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Research Article

Foreign Direct Investment's Impact on Nepal's Economic Progress

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ABSTRACT

Foreign direct investment (FDI) plays a crucial role in the economic growth of developing countries like Nepal by bringing in essential capital, technology, and expertise. Over the past decade, Nepal has seen varying levels of FDI inflows, affecting different economic sectors. Despite its potential to attract more FDI, Nepal faces significant challenges, such as lengthy approval processes, implementation issues, and a bias towards the service sector among investors. Understanding the relationship between FDI and GDP, as well as the distribution of FDI across various sectors, is vital for optimizing investment policies and strategies. This study examines the factors influencing FDI and its sectoral distribution in Nepal's economy from 2011/12 to 2020/21. It explores the relationship and effects of FDI on sectors like minerals, manufacturing, construction, energy, and services. Using a descriptive and correlational research design, the study analyzes annual time series data over a ten-year period. Statistical tools were employed to assess the correlation between FDI and GDP, as well as the impact of sectoral FDI investments on the country's GDP. The study found a strong positive correlation

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(0.668) between FDI and GDP. Sectoral analysis revealed that investments in minerals, construction, energy, manufacturing, and services positively impact Nepal's GDP. However, challenges like long approval processes, implementation issues, and investor bias towards the service sector hinder the full potential of FDI in higher-productivity sectors.

Keywords: Foreign Direct Investment (FDI), Nepalese Economy, Sectoral Distribution, GDP Impact, Investment Opportunities

Introduction

Foreign direct investment (FDI) is the process of investing cash, property, technology or other resources by foreign individuals, companies or organizations to conduct business in another nation. FDI, as opposed to portfolio investment, entails foreign businesses actively taking part in regular operations within the host nation. Political instability is currently a problem in Nepal, and there is still work to be done in order to alleviate this uncertainty. As a result, creating a business-friendly atmosphere to draw in international investors is still a hot topic. In contrast to vertical investment, which consists of establishing or acquiring separate but related commercial ventures abroad, Establishing a corporate enterprise in a foreign country that is identical to its own in its home country is known as horizontal direct investment. Purchasing property in a host nation with the goal of actively managing that property is known as FDI. FDI in underdeveloped countries has the ability to significantly strengthen economies (UNCTAD, 1999). Through the use of fresh resources, including money, marketing, management, and technology—to the host economy through competitive market circumstances that allow both domestic and foreign private companies to operate, FDI has the potential to drive economic growth (Pradhan, 2017). Midway through the 2020–21 fiscal year, in March, net foreign direct investment fell by 34.8 percent to Rs. 10.18 billion. In mid-July 2020, Liabilities for foreign investments stayed at Rs. 202.40 billion, but approvals for dividend payments against foreign investments increased to Rs. 24.88 billion from Rs. 9.58 billion during the same time of the 2019–20 fiscal year. Li and Liu (2022) shed light on the contribution of FDI to economic progress and technological advancement, highlighting the fact that FDI fosters innovation and knowledge transfer to advance economic growth (Liu et al., 2022). The study highlighted how important FDI is to raising host nations' technological capacities. Taking a different angle, Javorcik and Poelhekke (2017) investigated how foreign direct investment (FDI) affects income inequality in host nations. Their findings showed that although foreign direct investment (FDI) is generally economic expansion, how it affects the distribution of income is complex and multidimensional. This study provided insightful information about the effects of FDI on society.

Recent empirical research has looked at the intricate connection between FDI and economic growth, shedding light on this dynamic and complex correlation. A study by Alfaro et al. (2020) emphasized the role that institutional caliber plays in affecting the way FDI affects economic expansion. Their results underscored the critical role of strong governance frameworks in ensuring that FDI has a beneficial impact based on the calibre of the host nation's institutions. To elaborate, Blomström et al. (2000) investigated how foreign direct investment (FDI) is distributed spatially and how it affects economic growth. They found that FDI patterns significantly boost regional economic growth and revealed spatial spillover effects. This study improves our understanding of how foreign direct investment (FDI) impacts different regions within a country.

