

CHAPTER 7

Nepal Country Investment Study

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Country Economic Profile

Overall Macroeconomic Conditions and Business Climate

Nepal introduced economic liberalization only in the early 1990s when the Government reduced its intervention in the economy and encouraged exports. Trade liberalization, foreign exchange and banking deregulation, and privatization have been the major planks of this liberalization. Nepal also reduced the average import tariff rates to the lowest in South Asia and these policies have started to show some positive impacts with the ratio of exports to gross domestic product (GDP) rising from 6.1% in 1990 to 14% in 2001. The financial sector also grew with the establishment of banks and finance companies, including joint ventures, and the cost of funds has since come down as financial markets have become more competitive. The Nepalese rupee is fully convertible on the current account and convertibility on the capital account is under consideration. However, Nepal's landlocked location, technological backwardness, and internal political conflicts have prevented it from fully developing its economy. Its special relationship with India, embodied in a trade treaty, offers significant access to the largest market in the region. Its membership of the World Trade Organization (WTO) in 2004 is also expected to further open the economy.

Speeding up economic and inclusive growth is the top priority of the Government. Foreign direct investment (FDI) could potentially play a crucial role by supplying capital and expertise. To achieve this, the Government

has introduced a "one-window" system to facilitate and encourage FDI. However, business taxation is a serious impediment in attracting FDI because of poor tax administration. The principal taxes include income tax, customs duties, excise tax, and value-added tax, which foreign investors consider a burden.

Nepal is still among the poorest and least developed countries in the world, but the segment of the population living below the poverty line has decreased, from 42% in 1996 to 31% in 2004. The economy has also seen significant changes and improvements in terms of diversification. The share of agriculture has decreased from 62% 20 years ago to less than 40% at present, while the share of industry has increased from 13% in the 1970s to 20% now.

In 2002, unemployment was reported at 5.1%. Because of the lack of employment opportunities in the country, the number of Nepalese workers abroad reached 971,000 in 2006. In addition to India, the main destinations for Nepalese workers are the Gulf countries; Malaysia; Hong Kong, China; and the Republic of Korea. Israel has also emerged as a new destination. As a result of the increasing number of such workers, remittances reached roughly \$1.37 billion, or about 16.2% of GDP, in 2006 (Government of Nepal, Ministry of Finance 2007).

One of the economic challenges of Nepal is reducing the savings–investment gap (Table 7.1). Gross domestic savings and gross investment as shares of GDP stood at 9.7% and 28% in FY2007, respectively.¹ These ratios have resulted in a savings–investment gap of 18.3% in FY2007, up from 10.7% in FY2002. The slow pace of growth in the country may be

¹ The fiscal year for Nepal runs from 16 July to 15 July. FY before a calendar year denotes the year in which the fiscal year ends (e.g., FY2007 ends on 15 July 2007).

Table 7.1: Key Economic Indicators, FY2002–FY2007
(%)

Indicators	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007
Real GDP Growth	0.2	3.8	4.4	2.9	4.1	2.6
Ratio of Gross Domestic Savings to GDP	9.5	8.6	11.8	11.6	9.0	9.7
Ratio of Gross Investments to GDP	20.2	21.4	24.5	26.5	26.8	28.0
Savings–Investment Gap	(10.7)	(12.8)	(12.7)	(14.9)	(17.8)	(18.3)

() = negative.

Source: Government of Nepal, Ministry of Finance (2007).

attributed to declining expenditures due to the Maoist insurgency. However, low expenditure in areas like education, health, and economic infrastructure has suppressed private sector investment. Regional disparities within Nepal, poverty, and the conflict have also contributed to the sluggish pace of capital formation. Real GDP growth was just 2.6% in FY2007.

Remittances play an important role in filling the savings–investment gap as reflected in the rapidly rising ratios of remittances to savings. This increasing ratio also means that dependency on foreign earnings can be lessened through strategic plans and programs that can mainstream remittances and funnel them into productive use. A conducive environment where returnees can invest their income and use their skills in productive endeavors is just as important as developing effective migration and remittance policies.

Trade Profile

Exports and Imports

Trade with India constituted 62.2% of total trade in FY2007, up from 54.6% in FY2003. However, the share of trade with overseas countries, which also include member countries of the South Asian Association for Regional Cooperation (SAARC) other than India, decreased from 38.0% in FY2003 to 30.5% in FY2007 due primarily to the decline in textiles and clothing (T&C) exports from \$184.4 million in FY2003 to \$94.4 million in FY2007 (Tables 7.2 and 7.6). Also, despite significant structural changes in Nepal's merchandise exports, the country remains dependent on export

of a few items, such as carpets, clothing, hides and goatskins, woolen and pashmina goods, and some agricultural products. In the case of trade with SAARC member countries, Nepal's exports to SAARC as a share of its total exports ranged from 53.9% in FY2003 to 72.5% in FY2007, and of this, India's share ranged from 97.5% to 98.4%.

Imports from SAARC countries ranged from 55.8% to 67.0% as a share of total imports during FY2003–FY2007. Countrywise, the share of imports from India in the total imports from SAARC increased from 99.1% in FY2003 to 99.5% in FY2007, indicating an overdependence on India. Imports from Bangladesh decreased from 0.5% in FY2003 to 0.1% in FY2006 due to transit problems at Phulbari–Banglabandh Marg, such as poor infrastructure, the need for entry permits for trucks into Bangladesh, and the need for a police escort while in Indian territory. However, the provision for an alternative trading route through Rohanpur Marg by the Bangladeshi Government is expected to boost imports from Bhutan and other countries, which remained stagnant for the period under analysis. (Imports from Bangladesh increased to 0.2% in FY2007.)

After India, Nepal's largest export partner during FY2003–FY2007 was the United States (US) followed by Germany, United Kingdom (UK), and France (Table 7.4). In terms of regions (Table 7.5), again with the exception of India, the US share of exports was the largest but decreasing from 59.6% in FY2003 to 40.5% in FY2006. In FY2007, the European Union (EU) slightly overtook the US with a share of 37.7% compared to a share of 36.3% for the US. Export shares to the EU and Asia were both increasing, albeit slowly.

Table 7.2: Foreign Trade Composition of Nepal, FY2003–FY2007
(%)

Direction	FY2003	FY2004	FY2005	FY2006	FY2007 ^a
Exports					
India	52.9	57.1	66.6	68.1	70.9
Overseas	43.7	38.5	30.0	30.2	27.1
PRC ^b	3.4	4.5	3.5	1.7	2.0
Total	100.0	100.0	100.0	100.0	100.0
Imports					
India	55.3	58.0	59.8	66.7	59.6
Overseas	35.8	34.0	30.7	25.2	31.5
PRC ^b	8.9	8.1	9.5	8.1	9.0
Total	100.0	100.0	100.0	100.0	100.0
Total Trade					
India	54.6	57.7	61.7	67.1	62.2
Overseas	38.0	35.3	30.5	26.6	30.5
PRC ^b	7.4	7.0	7.8	6.4	7.4
Total	100.0	100.0	100.0	100.0	100.0

PRC = People's Republic of China.

^a Provisional.

^b Includes overland trade with the Tibet Autonomous Region of the PRC and overseas trade with Hong Kong, China and Macau.

Source: Government of Nepal, Trade and Export Promotion Centre (2007).

Table 7.3a: Exports to SAARC, FY2003–FY2007
(%)

Country/Region	FY2003	FY2004	FY2005	FY2006	FY2007
India	98.0	97.5	98.3	98.4	97.7
Bangladesh	1.5	1.3	0.7	0.6	1.2
Bhutan	0.2	0.3	0.4	0.6	0.7
Maldives	0.0	0.0	0.0	0.0	0.0
Pakistan	0.3	0.9	0.6	0.5	0.3
Sri Lanka	0.0	0.0	0.0	0.0	0.0
Afghanistan	0.1	0.1	0.0	0.0	0.0
Total SAARC Exports	100.0	100.0	100.0	100.0	100.0
SAARC Exports as a Share of Total Exports	54.0	58.5	67.8	69.2	72.5

Table 7.3b: Imports from SAARC, FY2003–FY2007
(%)

Country/Region	FY2003	FY2004	FY2005	FY2006	FY2007
India	99.1	98.7	99.5	99.6	99.5
Bangladesh	0.5	0.8	0.2	0.1	0.2
Bhutan	0.1	0.0	0.0	0.1	0.1
Maldives	0.0	0.0	0.0	0.0	0.0
Pakistan	0.2	0.2	0.2	0.2	0.1
Sri Lanka	0.2	0.2	0.0	0.1	0.0
Afghanistan		0.0	0.0	0.0	0.0
Total SAARC Exports	100.0	100.0	100.0	100.0	100.0
SAARC Imports as a Share of Total Exports	55.8	58.7	60.1	67.0	59.9

Source: Government of Nepal, Trade and Export Promotion Centre (2007).

