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THE FOREIGN DIRECT INVESTMENTS IN NEPAL

Abstract: Nepal does not attract much foreign direct investment in spite of policy reforms initiated in the early 1990s to attract it. This is partly because a small, poorly developed, landlocked, mountainous country has little to offer to investors. Although FDI and Technology Transfer Act liberalized the entry of FDI and guaranteed repatriation of profit and capital, investors still face obstacles. The challenge for Nepal is to create an investors-friendly business climate that will complement its small bureaucracy.

Key words: Foreign Direct Investment, Nepal, technology transfer, financial sector.

1. Introduction

The volume of FDI inflows into Nepal has been small, averaging only about $8 million annually. The inevitable consequence is that FDI has not been an important source of aggregate investment finance and its impact on economic development has also been minimal. A comparison with selected high- and low-performing Asian countries brings out the underperformance of Nepal in terms of FDI inflows. As Nepal has some niche sectors such as tourism and herbal products, the country has the potential to attract FDI in such sectors. Even though most sectors are open to FDI and the standard of treatment has been fairly good, the FDI potential has not materialized. An overall improvement in the business climate is called for to make it more investor-friendly.[1]

2. Trends

2.1. FDI size and growth

During 1980-1989, FDI flows to Nepal were minimal or even negative, with an annual average of $0.5 million. There was a distinct acceleration during the 1990s, although total flows remained small, averaging $8.3 million per annum during 1990-2000, following a short-lived peak of $23 million in 2005.

[1] T. Sporek, *Wpływ kryzysu finansowego na globalizację gospodarki światowej*, Akademia Ekonomiczna, Katowice 2010, pp. 158-169.

One factor explaining the increased FDI in the 1990s is Nepal's more liberal trade policy. For example the unbalanced average rate of import tariff was drastically reduced from 111% in 1989 to 16% by 1992; and the number of tariff slabs fell from more than 100 in the 1980s to only 5 in 1996. In addition, the establishment of bonded warehouses and the introduction of a duty drawback scheme reduced the previous trade policy's anti-export bias. Complementing this overall trade reform programme was a bilateral trade treaty with India concluded in 1996, which allowed India to import goods from Nepal free of import duty and quantitative restrictions if the goods were manufactured in Nepal (except those on the negative list). This has been cited as an explanation of the considerable expansion of Indian investment in Nepal after 1996.[2]

The low volume of annual inflows also translates itself into meagre FDI stock in Nepal, compared with Mongolia and the Lao PDR (Table 1). A comparison of Nepal's FDl inflows per $1000 GDP with those of other Asian countries, high- and low-performing, points to a poor performance (Table 2).

Table 1. FDI stock in three Asian landlocked countries in the period 1990-2005 (millions of dollars)

Country	FDI 1990	FDI 1995	FDI 1999	FDI 2000	FDI 2005
Lao PDR	13	204.8	515.9	549.8	762.5
Mongolia	–	37.7	127.9	181.6	235.1
Nepal	12	38.8	97.4	96.9	168.5

Source: *World Investment Report 2005*, UNCTAD, New York and Geneva 2005.

Table 2. FDI inflows per $1000 GDP for selected Asian economics

Economy	1990	1995	2000	2005
Bangladesh	0.1	0.1	5.9	8.7
Hong Kong (China)	43.8	44.6	380.8	–
India	0.7	6.1	5.1	9.9
Malaysia	59.3	65.5	42.2	165.1
Nepal	1.6	1.8	–0.1	3.2
Philippines	12.4	19.7	16.6	19.8
Singapore	152.0	105.4	58.6	88.6

Source: *World Investment Report 2005*.

Compared with South Asian LDCs, Nepal does not fare well in attracting FDI (Figure 1). This is mainly because Bangladesh, a much larger country, experienced a major acceleration of FDI inflows during the second half of the 1990s but it is also due to Nepal's inability to sustain the momentum of its flows of 1996-2005.

[2] *South Asian Development and Cooperation Report 2004/2005*, New Delhi 2005, p. 36.