Recent research on foreign direct investment (FDI) that takes social, environmental, and governance factors into account offers a thorough analysis of how FDI affects economic growth (Destek et al., 2023). Studies demonstrated that the connection between FDI and economic expansion is understood. Contextual elements like institutions, technical spillovers, regional differences, and social ramifications have drawn more attention from researchers in recent years, adding to the continuing conversation over how FDI shapes economic results.

Nepal struggles with issues including a landlocked location, rough terrain, a lack of agriculture, and high rates of poverty as a result of structural limitations and political unrest during the previous ten years. Foreign direct investment (FDI) is deemed essential for both poverty alleviation and the maintenance of development activities in an economy with limited resources that primarily depends on aid from abroad (Adhikari & Kharel, 2011; Pradhan & Dhungel, 2023). Even though Nepal has an abundance of natural resources, it has struggled to experience the kind of economic growth that is sought and has become increasingly dependent on imports as a result of a significant population migration abroad that has reduced industrial activities.

Recent assessments highlight Nepal's significant potential for economic growth through industrialization and increased domestic output. The study reveals that FDI in manufacturing, energy, construction, and services is strongly correlated with GDP growth, emphasizing industrialization's transformative role. Challenges include inconsistent policies and underutilized FDI potential, necessitating targeted reforms to unlock this opportunity. Nonetheless, issues still exist, such as inconsistent policies and a dearth of well-defined government initiatives to encourage investment in the private sector. Small and medium-sized businesses have the potential to be crucial in accelerating development, thus it is concerning that the government is prioritising major investments while ignoring smaller ones. Cho (2021) highlights that the liberalisation of foreign investment regions is a crucial component of this strategy. This acknowledgment is based on the awareness that FDI may significantly contribute to the host nation's ability to seize opportunities arising from global economic integration. This is a goal that is becoming more widely recognised as one of the main goals of any development strategy. Uncertain government laws, lengthy bureaucratic processes, and other problems make Nepal a not welcome place for foreign businesses. Language challenges make it difficult for foreigners to access the government's recent regulatory measures, which aim to regulate foreign investment, especially in the areas of private equity and venture capital.

Using arguments like those made by Bornschier and Chase-Dunn (1985), who contend that FDI might be harmful to developing nations, this study looks into complaints about how foreign direct investment affects the host economy (Bornschier & Chase-Dunn, 1985). The essay examines the connections between trade, employment, technology transfer, GDP growth, and foreign direct investment (FDI), with a focus on Nepal, an LDC with no foreign aid and a substantial savings-investment mismatch. It emphasizes how FDI is increasingly being drawn to massive infrastructure projects, a sector that has historically been risky. Although Nepal welcomes FDI in all areas, the report emphasizes that FDI is especially important in the infrastructure sector because of resource constraints. It highlights that FDI is not just a vehicle for funding progress but also for technology transfer and other positive ripple effects including the growth of managerial and leadership competencies and the local knowledge and skill base. The UN (2020) emphasizes that the ability of the host economy to absorb best practices is a necessary condition for their potential to spread domestically. The host economy must have adequate infrastructure and educational levels in order to compete in the home market and fully benefit from FDI.

The existing literature defines foreign direct investment (FDI), describes its composition, and highlights its significance given Nepal's general economic circumstances. There is a significant study gap on the precise connection between FDI and job creation, even though prior research recognizes the critical role that FDI plays in getting past economic obstacles and growing the economy. The aim of this study is to look at the connection between FDI and a number of economic variables, including GDP and FDI in the manufacturing, oil, mining, and building industries, given the significance of FDI to Nepal's development. This study aims to offer insights that will be useful to researchers, academics, policymakers, students, and business professionals by taking a wide range of economic indices into consideration. The study also fills up the gaps found in earlier research by including variables like inflation, currency rates, and GDP growth rate. In addition, this study sets itself apart by employing a fixed-effect model for regression analyze to analyse a 10-year time series of data spanning from 2011/12 to 2020/21. This approach provides a more nuanced viewpoint than previous research projects covering varying time periods (Bayar, 2014).

