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Trade and investment linkages and coordination in Nepal: Impact on productivity and exports and business perceptions

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Executive summary

Today, Nepal is one of the most liberalized countries in the South Asian region. However, growth performance has been very poor in recent years, with sluggish exports and stagnating investment. In this context, a closer examination of the linkages between trade and investment is critically important from a policy point of view. There are highly liberal trade- and investment-related policies supplemented by important Acts. In the aftermath of liberalization that began in the early 1990s, both trade and investment increased substantially. However, that could not be sustained for long.

Although some improvement in the total factor productivity has taken place in the post-liberalization period, it is still negative. Hence, economic growth has so far been primarily influenced by labour and capital inputs. The Granger Causality test, carried out to find the sequences of causality, has revealed that causation is from investment to trade. Although the investment function, estimated to examine the direct effect, shows a positive relationship between trade and investment, the relationship is weak. The lag effect further indicates that no strong dynamic effect of trade on investment can be found in the Nepalese context. One of the features of the investment structure is that after some acceleration in the post-liberalization period, foreign direct investment (FDI) has decelerated considerably.

A small-scale perception survey finding found that the majority of respondents considered that trade policies such as tariffs, licensing and customs procedures as most important for investment decisions. More than 80 per cent of the respondents agreed that policies related to trade in goods and services could support more and better quality investment. However, no one was fully satisfied with the existing policies and the investment environment. They felt that existing trade- and investment-related policy and procedures as well as government efforts were highly inadequate. The private sector gave the highest priority to reducing the compliance costs of the customs, regulatory and administrative procedures in order to improve the national policy framework for investment. Moreover, many respondents also regarded coordination between trade and investment policy as critically important. It was felt that low competitiveness and investment was also due to poor coordination. Delays and cumbersome procedures in particular were blamed for making business highly non-competitive.

Hence, the system of unaccountability or indecisiveness has to be brought to an end, and the one-window committee for providing all facilities to investors has to be made effective in order to encourage both domestic and foreign private investment and ensure better policy coordination. Policies need to be implemented in a comprehensive manner, with the highest priority being placed on policy coherency. As per the survey findings, it is necessary to reduce the compliance costs of customs, regulatory and administrative procedures to improve the national policy framework for investment. Policy stability should be ensured by avoiding unpredictable changes. Government bureaucrats and agencies should be supportive in order to enhance investment by co-operating investors, and by making policies and procedures transparent. There should be no conflicting regulations or harassment of investors.

Introduction

A. Need for wider research

Today, Nepal is one of the most liberalized countries in South Asian region. The average tariff rate has been reduced to below 9 per cent (Khanal, 2006). The Nepalese currency is fully convertible in the current account. In the large and medium-sized industries, 100 per cent foreign equity participation is permissible, with no restrictions on repatriation of invested funds. There is no entry barrier to foreign investors in the financial sector. All forms of subsidies have been almost completely removed. Despite the fixed exchange rate with India, the hard currency exchange rate is market determined. This is also true in the case of interest rates. After becoming a World Trade Organization (WTO) member in 2004, Nepal has been pursuing further opening up and liberalization policies on the trade front. Nepal is also a member of the South Asian Preferential Trade Arrangement (SAPTA) and the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation-Free Trade Area (BIMST-EC FTA). New initiatives on the trade front have been taken with the aim of enhancing sustained growth and reducing poverty.

There is consensus, both in policy and academic circles, that those economies open to international trade have higher rates of growth as a result of higher investment and sustained gains in factor productivity (Franklin and Romer, 1999). It is argued that along with faster growth rates, trade openness brings about industrial transformation, changes in the structure of employment and a decline in poverty (Dollar and Kraay, 2001). Higher investment and productivity gains are regarded as major channels through which higher growth and poverty reduction take place.

However, due to diverse nature of trade reforms and their sequencing, including initial conditions ranging from structure of an economy to its institutional settings, the relationship between trade liberalization and investment can be quite different from one country to another. Apart from macroeconomic and political stability, social cohesion and rule of law are equally important for trade and investment promotion. Hence, national experiences indicate that some countries have benefited more than others from trade liberalization. There is no conclusive evidence of trade-induced productivity gains and exports, bigger intra-industry reallocation of resources among import competing industries or even efficiency gains and spillover effects in developing countries.¹ In this regard, Nepal's experience is also similar to many other least developed countries.

Together with the speed of reforms in the early 1990s, fast growth occurred in the Nepalese economy. The growth rate was about 5 per cent on average, with non-agricultural growth rate reaching around 10 per cent during the Ninth Plan (1992-1997) (Khanal, 2006). During these years, the growth in exports was particularly robust. A steady rise in private investment, including FDI, contributed to the expansion of economic activities in sectors such as manufacturing, transport and finance (Dahal and Aryal, 2003; UNDP, 2003b; and Khanal

¹ For a detailed survey along these lines see Winters and others, 2004.

et.al.,2005). However, such momentum could not be sustained for long. Deceleration of the growth rate that began from the late 1990s led to a negative growth rate in 2002. Although some revival of the economy is underway, the growth performance is still very poor, ranging between 2 per cent and 2.5 per cent. A slow growth in both exports and imports, with wider fluctuation from one year to another, has also been recorded in recent years. A stagnating trend in investment, including FDI, is also evident (Ministry of Finance, 2006). For these reasons, a thorough study of linkages between trade and investment and underlying reasons for poor spillover effects in the Nepalese context is extremely important. Without closer examination of trade and investment linkages as well as the channels through which factor productivity and exports are induced, it will be difficult to correct inherent weaknesses in ongoing trade liberalization policies. The benefits of trade and investment do not necessarily accrue automatically. They require continuous efforts at improving policies and strengthening policy coordination.

B. Research questions

In considering possible channels and transmission mechanisms linking trade and investment, and the potential impact on productivity and export growth in the Nepalese context, the following research questions were addressed by the study:

- (a) Are there similar trends in trade and investment? Do they exhibit close linkages? Is the direction of causality moving from trade to investment?
- (b) Is there a positive effect of trade liberalization on total factor productivity?
- (c) Has trade liberalization induced or stimulated investment including FDI and exportable industries?
- (d) What existing mechanisms are in place for trade and investment policy coordination? Is there a need for better coordination in some sectors?

C. Scope of the study

The scope of the study includes:

- (a) A review of the multilateral and bilateral trade liberalization policies and examination of the linkages between trade and investment growth in Nepal, in terms of flows and institutional mechanisms for policy coordination;
- (b) An examination of the impact of trade liberalization on total factor productivity growth;
- (c) An assessment of the effect of trade liberalization on exports in general, and on investment (including foreign direct investment) in exportable industries in particular;
- (d) Determining policy implications from the standpoint of enhancing trade-induced investment in Nepal, and developing a more coherent policy framework for investment in Nepal.

