NEPAL MATTERS FOR AMERICA

Foreign Direct Investment in South Asia: A theoretical Perspective and Nepal's Policy Case*

-Janja Avgustin and Anil Sigdel, October 31, 2017

There are different ways of describing foreign direct investment (FDI). According to the Financial Times Lexicon, it is: "Investment from one country into another (normally by companies rather than governments) that involves establishing operations or acquiring tangible assets, including stakes in other businesses."[i] According to Investopedia, FDI is "an investment made by a company or individual in one country in business interests in another country, in the form of either establishing business operations or acquiring business assets in the other country, such as ownership or controlling interest in a foreign company."[ii] According to the United Nations Conference on Trade and Development (UNCTAD), FDI "refers to an investment made to acquire lasting interest in enterprises operating outside of the economy of the investor."[iii]

Organisation for Economic Cooperation and Development (OECD) provides the following definition: "Foreign direct investment (FDI) is the category of international investment that reflects the objective of a resident entity in one economy to obtain a lasting interest in an enterprise resident in another economy."[iv] All these give us a general notion of *who* does the investment and *where*, even *how* to a degree. However, *why* seems to be left out, particularly if focusing on the recipient side. This brief report will aim to show that the way we think about and measure FDI is predominantly focused on the general picture and the country/economy of origin.

*** Nepal's policy case article is originally published by Hudson Institute, Washington**

It would seem rather little has been done to discuss various reasons different recipient countries might want to attract FDI and how

their different circumstances dictate their approaches. The aim is to show that despite general appearances there isn't a general recipe to follow for aspiring recipient countries.

Traditionally, one thinks of FDI in terms of post-WW2 American firms moving their operations overseas to profit[v] from their competitive edge and advantage, or "to pre-empt competitors' access" (Froot 193, 1). In the last decades, with other (Western) nations gaining on with competitive advantages in different fields,[vi] the US has to a large degree also become a host of foreign multinational corporations.[vii] The global economic stage has been changing significantly, but the mode of FDI has as well – since 1990s for example, the majority of FDI is done through mergers and acquisitions (Froot 1993, 3).[viii] Tax politics, international organisations rules, resource distribution, consumer preferences, management style and funding sources, the internet and much more have all had an influence on the way FDI flows have been changing.[ix] However there is one constant feature, FDI seems to remain an investment the developing countries continue to strive for, even if tangible positive effects for the recipient countries remain somewhat elusive.

For example, Williams (2017, 33) confirmed that FDI has a significant positive effect on economic growth, however, "economic growth on the other hand did not significantly increase FDI inflows." Furthermore, Carkovic and Levine (2002, 1) state that "firm-level studies of particular countries often find that FDI does not boost economic growth and these studies frequently do not find positive spill-overs running from foreign-owned to domestic-owned firms." Nonetheless, Ungureanu and Baldan Florentina (2017, 169) state that "foreign investments are a barometer of the attractiveness of the local business environment and reflect the perception of foreigners." As Busse and Hefeker (2005, 20) argue, FDI "are the most desirable form of capital inflows to emerging and developing countries because they are less susceptible to crises and sudden stops."