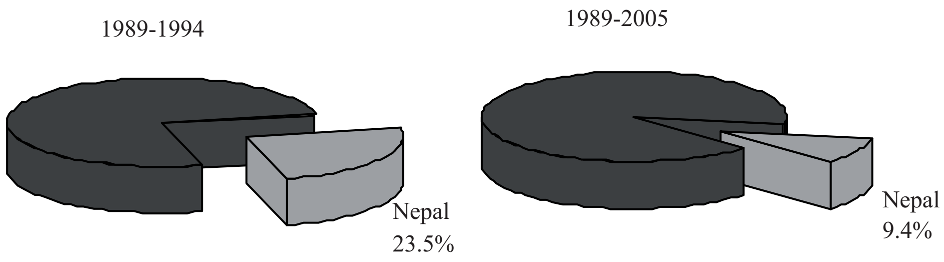

Figure 1. Nepal's share of FDI inflows into South Asian LDCs (annual average)

Source: *World Development Report 2005/2006*, Oxford University Press for the World Bank, Washington 2006.

2.2. Form of FDI

Many of the foreign investors in Nepal are individuals rather than corporate entities. In mid-July 2001, there were 234 enterprises in operation with foreign equity participation[3] with foreign ownership held by individuals in nearly 50% of these. All except nine of the firms were small in size, with authorized capital of less than $1 million. In the nine larger firms, the share of foreign ownership ranged from 36 to 99%, with individuals having majority ownership in eight of them. Reflecting the overall pattern of sectoral distribution of FDI, four of the nine enterprises were in the tourism (hotel) industry and three were in the textiles/garments industry.

The second feature is the preponderance of joint ventures. This occurs despite the fact that 100% equity ownership by foreign investors is allowed in almost all the sectors (except for a short negative list that includes cottage industries, retail business, industries related to arms and ammunition. Fewer than 36 of the 350 firms are wholly foreign-owned. Most of these 36 firms are relatively small, but they include seven of the nine firms with capital exceeding $1 million. The preponderance of joint ventures may be seen as an effort by the foreign investors to minimize non-commercial risks by taking on local partners.

Thirdly, most FDI in Nepal has been "Greenfield" as there is no significant incidence of acquisition. Even the privatization process has attracted little FDI, although 16 enterprises were privatized between 1992 and 1999,[4] and there is no bar on foreign investment. Two well-known exceptions are a European acquisition of 22% of the privatized Lube Oil Company, and the establishment of Nepal Grindlays Bank (which later became Standard Chartered Bank Nepal).

[3] *Nepal and the World*, International Finance Corporation. A Statistical Profile, Washington 2002.

[4] Nepal Ministry of Finance, December 1999.

2.3. Distribution by sector, origin and geographical location

FDI is most highly concentrated in the manufacturing sector, which accounted for 50% of approved FDI projects, over 40% of foreign investment and 65% of total employment in 2001 (Table 3). Two industries stand out in the sector. Firstly, the food, beverages and tobacco industry accounts for 25% of total investment in all approved manufacturing projects, the share of FDI being 24%. Secondly, the textile and garment industry accounts for 24% of total investment in all approved manufacturing FDI projects. Tourism also attracts significant FDI. It accounts for almost a quarter of total FDI projects, a fifth of total FDI and about a sixth of employment in all approved FDI projects.

FDI is reasonably concentrated in its source, with seven countries accounting for over four fifths of cumulative FDI. India alone accounted for one third, followed by United Sates and then China. In total, investors from 40 different countries have invested in Nepal, but the scale and number of projects in most cases is small. Finally, the factor intensity of investments tends to reflect each home country's comparative advantage: comparing the share in FDI with share in employment Indian investments are most labour-intensive, while those of Norway and the United States are more capital-intensive.

Table 3. Sectoral distribution of all approved FDI projects until 2001 (in %)

Sector	Number of FDI projects	Amount of FDI[a]	Employment in FDI projects
Agriculture	1.7	0.4	1.0
Manufacturing	50.3	43.3	64.9
Tourism	23.9	21.0	16.0
Services	21.5	20.8	11.0
Others[b]	2.6	14.4	7.1

[a] Defined as foreign investors' equity; [b] Includes constructions, energy-based and mineral-based projects.

Source: compiled by the author from data of Nepal Department of Industries.

The United Kingdom is not a significant investor despite its historical links with South Asia. Similarly, some of the Asian developing economies which are emerging as notable outward investors do not have a significant presence in Nepal. I give the sectoral and home country distribution in dollars.