D. Limitations of the study

There was no direct way of identifying the linkage between trade and investment. Unavailability of necessary data was an additional constraint. There were no official data on the workforce and capital stock required to calculate total factor productivity, and information was not readily available on the performance of exportable industries. Moreover, getting a quick response from the respondents involved in business activities was also a difficult task; therefore, the survey results had to be based on the response of the limited number of respondents, which may not provide a representative picture of the overall situation of trade and investment in Nepal.

I. Literature review

Free and open trade is considered to contribute positively to enhancing investment, factor productivity and growth through different channels. First, open trade facilitates higher specialization by allowing countries to exploit their areas of comparative advantage and achieve total factor productivity (TFP) gains. Second, it expands potential markets, which allows domestic firms to take advantage of economies of scale leading to further increases in TFP.² Third, trade diffuses both technological innovations and improved managerial practices through stronger interaction with foreign firms and markets. Fourth, freer trade trends lessen anti-competitive practices and rent-seeking activities by domestic firms that are mostly unproductive.

On the same grounds it is argued that trade openness, by changing relative prices, induces firms to reallocate resources away from protected sectors towards more efficient activities. These activities tend to raise economic efficiency and competitive strength in the economy because freer trade, by lessening anti-competitive and rent-seeking practices, discourages allocation of resources in unproductive firms and activities. Some sectors gain directly from the removal of tariffs that act as an implicit tax on their inputs and which therefore lead to a rise in the demand for a wide range of products and an increase in the return on investment even in the short term (Kouparitsas, 1997). Many cross-country studies suggest that trade does appear to create, and even sustain, higher growth (Bhagwati and Srinivasan, 1999). Finally, based on many country case studies (Hay, 2001; Jonsson and Subramanian, 2001; and Lee, 1996), it is said that trade openness through its direct and indirect spillover effect on both factor and product markets helps to raise income and employment opportunities as well as augment welfare in societies, leading to reduction in poverty gradually.

Despite many studies highlighting the role of trade in augmenting investment, very few studies have examined the direct linkages or transmission mechanism of such linkages. This is because both theoretically and empirically, the identification of the trade-induced impact on investment is not straightforward. Nevertheless, studies have specified certain channels through which trade can induce investment. Trade liberalization, by enhancing factor productivity, may stimulate investment in an economy. Similarly, by promoting exports, trade liberalization may encourage investment in an economy in general and exportable industries in particular. Likewise, by facilitating imports of capital goods, trade liberalization may lead to increased investment in

² TFP is a productivity measure that takes factors of production such as capital and labour into consideration.

an economy. Trade liberalization may also promote FDI, a major source of capital for the capital-scarce economies.

There is a good deal of empirical support for the argument that trade liberalization stimulates long-term economic growth by enhancing factor productivity (Winters and others, 2004). Many researchers have examined trade and productivity linkages by using sectoral or firm-level data. Lee (1996), by using industry-level data for the Republic of Korea, found that trade protection reduced both labour and factor productivity. In a cross-country analysis, Coe and others (1997) derived a strong positive effect of openness on total factor productivity. Many cross-sectoral studies carried out on individual countries have shown that a reduction in trade barriers coupled with increased import competition have significantly contributed to raising productivity (Hay, 2001; and Jonsson and Subramanian, 2001). A few studies have also found some weak linkages. Lall (1999), by examining the technological adaptation in the Kenyan, Tanzanian and Zimbabwean engineering and garment sectors, found that the majority of firms responded to pressure by contracting out rather than upgrading the technology.

For Asian economies, Pack and Page (1994) found that with trade liberalization, spectacular export performance not only allowed these economies to reap economies of scale from expanding market size, but also gave them the ability to move to a new and higher level of production. Using time series and cross-sectional analysis on a sample of 22 developing countries, Paulino and Thirlwall (2004) found that trade liberalization stimulated export growth but also increased imports, leading to a worsening of the balance of trade and payments. Hwang (2003) in the case of manufacturing industries in Taiwan Province of China, found a significant external economies of scale effect on exports and also a strong positive relationship between the productivity of individual firm and their own export intensity.

It is generally believed that with trade liberalization in the developing countries, FDI inflows would lead not only to augmenting investment in capital-scarce economies but also to increased marginal returns of investment. An increase in foreign investment would mean addition to the existing capital stock, which would be one of the factors responsible for higher economic growth. By observing post-transition investment behaviour in Poland, Murgasova (2005) found an important role was played by FDI in increasing investment. Nonnemberg and Mendonca (2004) found that although FDI was linked to an economy's degree of openness, other variables such inflation, risk and education were equally important. Garibadi and others (2001) also found that trade openness and economic reforms were important determinants of FDI. Soto (2000), by using panel data for developing countries during 1986-1997, concluded that FDI contributed positively to growth through the accumulation of capital and transfer of technology.

In the traditional Heckscher-Ohlin-Samuelson theory, the positive effect of trade emanates from trade-induced specialization and differences in relative prices. In an endogenous growth model, dynamic gain from trade comes from technological change. As found by Romer (1993), trade openness can help to maintain macroeconomic stability particularly through lower inflation, which, in turn, can promote investment. Technological change and diffusion of knowledge through trade can also induce investment.

Moreover, with the opening up of trade, a country gains access to a larger market; this can increase returns to innovation so that more investment can occur in an economy (Nicolas,

2004). Taylor (1998) and Wacziarg (2001) argued that investment was the key link for benefits from trade. Without a positive response from investment, an economy cannot grow just by liberalizing trade. Dollar (1992) and Edwards (1993) concluded that, based on the cross-country experience, openness to trade was a major factor in accelerating growth and increasing real GDP per capita. This is particularly due to a favourable environment for investment (UNCTAD, 2006). However, a study by Berg and Krueger (2003) based on a detailed survey of research, found that despite openness being a necessary condition it did not guarantee faster growth. Overall policy coordination is needed to stimulate investment and trade in the economy. The Organization of Economic Cooperation and Development (2006) therefore prepared the Policy Framework for Investment (PFI) promotion. It comprises 10 different policies, including an investment policy and investment promotion and trade policy, to promote investment in an economy.

In the Nepalese context, no study that examines the linkages between trade and investment and possible channels establishing linkages has been found. However, a few studies have examined the investment environment and FDI inflow in Nepal. UNCTAD (2003b) found that the pattern of FDI in Nepal largely conformed to the country's comparative advantage such as tourism, herbal products and apparel, and that it had positive impacts on exports, particularly garments and tourism. FDI has also enabled the country to export non-traditional manufactured products such as micro-transformers and personal consumer products (UNCTAD, 2003b). However, the overall inflow of FDI is so low that it has not been a significant development catalyst, although Nepal witnessed an increase in inflow of FDI in the 1990s following the introduction of the liberal trade policy. According to the study, FDI inflow was constrained by political instability, outdated foreign investment law, rigid labour regulations and poor physical infrastructure. This situation remains current due to political instability and political transition.