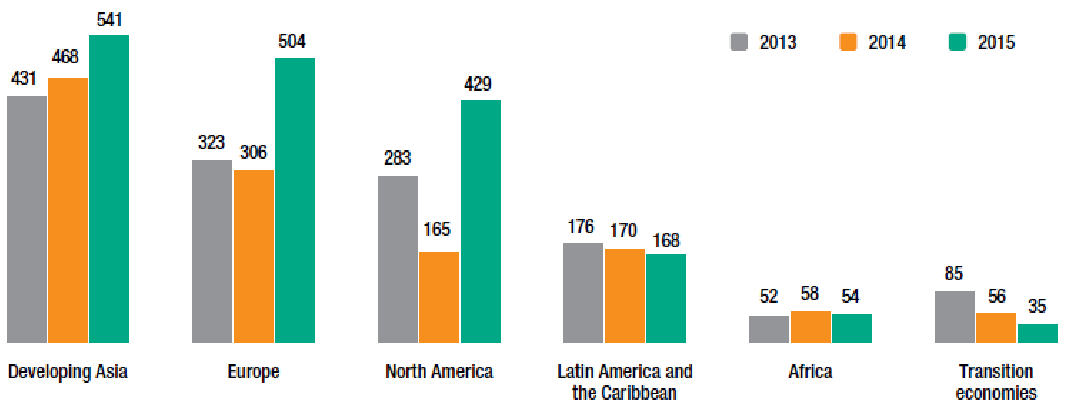
Shah (2010, 1) for instance explores "the factors/characteristics that multinational seeks from a host location for their possible overseas expansion" and "how can the developing countries enhance their ability to host more FDI".[x] He investigates "the importance of linkage factors like same colonial background, language, religion, ethnic origin, trade agreements, bilateral investment and double taxation treaties in affecting FDI inflows into a developing country" (ibid.). He, unsurprisingly, finds that even now "much of the FDI in developing countries is prompted by traditional location factors"[xi] (Shah 2010, 168). Imtiaz and Bashir (2017, 287) also confirm that "large sized market represents greater domestic demand so it is an attractive factor for investors seeking higher demand for their products. However large market size will help in economies of scale, efficient allocation of resources, cost reduction and maximize profit." However, Shah (2010, 168) also finds that "value distortion free market conditions together with a liberal macroeconomic environment and investment framework and the strength of the institutions governing the host country's business and economic environment and intellectual property rights laws, tend to play a more decisive role than they once did". Busse and Hefeker (2005, abstract) similarly conclude that "government stability, the absence of internal conflict and ethnic tensions, basic democratic rights and ensuring law and order are highly significant determinants of foreign investment inflows."

It seems straightforward – all that developing countries need to do in order to attract FDI[xii] is to create a copy of the (Western) environment in which the investing company operates, but keep factors which would yield that company profit at a competitively low expense.[xiii] Similarly, Markusen (2000, 18) found that "trade liberalization (in the presence of relatively liberal investment) will tend to reduce investment for relatively similar countries (horizontal investment) but tend to increase investment for relatively dissimilar countries (vertical investments)." A study by Imtiaz and Bashir (2017) also recommends improving domestic investment environment, particularly in terms of economic freedom.[xiv] It has been shown that "FDI is an important vehicle for the transfer of technology, contributing relatively more to growth than domestic investment" (Borensztein et al. 1997, 115), however there are also warnings that "FDI contributes to economic growth only when a sufficient absorptive capability of the advanced technologies is available in the host economy" (ibid.).[xv] Furthermore (Borensztein et al. 1997, 134), there is a strong positive interaction between FDI and the level of educational attainment (i.e. level of available human capital). Even more, skilled, well-educated and trained labour force can be a key feature in acquiring foreign capital flows (Imtiaz and Bashir 2017, 287). In comparison, Konings (2000, 4) found that "on average there are negative spill-overs to domestic firms in Bulgaria and Romania, while there are no spill-overs to domestic firms in Poland."

As Williams (2017, 17) also shows, not all international capital inflows to developing countries are growth-inducing." For instance, short-term capital inflows are unlikely to generate long-term growth, even more, they are "widely believed to have contributed to the financial crisis and subsequent economic crisis in East Asia in the late 1990s and in Mexico in 1994" (Williams 2017, 18).[xvi] Even more according to Carkovic and Levine (2002, 13), even though "many countries have offered special tax incentives and subsidies to attract foreign capital" expecting the macroeconomic positive benefit of "technology transfers that accelerate overall economic growth in recipient countries" it was indeed shown that "FDI inflows do not exert an independent influence on economic growth". However, studies show other positive benefits – according to Imtiaz and Bashir (2017, 278) "FDI plays a critical role in the development of recipient countries by helping nations to improve their economic performance, through technological development, capital accumulation, improving resource allocation and strengthening financial capital." Moran (2008, 121, italics added by author) also agrees that "*under the right conditions*, FDI can play an important, and in some ways unique, role in promoting broad-based economic and social development." Despite all statistics and economic indexes, it would seem that "mere liberalization of the investment regime and the introduction of financial incentives are not substitutes for an all-encompassing effort to improve the investment climate" (Atukorala and Sharma 2006, 125).

It is clear that the FDI have significantly increased since the 1970s,[xvii] but how do we measure FDI? Borensztein et al. (1997, 122) explain that "there are several sources for data on foreign direct investment: two IMF publications which provide data on net and gross foreign direct investment[xviii] (International Financial Statistics, and Balance of Payments Statistics, respectively), and an OECD publication (Geographical Distribution of Financial Flows to Developing Countries) which tallies gross FDI originated in OECD member countries into developing economies. World Investment Report (UNCTAD 2016, x-xi) on the other hand, offers more stratified data on regional investment trends for the whole world; in 2015 FDI flows to Africa decreased, increased to developing Asia, and remained flat to Latin America and the Caribbean, transition economies. More trends are visible from the figure below (UNCTAD 2016, 4).