The geographical distribution of FDI within Nepal is strongly concentrated in the Kathmandu Valley which includes the capital city, Kathmandu, and offers the best infrastructure (transportation, power and telecommunications) and proximity to administrative decision centres. 57% of total FDI-related projects are located in this

Table 4. Home economy distribution of FDI in Nepal

Home economy[a]	Share in the number of enterprises	Share in total FDI	Share in employment in FDI projects
India	35.0	35.8	40.0
USA	10.3	17.1	8.1
China	7.7	10.9	7.8
British Virgin Islands	0.6	6.4	1.4
Norway	0.7	4.9	0.2
Japan	10.5	4.2	5.5
Republic of Korea	3.9	3.5	2.8

[a] Ranked by share in total FDI.

Source: compiled by the author from data of Nepal Department of Industries.

region, accounting for 63% of total project cost and 48% of employment. Little FDI is found in Nepal's hilly and mountainous region which hosts only 12% of projects in operation and 14% of employment, although it is inhabited by more than half of Nepal's population. The remainder of FDI projects are located in the Terai region which runs along Nepal's southern border.[5]

2.4. Profile of the largest enterprises with FDI

The common feature of the nine largest of Nepal's 250 foreign affiliates is that they are joint ventures, with India as the most frequently occurring home country (Table 5). Foreign investors have majority ownership in only four out of the nine firms, and

Table 5. The largest enterprises with FDI in operation mid-April 2001

Name of company	Authorized capital (million dollars)	Product	Share of foreign ownership	Status of foreign partner	Home country economy
Suriya Tobacco Company	28.02	cigarettes	51	corporate	India
Taragaon Regency Hotel	20.15	hotel	36	individual	India
Bhrikuti Pulp and Paper Industry	14.64	paper, paper box, board	20	corporate	Bermuda
Bashu Linga Sugar	12.02	sugar, molasses	60	individual	India
Hotel Yak and Yeti	11.57	hotel	60	corporate	Australia/India
Nepal Orient Magnesite	11.03	refractory bricks	50	corporate	India
Gorakhali Rubber Udyog	9.01	tyre and tube	44	corporate	China
Shree Ram Sugar Factory	7.46	sugar processing	20	corporate	Bermuda
Colgate Palmolive (Nepal)	7.20	toothpaste/toothpowder	100	corporate	India

Source: *Nepal and the World*, c. 13.

[5] *Investment Policy Review: Nepal*, United Nations, New York and Geneva 2003.

only one is wholly owned. The firms also stand out from the bulk of foreign affiliates in Nepal for reasons other than their greater authorized capital. Firstly, individual owners play a much less significant role than is typically seen in overall FDI. This is understandable, given the size of the enterprise. Secondly, the nine firms are not in the textile and garments sector, although this was the second largest form of FDI in Nepal. This reflects the sector's lack of integration.

3. Impact

The amount of FDI that Nepal receives is small and therefore its impact on the economy also tends to be meagre. This section provides a qualitative assessment of the other benefits that Nepal seems to have enjoyed from its links with TNCs.[6]

3.1. Access to export markets

Total merchandise exports from Nepal grew by 170% between 1990/91 and 1999/00, compared with a mere 12% in dollar terms from the fiscal years 1980/81 and 1989/90. The annual average growth of exports was 14.3% for 1990-1999,[7] compared with 3.9% for the period 1980-1989. This astounding export growth and the increase in the inflow of FDI in the 1990s are more than coincidence.

Much of the growth in experts has been concentrated in textiles and garments, the second largest FDI manufacturing sub-sector. By the fiscal year 1999/2004, ready-made garments were the largest single merchandize export, amounting to nearly 60% of convertible foreign exchange earnings from merchandize exports. Foreign investment in this sector may have been motivated by the quota restrictions faced by investors' home countries. Garments exports are also known to have benefited through non-equity links with foreign affiliates, particularly in the form of subcontracting. In the process, domestics producers were able to secure assured markets and advice on design and quality.