The World Bank, in collaboration with the Federation of Nepalese Chambers of Commerce and Industry (FNCCI), conducted a survey of 223 private manufacturing enterprises in 1999, covering all regions of the country, to assess the prevailing business environment in Nepal. The study concluded that an impressive growth of investment after liberalization could not continue in the long term. It was found that most of the firms were operating below full capacity. The excessive bureaucratic burden as well as continued political and policy uncertainties were found to be weakening the investment environment. In addition, firms were suffering from long delays in the provision of government services and problems with corruption (World Bank and FNCCI, 2000).

A World Bank (2003) study concluded that Nepal's trade policies were generally sound and that the country was competitive in a variety of products. It also revealed the existence of a number of constraints such as the mountainous geography, high infrastructure costs, a rigid labour market, the landlocked situation resulting in dependency on India for transit routes, delays in customs and trans-shipment to India's Kolkata port as well as weak policies and institutions in the areas of taxation, investment and trade promotion. In addition, it found that many hurdles were imposed on Nepal's exports to India by the State governments in India. These constraints have resulted in Nepal's productivity being the lowest in the region as well as the creation of an inhospitable business environment, thus discouraging FDI.

In view of the diverse findings by many studies as well as the apparent weak linkages observed in the Nepalese context, a closer examination of linkages between trade and investment is critically important. Such a study, in addition to filling the research gap in this area at the global and regional levels, can also enable exploration of the measures required in the course of ongoing trade liberalization in Nepal to enhance investment that could contribute to increasing productivity, exports and economic growth.

II. Review of trade and investment policies in pre- and post-liberalization Nepal

This section reviews the trade and investment policies in the pre- and post-liberalization periods together with other policies affecting trade and investment, including the trend of trade flow and investment in Nepal since 1975. It also reviews the existing institutional mechanism of trade and investment coordination. After the 1990s, most of these policies have been formulated to enhance economic liberalization policies. In the pre-liberalization period, however, such policies were governed by State regulation and control.

A. Trade policy

Pre-liberalization trade policy was guided by the inward-looking import substitution strategy. Protection of domestic industries and state-led industrialization were the main policy measures. A licence was required from the Government for involvement in export-import businesses. High tariff and quota restrictions were practiced in order to protect domestic industries, guided by the policy of self-sufficiency. Even imports of intermediate inputs were subject to import licensing. Strict and rigorous control was imposed on the foreign exchange facility, which required official permission. Foreign currency was not provided easily to importers. These policy-led distortions gradually resulted in a foreign exchange crisis.

The severity of the foreign exchange situation emerged at the beginning of 1980s. As a result, Nepal, through the structural adjustment programme, initiated economic reforms in the mid-1980s. Trade policy was one of the key areas of reforms, which placed emphasis on market orientation of trade policies. The reform, however, was expedited only after the restoration of multi-party democracy in 1990. Accordingly, Nepal introduced a more liberal trade policy in 1992, with the objectives of:

- (a) Enhancing the contribution of trade by promoting both internal and external trade with increased private sector participation;
- (b) Diversifying trade with the promotion of backward linkages;
- (c) Expanding trade on a sustained basis to reduce imbalance;
- (d) Coordinating trade with other sectors.

The policy of 1992 is more liberal as it emphasizes the enhancement of the role of the private sector in promoting trade and industry, sustaining exports and fulfilling internal demand. The policy offers various facilities to foreign investors in order to attract FDI in Nepal.

In order to boost the liberal trade policy, the current account was made fully convertible in 1993. Similarly, high customs duty rates were reduced substantially. Exporters were also allowed to open foreign currency accounts. With regard to export promotion, the trade policy aims to raise the production and quality of exportable products. It emphasizes increasing and diversifying exports of goods and services, particularly exports of profitable products. It also places emphasis on encouraging exports of hydropower. It provides certain policy incentives for appropriate and potential skills in order to promote the services sector. In this regard, it also

provides some support for domestic employment. The trade policy also seeks suitable policy changes in monetary, foreign exchange and fiscal policies.

The trade policy waived the licence requirement for exports with the exception of some banned items.³ The improvement of the transit transport network and infrastructure, the simplification of administrative procedures, facilities for container services and bonded warehouses are some of the important reform areas prioritized by the trade policy, especially for promoting exports. The duty drawback scheme for raw material imports used for exportable products is the other incentive introduced for export promotion. The trade policy has also made exports free from all charges except the service charge. Similarly, income tax on exports has also been exempted by the trade policy.

The trade policy considers imports as a medium of export development and a vehicle of creating a competitive industrial and trading environment. All imports, except some banned items,⁴ were made free by the trade policy. Hence, an import licence is required only for imports of restricted products. There are no any quota restrictions on imports. Under the WTO agreement, Nepal has committed to eliminating other duties and charges such as the local development fee, agricultural development fee and special levies. The phasing out of these fees and levies has already started. Similarly, high tariff rates on vehicles and a few other products are being further reduced in order to fulfil WTO obligations. This will lead to the tariff rates being among the lowest in South Asia.

B. Investment policy

In the pre-liberalization period, the investment regime was more restrictive. Investors had to obtain a government licence before undertaking any production and business activities. There was massive involvement of the Government in production activities through the establishment or creation of public enterprises. The FDI was almost nil before 1980. Although some attempts to liberalize the investment policy were made from the beginning of the 1980s, it was speeded up only after 1990. To ensure investment, both domestic and foreign, the Government adopted various liberal policies, which are still in operation. These policies include the Industrial Policy, 1992, Industrial Enterprises Act, 1992 (first amendment, 1997), Foreign Investment and One-window Policy, 1992, and the Foreign Investment and Technology Transfer Act, 1992.

The Industrial Policy, 1992 gives priority to investment promotion for accelerating industrialization in Nepal. The establishment of industry does not require any permission except for those that are considered to adversely affect security, public health and the environment. An industry can get permission within 30 days of application. The policy offers many facilities. Cottage industries are exempted from VAT, excise duty and income tax. Industries established in certain underdeveloped, remote and semi-developed areas get certain rebates on excise duty and income tax. The customs duties, VAT and excise duty paid on raw materials used in the production of exportable goods are reimbursed. Such facilities are provided to the exporting

³ Items banned from export include: archaeological and religious articles; conserved wildlife; drugs; explosives, arms and ammunition; industrial raw materials and other products such as mamira, logs and timber.