Table 7.4: Major Trading Partners, FY2003–FY2007
(‘000 NRs)

Exports	Countries	FY2003	FY2004	FY2005	FY2006	FY2007
1	India	26,430,000	30,777,100	38,916,900	40,714,700	41,874,800
2	US	12,686,537	9,695,977	7,570,742	6,993,442	5,571,274
3	Germany	3,555,327	3,567,036	3,121,753	2,843,770	2,573,710
4	UK	1,070,737	1,677,085	1,050,009	1,184,079	998,689
5	France	453,961	581,762	617,800	1,297,493	903,951
6	Italy	530,869	589,370	582,847	712,327	684,308
7	Canada	383,651	546,403	528,726	644,633	593,703
8	Japan	474,247	525,601	534,997	572,094	559,457
9	Bangladesh	411,335	421,308	290,877	234,323	521,498
10	Spain	200,144	206,015	223,091	282,625	382,556
Imports	Countries	FY2003	FY2004	FY2005	FY2006	FY2007
1	India	70,924,200	78,739,500	88,675,500	107,143,100	117,740,400
2	PRC ^b	11,375,973	10,941,473	14,145,609	13,014,427	17,718,164
3	Indonesia	3,976,734	3,253,785	5,222,737	5,647,780	11,172,109
4	Singapore	9,039,197	8,698,647	7,746,820	3,375,219	5,496,878
5	US	1,707,673	1,433,261	1,763,841	1,677,499	4,259,983
6	United Arab Emirates	583,054	407,933	771,774	1,095,681	3,918,139
7	Thailand	2,988,929	4,320,169	3,117,567	2,602,072	3,459,455
8	Japan	1,890,844	1,690,396	2,565,231	1,935,082	3,228,975
9	Malaysia	4,009,640	3,676,428	2,820,876	2,474,661	2,794,632
10	Saudi Arabia	2,363,956	2,547,901	3,138,492	2,329,692	2,592,689

^a Trade with India for FY2007 is provisional.

^b Includes overland trade with the Tibet Autonomous Region of the PRC.

Source: Nepal Rastra Bank and Government of Nepal, Trade and Export Promotion Centre (2007).

Table 7.5: Exports and Imports, FY2003–FY2007
(%)

Exports to Regions	FY2003	FY2004	FY2005	FY2006	FY2007
Asia (excluding India)	6.8	17.8	18.8	15.8	19.4
Africa	0.1	2.1	0.2	0.6	1.7
US	59.6	44.3	41.7	40.5	36.3
EU	31.3	32.5	35.5	38.5	37.7
Europe (excluding EU)	1.8	2.8	3.1	3.8	3.5
Oceania	0.5	0.5	0.6	1.0	1.4
Total	100.0	100.0	100.0	100.00	100.00
Imports from Regions					
Asia (excluding India)	74.1	72.1	74.6	68.9	71.0
Africa	0.2	0.6	0.4	0.5	1.2
US	5.9	7.0	7.1	9.4	12.0
EU	15.2	11.5	10.4	11.2	10.3
Europe (excluding EU)	2.1	2.5	2.9	4.8	2.1
Oceania	3.7	4.5	4.6	4.6	3.4
Total	100.0	100.0	100.0	100.0	100.0

Source: Government of Nepal, Trade and Export Promotion Centre (2007).

In FY2007, imports to Nepal were primarily from Asia—India, People’s Republic of China (PRC), Indonesia, Singapore, and US (Table 7.4).

Problems and Challenges

The preceding analysis clearly indicates the need to diversify Nepal’s trade inside and outside SAARC. The country’s prospects for further growth in trade remains high as its shares in both world merchandise trade and services trade are both 0.03% (UNCTAD 2008). Nepal faces numerous challenges and constraints in realizing its export potential. The first is the trade agreement signed with India in 2002, which has been criticized because of its restrictive sanitary and phytosanitary requirements. Further constraints to Nepalese agricultural exports stem from the complex quarantine rules imposed by India, which act as nontariff barriers. In addition, the uneven implementation and interpretation of the trade treaty’s measures by state governments in India are posing additional barriers to Nepalese exports.

Another barrier is the disagreement on customs clearance procedures for cross-border rail operations

(i.e., Nepal wants the procedures to be carried out at its newly built inland container depot while India favors these measures to take place at the border). The Banglabandh Marg provided by Bangladesh is also little used due to lack of infrastructure. Similarly, the end of quotas under the Multi-Fiber Arrangement (MFA) since 2005 has greatly hampered Nepal’s exports of clothing.

Nepal faces challenges from its integration in WTO, which have to be met in a way that promotes its economic competitiveness. The country also has to address its significant domestic and border regulatory constraints (such as government red tape, public service delays, labor laws, and the industrial relation environment) that lower productivity and make the domestic investment climate unfriendly and uncompetitive. Exports from Nepal, as from other low-income countries, remain concentrated in a few manufacturing items, mainly clothing and carpets, which accounted for nearly 62% of export receipts in 2005. The phasing out of the MFA in 2005 posed an additional challenge. Exports are also concentrated in only a few countries (US for clothing and EU for knotted carpets), making the country susceptible

to volatility in the global economic climate. Other export items include hides and skin to Italy, lentils to Bangladesh, large cardamom to Pakistan, handicrafts and silver jewelry to the US, and pashmina shawls and other pashmina goods, as well as paper and paper products, to the UK and US.

Nepal's proximity to the PRC and India offers opportunities for trade. However, trade data show that exports to India and the Tibet Autonomous Region of the PRC have not been increasing relative to imports. This is mainly because of decreased exports of some products, such as vegetable ghee to India and the Tibet Autonomous Region, as well as textiles to the latter. Nepal's inability to improve competitiveness arises from various factors related to geography, policy, and institutions: the country suffers from low productivity and a poor business climate due to government instability, inefficient government bureaucracy, corruption, and inadequate supply of infrastructure (World Economic Forum 2007). Other critical constraints include delays in customs and transshipment, high costs of transport and power, a rigid and formal labor market, lack of labor–employer cooperation, terrorism, and poor work ethic of the labor force (World Bank 2004).

Industry Profile

The economy is largely supported by agriculture and buttressed by many niche products such as medicinal herbs and high-quality tea. In terms of manufacturing, the share in GDP decreased from 9.0% in FY2001 to 7.5% in FY2007 with a preliminary estimate of 7.0% for FY2008. In contrast, the contribution of services increased to reach about 51% of GDP in FY2007. Tourism is the main source of foreign exchange, contributing about \$155 million, or 4.5% and 1.4% of total foreign exchange earnings and GDP, respectively, in FY2007. The growth of industry was stifled until the recent peace agreement among political parties. Power generation has great potential in view of the estimated realizable hydroelectric power of 43,000 megawatts (MW). Indeed, the development of electricity for export also promotes energy-intensive manufacturing activities in Nepal, and electricity with India is already being traded. Several areas in niche agricultural products, power generation, and tourism are the main potential areas for FDI. Opportunities lie in other sectors as well, such as readymade clothing and textiles.

Textiles and Clothing Industry

Within this industry, the textiles subsector includes fabrics, pashmina, yarns, made-up textiles, and jute goods. Spinning, weaving, and finishing of fabrics alone accounted for about 85% of the subsector's value added in 1997 (UNCTAD 2005). According to the Nepal Textile Association, the total production of fabrics in the country stood at 50 million meters in 2000, down from 80 million meters during the 1990s. Many firms closed, with the remaining businesses running at minimum capacity. The reduction was due to stiff competition from imports, due to the liberalization of trade and smuggling from the PRC and India. Despite considerable upgrading of machinery and technology, domestic producers were unable to keep up with rapid technological developments in the rest of the world. As a result, domestic fabric manufacturers could not supply the needs of clothing producers in Nepal. In fact, only about 6% of their demand was met by domestic production in 2000. Indeed, this is unsurprising given that there is virtually no FDI in the textile subsector (UNCTAD 2005).

Clothing is another important subsector. The major products include men's and boys' shirts and trousers as well as ladies' dresses. Exports of clothing reached their peak in 2002. Fabrics and accessories used in exported clothing are entirely imported and mostly from India. Only packing materials are sourced locally, indicating limited backward linkages. The growth in the industry was the result of quotas from the US and spillovers from India. When the quota to the US is filled in India, orders are placed in Nepal through India's intermediation. Table 7.6 shows the breakdown of T&C exports and imports.

The share of clothing in manufacturing grew from 26% in 1994 to 37% in 2000, but declined to its 1994 level in 2003, and went down further to just 16% in 2004 (SAWTEE 2006). The clothing industry has been facing stiff competition in recent years and has been struggling to survive. Indeed, the end of the quota system in T&C on 1 January 2005 led to a reduction in T&C exports and the closure of T&C firms. In fact, the share of T&C exports in total overseas exports fell from 58.6% in FY2003 to 35.8% in FY2007 though the T&C share of Nepal exports to India increased from 11.9% in 2003 to 17.8% in 2006, but decreased again to 13.8% in FY2007 (Table 7.6). Thus, in order to improve the export performance of T&C, the country

Table 7.6: Exports and Imports of Textiles and Clothing, FY2003–FY2007
(\$ million)

Item	FY2003	FY2004	FY2005	FY2006	FY2007
Total Overseas Exports (excluding India)	314.4	311.5	276.6	256.2	264.0
T&C Overseas Exports	184.4	157.4	120.8	102.0	94.4
Readymade Clothing	155.0	128.9	90.0	73.2	60.6
Woolen and Pashmina Goods	20.5	19.8	20.7	22.4	27.5
Towels	4.5	3.4	1.9	1.4	1.0
Cotton Sacks and Bags	2.0	2.0	3.7	4.7	5.1
Textiles	2.4	3.3	4.5	0.3	0.3
Share of T&C in Total Exports (%)	58.7	50.5	43.7	39.8	35.8
Total Exports to India	352.4	413.7	551.2	547.2	642.7
T&C Exports to India	39.4	48.7	70.2	97.5	88.4
Jute Goods	25.3	25.3	38.2	35.4	42.3
Polyester Yarn	8.8	15.0	26.9	46.7	34.4
Readymade Clothing	5.3	8.4	5.2	15.3	11.7
Share of T&C in Total Exports to India (%)	11.2	11.8	12.7	17.8	13.8
Total Imports from India	945.7	1,058.3	1,265.6	1,440.1	1,807.2
T&C Imports from India	77.7	71.4	61.6	72.8	87.2
Textiles	55.8	50.1	31.1	27.6	26.5
Readymade Clothing	5.9	6.6	12.8	14.6	11.2
Raw Cotton	1.2	1.3	2.0	1.5	1.1
Threads	14.7	13.5	15.7	29.1	48.5
Share of T&C in Total Imports from India (%)	8.2	6.7	4.9	5.1	4.8

Note: Average of buying and selling rates at mid-July each year given by the *Economic Survey Fiscal Year 2007/08* was used to convert Nepalese rupees into US dollars.