In at least one case a foreign investor introduced an entirely new product with 100% export orientation (Box 1). Another enterprise, with majority FDI, producing personal care consumer goods such as soap, shampoo and skin care products, now exports about 50% of its output (Box 2). These sorts of exports from Nepal did not exist before. Dabur Nepal Private Limited (Box 3) exports honeybee equipment to Australia, the United Kingdom and the United States; honey and queen bees to Europe; and more recently, fruit juice to Maldives. It is currently exploring other export markets. Alcoa of the United States, a global leader in the beverage closure

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[6] T. Sporek, *Internacjonalizacja, globalizacja i integracja we współczesnej gospodarce światowej*, Akademia Ekonomiczna, Katowice 2006, p. 265-277.

[7] *World Development Report 2000/2001*, Oxford University Press for the World Bank, Washington 2001.

industry, is setting up a 100% foreign-owned export-oriented enterprise, jointly with Nilkamal Plastics of India. Production is expected to begin in the near future, and the company expects to sell 95% of its output to India.

Box 1. Nepal Bayern Electric Company: A unique exporter

Nepal Bayern Electric (NBE) is a joint venture, owned in 51% by Wüst (a German family-owned business) and in 49% by a well-known Nepalese business conglomerate (Narayani Group). It is a small company with an authorized capital of under $700,000. It assembles micro transformers (for use in the telecommunications industry) that permit speedier data, speech text and image transmissions. Its special significance in the context of Nepal is that it produces products that no other Nepalese company either produces or would normally consider producing, all of which are exported.
NBE started operation in May 1993 with only 16 employees and has now grown to employ about 250. Most of the production-level workers are women. The company receives technology back-up from its German partner; and its engineers, all of whom are Nepalese, make regular visits to foreign customers, sometimes spending weeks for training in their facilities. Customers include Macom Euvotec of Ireland. Matsushita, Siemens and the German partner, with all of which it has subcontracting arrangements. The customers provide the design specification and the required materials.
NBE illustrates the potential for the assembly of electronic products in Nepal. In this case, the combination of Nepal's low labour costs and German technology has opened up an entirely new avenue of production in and export from Nepal.

Source: *World Investment Report 2000*, UNCTAD, New York and Geneva 2000, 16.

Box 2. Nepal Lever Limited

Nepal Lever Limited is a 10-year old joint venture in 80% owned by the Indian public limited company Hindustan Lever Limited. Its range of personal care consumer goods includes soap, shampoo, laundry detergents, toothpaste and skin care products.

The company once had a strong export orientation, primarily focused on the Indian market. However, as shown below, the share of exports in total turnover has been declining since 1998, and there was an absolute fall in exports in 2000. According to the company's annual reports, this was caused by changes in India's import duty structure, which caused a loss of competitiveness in the market for toilet soaps, and the cessation of sales of toothpaste.

Fiscal year	1998/99	1999/00	2000/05
Domestic turnover	7.69	10.01	12.14
Exports	18.22 (70)	19.78 (66)	14.43 (54)
Total	25.91	29.70	26.57

Note: All values in US$ million.
Numbers in parentheses show percentage shares of exports in total turnover.
The company directly employs about 200 Nepalese citizens and estimates that it generates employment in Nepal for over 10 times that number through its network of suppliers, distributors and subcontractors. Nearly 100 distributors and stockists service over 24,000 retail outlets, directly.

Source: UNCTAD interview and company's annual report.

At the product level, a sector that is experiencing high export growth to India, includes toothpaste, vegetable oil, soap and Ayurvedic health care products. This is largely attributable to Indian joint-venture enterprises operating in Nepal.

The tourism sector is a good example of the important role of FDI Tourism is Nepal's second largest source of FDI, and an important source of foreign exchange earnings. It is unlikely that foreign exchange earnings from this sector could reach their current levels without FDI. Foreign investors in this sector bring strong marketing links, particularly when part of a chain of international hotels. For instance, one of Nepal's hotels with majority FDI Hotel Yak and Yeti, actively arranged sales through offices located outside Nepal and through its website. This cannot easily be rivalled by domestic investors.

3.2. Technology transfer and linkages

Obtaining improved technology is one of the most important reasons why developing countries wish to attract FDI. The "hardware" aspect of technology embodied in machinery and equipment has to be imported into Nepal, which has virtually no capital goods industry. However, other aspects of technology transfer through FDI are also particularly relevant, including (a) the transfer of skills to the employed labour force; (b) the diffusion of technology outside the affiliates/subsidiaries; and (c) the introduction of new products.