⁴ Narcotic drugs, highly alcoholic liquor, arms and ammunition, communications equipment (except under import licence), valuable metals and jewellery, beef and beef products.

industries producing intermediate goods. In addition, industries selling their products within the country in any foreign currency are also entitled to reclaim excise and custom duty paid on raw materials and auxiliary raw materials

After an industry coming into the operation, deduction of 10 per cent of the gross profit is allowed against taxable income on account of expenses related to technology, product development and efficiency improvement. No tax, fee or charge of any kind is levied on machinery, tools, other equipment and raw materials to be employed by an export promotion industry as well as on the products of such industry. An industry can deduct the expenses, for income tax purposes, incurred for long-term benefits to its workers and employees including housing, life insurance, health facilities, education and training. The rate of customs duty on imports of raw materials cannot be higher than the import duty on readymade goods produced with such raw materials.

The Government also introduced the “Foreign Investment and One-window Policy” in 1992 to attract foreign capital. Foreign investment can be in the form of equity investment and loans; the use of rights, specialization, formulae, processes and patents related to any technology of foreign origin; the use of foreign trade marks, and goodwill; and the use of foreign technical, consultancy, management and marketing services. Foreign investment is permitted up to 100 per cent in large and medium-sized industries. FDI is open for most sectors of economic activity except those such as cottage industries, arms and ammunitions, security printing, currencies and coinage, retail business, travel and trekking agencies, and consultancy services. To comply with its WTO commitments, the Government even opened up some service sectors to foreign investors on December 2005. These sectors include business and management consulting, accounting, engineering and legal services, travel and trekking services, tourist lodging, international retail sales services, and the production of alcohol or cigarettes.

Foreign investors are permitted to acquire real estate in the name of the business entity they own. Acquiring real estate as personal property, however, is not allowed. But they are allowed to buy shares in government corporations by participating in the bidding for the privatization of such corporations. However, foreign investment requires permission from the concerned authority with which applications need to be lodged. Permission is provided for foreign investment except in the case of a few sectors.⁵ However, permission for technology transfer can be granted to any industry. Foreign investors are allowed to repatriate the amount received from the sale of shares, profit and payment of principal as well as interest on foreign loans from outside the country in a foreign currency. Similarly, a foreign investor is allowed to repatriate the amount received under an agreement for the transfer of technology. Foreign experts working in Nepalese industries are allowed to repatriate 75 per cent of the amount received as salaries and allowances.

⁵ Cottage industries, personal service businesses, arms and ammunition industries, explosives and gunpowder, radioactive materials, real estate business (excluding construction industries), motion picture business, security printing, currency and coinage business, retail business, travel and trekking agencies, water-rafting, pony-trekking, horse-riding; cigarette, tobacco and alcohol (excluding those exporting more than 90 per cent of production), internal courier service, atomic energy, tourist lodging, poultry farming, fisheries, bee-keeping and consultancy services.

The Foreign Investment and Technology Transfer Act 1992 has made easy provision of visas to foreign investors. Under the dispute settlement mechanism provided in the Act, the concerned parties are encouraged to settle disputes through consultation in the presence of the Department of Industry, based on the prevailing arbitration rules of the United Nations Commission on International Trade Law (UNCITRAL).

Industries established with foreign investment are provided additional facilities such as exemption from income tax on interest income from foreign loans and exports. Only 15 per cent tax is charged on royalties, and technical and management fees. An additional incentive is offered to those foreign investors who generate electricity for use by industry. The foreign investment policy guarantees no intervention in the fixation of prices for goods produced by industries owned by foreign investors. Taxes are not levied on machinery and equipment, raw materials and finished exportable products of those industries that are established in the export-processing zone. The Government has also waived double taxation on foreign investment. Separate agreements have been made with a number of countries including Austria, China, India, the Republic Korea, Mauritius, Norway, Pakistan, Sri Lanka and Thailand in this regard.

C. Other policies affecting trade and investment

There are some other specific rules, regulations and policies that would affect trade and investment. All companies, national or foreign, require registration in Nepal. The Private Firm Registration Act, 1956 governs the registration of a private firm involved in the export or import business. The Department of Commerce registers firms engaged in business activities. Similarly, the Department of Industry is responsible for the registration of industries. The Company Act, 2006 governs the registration of a company. Other laws such as the Nepal Agency Act, 1958 and the Partnership Act, 1964, govern the registration of entities with respect to trade in services. The system of registration in Nepal is mainly for recording or statistical purposes.

The Income Tax Act, 2002, the Immigration Rules, 1994, the Custom Act, 1997, the Electricity Act, 1992, the Privatisation Act, 1994, the Patent, Design and Trademark Act, 1965 and the Copyright Act, 2002 also are associated to some degree with trade and investment policy in Nepal.

D. Trends in trade flows and investment

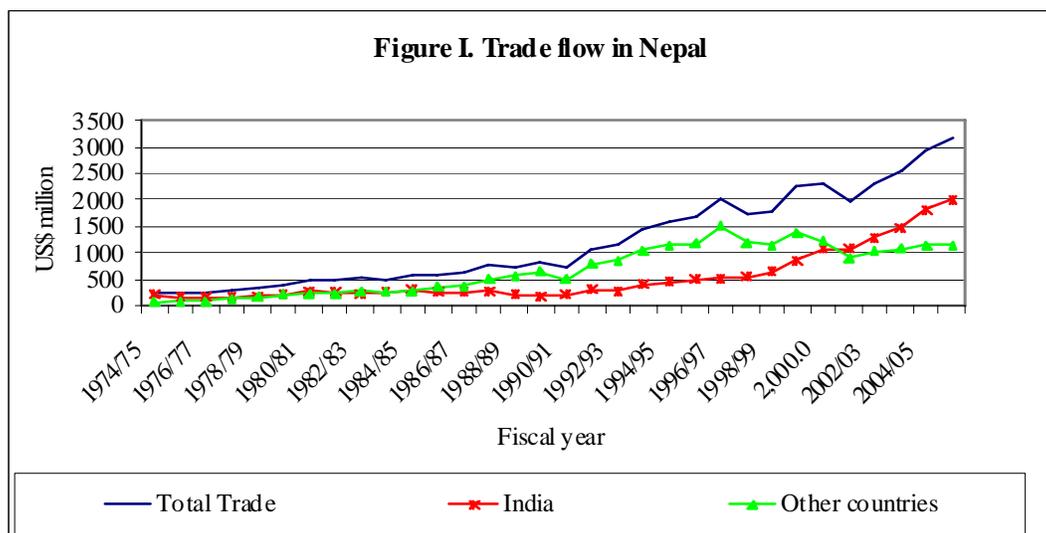
Total trade in the post-liberalization period grew at a rate of 10.1 per cent on average in United States dollar terms compared with 8.4 per cent growth in the pre-liberalization period (table 1). Total trade flow surged substantially after 1990 (figure I.). The total trade to GDP ratio, which was 20.5 per cent during 1975-1990, rose to 37.5 per cent during 1991-2006. This shows that, after 1990, the Nepalese economy opened up considerably (figure I).