Source: Government of Nepal, Trade and Export Promotion Centre (2007).

Table 7.7: South Asia's Market Share in US Imports of PRC-Restricted T&C, 2004–2006
(%)

Country	Volume			Value		
	2004	2005	2006	2004	2005	2006
Bangladesh	4.9	5.2	6.2	3.1	3.7	4.7
India	2.2	2.7	2.9	2.8	3.6	3.9
Nepal	0.1	0.1	0.1	0.1	0.1	0.1
Pakistan	2.4	2.5	3.2	2.0	2.2	2.4
Sri Lanka	1.5	1.7	1.9	2.0	2.4	2.5
SAARC Total	11.1	12.2	14.3	10.0	12.00	13.6

Source: Tewari (2007).

needs to focus on the expansion of standard fabric industries by improving quality, minimizing costs of production, and enhancing productivity.

Nepal has been a dismal performer with regard to trade in T&C. For example, its share in US imports of PRC-restricted clothing has been declining and is at the bottom compared to the increasing shares of all other SAARC countries, reaching only 0.06% and 0.07% in volume and value terms in 2006, respectively (Table 7.7). This implies the need for competitive capacity, reducing the costs of production, finding out its comparative advantage in clothing, and integrating with other countries in South Asia.

Automobile Industry

Nepal's automobile industry is estimated at about \$80 million a year. The country has all the vehicle brands available in India and allows imports of automobiles from other countries. At the end of FY2007, Nepal had 617,000 vehicles, many of them motorcycles. Vehicle numbers shot up by over 47% annually during FY2005–FY2007, indicating a growing demand and the possibility of some FDI in this sector. Two motorcycle producers operate with PRC collaboration. Automobile players like Hyundai and Yamaha are also present in the country through their supply chain. A Nepalese manufacturer, Hulas Motors, has also emerged, manufacturing light commercial vehicles and mini-utility vehicles, which are sold under the Sherpa, Mustang, and Mini V brands.

Nepal is heavily dependent on vehicle imports, which account for nearly 68% of total demand. It has a good supply of tires, which are mainly produced by Gorkhali Tyre, a government-owned corporation. The expansion of the automobile industry has shown the increasing preference of Nepalese to own motor vehicles. This has also been spurred by the supply of loans from banks and other financing companies. Concerns about emissions and congestion have given rise to increased demand for two-wheeled and smaller motor vehicles. There is great potential for producing cheap vehicles and spare parts, but it is foreseen that the country will depend on outside supplies, particularly from India. The automobile industry is also a good source of taxes and duties for the Government, with rates adding up to as much as 156% of the basic price for most vehicle categories.

Infrastructure

The hilly and mountainous terrain of Nepal has made the construction of infrastructure difficult and expensive. There are also the problems relating to the lack of essential materials and the inability to mobilize people. By mid-March 2007, total road length reached 17,609 kilometers (kms), of which 5,222 kms were metaled, 4,738 kms graveled, and 7,649 kms fair-weather roads. Nepal has 47 airports, of which one is international and three are regional hub centers. In addition, four airports are under construction. The problems of transport and logistics, as well as costly and unreliable infrastructure, have had adverse effects on the private sector, including FDI, by acting as constraints to doing business and increasing transaction costs.

Resource Endowments

Water is the country's most important natural resource with about 6,000 rivers and rivulets totaling 45,000 kms in length. Total average run-off is estimated at about 170 billion cubic meters with an estimated hydroelectric power potential of 83,000 MW. This is one of the largest potential capacities in the world, of which about 50% could be economically harnessed. Another natural resource, forests, covers about 42.4% of the country's landmass and provides 79% of the country's total energy consumption and more than 90% of rural household energy needs. There are only limited deposits of mineral resources, which are being economically exploited. Nepal also has a large deposit of limestone and other minerals including magnetite, lead, and zinc.

The labor force is about 11.1 million (2006 estimate), but skilled labor is severely lacking in many areas. Nepal is a labor-surplus country, which exports its labor; skills development courses are run by private and public institutions under the Council for Technical Education and Vocational Training. The country has a serious brain drain problem, as highly qualified people do not find enough opportunities at home.

It is often argued that Nepal's rich endowment of natural and human resources has not been used optimally. Foreign investment could therefore help the country by using its available resources. Low labor costs are also a significant advantage for investors, even if low productivity is taken into account.

Regional Trade Agreements

As a member of SAARC, the implementation of the South Asian Free Trade Agreement (SAFTA) is expected to offer the country greater market access. The agreement on the SAARC Preferential Trading Arrangement covers around 4,000 items, most of which are nontradable. Trade in goods has already been brought under SAFTA, and SAARC countries are preparing to include trade in services. Nepal also participates in different working groups (such as trade, investment, and private sector cooperation; power and energy; transport and tourism; and the environment) under the South Asia Sub-regional Economic Cooperation. Nepal has a special agreement with the PRC for reduced tariffs on trade with the Tibet Autonomous Region of the PRC.

Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka, and Thailand have also grouped together in the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) in an effort to achieve a free trade area by 2017. The cooperation between the two regional blocs, SAFTA and BIMSTEC, may be able to bring about substantial investment in South Asia and could also provide a huge market for a small country like Nepal.

How these two regional agreements will shape Nepal's trade and industry remains to be seen. As a least developed country, Nepal has preferential access to the EU under the Everything But Arms initiative. A memorandum of understanding between Nepal and the PRC was signed in November 2001 to facilitate visits by PRC citizens to Nepal, making Nepal the first nation in South Asia to receive approved (tourist) destination status from the PRC.

FDI Policy and Environment

History

FDI is seen as bringing the necessary capital, technology, skills, and best practices into Nepal, as well as a means to access the international market. Therefore, FDI contributes to economic development, leading toward self-reliance and self-dependence, through the expansion of industries and the revenue base. In addition, it contributes to employment

generation and other benefits to labor, resulting from the difference in shadow and market wages.

The first attempt by Nepal to attract FDI came in 1987, after the Industrial Policy and Industrial Enterprise Act was promulgated. This provided a legal framework for facilitating FDI in large and medium-scale ventures in every industry except defense; steps were also taken to privatize dozens of government-owned public enterprises, and to open them to private investment (they were previously government monopolies, and included telecommunications, hydroelectric power, and air transportation companies). A new Foreign Investment Promotion Division was created to act as the central body for the approval and monitoring of foreign investment projects. Joint ventures were the preferred form of investment and limitations were set on the level of foreign equity holdings, depending on the size of the industry.

The Government reemphasized the importance of FDI and technology transfer in the development process in the early 1990s and introduced the Foreign Investment and One-Window Policy as well as the Foreign Investment and Technology Transfer Act (FITTA) of 1992, and established the Investment Promotion Board. In addition, a Foreign Investment Promotion Committee was set up to simplify procedures for attracting foreign investment, with applications to be processed within 30 days. A One-Window Committee was also set up at the Department of Industries (DOI) to provide institutional facilities and services under one roof. However, it failed to provide such services and was subsequently criticized for having too many procedures. Nepal does not have a separate investment promotion agency; investment promotion is carried out by the DOI.

As part of FDI policy, the Government entered into investment protection agreements with France, Germany, and UK. Double taxation agreements were signed with India, Norway, and Thailand, and its laws have provisions for arbitration within the framework of the United Nations Commission on International Trade Law to settle FDI-related disputes.