Methods by which FDI can develop and transfer skills through FDI would likely be formal in-house training programmes, including on-the-job training; replacement of foreigners by local nationals at progressively higher levels of responsibility; and sponsorship of off-the-job training through provision of scholarships and support for technical and professional personnel.

Training of employees by FDI enterprises is quite common in Nepal. In some instances, professionals have been trained abroad. In others, training has been imparted through employer-sponsored programmes in local universities and management institutions. Sometimes, foreign trainers are invited to the enterprise (for example, see box 1). Nepal Lever, in addition to continuous on-the-job training, puts all its employees through at least five days of training annually to upgrade their productivity, skills and personal effectiveness.

The majority of employees in the professional category in FDI enterprises are Nepalese. For example, Nepal Bayern employs one general manager and six engineers, all of whom are Nepalese. Hotel Yak and Yeti employs about 50 professionals, of whom only 11 are expatriates. In the case of Himal Power Limited, there are five management staff members, two of them are Nepalese, while of the nine engineers, six are Nepalese. Of the 35 officers in the Indo-Suez Bank, all are Nepalese except the Chief Executive Officer. Similarly, the Standard Chartered Bank employs a total of over 250 full-time staff, among whom there are only two expatriates. There are also instances of progressive localization at the professional level. For instance, when Dabur Nepal started, nearly all its professionals were Indian; a decade later the share of Nepalese professionals had risen to about 70%.

Some enterprises run internship programmes to train the local workforce. For example, Hotel Taragaon Regency runs an internship programme – the "Learn and Earn Programme" – under which some 200 people have been given training. Himal Power has provided training for many employees of other companies.

There appears to be little mobility of employees from foreign to local enterprises because the former generally pay higher wages and other benefits. However, the first private Nepalese bank was set up with the help of a number of professionals who were previously employees of a joint venture bank.

Technologies can be diffused beyond the foreign affiliates and subsidiaries in a number of ways. Linkages with suppliers may lead to the upgrading of the latter's product quality. A second channel is through the training of personnel employed in domestic enterprises by foreign investors. A third likely source of diffusion is a kind of "demonstration effect": the presence of foreign affiliates enables local enterprises to become aware of the existence of improved product and process technologies and then to adopt them, where profitable. Some of the mechanisms of technology transfer and diffusion through FDI have clearly been in operation in Nepal. Although their economy-wide impact cannot be quantified, some illustrations include:

– A construction joint venture between Ansal Buildwell of India and Chaudhary group of Nepal introduced multi-storied apartment complexes and earthquake-proof technology. This had a demonstration effect on local producers, who are emerging as competitors. The company is also contributing to the skill development of local contractors by providing construction-related technical advice.
– Nepal Lever created a distribution infrastructure (box 2) and introduced new advertising techniques. Once the market for personal care products had been created, domestic producers started engaging in the production of similar products.
– Dabur Nepal (box 3) introduced plastic boxes as a wood-saving technology for raising honeybees.
– In the financial sector, joint venture banks pioneered computerization, automatic teller machines, telephone banking and consumer loans. One such bank, Standard Chartered Bank, introduced a system under which exporters to India can have their cheques cashed within three days; this used to take three to four weeks before.
– The manufacturer Nepal Bayern (box 1) introduced an entirely new export product.

Linkages between foreign investors and the linked Nepalese enterprises can also be mutually beneficial. The former can benefit from low-cost supply of inputs and specialization in the production of final outputs. The local suppliers receive an assured market; this helps them increase their output and employment. They are likely to receive technical advice from the foreign investors, who have a strong interest in the high quality of the supplies they procure. In view of the data limitations it is not possible to generalize about the extent to which linkages actually exist between foreign-invested enterprises and the local suppliers or the kind of benefits gained by them. There is, however, at least one case in which the linkage effect has been strongly positive for the Nepalese economy (box 3).

Box 3. Dabur Nepal Private Limited: An example of backward linkage

Dabur Nepal Private Limited (DNPL) is a joint venture, in 80% owned by the foreign investor, Dabur India Limited. The company was established in 1989, construction of plants began in April 1992, and commercial production began in November 1992. The company started by producing herbal hair oil, tooth powder and other powder. It has now diversified its product range to include Glucose-D, confectionery, fruit juice, perfume compounds, honey processing and medicinal products.