Literature Review

Gautam (2024) conducted studies on how FDI and Nepal's economic progress are related. Even though Nepal has good market access and a key location, problems like bureaucratic red tape and a weak banking sector have made it harder for large amounts of FDI to come in. For econometric analysis, the study employed information gathered by NRB, MOF, MOI, and CBS from FY 1994 to 2021. It emphasized the significance of fostering a place that is good for investors to draw in foreign investments and highlighted sector-specific FDI inflows. The study emphasizes how important foreign direct investment (FDI) has been to Nepal's economic progress and makes policy recommendations to encourage FDI inflows. Chaudhary et al. (2020) examined how the COVID-19 epidemic affected FDI in Nepal and examined the numerous obstacles that prevented FDI from entering the country throughout the crisis. The study demonstrated how Nepal's economic goals in industries including infrastructure, tourism, and agriculture attempted to promote rapid development through foreign direct investment (FDI). It did this by utilising descriptive and analytical methodologies with secondary data. Significant obstacles persisted in the form of weakening business environments, poor infrastructure, and political transitions, despite government efforts to draw in international investment. While FDI in Nepal had been growing at a promising rate up until 2019, the pandemic in 2020 upset this trajectory, according to the study, underscoring the need for favourable conditions in South Asia to encourage FDI inflows. This study adds to our knowledge of the ways in which external influences, such as the pandemic, affect Nepal's economic policies and has wider implications for research in the area going forward. Subedi et al. (2024) looked at the patterns of FDI in Nepal, highlighting the contribution of FDI to export development and economic progress. They discovered a good connection between FDI, GDP growth, and higher exports; they ascribed Nepal's increase in foreign direct investment throughout the 1990s to the application of FITTA and pro-business economic policies. Based on correlation and regression analysis, their study (2010–11–2022/23) emphasizes the critical role FDI had in Nepal's economic development. Paudel et al. (2020) examined, using data from 1965 to 2018, how Nepal's economic growth is related to financial development using an ARDL technique. Despite its advantageous position and early economic reforms, Nepal is still a developing landlocked nation that has seen recent political changes. The study looked at five financial development indicators and how they affected economic growth. It found that capital formation, broad money, domestic credit extended to the private sector, and overall banking sector credit all made important contributions to economic growth. FDI did not, however, significantly affect economic development, indicating the need for better FDI-attracting policies. The findings demonstrate how important it is to foster an environment that encourages investment in order to further Nepal's economic development. Pradhan et al. (2020) looked at the effects of international assistance on Nepal's economic expansion during a forty-year span (1975–1976 to 2015–16). They discovered a positive but statistically insignificant correlation between foreign aid and GDP using a partial adjustment model and the Chow test. According to the analysis, a large portion of the aid was allocated to social welfare and humanitarian causes rather than to businesses. The study advised reallocating aid towards productive sectors and capital expenditures to increase economic growth and meet long-term development goals in Nepal, even if it did not find a structural breakthrough in the aid-GDP link. Kaphle (2021) centred on employing time series information from 1975 to 2018 to examine the contributions made by foreign currency reserves to the expansion of Nepal's economy. The link between these variables was examined using tests for unit roots, cointegration analysis, and the Vector Error Correction Model (VECM) in this work. The variables showed a long-term link according to the Johansen cointegration tests, and the VECM and Wald tests verified that historical foreign exchange reserve values had a beneficial impact on economic expansion. The study came to the conclusion that Nepal's economic growth has benefited from having foreign exchange reserves. An et al. (2021) investigated, from 1996 to 2017, how FDI affected economic expansion in emerging and developing Asia. They focused on various proxies of financial development (FD) and used the panel smooth transition regression (PSTR) model across 18 countries to analyse the link. The research found two discrete FD thresholds at which the growth-promoting benefit of FDI is noteworthy, emphasising that unnecessarily high FD levels attenuate this effect. Policymakers can use these new insights to better shape long-term plans that maximise the positive impacts of FDI on regional economic expansion. Rao et al. (2023) investigated the relationships that existed between 1980 and 2016 between economic growth, foreign aid, and FDI in South Asia and South-East Asia. Empirical studies revealed that while FDI positively impacted economic progress in both areas, foreign aid negatively correlated with both FDI and growth. Across all studied models, financial support for investment from the government to the business world within the country was found to be essential in boosting FDI flows and economic growth. The report suggested that to get people to come in and stay faster rates of economic growth, governments in the SEA and SA should give priority to funding domestic investment, trade openness, macroeconomic stability, and effective aid utilisation. Nguyen (2022) From 1998 to 2017, researchers looked at the relationships between trade openness, FDI inflow, GDP growth rate, and unemployment in five South Asian countries using a vector autoregressive model. According to the study's empirical results, the GDP growth rate was positively correlated with both FDI and unemployment. Directionality was demonstrated in the link between FDI and, unemployed people and the rate of GDP growth. In addition, the study discovered a long-term link between trade freedom, FDI, GDP growth rate, and lack of work rate in the area. Macroeconomic initiatives have been proposed to enhance economic expansion, draw in FDI, and lower South Asia's jobless rates. Bilas (2020) looked analysed what FDI has to do with Croatia's economic growth between 2000 and 2019 using quarterly data that was taken from the Eurostat and Croatian National Bank databases. The logarithms of the rate of GDP growth and FDI, as well as the logarithms of the GDP growth rate and FDI/GDP, were the two possibilities of time series that were examined. Engle-Granger, Johansen, and limits cointegration tests were the three used, and they all showed there wasn't any long-term equilibrium link between any FDI series and the quarterly GDP growth rate. The lack of long-run equilibrium further suggested that there was no Granger causal link between these variables. The study recommended measures to draw more advantageous greenfield FDI types, arguing that the preponderance of brownfield FDI might account for the lack of a discernible influence on GDP growth.