Performance of FDI

Historically, the major areas of FDI have been manufacturing, followed by services (mainly tourism). From 1990 to 1997, the average annual inflow of

Table 7.8: Foreign Investment Projects, mid-November 2007
(\$ million)

Industry	No.	Total Project Cost	Total Fixed Cost	Foreign Investment	Employment
Agriculture and Forestry	14	26.1	23.6	7.2	850
Manufacturing	494	578.0	419.1	180.9	64,590
Food, Beverages, and Tobacco	76	142.4	123.6	34.2	9,143
Textiles and Clothing	177	138.0	87.0	50.3	35,570
Wood and Wood Products	8	1.8	1.4	0.6	1,440
Paper and Paper Products	23	28.3	23.9	5.2	944
Chemical Products	89	111.0	81.0	45.8	7,075
Nonmetallic Products	20	59.4	35.9	17.3	3,188
Basic Metal Products	25	34.1	22.4	10.7	1,971
Fabricated Metals	55	49.3	34.2	13.3	3,803
Other Manufacturing Units	21	13.7	9.7	3.4	1,456
Electricity, Water and Gas	23	310.1	282.4	54.3	5,146
Construction	37	29.3	21.8	18.0	1,957
Hotel and Resorts	281	250.9	236.2	73.7	16,554
Transport and Communications	31	65.5	45.3	261.6	5,225
Housing and Apartments	18	4.3	1.8	2.5	1,694
Service industries	44	317.3	281.1	210.1	21,402
Total	552	921.4	723.8	398.2	182,008

Source: Ministry of Industry, Commerce and Supplies (2007).

FDI in Nepal stood at about \$7.3 million, but it fell to about \$2.7 million a year from 1998 to 2006 (Chitrakar and Bhatt 2007). The share of services FDI in total FDI increased from 30% to 52% during the same period. While the share of tourism FDI in total services FDI decreased slightly from 16% in 1998 to 15% in 2006, the shares of other subsectors in services FDI, namely health and health education, as well as communications and software, increased from 5% to 11% and from 0.3% to more than 5%, respectively. Clearly, Nepal's performance in FDI inflows has been dismal when compared to other developing countries.

In 2004, 63 industries with a total project cost of about \$27 million were established from FDI. The following year, the number of industries given permission to operate by the Government grew to 116 with a total project cost of \$64 million. In 2006, 186 industries with a fixed capital of \$42 million and a project cost of \$52 million were granted permission to operate. As of mid-November 2007, 552 FDI projects with a total project cost of \$921.4 million and

approved employment of 182,008 were allowed to operate (Table 7.8). However, actual investment may be less since the realization rate is estimated at around 50% of approved projects. There are implementation problems in the sense that agreements are signed with foreign investors, but projects remain in the pipeline and never come to fruition. The areas of investment include manufacturing, services, tourism, construction, agriculture, minerals, and energy.

In terms of country of origin, 57 countries had made investments in Nepal by mid-November 2007, of which 39.3% of investments in terms of project costs, 36.4% in terms of total fixed costs, and 44.5% in terms of total FDI were made by SAARC countries (Table 7.9). In addition, SAARC investments contributed 45.2% of employment in FDI projects. India accounted for 97.6% of SAARC investment, implying a need for increasing investment from other SAARC countries. However, India's share is greatly reduced if Indian investments that have been closed (three of them in recent years) are taken into account. Their closure was due to hostile

Table 7.9: FDI Projects from SAARC Countries, mid-November 2007

Country	Number	Total Project Cost (\$ million)	Total Fixed Cost (\$ million)	Foreign Investment (\$ million)	Employment
Bangladesh	15	7.1	3.3	3.4	3,808
Bhutan	3	0.4	0.3	0.1	98
India	376	607.2	469.5	248.7	46,691
Pakistan	12	4.9	3.6	2.1	2,365
Sri Lanka	3	1.2	0.9	0.6	83
Total SAARC	409	620.8	477.6	254.9	53,045
Rest of the World	936	960.6	833.6	318.0	64,373
Total World	1,345	1,581.4	1,311.2	572.9	117,418
Share of SAARC in Total World (%)	30.41	39.3	36.4	44.5	45.18

Source: Authors' calculations from data from the Ministry of Industry, Commerce and Supplies (2007).

Table 7.10: Trend of Foreign Investment, FY1998–FY2007
(\$ million)

Origin	FY1998	FY1999	FY2000	FY2001	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007
Rest of the World	29.0	13.8	16.5	24.1	6.7	17.0	12.8	6.7	13.9	16.7
SAARC	3.3	10.6	3.5	17.3	8.8	6.9	24.3	16.5	21.1	29.1
Total World	32.3	24.3	20.0	41.4	15.5	23.9	37.1	23.2	35.0	45.8

Note: Average of buying and selling rates at mid-July each given by the *Economic Survey Fiscal Year 2007/08* was used to convert Nepalese rupees into US dollars.

Source: Authors' calculations from data from the Ministry of Industry, Commerce and Supplies (2007).

labor relations in the current political environment and unstable policies, where the regulatory framework is changed unilaterally in the middle of operations.

Foreign investment has fluctuated in terms of total investment and the split between SAARC countries and elsewhere. Investment from the former has been growing faster than from the rest of the world since 2003, reaching \$29 million in FY2007. Investment from the latter began to increase gradually from FY2006, reaching NRs1,175.64 million (\$17 million) in FY2007 (Table 7.10 and Figure 7.1).

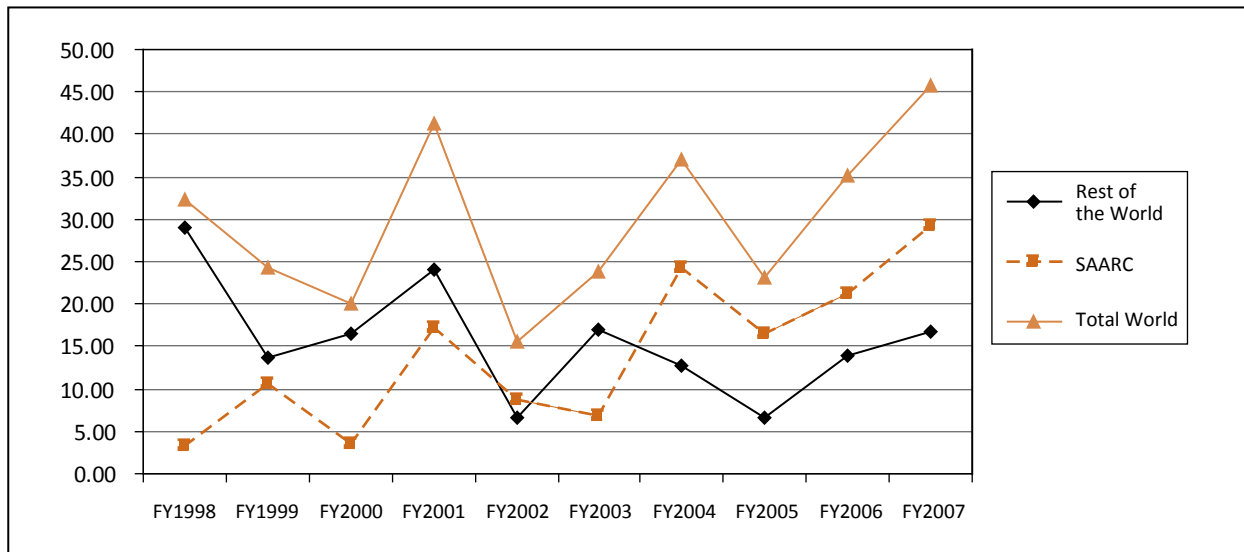
Aside from SAARC, other major sources of FDI include US, PRC, Republic of Korea, Norway, and Japan. Nepal is exerting additional effort to improve its investment climate by means of more liberal policies.

Current FDI Regime and FDI Promotion Policy

FITTA is the main legal framework that guides FDI policy. It provides various incentives to attract foreign investments and has opened up all sectors to FDI except for defense, cigarettes, *bidi*,² and alcohol. It also promotes technology transfer from FDI. In addition, it guarantees 100% repatriation of equity invested, dividends obtained from foreign investments, and amount received as payment of principal and interest on foreign loans in convertible currency. FITTA also identified priority sectors (i.e., industries producing goods that meet basic needs; export-oriented industries, which export 50% or more of sales; and hotel and tourism projects).

² A small hand-rolled, often flavored, cigarette.

Figure 7.1: Trend of Total FDI, Investment from SAARC Countries, and Investment from Rest of the World, FY1998–FY2007



Source: Authors' calculation from data from the Ministry of Industry, Commerce and Supplies (2007).

FITTA extended the tax holiday from 5 to 10 years and eased visa problems and the settlement of disputes. It originally banned the entry of FDI into cottage industries and projects with fixed assets of less than \$300,000, but was amended in 1996 to eliminate the fixed asset limit and expanded the scope of FDI to include all industries except some on the negative list.

The Government made several amendments to FITTA through the Finance Act of 2001 and budget speeches delivered by the Finance Minister before the beginning of each fiscal year. These, along with the establishment of WTO and Nepal's membership of WTO, SAFTA, and BIMSTEC, have made the existing Foreign Investment and One-Window Policy and FITTA virtually useless. In response, the Ministry of Industry, Commerce and Supplies drafted a new policy and act in 2002, which have yet to be implemented. The Government has also taken steps to formulate a new industrial policy, though this also has yet to be implemented. The current 3-year interim plan for 2007–2009 includes policies targeted to encourage foreign investment in areas that provide employment and that lack local capital and technology. The Government has also recently introduced the Non-resident Nepalese Act to attract FDI from such Nepalese. Yet despite these various efforts, FDI remains very low.

Laws relating to FDI allow investors to obtain suitable title to land. There are no legal impediments in registering mortgages or repossessions. However, unlike other countries in South Asia, Nepal has actually withdrawn some of its incentives provided after 1992. For example, the Government used to provide reinvestment allowance in the form of deductions from taxable income of up to 40% of investment in expansion or modernization, but this was withdrawn in 2002. Similarly, the corporate tax rebate of 10% for high local content was removed.