Two projects have particular significance for backward linkage. DNPL has an unique apiary project which is rearing farmer bees and queen bees as well as fabricating wood-saving plastic apiary boxes. The company sells these to farmers with a guarantee that it will buy back honey. It has already started exporting honey.

More importantly, it has a medicinal plant project. Medicinal plants have historically contributed to the Nepalese economy through the generation of income and employment for the farmers, collectors, traders and processors. However, owing 10 indiscriminate exploitation, premature harvesting, lack of post-harvest technology and poor collection methods, the natural reserves of the plants have been rapidly depleting. In view of this situation, the project is to accomplish the following:

- to preserve and propagate threatened medicinal plants and thereby provide employment and income to the local people;
- to provide technical assistance, seeds and planting materials to Nepalese farmers for the cultivation of medicinal plants;
- to carry out scientific studies and research for the sustainable cultivation of medicinal plants;
- to produce value-added products for domestic and export markets.

DNPL has set up a "state-of-the-art" greenhouse with the capacity to produce three to four million saplings of medicinal plants per annum. It supplies the saplings to the farmers directly or through development agencies and national/international non-governmental organizations at cost price. The farmers are given training and technical assistance for plantation, cultivation practices, plant protection measures and harvesting, as well as post-harvesting technology. DNPL guarantees purchase of the final produce at prevailing market prices to produce herbal products in Nepal.

The project is a concrete step developing sustainable cultivation of Nepal's medicinal plants, on marginal and often unused land. It will help generate employment and income for people in the remote regions.

Source: UNCTAD interviews.

There are also other examples of beneficial linkages between foreign affiliates in Nepal and local producers. For example, Nepal Lever is concentrating on manufacturing relatively higher value-added products, shifting the production of other items to ancillary local enterprises. A local company, M/s. National Soaps Industries, now meets its entire detergent powder requirements; and two other local enterprises manufacture detergent bars, and pack blended tea. Thus, Nepal Lever is developing partnerships with local industries, although it does not source many of its inputs from within Nepal (local sourcing is only around 10%). In contrast, Hotel Yak and Yeti sources about 50% of its inputs locally, while the construction joint venture between Ansal Buildwell of India and Chaudhary group mostly uses local construction materials (except cement which the consortium believes is not of adequate quality).

3.3. Employment generation

The contribution of FDI to employment in Nepal is particularly significant in the manufacturing sector, where UNIDO (2002) estimates that FDI generated 27% of employment. This figure may be an overstatement, because it is calculated as a ratio of FDI-generated employment in manufacturing sector projects to total manufacturing sector employment, and more than half of the approved FDI projects do not materialize. This overstatement may be balanced, however, by the lack of accounting for numerous jobs indirectly generated by FDI in related support and service industries.

4. Conclusions

The sectoral distribution, with light manufacturing and tourism as the principal recipients, suggests that the pattern of FDI largely conforms to the country's comparative advantage. The positive impact is most apparent in the case of exports. FDI has undoubtedly played a major role in garments and tourism – Nepal's two most important foreign-exchange-earning industries. FDI has also enabled the country to export non-traditional manufactured products, such as micro transformers and personal care consumer products, illustrating its potential to open up new export horizons. In addition, FDI has played a beneficial role in Nepal's development through employee training, the establishment of backward linkages, development of infrastructure and the "demonstration effect" on local entrepreneurs.

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BEZPOŚREDNIE INWESTYCJE ZAGRANICZNE W NEPALU

Streszczenie: Nepal stał się atrakcyjnym miejscem bezpośrednich inwestycji zagranicznych od 1990 r., po przeprowadzeniu w tym kraju znacznych reform, zachęcających do przyciągania kapitału zagranicznego. Taka sytuacja występuje do dziś, a do Nepalu napływa kapitał w formie BIZ oraz kapitał portfelowy przez realizację kilku specyficznych projektów finansowych powiązanych z kapitałem bankowym. Obydwie formy wpływają pozytywnie na całokształt gospodarki po wdrożeniu nowoczesnej technologii, na handel zagraniczny i ogólną współpracę międzynarodową.