic development is essential for every country but it is especially crucial for post-conflict transition countries such as Nepal, requiring peace-building, recovery and reconstruction. Development aid *per se* cannot transform a post-conflict economy, and it

is here that FDI can be an effective technique for revitalizing industries and rebuilding infrastructure.

The country needs to remain attractive for FDI in the current context of global recession, especially for such investment that serves its long-term development goals and enhances competitiveness (for instance, investment in areas such as infrastructure and hydropower). Retaining existing investment is equally important, particularly in the present deteriorating security conditions where MNCs may consider closing foreign affiliates or transferring them to other safe locations. Moreover, as the recent political trends are very disturbing, the country must make every possible effort to ensure that the trend of FDI inflows is not jeopardized by such negative images.

Finally, though some measures have been spelled out in this paper for boosting FDI flows into Nepal, there are certain issues pertaining to FDI that demand further research. In the first place, should Nepal try to influence the mix of FDI by pursuing to draw in only export-oriented FDI and smaller firms and exclude multinationals in order to limit the risks of monopoly? Secondly, how can the country be successful in directing FDI into specific locations or socially preferred sectors? Thirdly, how can Nepal satisfy the particular challenges posed by its small domestic market size, by the shortage of skilled labor and by the weakness of physical infrastructure? And, lastly, how can the country move ahead with the appropriate sequencing in tackling the different policy requirements?

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