Table 1 Trends in trade flows in Nepal during pre- and post-liberalization periods

Indicators	1975-1990	1991-2006
	(%)	(%)
Growth of total trade (US\$)	8.4	10.1
With India	0.2	17.0
With other countries	20.8	5.7
Growth of exports (US\$)	7.4	12.1
To India	-2.5	25.1
To other countries	23.9	7.1
Growth of imports (US\$)	9.6	9.8
From India	2.0	15.9
From other countries	22.0	5.9
Export/import ratio	36.1	37.4
Trade/GDP ratio	20.5	37.5
Export/GDP ratio	5.2	10.0
Import/GDP ratio	15.3	27.0

Sources: Economic Survey (MOF, 2006) and *Quarterly Economic Bulletin* NRB, 2006.

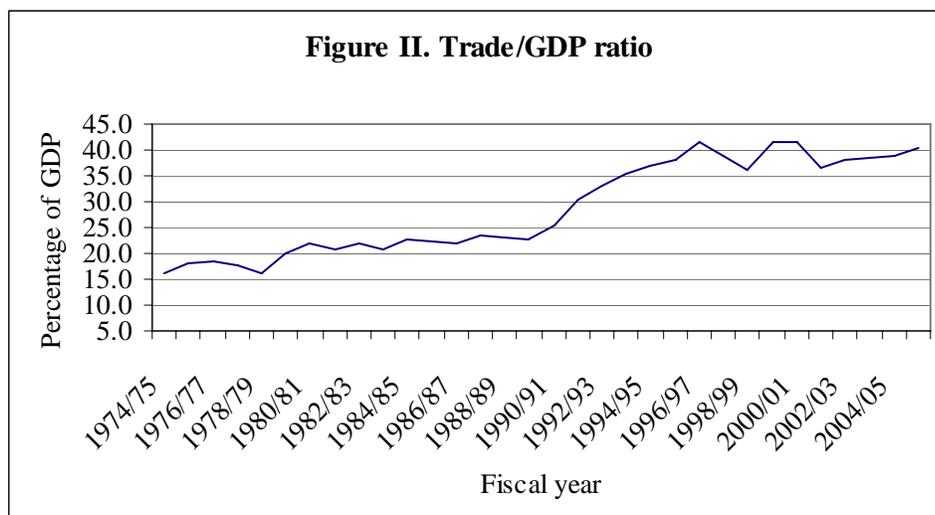
There was a gradual decline in trade with India during 1975-1990. As a result, trade with other countries increased markedly during the same period. The share of trade with India was as high as 82.2 per cent in 1974/75. It declined to 22.5 per cent in 1989/90. The policy of trade diversification, together with trade imbalances with India towards the end of the 1980s, contributed to this situation. The dual exchange rate policy and cuts in the subsidy scheme helped Nepal to augment exports to countries other than India during this period.



Source: Nepal Rastra Bank, 2006.

Interestingly, the direction of trade reversed in the post-liberalization period. On average, total trade with India increased by 17 per cent annually during 1991-2006 while total trade with other countries grew at a rate of just 5.7 per cent during the same period. Consequently, the share

of India in total trade increased from 29 per cent in 1990/91 to 63.6 per cent in 2005/06. Trade with India outpaced that with other countries, particularly after the mid-1990s and especially in the aftermath of signing the more liberal Trade Treaty with India in 1996. In that treaty, free access by Nepalese manufacturing products to the Indian market was allowed. A reciprocity clause restricting Nepal's exports to India was not retained in the treaty. Special arrangements for facilitating petroleum product imports from India through payments in Indian currency, imports of machinery and raw materials through payments in United States dollars, accompanied by higher Indian investment and import liberalization in India, contributed to reversing the pre-1990 period trend.



Sources: Ministry of Finance, 2006; and Nepal Rastra Bank, 2006.

In the post-liberalization period, exports grew at a rate of 12.1 per cent on average compared with 7.4 per cent during 1975-1990. Growth in imports was 9.6 per cent during the pre-liberalization period whereas growth during 1991-2006 was 9.8 per cent in United States dollar terms. As a result, the export-import ratio increased only marginally in the post-liberalization period, from 36.1 per cent during 1975-1990 to 37.4 per cent during 1991-2006. In terms of share in GDP, exports rose from 5.2 per cent in pre-liberalization period to 10 per cent in the post-liberalization period. The ratio of imports to GDP increased from 15.3 per cent during 1975-1990 to 27 per cent during 1991-2006.

Exports to India, which had increased at a low rate of 2.5 per cent during 1975-1990, recorded an average annual growth of 25.2 per cent during the post-liberalization period. On the other hand, export growth to other countries decelerated to 7.1 per cent in the post-liberalization period from a higher growth of 23.9 per cent during 1975-1990. Over-dependency on a few exportable items such as carpets and readymade garments and their decline had a strong adverse effect on exports (table 1).

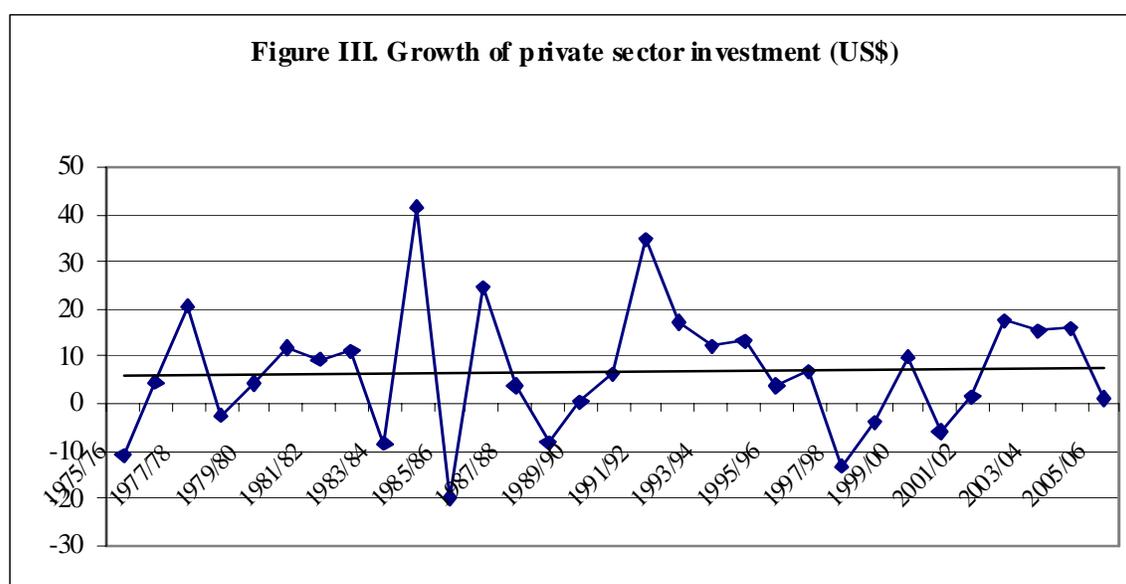
A steady increase in private investment also occurred in the post-liberalization period compared with pre-liberalization period levels. In the post-liberalization period, private investment in United States dollars grew at 8.2 per cent on average annually, compared with just