Figure 1: FDI inflows, by region, 2013-2015 (USD, billions)



Source: ©UNCTAD, FDI/MNE database (www.unctad.org/fdistatistics).

The figure below, also from UNCTAD (2016, 36) offers further details into FDI flows by region for the same time period.

Figure 2: FDI flows, by region, 2013-2015 (USD, billions)

Region	FDI inflows			FDI outflows		
	2013	2014	2015	2013	2014	2015
World	**1 427**	**1 277**	**1 762**	**1 311**	**1 318**	**1 474**
Developed economies	680	522	962	826	801	1 065
Europe	323	306	504	320	311	576
North America	283	165	429	363	372	367
Developing economies	662	698	765	409	446	378
Africa	52	58	54	16	15	11
Asia	431	468	541	359	398	332
East and South-East Asia	350	383	448	312	365	293
South Asia	36	41	50	2	12	8
West Asia	46	43	42	45	20	31
Latin America and the Caribbean	176	170	168	32	31	33
Oceania	3	2	2	2	1	2
Transition economies	85	56	35	76	72	31

Source: ©UNCTAD, FDI/MNE database (www.unctad.org/fdistatistics).

It is clear that FDI are on the rise despite evidence that they might not be as clearly and tangibly beneficial to the recipient countries' economies as advertised.[xix] UNCTAD (2016, 90) finds that "national investment policies continue to be geared towards investment liberalization and promotion."[xx] It would seem that Asian developing countries are achieving significant progress in that respect. The study (Imtiaz and Bashir 2017, 287) of economic freedom index in attracting FDI in selected South Asian countries (Pakistan, Bangladesh, India, Nepal and Sri Lanka) covering the time frame of 20 years from 1995 to 2014 showed that economic freedom has a positive relationship with FDI. Their main recommendations continue to be: "betterment of investment climate by raising its level through transparent policies, eliminating corruption, reducing tax burden and stable economy" and "tax burden through effective policies" (ibid.).

In some cases however, this formula is not that straightforward. According to Atukorala and Sharma (2006, 125), “despite significant liberalization of the foreign investment regime and the introduction of attractive investment incentives, Nepal’s achievements, both in terms of the volume of FDI and its developmental impact, failed to match national expectations.” An empirical study by Srinavasan et al. (2011, 245) suggests that “the enhancement of country’s economic growth performance was much needed to attract foreign direct investment flows rather than liberalised FDI-oriented policy efforts in the case of India. For rest of the SAARC nations, the economic growth performance is the driving force behind the surge in FDI inflows in addition to being a consequence of these inflows. Hence, these countries pursue the ongoing economic policies with regard to growth and FDI more vigorously. Predominantly, they should adopt effective policy measures that would substantially enlarge and diversify their economic base, improve local skills and build up a stock of human capital recourses capabilities, enhance economic stability and liberalise their market in order to attract as well as benefit from long-term FDI inflows.”

Nepal’s FDI Trajectory and Desire for Economic Growth

As post-conflict Nepal is approaching its final phases of political transition with peace on the horizon, the narratives of economics and development are gaining steam. Encouraged by the exemplary economic growth of its larger neighbors, China and India, Nepal’s political and economic establishments are actively calling on global investors, promising to create a friendly business climate. Nepal primarily wants mega international investors to invest in infrastructure, which it believes will lay the foundation for the country’s long overdue development and modernization. Nepalese increasingly argue that the country needs investment, not aid. By some estimates, Nepal is second to Afghanistan by poverty ranking in Asia, with a USD 21 billion annual GDP.