Priority Sectors

The improvement of FDI inflows into services indicates its potential, an increased market, and the continuing need for capital. Other priority sectors for FDI include medicinal herbs, vegetable and flowering seed production, honey production, hydropower, petroleum exploration, and natural gas exploration. These were identified as priority sectors for using domestic resources and aiding in the promotion of sustainable development. The approval of these sectors as priority areas for FDI was relatively easy and was accompanied by the provision of certain income tax rebates. However, automatic approval of priority sectors and more incentives seem to be necessary for attracting FDI to such sectors.

Labor Laws and Mobility

Labor mobility in the context of foreign investment is generally guided by visa policy. Some stipulations include the granting of residential visas to investors with at least \$100,000 worth of investment and the provision of business visas to a foreign investor and his dependents until his or her investment is retained.

The formal sector covers a very small portion of the labor market, primarily because of red tape and unclear and unpredictable consequences of company- and labor-related legislation. This has resulted in the segmentation of the labor market into permanently employed staff, who have strong legal workplace protection; and contract workers, who can be hired and fired at will. Agricultural workers and subsistence farmers belong to the latter category, along with the bulk of unskilled workers, who dominate the labor force. It is the informal sector that absorbs the bulk of new job seekers, simply because the formal sector provides very few jobs.

Nepal is a pluralistic society with diverse ethnic, caste, linguistic, and religious communities. The social structure, which is largely fixed or constrained by birth, influences occupational distribution and limits moves between occupations. This has resulted in labor market imbalances that are filled by Indian laborers.

The 1999 National Labor Survey of Nepal showed high labor force participation (86% of the population above 15 years of age) and low unemployment (less than 2% nationally and 7% in urban areas). This apparent low unemployment level is expected in a country where the large majority of the working age population lives in rural areas, depends on subsistence agriculture, and migrates for work when nothing is available at home. However, there are many underemployed, currently estimated at 47% of the total employed labor force. With regard to wages, once these have been negotiated, these cannot be changed for 2 years and the minimum wage for unskilled workers is about \$27 per month.

Parliament has enacted the Labor and Trade Union Act, which permits strikes, though strikes have been infrequent since the law was promulgated. In the past, strikes and other political actions closed businesses and transport operations in major cities, severely damaging the business climate and tourism. The

Labor and Trade Union Act also requires unions to be affiliated with political parties. Union participation in the formal sector is only 10% of the total labor force, but its leaders exercise significant political influence through their party affiliations. Efforts at collective bargaining have been hampered by unrealistic laws, such as the Bonus Act, which provides that workers must get 10% of yearly profits as bonus regardless of improvements in productivity. In the hydropower sector, the Electricity Act of Nepal has limited bonuses of workers to 2% of yearly profits. However, according to reports by the International Labour Organization, dialogue between trade unions and employers has improved tremendously over the last decade.

Results from a survey conducted by the Federation of Nepalese Chambers of Commerce and Industry showed that all managers identified the Labor and Trade Union Act as placing a significant burden on firms. The law has also made the cost of retrenchment so high that firms attempt to limit the number of permanent workers. Many older firms are therefore severely overstaffed and unproductive, whereas new firms are reluctant to hire new workers. As a result, 50% of the manufacturing workforce is composed of casual workers, who earn the same wage as permanent workers, but who have less job security and fewer fringe benefits. The law was originally intended to protect workers, but has become one of the main obstacles to formal sector development.

Employment of foreigners other than Indians is regulated by the Department of Immigration, and many companies have reported that this arrangement makes it very difficult to bring in skilled and experienced specialists, such as pilots, economists, engineers, or architects. In the other direction, the placement of Nepalese workers in other countries is regulated by the Foreign Employment Act.

In terms of trade in service, imports (debit) of Nepal's cross-border supply of services (Mode 1 based on WTO/General Agreement on Trade in Services [GATS] categorization) is substantially higher than exports (credit), mainly because of the transportation sector, implying high payments for the consumption of transport services. Consumption abroad (Mode 2) is an important mode mainly because of travel services. In the case of commercial presence (Mode 3), data for 1999–2004 show that equity earnings payments are

higher than FDI inflows, implying a negative balance-of-payments effect of FDI. They also indicate the need for caution in bringing in foreign labor. Finally, movement of natural persons (Mode 4) is important for Nepal, with credit values far exceeding debit values. This is mainly because of workers' remittances and implies the need to focus on foreign employment of Nepalese labor (Chitrakar and Bhatt 2007).

Trade Policies and Nontariff Barriers

Nepal's economic liberalization has enabled a favorable environment for manufacturing, infrastructure, and services. The country continues to pursue the objectives of low and nondiscriminatory import tariffs and its effective tariff rate compares favorably with those of neighboring South Asian countries.

Tariff slabs have fallen from over 100% in the 1980s to just 5% in the 1990s. The country's average import tariff rates are probably the lowest in South Asia. Nevertheless, the current most-favored-nation tariff rate structure, ranging from 5% to 40%, which applies to countries other than the PRC and India, is complicated somewhat by the preferential trading arrangement with India. Only a few rates fall outside these rates and the high rates are set for revenue purposes. However, intraregional trade among the countries in South Asia is the equivalent of less than 2% of GDP, compared to 20% for East Asia (World Bank 2004). Some of the reasons for this include political conflict, similar endowments, and competition in the global export market.

Although tariffs have fallen, various nontariff barriers (NTBs) are taking increasingly larger shares in total trade costs (Mirza and Hertel 2007). Trade facilitation, therefore, plays an important role in reducing trade costs, promoting greater regional integration, and stimulating growth and development in the region.

Nepal has made several efforts to facilitate trade with other countries. Indeed, the Indo–Nepal Free Trade Agreement of 1996 and the agreement with India to ease access to the port of Kolkata have significantly facilitated trade between India and Nepal. However, influential competing producer lobbies in some neighboring Indian states have resisted (some would say sabotaged) this trade agreement by means of high local charges, which have created severe and

unpredictable problems for Nepalese exporters and importers. In March 2002, India agreed to extend the trade treaty, only after Nepal agreed to a series of concessions.

Another problem that needs to be addressed is the complicated quarantine rules of India, which have negatively affected Nepalese agricultural exports. In addition, delays in customs clearance for cross-border rail operations are also nagging issues. According to the World Bank (2004), customs processing delays at the border and at Kolkata port increase travel time between Kathmandu and Kolkata from 3–5 days to about 8 days. Customs and transshipment delays can also account for as much as 55% of the logistics costs of sending certain types of goods from Kathmandu to Kolkata, instead of 25% on average for other international routes. Nepal has requested India for the use of Jawaharlal Nehru Port at Mumbai. The port is likely to facilitate trade with Europe and the US by reducing transport costs of up to 40% of the costs incurred at Kolkata port. It will also reduce delivery time to the US by 20 days. India has yet to grant Nepal's request and has asked Nepal to submit a report on the modalities of its use (Government of Nepal, Ministry of Finance 2008).

Screening, Admission, and Establishment Policies

Foreign investors setting up 100% foreign-owned enterprises or joint ventures are required to make an application to the DOI and to submit a detailed feasibility report. In granting the approval for foreign investment involving new investment, modernization, diversification, or expansion, projects are assessed on the following criteria: investment in a priority industry as prescribed by the Government; financial and technical viability; contribution to employment generation, and to foreign exchange earnings or savings; competitiveness of products in international markets; appropriateness of technology; terms and conditions of investment and technology transfer; and participation of Nepalese nationals in investment and management.

Fiscal and Financial Incentives

Studies have shown that fiscal and financial incentives play some role in promoting FDI. In this regard, Nepal's FDI regime includes the granting of up to 100% equity participation by foreigners in almost all sectors except

for some in the negative list.³ Licensing requirements have also been streamlined, and the legal bases for full-scale private development of hydroelectric resources and private exports to India have been laid. Other features include full repatriation of equity, profits, or dividends, and of interest on loans; technology transfer payments; proceeds of divestments; guarantee against nationalization; income tax allowances with a minimum 5-year tax holiday for most industries; no tax on dividends, export earnings, or interest on foreign loans; and only 1% duty on imports of capital goods. In addition, any duty or taxes levied on raw and auxiliary materials that are used for producing goods for the export market are entitled to refunds based on the quantity of exports. A bonded warehouse facility is also available for raw materials. Moreover, foreigners and companies can open foreign exchange accounts in any of the country's commercial banks, although this account can be used only for importing equipment, plant, and other fixed assets necessary for the industry.

Performance Requirements

The Government does not impose performance requirements on foreign investors as a form of incentive.

Property Rights including Intellectual Property

Some risks have been noted regarding intellectual property rights in South Asia's T&C sector. To quote Tewari (2007), "... some local textile and design traditions [referring to Bangladesh, India, Sri Lanka] were at risk of being appropriated by entrepreneurs from outside the region." As a SAARC member, Nepal needs to work with other South Asian countries in promoting such rights since, in textiles, they can be thought of as the glue that can bring members together around a common regional brand.