Method

In order to determine cause-and-effect linkages, the study combines a causal-comparative research design with a descriptive research design for gathering information and variable information collection. The report, which bases its analysis on FDI, looks at all areas of the economy, with a particular emphasis on manufacturing, services, energy, buildings, and minerals. How FDI changes the economic progress in Nepal is examined using convenience sampling and secondary data from the fiscal years 2011–12 to 2020–21. The research looks into how FDI impacts Nepal's economic progress using data from the backup database for the Ministry of Finance, which covers the fiscal years 2011/12 to 2020/21. All secondary data is carefully processed and tabulated to fulfil research objectives, and FDI data over time in manufacturing, energy, construction, and minerals are included as separate factors in relation to GDP. Regression analysis was used to examine data patterns and find correlations between different variables that are pertinent to the research question. The outcomes obtained from these statistical instruments, include covariance, correlation, regression analysis, mean, and standard deviation are tallied and compared amongst several categories in order to provide a comprehensive interpretation of the data.

Research Framework

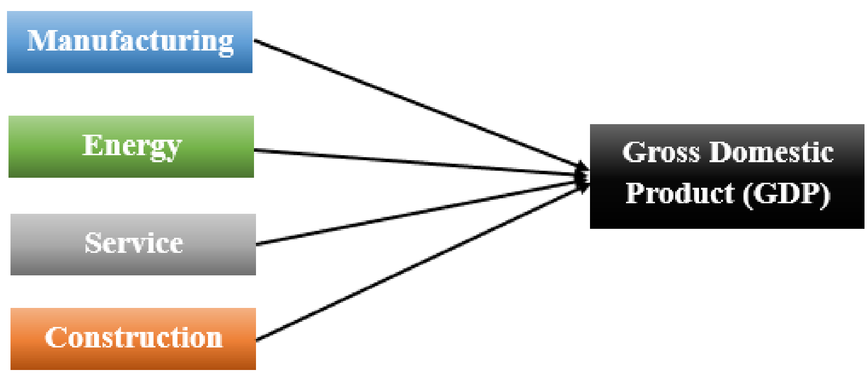

Figure 1: Research Framework

Model Specification

$GDP = \alpha + \beta_1\ ENG + \beta_2\ CONS + \beta_3\ MFG + \beta_4\ SER + \beta_5\ MIN + \mu$

Where,

Gross Domestic Product is what **GDP** stands for,

FDI stands for "Foreign Direct Investment,

β_1 , β_2 ,β_3 , β_4 and $\beta_5$show the regression coefficients for the factors that are not being changed,

ENG is the same as **FDI** when it comes to energy,

CONS stands for **FDI** in construction,

MFG indicates **FDI** based on Manufacturing,

SER stands for **FDI** based on Service,

and **α** represents the constant term.