Nepal had its parliamentary system restored in the 1990s, and the new democratic government initiated policy reforms which resulted in some growth in the foreign direct invest (FDI) when compared to the nominal inflows of FDI in the 1980s. Nepal adopted liberal trade policies – the Washington Consensus – which reduced heavy tariffs and liberalized the exchange regime. For the low cost manpower, manufacturing was one attractive sector, along with Nepal's untapped sectors of hydropower and tourism. Since then India has been the major FDI source for Nepal for two decades, and has only recently been surpassed by China. In the Fiscal Year 2010-11, the 10 leading investor countries were: India, China, USA, South Korea, Mauritius, Canada, UK, Singapore, Japan and Norway (Source: Department of Industries, Industry Statistics)

The Nepali Congress, the biggest democratic party of the time, embraced policies to roll out the red carpet to the liberal institutions and international investors. The Foreign Investment and Technology Transfer Act was introduced in 1992. However, such measures failed to attract international investments for several reasons, and Nepal remained the lowest recipient of FDI compared to other South Asian countries.

Nepal continued to be unfavorable for investments due to several factors. Apart from Nepal's untapped hydro-power potential and tourism, there were very few niche sectors. The reforms adopted were insufficient to facilitate trade and investment. Nepal's scale of economy could not attract large international investment without the market access to the neighbors India or China. The newly restored multiparty system became extremely partisan and large investments were highly politicized to the extent that investors pulled out, for instance, the World Bank withdrew from the Arun III hydropower project. Most importantly, in the mid-1990s the Maoists rebels waged an armed conflict which led to an unprecedented worsening of security situation. Similarly, other barriers remained in place: red tape, problems regarding labor laws and taxations, ineffective management, corrupt behavior, lack of infrastructure, and a lack of skilled manpower. There has been a push back from protectionist camp. Some leaders have also used trade and investment agreements to get political mileage by portraying them as a breach of sovereignty.

The FDI began to increase in 2008 as Nepal took a major step forward in its peace transition with the promulgation of the interim constitution and the subsequent constituent assembly election. At this point, Indian investment spiked from USD 28 million to USD 70 million; in fact, India's investment expanded significantly in Nepal after the two countries signed a trade agreement in 1996. Successive Nepalese governments took different initiatives to attract FDI in 2011-14, which included the formation of a Nepal Investment Board with the view to provide an effective one-stop shop for investors to promote investments, commitments to establishing Special Economic Zones, "a Trade and Industrial Policy, Trade Integration Strategy, Bilateral Investment Promotion and Protection Agreement (BIPPA) with India, and Trade and Investment Framework Agreement (TIFA) with the US." However, given the volatile political transition, the country did not see much increase in FDI inflows.

Mainly due to the growing investment from India and China, FDI rose substantially reaching USD 104.6 in 2009-10 and USD 116.3 in 2010-11, but then slowed down due to domestic political uncertainty, despite the fact that the global FDI flows recovered in 2012. After the 2015 earthquake, the figure dropped and then picked up again in 2016 when Nepal received USD 106 million in FDI, doubling the FDI inflows of 2015 and had USD 653 million FDI stock. In the Fiscal Year 2014-15, the government approved many project proposals from various countries: 125 from China, 55 from South Korea, 40 from US, 23 from India, 18 from Japan, 11 from the UK, and several more from other countries (Source: Department of Industry)

Despite all these efforts and gradual upward FDI inflows, in the last 5 years, there has not been any increase in large investments, although sector-wise there was some investment growth. Nepal is missing out on an opportunity, since globally the LDCs (Least Developed Countries) are the bigger recipients of FDI than developed countries. In fact, companies are pulling out from Nepal due to the country's unfavorable political climate. For instance, Norwegian company Statkraft withdrew from 650 MW Tamakoshi hydropower project citing regulatory and bureaucratic hurdles.

In the 2017 Nepal Investment Summit, several countries pledged huge amounts for sectors such as agriculture, roads and railways, tourism, energy. China promised massive USD 8 billion investment in Nepal. Altogether Nepal received over USD 13 billion investment offer in response to Nepal's "great desire" (in the words of Indian Finance Minister Arun Jaitely) for economic growth. However, despite these pledges, questions remain about such investment materializing. Nepal ranks 107th in the World Bank's 2017 Doing Business list. The traditional hurdles remain, and the country continues to suffer from very weak law and order situation, increasing corruption and political brinkmanship which will most likely discourage potential investors. However, leaders across the political spectrum, liberals and "communists" alike, are "on the same page" (in the words of the Communist Party of Nepal - United Marxist Leninist leader K P Oli) regarding the important role of foreign investments and private sectors in economic growth.