With regard to intellectual property in Nepal per se, there is limited literature on the subject. However, from the information available, the following can be gathered. The DOI is legally responsible for patents, designs, and trademarks. Nepal has been a member of the World Intellectual Property Organization

(WIPO) since 1997, and recognizes the protection of intellectual property as essential in safeguarding the interest of investors and in benefiting from globalization and integration. A copyright act has also been passed in keeping with the Trade-Related Intellectual Property Rights Agreement (TRIPS) and the WIPO Copyright Treaty of 1996. The Act is expected to provide a basis for a stronger intellectual property regime in the future. In addition, Nepal acceded to the Paris Convention in June 2001.

Despite these laws, the protection of intellectual property in Nepal is still inadequate. The main problems identified are the long processes of law enforcement; lack of awareness of industrial rights and copyright; availability of cheap pirated goods; lack of formal education and training of institutions on intellectual property; and lack of a separate law for the administration of traditional knowledge, folklore, genetic resources, geographic indication, and biodiversity. These indicate the need to hasten the process of law enforcement, launch public awareness programs, provide training, include intellectual property as part of the formal education curricula, and establish a responsible and appropriate institution for intellectual property matters.

Institutions

The DOI is the focal contact point for foreign investments and is the agency that administers the provisions set forth in the Patent, Design and Trademark Act and the FITTA. The DOI is also responsible for granting licenses, facilities, and other administrative services to industries, including those established with foreign investments and/or technology transfer arrangements. It also evaluates project proposals and grants permission for industries with fixed assets of up to NRs500 million within 30 days from the date of application. Industries with fixed assets exceeding this limit have to go to the Industrial Promotion Board for approval.

Special Economic Zones

In 2003, a special economic zone (SEZ) project was launched with the twin objectives of attracting foreign

³ Restricted sectors include cottage industries, personal services, arms and ammunition, explosives and gunpowder, industries related to radioactive materials, real estate, motion pictures, security printing, currencies and coinage, retailing, horse riding, internal courier services, atomic energy, poultry farming, fisheries, and bee keeping.

investment and attaining high economic growth. SEZs include industrial estates, export processing zones, special trade zones, tourism-entertainment zones, information and technology parks, and banking facilities. The activities of the project include developing an SEZ law, conducting feasibility studies for the establishment of SEZs in different areas, and constructing basic infrastructure for such zones. To date, Nepal has SEZs at various stages: the Bhairahawa Export Processing Zone, which is under construction; and the Birgunj, Panchkhal, and Nuwakot SEZs, where prefeasibility studies have been carried out. The Government has also announced that a clothing processing zone will be established in Simara. Studies for setting up SEZs at Nepalgunj, Kailali, and Kanchanpur are planned.

Although none of the SEZs is yet operational, industrial districts are, although they are not intended for FDI. Industrial districts were developed to promote the establishment of industries by providing the necessary facilities in one place.

Investment Treaties

Nepal has entered into bilateral investment agreements with four countries: France in 1983, Germany in 1986, UK in 1993, and Mauritius in 1999. Surprisingly, Nepal has not yet signed any such agreements with its three major investors—India, US, and PRC. Nevertheless, it is in the process of making investment agreements with India, along with five other countries—Belarus, Qatar, Russian Federation, Sri Lanka, and Thailand—and two regional investment agreements with the Asia-Pacific Economic Cooperation and SAARC. Nepal has also signed double taxation agreements and the prevention of fiscal evasion with respect to taxes on income with Austria, PRC, India, Republic of Korea, Mauritius, Norway, Pakistan, Sri Lanka, and Thailand.

FDI and the Economy: Potential, Impact, and Constraints

Analytical Framework and Rationale

This study now analyzes two aspects of FDI in Nepal: the policy environment and economic and social benefits. In addition, it looks into the potential and constraints of FDI; and provides policy

recommendations both to address the constraints and risks of investment, and to achieve the full potential of intraregional investment. Recommendations are likewise presented at the sector level on industries that are critical to the country, and on regional policies and agreements to complement and support the recommended country policies.

Based on the available literature, the first aspect is analyzed in terms of foreign investment promotion policy and its related acts and rules, as well as complementary FDI policies and other related policies. Analysis of the economic and social benefits of foreign investment uses the United Nations Conference on Trade and Development (UNCTAD) *World Investment Report* approach, which assumes that FDI is a package of tangible and intangible assets—resources that are critical for development.

FDI Potential

The Government has provided three reasons why firms should invest in Nepal. The first is access to the markets of India and the PRC. India's guarantee of duty-free access to most Nepalese manufacturers and a memorandum of understanding with the PRC with regard to Nepal being an approved tourist destination are important in this regard. As a least developed country, Nepal is also eligible to benefit from the Everything But Arms initiative of the EU.

The second reason is the abundance of the country's natural resources. Indeed, there are five climate zones in Nepal, which offer opportunities for a range of agricultural products. And the country's potential in hydropower is enormous.

The third reason is related to Nepal's policies and people. Policies include low tariff rates and a liberal foreign exchange regime, while investors value the friendliness of Nepalese people and accessibility of the bureaucracy.

Despite the laggard performance of Nepal in attracting foreign investment, especially compared to its South Asian counterparts, the country has potential for FDI, particularly in the services sectors, where FDI inflows witnessed a substantial increase of more than 20% during 1998–2006. Among the subsectors in this area, tourism, health and health education, and information technology (IT)—primarily data entry and computer

software—have the highest potential, as well as freight forwarding, nursing homes, and construction. However, at least for now, Nepal's IT subsector may mainly have to piggyback on India's \$10 billion software export industry.

Tourism is a potential source of FDI given Nepal's natural and cultural assets. In terms of health, Nepal has increasingly emphasized that the private sector should provide specialized services while the Government should focus on primary health care. As a result, a number of private health centers have been established, some with foreign participation. In addition, the Government has approved a policy to provide land in the hills on long-term leases to private sector investors for hospitals, health centers, and educational institutes. In terms of pharmaceuticals, opportunities for foreign investment exist since only 30% of the country's demand for drugs is met by local producers. In addition, the National Drug Policy of 1995 mandates a move toward achieving 80% self-sufficiency in the production of essential drugs. There is also potential in the production of ayurvedic formulations and other herbal medicines. Information and communications technology also offers potential for FDI since professionals and workers in the field are readily available. In addition, labor costs in Nepal are very low relative to those in industrial countries.

The flow of FDI in financial services has been notably limited. Nevertheless, the past few years have witnessed an increase in the number of joint-venture banks and finance companies. These institutions have also been making profits and their shares were subscribed several times more than their public issue, which indicate investment opportunities in the sector. Nepal has also made 12 major commitments with regard to the opening of financial services to foreign investment. These include the acceptance of deposits and other repayable funds from the public and lending of all types. Similarly, financial leasing and all payment and money transmission services have been opened up. Guarantees and commitments, and trading for own account or for the account of customers, are also available to foreign investors. Nepal, therefore, has generated a congenial business environment for FDI in financial services and this is expected to promote other businesses in the country.

There is huge hydropower potential in light of severe power shortages in Nepal and India and increasing

energy demand in the country. There are up to 42 hours per week load-shedding in Nepal at present, affecting both the economy and consumers. Load-shedding is expected to increase further (it had already gone up to 16 hours per day by late 2008). Two of the foreign investments in power (on a build-operate-transfer basis) are Panda Energy Corporation of the US and Statkraft of Norway. All these factors imply potential for FDI in this sector. Indeed, FDI has been increasing in this area and the Government has also prioritized FDI in biogas, wind, and solar energy. In order to harness the immense potential of hydropower, the sector should be managed in a purely professional and businesslike fashion. However, this does not seem to be happening as hydropower projects in the pipeline are not progressing well.

In agriculture and agro-based industries, there is increasing demand for flowers, flowering seeds, tea, and coffee in both the local and international markets. This would then require investments but also market linkages—hence the potential for FDI in these areas. In terms of tea, exports from Nepal increased from a mere 83 metric tons (MT) in FY2002 to more than 1,000 MT in FY2004, but decreased slightly thereafter. In the case of coffee, Japan and the Netherlands have been the country's major markets. Both the tea and coffee industries in Nepal have not developed due to lack of long-term loans and poor marketing. Thus FDI in tea and coffee will find opportunities in processing, marketing, and cultivation, if it comes with financing, quality control technology, or a marketing network (UNCTAD-ICC 2003).

For flowers and flowering plants, diverse agroclimatic conditions offer good prospects for the production of a wide variety of flowers and flowering seeds for export. The workforce suitable for this industry is also available in the country. Nevertheless, this is a new area and exports have not yet started. The direct air link to northern Europe—the traditional market for flowers—will help this sector.

In addition, the country has immense potential for producing marketable products from its medicinal and aromatic plants, given its rich biodiversity.

Textiles and Clothing Industry

Information on the T&C industry shows approval given to 177 joint-venture firms out of a total of

1,345 such firms approved (based on November 2007 data). The status of these firms is not clear, although many may have closed down due to stiff competition in the international market, the end of quotas in January 2005, and the closing of Indian investment companies that were established in Nepal to benefit from Nepalese quotas. Thus there is little current potential in the sector. However, some potential exists in particular segments, mainly in the production of terry towels, bed linen, and some specialized items of readymade garments.