Result

The manufacturing, energy, construction, and service sectors—as well as their respective patterns in FDI—are the main subjects of the analysis. Furthermore, it seeks to look into the direct correlation between FDI, foreign investment dependency (FID) across different industries, and the GDP. The research also looks at any structural alterations or deviations from the trends of GDP and FDI throughout the given time frame. It also explores the relevance of these economic metrics for Nepal's GDP and FDI patterns.

Table 2 shows the pattern of FDI in Nepal's construction industry and how much it contributes to GDP. The typical construction FDI flow throughout the ten-year period from 2011/12 to 2020/21 is 24.40%, with a standard deviation of 4.48%. For this time frame, the coefficient of variance is 18.37%. Over the past ten years, FDI in construction has totaled Rs. 45,460.30, although the average GDP flow was Rs. 182,540.80 over the same period.

Table 1: GDP and Sectorwise FID Correlation

	MFG	ENG	SER	CONS
MFG	1			
ENG	832**	1		
SER	922**	873**	1	
CONS	884**	975**	900**	1
GDP	879**	804**	876**	898**

The GDP and FDI have a positive link, as seen by the correlation value of 0.751. When you take a 95% chance, the p-value of 0.039 is less than the significance level (±) of 0.05. This means that there is a strong link between GDP and FDI. As a result, FDI and GDP both show a continuous upward trend.

With a 0.879 correlation number, we can see that there is a strong link between the manufacturing sector and GDP, although it is not statistically significant. In the same way, GDP and the service sector are linked positively (correlation value = 0.877). The coefficient of association between GDP and the construction industry is 0.899, showing that a good relationship. Additionally, the correlation value of 0.805 between the GDP and the energy sector indicates a positive relationship.

Regression Model and Coefficients

The model of multiple regression demonstrates a strong ability to explain with an updated R-square of 0.997, indicating that independent variables such as manufacturing, energy, construction, service, and mining and minerals account for 99.7% of the variation in GDP. For the multiple regression model, the standard error of the estimate is 0.00762. A significant F-value of 524.271 indicates the model's fitness, implying that the research model satisfactorily describes sectoral FDI's influence on Nepal's GDP. When looking at specific industries, the manufacturing sector's positive regression coefficient (0.246) suggests a clear correlation with GDP. By being smaller than 0.05, the accompanying p-value (0.016) verifies a Statistically important ink.

Table 3:GDP Regression Model

Model	Regression Coefficients	t	Sig.
(Constant)	10.172	17.945	.000
MFG	.246	2.166	.016
MIN	.224	1.807	.045
SER	.001	.082	.939
CONS	.052	.650	.551
ENG	.044	1.306	.026
Adjusted R2 = 0.997 Std Error = 0.00762			
F-Value = 524.271 p-value <0.001			

Comparable analyses are carried out to uncover the corresponding coefficients, p-values, and levels of importance for the energy, minerals, service, and construction sectors.