But regardless of politicians' words, Nepal has big internal and external challenges before it puts commitments into action. In 2015, about 20% of the FDI inflows came from "tax havens." Some non-transparent approval process for investments coming in from British Virgin Islands is already dragging bureaucrats and politicians into controversy. For its part, the Nepalese business community is asking the government to enable FDI outflows from Nepal which they deem necessary to increase FDI inflows. Similarly, Nepalese leadership is far from ensuring Nepal's integration into the South Asian economy to make the country an attractive FDI destination. Likewise, protectionism still resonates in Nepal. Therefore, whether Nepal will be able to convince international partners to invest remains to be seen Nepal's case shows that liberalized policies only are insufficient to attract FDIs without domestic social, political and economic stability, inter alia.

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[i] For more see: http://lexicon.ft.com/Term?term=foreign-direct-investment
[ii] For more see: http://www.investopedia.com/terms/f/fdi.asp
[iii] For more see: http://unctad.org/en/Pages/DIAE/Foreign-Direct-Investment-(FDI).aspx
[iv] For more see: https://stats.oecd.org/glossary/detail.asp?ID=1028
[v] According to Borensztein et al. (1998, 133), in the case of developing countries in particular, it is likely that the higher efficiency of FDI would result from a combination of advanced management skills and more modern technology.
[vi] In 2015, Europe was the largest investor region with USD 576 billion (UNCTAD 2016, xi).
[vii] In fact, according to Moran (2008, 122), the "U.S. policy to promote development through FDI has not grown more supportive over time, has not even stood still, but rather has grown increasingly restrictive."
[viii] It used to mostly take form of greenfield investment (ibid.). In 2015, mergers and acquisitions were at USD 721 billion while greenfield investment reached USD 766 billion (UNCTAD 2016, x).
[ix] One further significant characteristic of recent FDI is intragroup investment. According to UNCTAD (2016, 8), the "G20, Transatlantic Trade and Investment Partnership, Asia-Pacific Economic Cooperation, Trans-Pacific Partnership, Regional Comprehensive Economic Partnership and the BRICS account for a significant share of global FDI. Intragroup investment is significant, with some 30 per cent to 63 per cent of these inflows originating from within the group."
[x] Data used covered the period from 1990 to 2007 and encompassed 16 OECD countries and 12 host developing countries: Brazil, China, Czech Republic, Egypt, India, Hungary, Malaysia, Mexico, Morocco, Poland, South Africa and Turkey.
[xi] Interestingly though, Williams (2017, 33) found that political instability did not affect FDI and growth in Sub-Saharan Africa differently relative to other regions.
[xii] It is important to note that "both foreign aid and foreign direct investment have positively contributed to economic growth. However, the impact of foreign direct investment is greater than that of foreign aid in relatively open economies" (Trevino and Upadhyaya 2003, 119).
[xiii] According to Borensztein et al. (1998, 133), it is most likely that a foreign firm that decides to invest in another country enjoys lower costs and higher productive efficiency than its domestic competitors.
[xiv] However, only fiscal and trade freedom has statistically significant influence on FDI (ibid.).
[xv] The effect of FDI on economic growth was tested on FDI flows from industrial countries to 69 developing countries in the 1980s and 1990s.
[xvi] Further, "there is evidence that the recent financial crisis in the U.S. was propagated to developing countries through the short-term dynamics of international capital flows" (ibid.).
[xvii] World Bank data shows that in 1970 there was USD 10.2 billion FDI net inflows in the world and in 2016 there was USD 1.8 trillion FDI net inflows in the world. In this case, FDI "refers to direct investment equity flows in the reporting economy. It is the sum of equity capital, reinvestment of earnings, and other capital." For more see: https://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD
[xviii] Net FDI refers to inflows net of outflows, and gross FDI refers only to inflows, that is, foreign direct investment into the country (ibid.).
[xix] It is important that even in 1990 measuring FDI and its determinants was not yet empirically determined – "while most explanations of foreign direct investment receive some empirical support, there is not sufficient favorable evidence on any one of them to merit rejection of all the others" (Lizondo 1990, i). Even more, according to Moran (2008, 129) "Traditional models to calculate the value of FDI to development relied upon conventional trade analytics of comparative advantage: multinational firms provide capital to put the host economy's abundant resource, low-skilled labor, to work, allowing the country to do what its natural endowment allowed more efficiently. But this conceptualization now proves to be far too static."
[xx] Nearly half (42 per cent) of all policy measures were undertaken by Asian developing economies (ibid.).