5.4 per cent average annual growth during 1975-1990 (table 2). In terms of annual growth rate, volatility in investment is observed (figure III).

Table 2 Trend of investment

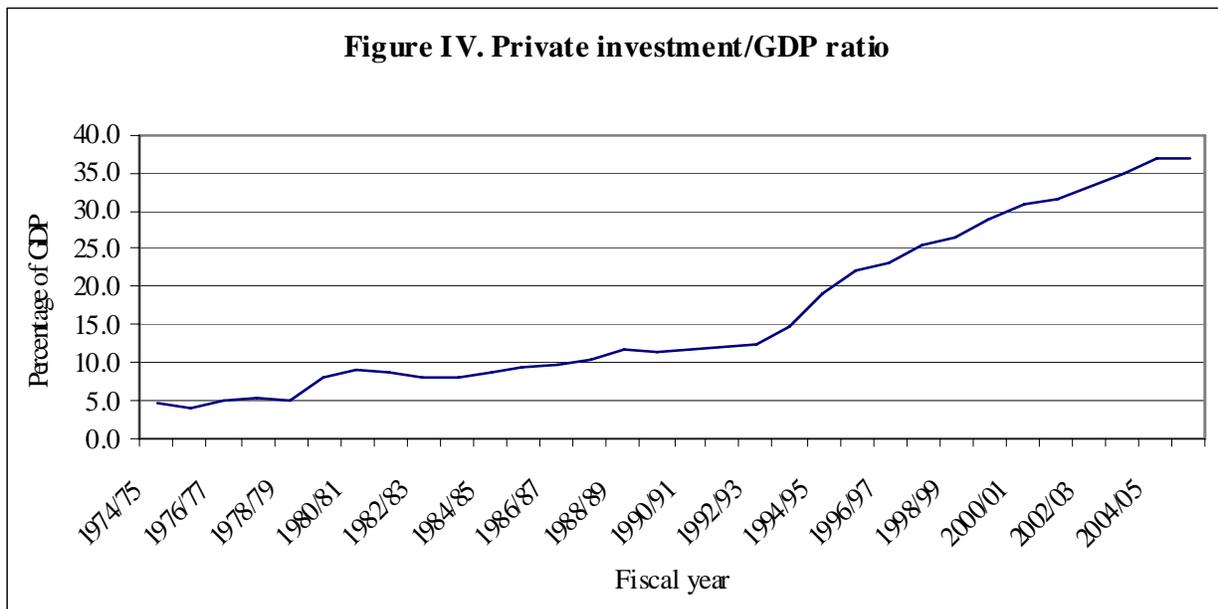
Indicators	1975-1990	1991-2006
Growth of		
Private investment (US\$)	5.4	8.2
Public investment (US\$)	13.7	3.5
As a percentage of GDP		
Private investment	10.1	13.2
Public investment	6.5	6.9

Sources: Ministry of Finance, 2006; and Nepal Rastra Bank, 2006.



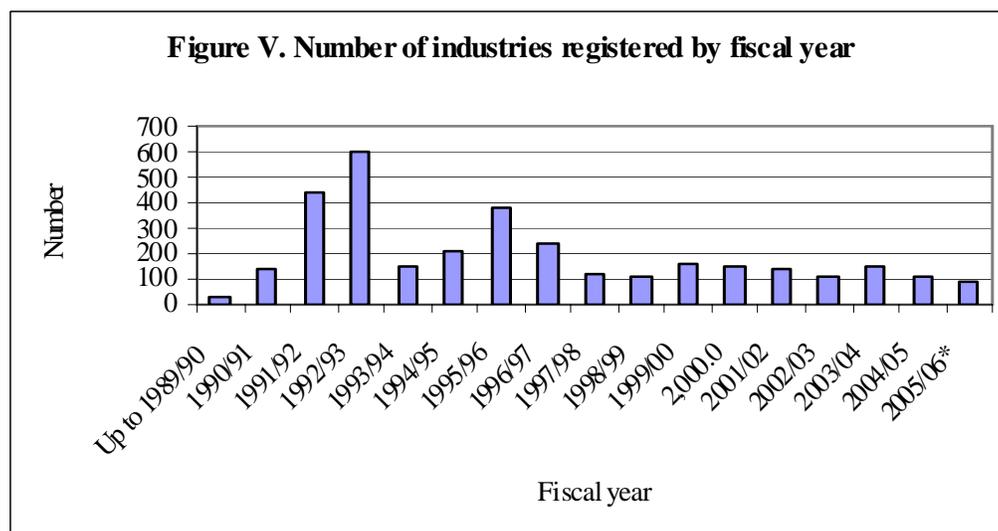
Source: Ministry of Finance, 2006

As a percentage of GDP, private investment increased from 10.1 per cent in the pre-liberalization period to 13.2 per cent in the post-liberalization period. Figure IV shows the growth of private investment/GDP ratio, which increased substantially after 1990.



Source: Ministry of Finance, 2006.

Figure V shows the number of industries registered over time. Until 1990/91, 30 industries were registered in Nepal. With the liberalization policy, the number of registered industries increased year by year before the slowdown, particularly after the mid-1990s with the escalation of internal conflict. As of the first nine months of 2005/06, 3,302 industries had been registered.



Source: Department of Industry, 2006.

* First nine months.

Of the total industries registered, 53.1 per cent were involved in manufacturing, 24.9 per cent in services and 15.4 per cent in tourism while 4.8 per cent were agro-based industries. Construction, energy and mineral-based industries constituted the remainder. Of the registered

industries, two-thirds (2,178) were small-scale industries, one-quarter were medium-sized industries and one-tenth were large-scale industries.