In terms of textiles, pashmina shawls and other pashmina products offer prominent export potential, but the handmade variety is classified as a traditional cottage industry, and so no direct FDI is allowed. Nevertheless, technological collaboration is possible, and there exists considerable scope for such partnership to bring the country badly needed marketing, design, and quality control expertise. FDI is possible in machine-made pashmina products, as shown by the operation of Emperor's Gold Mount, a PRC company that is in a joint venture with Momento Apparels, one of the largest exporters from Nepal. Since financial investment in the form of joint ventures is allowed in machine-made pashmina, allowing some percentage of FDI in handmade pashmina must be likewise explored through a consultative process with different stakeholders. Pashmina is the third-largest export item from Nepal with a share of 10.4% of overseas exports in FY2007.

Other examples of opportunities for niche products include other textiles, such as curtains, bed sheets, tents, tarpaulins, sails, hand-woven design fabrics; and bed, toilet and kitchen linen. The liberalization of the Indian market also offers huge possibilities for these products, and FDI could also be an appropriate avenue to pursue such opportunities.

Automobile Industry

Although Nepal has two motorcycle producers operating with PRC collaboration, the automobile industry's potential does not look promising given the dominance of Indian imports and India's strong comparative advantage and geographic proximity. However, there may be some potential for producing automobiles targeted at certain market segments, particularly low and medium income groups. The spillover provided by domestic production

in terms of backward linkages and training of the domestic workforce are some of the benefits that FDI may provide. More potential exists in producing motorcycles and their spare parts due to their higher demand. Prospects for investment in other sectors, however, remain poor due to the small size of the economy, technological backwardness, remoteness, civil strife, and susceptibility to natural disasters.

Economic and Social Benefits

Based on the limited studies on the impacts of FDI in Nepal and interviews conducted in the course of this study, the economic and social benefits of FDI in Nepal are analyzed in terms of technology spillovers, trade and investment effects, country reputation and linkages, the foreign exchange gap, and employment generation.

Technology Spillovers

As with other countries, one of the main reasons for attracting FDI is to benefit from technology transfer and spillovers. According to Chitrakar (2003), the transfer of technology through FDI appears to have helped Nepal in terms of introducing new production or process technology. Firms engaged in FDI have also been found to be more oriented toward new technology than domestic firms. Also, certain external benefits have resulted from technology transfer, mainly in the form of diffusion of technical knowledge from foreign personnel to their Nepalese counterparts, although this has happened to only a limited extent.

Nepal seems to recognize the need for technology transfer, but the optimal implementation and exploitation of such does not appear to be forthcoming. One of the reasons may be the country's poor absorption capacity, which implies the need for government intervention to stimulate benefits from such activities. Training programs of foreign investment firms also differ according to the country of origin, with Indian firms having more training activities, possibly due to the lower cost of sending personnel to India (given its nearness).

In return for technology transfer, foreign investors receive adequate compensation in terms of technology fees. These fees are in addition to the share that foreign investors derive from profits in

joint-venture undertakings and are charged regardless of the financial status of firms. As a result, higher returns accrue to foreign investors than their domestic counterpart. Thus, establishing a compensation package for technology transfer based on the firm's performance seems to be necessary. Training of the local entrepreneurs is also required to improve and increase their negotiating skills.

Trade and Investment Effects

FDI has helped expand Nepal's financial resources and ensure the availability of financing for trade facilitation through trade credits. In addition to supplementing domestic investments and boosting the domestic economy, FDI also assists in accessing international markets. In this regard, FDI—particularly export-oriented investments—has long been recognized as an important catalyst for trade-related growth. However, data from the Industrial Perspective Plan show that FDI during 1987–2001 was concentrated in nonexport manufacturing activities and travel (World Bank 2004). The number of industries permitted in service industries and tourism reached 88 and 55 in FY2007, respectively, compared to 40 in industrial production (Government of Nepal, Ministry of Finance, 2008).

Country Reputation and Linkages

Foreign investment, particularly in tourism, has helped in establishing and improving the country's reputation. Some upmarket hotel chains (e.g., Crowne Plaza, Hyatt, Radisson, and Taj) have investments in the country, which have helped establish Nepal as an important tourist destination. Similarly, tourism products targeted at Buddhists and Hindus from around the world have helped the world focus on Lumbini, and recognize Nepal as the birthplace of Buddha and the land of Shiva.

In addition, products such as carpets and pashmina have helped establish linkages abroad, mainly the EU and US. These products are well known to the West and are important exports. Clothing likewise was a very important export item of the country until the end of quotas in 2005.

Foreign Exchange Gap

FDI is assumed to bring in foreign currency, thereby helping minimize the foreign exchange gap. However,

data for 1999–2003 show that equity earnings payments were higher than FDI inflows, which implies that FDI has not helped much in bridging this gap. The situation subsequently improved, and is expected to pick up further, as a result of the improved peace situation. Immediate results have in fact been felt by the tourism industry, as seen in greater tourist numbers.

Employment Generation, Gains to Labor, and Other Benefits

FDI has helped generate employment and improve other labor benefits, such as the difference between the market and shadow wage rates. In 2007, total employment provided by approved FDI projects in Nepal exceeded 180,000, with manufacturing other than T&C accounting for around 35% of this total, followed by T&C with around 20%, and tourism with 9%. Chitrakar and Pant (2007) show that FDI-funded financial institutions provide higher salaries and more training to their employees: employees from these institutions add about \$90 per month to the value of labor plus the skills from training. Given that FDI projects in financial institutions in Nepal number 2,407, the equivalent net labor benefits from FDI in the financial sector is about \$209,000 per year. In addition to employment and labor gains, FDI also provides benefits in terms of forward and backward linkages.

Risks and Negative Effects

Negative consequences can arise from incorrectly planned liberalization. In fact, there is still no consensus on whether certain critical services, such as health and education, should be liberalized. Some believe that their liberalization displaces domestic investors and becomes difficult to monitor in terms of the quality of services they provide. However, no domestic firms have been displaced by foreign manufacturing, tourism, or financial firms. Rather, many new domestic banks seem to have been established as a result of demonstration effects (Chitrakar 1994). Hence, Nepal needs to pay close attention to sequencing and pacing, and ensuring that an appropriate regulatory framework is in place.

Yet not all FDI has a positive impact. Experience from manufacturing (Chitrakar, 1994) and banking (Chitrakar and Pant, 2007) shows that performance

differs depending on the firm or bank, indicating a need for selective intervention to steer the firm in the right direction. Such interventions may include providing the necessary help to firms that are facing difficulties, offering training programs in FDI firms, requiring some research and development (R&D) activities in host countries, balancing the inflow and outflow of foreign exchange by FDI firms, and restricting domestic borrowing. The foreign exchange impact discussed earlier also demonstrated the negative effects in 4 out of 5 years under analysis. The outflows of foreign exchange during these years were more than the inflows in terms of foreign investments and loans. Firm-level long-term analyses also show that some of the finance companies with foreign investments perform poorly (Chitrakar and Pant 2007). Economic costs (e.g., domestic investment in the FDI-funded firm, returns to foreign investors, domestic borrowings, technology fees, and repayment of foreign loans and interest) of some of the finance companies with FDI were found to exceed the economic benefits that they generate in terms of FDI inflows.

In addition, multinational corporations might also introduce transfer pricing and negative noneconomic effects, such as cultural dependency or even ethnocide. Although these risks are not specific to Nepal, multinational corporations are thought to influence the culture of the country. Moreover, since foreign firms pay more than domestic firms, this may likely result in engendering income inequality.

Constraints

Nepal has been unable to attract FDI partly because of its small domestic market and infrastructural problems, resulting from its landlocked and mountainous nature. Its low per capita income has further constrained the domestic market. Exports have been limited by low labor productivity, resulting in higher production costs. Other costs include delays in customs and transshipment to India's Kolkata port; high costs of transport and power; a rigid and formal labor market; lack of labor–employer cooperation; weak policy and institutions in the areas of taxation, investment, and trade promotion; terrorism; and poor work ethic of the labor force (World Bank 2004).

The *Global Competitiveness Report 2008–2009* (World Economic Forum, 2008) enumerated the five most

problematic constraints to doing business in Nepal, namely: government instability, policy instability, corruption, inefficient government bureaucracy, and inadequate supply of infrastructure. The study also ranked Nepal's overall quality of infrastructure as 130 and business costs of terrorism 132 out of 134 countries surveyed. The country was at ranking 120 on transparency of government policy making, 126 on prevalence of trade barriers, 113 on impact of rules on FDI, and 126 on prevalence of foreign ownership. Other notable constraints include organized crime (128), labor–employee relations (133), firm-level technology absorption (130), extent of marketing sophistication (129), and company spending on R&D (126). Nepal also relies very little on professional management (115).

The only possibility to offset these constraints is to implement policies that aim to improve the investment climate. This is not happening now, and indeed, many foreign investors regard the law as unclear and its policies ineffective. Integrating regionally with other South Asian countries is also necessary for increasing the size of the market. In addition, there is a need to improve infrastructure, governance, and security. Special focus should be given to ensuring improved customs procedures and the supply of electricity.

Nepal also faces challenges resulting from its membership of WTO, which have to be met by promoting the country's economic competitiveness. Nepal's general and specific commitments to allow foreign equity participation in various services sectors are very attractive, but there are still numerous practical difficulties in setting up and operating an entity with foreign equity participation. The Government and people are likewise not yet ready to accept foreign investment easily in some sectors, such as wholesale and retail, as well as community and social services. Some feel that certain sectors like health and education are the responsibility of government, and should be reserved for domestic investors.