Table 2: GDP and Its Contribution

Fiscal Year	GDP	Manufacturing Industry		Sector of Energy		Sector of Service		Construction Sector	
		FDI	Ct GDP	FDI	Ct GDP	FDI	Ct GDP	FDI	Ct GDP
2011-12	150716	41628	27.61	3611	2.41	2145	1.43	27626	18.34
2012-13	155351	45718	29.44	4472	2.87	2377	1.52	29586	19.05
2013-14	164270	51507	31.35	4935	3.01	3246	1.99	33374	20.33
2014-15	170042	54001	31.77	5155	3.02	3595	2.10	36236	21.30
2015-16	170044	53502	31.45	5387	3.18	3976	2.35	39888	23.47
2016-17	184652	63635	34.47	7666	4.14	4266	2.30	48070	26.02
2017-18	198264	72587	36.60	9003	4.55	4493	2.28	56945	28.73
2018-19	210927	82202	38.98	10604	5.02	4589	2.17	64978	30.80
2019-20	206459	75744	36.68	12106	5.87	4703	2.29	58010	28.11
2020-21	214683	82082	38.24	12713	5.91	4747	2.20	59890	27.89
Mean	182540.80	62260.6	33.66	7565.20	4.00	3813.70	2.06	45460.30	24.40
SD	23713.28	15058.2	3.88	3351.52	1.29	953.13	0.33	13814.96	4.48
CV	12.99	24.19	11.54	44.30	32.27	24.99	16.02	30.39	18.37

Although Nepal has made FDI a priority in its policies, there is still more study to be done to fully understand the effects and advantages of this Funding, especially in industries like energy. FDI is seen as a key driver of economic expansion, bringing in resources, expertise, and technology that boost GDP and create jobs. Even if more projects and investments are being made in Nepal, the country still needs to provide a more favourable investment climate. China leads the world in projects and investments, especially in the energy, manufacturing, service, and tourist sectors—all of which are in line with the government's priorities. On the other hand, political dangers, unknown labour relations, transportation issues, and seaport accessibility pose barriers to execution. Due to poor execution, drawn-out approval procedures, and an emphasis on the service industry rather than other profitable sectors, Nepal's foreign direct investment (FDI) potential is still underutilised. Although the country has potential for investors seeking resources and markets, there are obstacles in the way of establishing an environment that is conducive to investment.

Conclusion

FDI's impact on Nepal's economic sectors has been thoroughly examined in this study, with an emphasis on how it relates to GDP growth. The results show a positive correlation between FDI inflows and economic expansion, highlighting FDI's crucial role in injecting capital, technology, and managerial expertise into Nepal's economy. The substantial correlation coefficients and p-values found in a variety of industries, such as manufacturing, energy, services, and construction, support this association. The manufacturing sector emerged as a significant contributor to GDP growth, as indicated by its statistically significant positive regression coefficient. Similarly, the construction sector demonstrated notable contributions, reflecting its substantial share in total FDI inflows over the study period. These findings underscore the sector-specific impacts of FDI, emphasizing the importance of sectoral diversification in enhancing overall economic performance. The regression model employed in this study exhibited a high explanatory power, with a 0.997 corrected R-square and a significant F-value, indicating the model's robustness in capturing the link between sectoral FDI and GDP growth. This underscores the effectiveness of FDI in driving economic progress across different industries in Nepal. However, the study also identifies significant challenges hindering Nepal's ability to fully leverage FDI for economic development. Political instability, bureaucratic inefficiencies, and regulatory uncertainties present substantial barriers to attracting and retaining foreign investment. Furthermore, the underutilization of FDI potential in sectors such as energy highlights the need for targeted policy interventions and institutional reforms to create a more conducive investment climate. In light of these findings, policymakers are encouraged to prioritize reforms that streamline approval processes, enhance regulatory frameworks, and promote political stability to foster a more favourable environment for FDI. Additionally, focusing on sectors with high growth potential, such as energy and manufacturing, could amplify the positive impacts of FDI on Nepal's economic landscape. Future research should delve deeper into the specific socio-economic impacts of FDI, including its effects on employment generation, technology transfer, and income distribution within Nepal. Furthermore, incorporating additional variables such as inflation rates and exchange rate fluctuations would provide a more comprehensive understanding of how external investments shape Nepal's economic trajectory. In conclusion, while FDI holds significant promise as a catalyst for economic growth in Nepal, realizing its full potential requires concerted efforts to address existing challenges and capitalize on opportunities. By implementing targeted policies and fostering a conducive business environment, Nepal can use FDI's transformative power to create sustainable development and raise the standard of living for its people.

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