E. Institutional mechanism for policy coordination

There is growing empirical evidence that an institutional mechanism ensuring policy coordination is a key to the effectiveness of trade and investment policies in developing countries such as Nepal. The introduction of various Acts, accompanied by special institutional arrangements, in the reform process is designed for the same purpose in Nepal. A Board of Trade, which is functioning under the chairmanship of the Ministry of Commerce, includes adequate representation of the private sector. The purpose of the Board is to streamline trade and investments.

The Trade Promotion Centre and the Export Promotion Board are working in tandem to facilitate trade and provide policy and other feedbacks to the Government in general and the Ministry of Trade, Industry and Supply in particular. The Ministry of Trade and Industry is also fully responsible not only for bilateral treaties and multilateral agreements but also for supervising the working of treaties and agreements at the operational level.

The Department of Industry registers and classifies foreign investment. It is designated as the one-window servicing agency. The Industrial Promotion Board, as the highest authority, is chaired by the Ministry of Trade, Industry and Supply, and is responsible for granting permission for foreign investment. Representatives of various government agencies, private sector organizations and the Central Bank are represented on this Board. The Board's main responsibility is not only to approve licences for the foreign investors but also to ensure that the facilities granted to investors are provided in a timely manner through the one window service by the department in order to create a suitable investment environment. In particular, the department facilitates corporate registrations, land transfers, utility connections, administrative services agreements and coordination among various agencies. It also manages the income tax and duty drawbacks granted to foreign investors.

The Export Promotion Board and Trade Promotion Centre are engaged in facilitating exports in Nepal. The former undertakes the tasks of preparing product catalogues, conducting workshops and organizing exhibitions. The Trade Promotion Centre is engaged in identifying exportable products.

The One Window Committee (OWC) under the Department of Industry refers large investments to the Industrial Promotion Board, which is another problem with regard to ensuring quick and effective implementation. The Industrial Promotion Board meets infrequently and inputs are required from the other ministries, which causes delays in the approval of foreign investment projects. The Industrial Promotion Board faces the same type of problems as OWC. Registering and getting approval is only the first step in the process of implementing project investment.

Approvals are also required from other line ministries and agencies at various levels, ranging from approval to import raw materials and equipment to registration at the tax office. Importers/exporters must also complete documentation from the Central Bank concerning the

monitoring of foreign exchange transactions. The frequent but unexpected changes in customs duties and the valuation system create further uncertainties in the business environment. Getting duty drawback is also a very cumbersome procedure in Nepal, often taking two to five years.

So far, Nepal also lacks an exit policy or Bankruptcy Act. Their existence could help investors to make an exit plan at minimum cost and the reallocation of their capital accordingly. This also prevents factor mobility. Despite the current account being fully convertible, importers are required to open letters of credit (L/Cs) for customs clearance and foreign exchange availability. Dozens of documents have to be completed by importers and exporters, making trading a very difficult and cumbersome procedure. The implementation of a coherent and integrated business and trade facilitation strategy would be essential in Nepal, if only to partially compensate for the inherent disadvantage of being landlocked.

III. Effect of trade liberalization on total factor productivity, foreign direct investment and exports

A. Methodology and data

Change in total factor productivity has been computed separately for the pre- and post-liberalization period. In order to calculate the total factor productivity, a Cobb-Douglas type production function in the following form has been employed.

$$Y = A K^\alpha L^\beta e^u \quad (1)$$

where Y = real GDP, A = constant term, K = real capital, L = Labour force, u = random error, and α and β are the elasticity of K and L , respectively. Assuming constant return to scale, the above equation can be reduced to

$$Y = A K^\alpha L^{1-\alpha} e^u \quad (2)$$

Dividing both sides of equation (2) by L and taking logarithms of both sides, we get

$$\log(Y/L) = A + \alpha \log(K/L) + u \quad (3)$$

A and α in this equation are the parameters that are to be estimated. A denotes the shift factor and α denotes the per capita capital elasticity of per capita real GDP. α gives the elasticity of output with regard to capital and $1-\alpha$ gives the elasticity of output with respect to labour. The output growth not explained by these factors would be attributed to total factor productivity, referred to as the Solow residual.

GDP at factor cost, taken from the economic surveys, is used in this study. Capital stock has been estimated based on the Perpetual Inventory method. With regard to data on the labour force, the economically active population taken from census figures has been used since the time series data on employed labour force are not available.

The following reduced form equation for investment has empirically been tested to examine the impact of trade liberalization on investment. To examine the impact on investment more distinctly, other control variables are also included in the equation. Trade openness (i.e., total trade to GDP ratio), changes in income ($Y_t - Y_{t-1}$) to represent accelerator type effect, government investment in physical infrastructure to examine complementary type effects, and private sector credit from the banking system to GDP ratio for examining the effect of financial deepening variables are included in the equation. A dummy variable to examine the effect of trade liberalization on investment is also included. The relationship of the following form has been examined:

$$\ln PVTIN = a_0 + a_1 \ln(Y_t - Y_{t-1}) + a_2 \ln GPHI + a_3 \ln PVTC_GDP + a_4 \ln TTRADE_GDP + a_5 D + \varepsilon_t \quad (4)$$

where PVTIN = private investment, Y_t = real GDP, GPHI = government investment in physical infrastructure, PVTC_GDP = private sector credit/GDP ratio, TG = Trade/GDP ratio, D = Dummy variable, 1 for trade liberalization period (especially 1 after 1990) and ε_t = error term.

Before estimation of the model, a unit root test was performed on these variables. Since they were found non-stationary, the above equation has also been examined in first difference form to examine the short-term relationship. Further, the co-integration technique, a widely known method for time series data analysis, was also applied to identify the long-term relationship between trade and investment. The Granger Causality Test was used to identify the direction of causality between trade and investment, as both theory and empirical evidence so far do not show a clear-cut direction.

The study covered 1975 to 2006. Secondary data sources and published documents were used for the study. The main data sources were Economic Surveys by the Government, *Quarterly Economic Bulletins* of the Central Bank, Nepal Living Standard Surveys (NLSS) and Manufacturing Censuses held by the Central Bureau of Statistics.

B. Empirical findings

1. Total factor productivity in pre- and post-liberalization period

Trade liberalization promotes competition in domestic markets, which in turn forces domestic firms to increase productivity. Domestic firms must make a better product at a lower price to be competitive. An increase in factor productivity can generate efficient and sustainable output level. This section examines the change in total factor productivity in pre- and post-liberalisation Nepal.

The estimation of the equation (3) is:

$$\log(Y/L) = 7.19 + 0.28 \log(K/L) \quad (5)$$

(24.3) (9.48)

t-statistics in parenthesis

The estimated equation reveals that the elasticity of output with regard to capital is 0.28. This means that the elasticity of output with regard to labour is 0.72. This implies that the share of capital in total production is 28 per cent while the remainder is from labour. Table 3 shows the change in total factor productivity between the pre- and post-liberalization periods. In the pre-liberalization period, total factor productivity declined by 2.04 per cent. Although total factor productivity growth improves in the post-liberalization period, from -2.04 to -0.21 per cent, it remains negative.