The economic and political upheavals, as well as the more than a decade-long conflict, have been greatly responsible for the poor inflows of FDI and the closure of some businesses. They also put pressure on foreign exchange and the balance of payments. The recent terrorist movements by certain Terai groups, including Terai bandh (blockade of roads and shutdown of

markets), the conflict, and load-shedding in electricity supply are likely to have serious impacts on FDI inflows.

Policy Recommendations

General

Studies have shown that foreign investment in Nepal generally has a positive impact, both for the foreign investor and the country. The five most problematic factors of doing business as shown by the World Economic Forum (2008) and by the World Bank (2004) need to be remedied to attract FDI. SEZs also need to start operating to draw efficiency-seeking and export-oriented FDI firms.

About 45% of foreign investment comes from five SAARC countries (Bangladesh, Bhutan, India, Pakistan, and Sri Lanka), indicating the high potential for intraregional investment. However, country-level data show that a large share of total SAARC investment comes from India. Although this is natural, it also indicates the need for a policy to diversify inflows and to attract investments from other countries. However, none of the studies conducted thus far has pointed out why investments are not flowing from other investors. The implementation of SAFTA and the gradual move toward an integrated South Asian economy, leading eventually to a South Asian Economic Union, could be the solution to the problem regarding the flow of goods and services.

Since Nepal is already a member of WTO, it is recommended that the services sector be classified according to WTO classification, and investment in the different subsectors be shown separately under a broad heading. This will help in classifying many of the new services sectors, such as wholesale and retailing, and consulting, which have already been opened up or which are in the process of being opened up, reflecting commitments to WTO. This suggested classification would help in making detailed analysis and intercountry comparisons. Strategies could then be formulated for improving trade and investment cooperation among South Asian countries. This will also help in harmonizing data keeping among SAARC countries.

Since trade costs constitute a major share in the production cost of SAARC countries, especially for

least developed countries like Nepal, trade facilitation is necessary in reducing these costs. A study by the World Bank (2004) showed that preshipment transport costs account for 7%–8% of the price received by exporters. Also, travel time from Kolkata to Birgunj can be reduced to 3 to 5 days if trade is carried out through the inland container depot, which in turn helps reduce transport costs by about 30% (World Bank 2004). Trade facilitation is especially important for products like clothing, pashmina, and agro-products, considering the volume of these products and the higher transport costs involved.

Improvements are also necessary in customs clearance procedures for cross-border rail operations with India. Similarly, intergovernment cooperation with Bangladesh is needed to improve the infrastructure of the Banglabandh Marg. In addition, Nepal should reform its Customs Act and Rules to make it consistent with WTO requirements. It should also simplify and harmonize trade documents and procedures. It is also recommended that systematic meetings with traders and training programs in new procedures are organized, and that sufficient resources are allocated to keep open major customs posts on a 24-hour basis.

Since the main issues regarding intellectual property rights are law enforcement and the lack of awareness, there is a need for improved enforcement and the establishment of public awareness programs and training. Similarly, intellectual property rights should be included in the curricula of formal education and an appropriate protection agency should be created.

India's new provisions of bringing its customs rate to zero to provide market access to Nepal, Bangladesh, Bhutan, and Maldives will introduce competition for Nepalese products in the Indian market. This indicates the need to build the country's competitive capacity and productivity through capacity development programs.

Sector Specific

The share of FDI in services to total FDI in Nepal has increased substantially, indicating some potential in the services sector. Tourism is one of the major industries with prospects for further investment growth. Possible areas for increased investment also include health and health education, and the communications and software sectors. The export

of services in information and communications technology is unaffected by distance or other trade barriers resulting from remoteness. Since Nepal has transport and transit problems, and high transaction costs, it is recommended that emphasis should be given to the promotion of investment flows in the services sectors, which requires the maintenance of peace, security and stability, a regular supply of electricity, and good labor–management relations.

Although Nepal has made general and specific commitments to WTO to allow foreign equity participation in various services sectors, this has not materialized due to practical difficulties in setting up and operating firms with foreign equity participation. This implies the need for improving infrastructure and the business environment, and introducing a clear and visionary FDI policy that increases inflows and that benefits the economy and its consumers. Thus, it is suggested that governance be improved in the institutions dealing with FDI.

Though the T&C industry is one of the major exporting sectors of Nepal, there is virtually no FDI in textiles, and the possibility of FDI inflows in this sector seems to be very slim since other SAARC countries are stronger in this area. Although the number of clothing firms has fallen substantially in recent years, the possibility of exporting certain categories of clothing under the EU's Everything But Arms initiative has to be capitalized on. The facility provided by the EU on rules of origin for textiles needs to be tapped since exports of clothing to the EU are expanding. Also, since the readymade clothing industries in SAARC are importing textiles from outside the region rather than from within the region, a shift to SAARC countries is recommended for cooperation among members, but this will happen only if products are competitive. The possibility of allowing FDI in handmade pashmina must also be explored. In terms of agriculture and agro-based industries, their FDI potential needs to be assessed. Efforts are also necessary to remove the constraints and obstacles in Nepalese agricultural exports created by complex quarantine rules imposed by India in 2001.

Nepal should take advantage of the liberalization of the Indian market, and FDI may be an appropriate avenue to pursue. Given that trade in T&C is the “glue that binds SAARC's member countries” (Tewari 2007) much attention should be given to the existing

strengths of each member country for the formation of regional production networks and clustering in clothing. Nepal also needs to concentrate on producing readymade clothing, where it has an advantage. It should also participate in labor training and exchanges with other member countries, including the training of managers, quality control specialists, technical personnel, and designers. The flow of skilled workers and managerial talent in the T&C industry across the major South Asian countries needs to be supported and nurtured, along with an easing of visa rules.

Assistance should also be provided to financial companies facing difficulties, and since any instability in the banking system affects the whole economy, the Government needs to keep a watchful eye on this sector. Indeed, domestic regulations that are most significant in determining whether financial FDI can generate benefits are still not well developed. Total foreign shareholdings in financial services are limited to 67% of the issued share capital. This low share may mean fewer benefits to the country, indicating the need for a gradual increase in such shares. Effort should also be made toward establishing more financial institutions in the country, which are expected to promote other businesses. Moreover, since financial institutions with foreign investments can contribute to employment generation and gains to labor, there is a need to encourage joint-venture banks. Nepal's commitments in opening financial services to foreign investments on WTO accession also imply that the country's financial market should be more competitive in the future, thereby indicating the need for capability building.

In the area of power generation, a quantum leap in hydropower production is required as the country is facing severe power shortages at present. This implies the need for increased investment in the power sector, including that from foreign capital. Failure to obtain private investment in time might lead to further power shortages by 2012. Therefore, more consolidated efforts are required from the Government and the bureaucracy to attract FDI into hydropower. Moreover, a transparent and enabling framework, improved peace and security, and the creation of a robust and growth-oriented power market, including full and nondiscriminatory access to northern India, are necessary. The country may also want to explore FDI in biogas, wind, and solar energy.

In the automobile industry, two investments in terms of technology transfer from the PRC have been made in motorbike manufacturing. Since these companies brought new technology, provided employment, and fostered backward linkages, they should be helped and assisted. Investment in terms of both finance and technology is also required at least in motorcycles, scooters, and spare parts.

Summary and Conclusions

The main objectives of this study were to examine the FDI policy and environment in Nepal, analyze the impact of FDI on the economy, and investigate key opportunities and barriers to investment. The study also considered the importance of policies to enhance labor mobility as a complement to capital mobility.

The Government has encouraged FDI in the country since liberalization in 1990. Although its foreign investment policy is attractive, a considerable barrier is the lack of implementation. Complementary policies, such as those on labor and customs, have also hindered FDI.

FDI is represented by a wide variety of companies and countries in various areas. There is the possibility of FDI in many niche agricultural products and the potential in hydropower is huge. Current severe power shortages point to further possibilities for development. The potential in the services sector is evidenced by its increasing role in the economy, but although the country committed to opening up various services after WTO accession, there is still no consensus as to whether certain services should be liberalized. Nepal should try to achieve the full potential of intra-regional investment. In manufacturing, investment in readymade clothing has been the most prominent.

Foreign investment brings economic and social benefits, improves the country's reputation, and offers access to the world market. In recent years, however, FDI has not helped much in terms of closing the foreign exchange gap.

Trade and investment are constrained by the small size of Nepal's economy, technological backwardness, remoteness, landlocked position, civil strife, and susceptibility to natural disasters. Nepal's low

productivity (the weakest among countries in the region) is another obstacle, as are government and policy instability, inefficient bureaucracy, corruption, and inadequate infrastructure. To this could be added a poor work ethic, tax regulations, delays in customs and transshipment, a rigid and formal labor market, lack of labor–employer cooperation, and weak policy and institutions in taxation, investment, and trade promotion. These are the areas where improvements are most needed.

Looking specifically at important sectors in the T&C industry, the number of firms with FDI has decreased gradually since the end of MFA in January 2005, although the facility provided by the EU under its Everything But Arms initiative has resulted in the gradual expansion of exports of textiles. Specifically, pashmina shawls and other textile products offer prominent export potential. In the automobile industry, the potential for FDI is in producing spare parts.

Finally, there is a considerable potential for intra-regional investment in Nepal, since much of such investment currently comes from India, suggesting the need to diversify inflows from other SAARC countries.

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