Table 3 Mean contribution of factors of production and total factor productivity to GDP growth

Sample period	Growth rate of real GDP	Growth rate of capital	Growth rate of labour	Growth in total factor productivity
1975-1990	3.9	16.7	1.8	-2.04
1991-2006	4.0	6.9	3.2	-0.21
1975-2006	4.0	11.7	2.5	-1.1

The results of total factor productivity evidently prove that economic growth so far has been possible as a result of additional inputs, both labour and capital, rather than improving factor productivity in Nepal. This means that liberalization alone does not guarantee higher productivity growth in the absence of efficient physical infrastructure and skilled manpower.

2. Determinants of investment

Investment, very important for production and economic growth, has dual effects. It generates demand and also enhances productive capacity of an economy. It is influenced by a number of factors. This section examines empirical results on determinants of investment in Nepal.

(a) Unit Root Test and co-integration

A Unit Root Test was done on private investment, real GDP, government investment, private sector credit to GDP ratio, and Trade/GDP ratio in order to identify their stationary conditions. An Augmented Dickey Fuller (ADF) test was carried out at first lag with intercept with no trend. Table 4 report shows the ADF results.

Table 4 Unit Root Test

Variables in level	ADF value	Variables in first difference	ADF value
Ln (PVTIN)	-0.491472	DLn (PVTIN)	-5.186847 ^a
Ln(RGDP)	-0.102014	DLn (RGDP)	-6.283591 ^a
Ln (GPHI)	-3.490790 ^b	DLn (GPHI)	-5.404926 ^a
Ln (PVTC_GDP)	-1.092940	DLn (PVTC_GDP)	-5.785311 ^a
Ln (TRADE_GDP)	-1.099372	DLn (TRADE_GDP)	-5.694735 ^a
Ln(Trade)	-0.860484	DLn (Trade)	-4.498479 ^a

^a Significant at the 1 per cent level.

^b Significant at the 5 per cent level.

where PVTIN = private investment, RGDP = real GDP, GPHI = government investment, PVTC_GDP = private sector GDP ratio and TRADE_GDP = trade GDP ratio.

Most of the above data are non-stationary in level but stationary in first difference; hence, these data are integrated in order (1). But, these data are co-integrated as reflected by the Johansen Co-integration Test (annex 1). There is at least one co-integration equation. Figures VI and VII show that trade and investment are moving together, highlighting the close relationship between the two.

Figure VI Movement of trade and investment

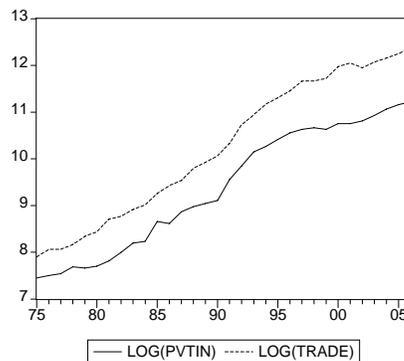
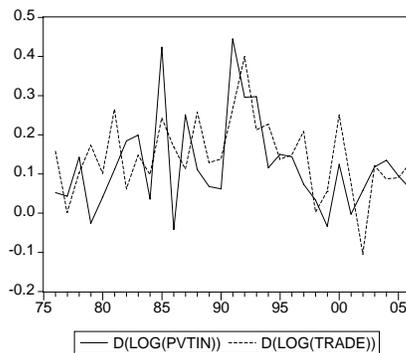


Figure VII Growth movement of trade and investment



(b) *Causality Test between trade and investment*

Trade and investment are, in fact, interlinked and co-related through various channels. While trade may contribute to increasing investment, investment may also induce trade. There is no theoretical or empirical evidence that could conclusively indicate sequencing from either direction. For these reasons, the Granger Causality Test was carried out on private investment and trade data.

As shown above, trade and private investment series are non-stationary in level. Since the Granger Causality Test requires stationary data, the causality test is applied to the growth rate of trade and investment. Table 5 shows the Granger Causality Test between investment and trade. The Granger Causality Test is applied to ascertain whether investment has influenced trade or vice-versa in Nepal.

The Granger Causality Test shows that causal effect ceases to exist after two years. Hence, the causality results are reported for two lags. Results show that causality runs from investment to trade. The null hypothesis that *private investment does not Granger Cause trade* is rejected at the 5 per cent level of significance when there is a one-year lag. The null hypothesis is rejected at the 10 per cent level of significance when there are two-year lags. However, the null hypothesis that *trade does not Granger Cause private investment* could not be rejected. Hence, it shows that past trade could not stimulate current investment significantly. It appears that with trade liberalization in Nepal, domestic industries are not competitive enough to augment trade compared to investment. In recent years, a massive inflow of remittance income has contributed to financing imports and trade has been a less stimulating factor in Nepal.

**Table 5 Granger Causality Tests between total trade and investment
(Sample: 1975-2006)**

Lags: 1				
Null Hypothesis:	Obs	F-Statistic	Probability	
Growth of trade does not Granger Cause growth of PVTIN	30	0.58831	0.45	
Growth of PVTIN does not Granger Cause growth of trade		7.00872	0.013	
Lags: 2				
Null Hypothesis:	Obs	F-Statistic	Probability	
Growth of trade does not Granger Cause growth of PVTIN	29	0.03877	0.96	
Growth of PVTIN does not Granger Cause growth of trade		2.82570	0.079	

(c) *Estimation of investment function*

Although private investment and trade are co-integrated, trade does not Granger Cause private investment as reflected by the above Granger Causality Test. Therefore, what determines the investment in Nepal? The empirical results help to provide an answer to this question to a great extent (table 6).

Table 6 OLS estimated results

Dependent variable: LOG(PVTIN)				
Variable	Coefficient	Std. error	t-Statistic	Prob.
C	0.51	1.12	0.46	0.65
Ln(RGDP-RGDP(-1))	-0.06	0.05	-1.10	0.28
Ln(GPHI)	0.52	0.12	4.18	0.00
Ln(PVTC_GDP)	0.17	0.23	0.75	0.46
Ln(TTRADE_GDP)	1.27	0.41	3.10	0.005
DUMMY	0.36	0.15	2.41	0.024
R-squared	0.98	F-statistic	286.000	
Adjusted R-squared	0.98	Prob (F-statistic)	0.000	
Durbin-Watson stat	0.63			

Regression results show that important determinants of investment are government expenditure on physical infrastructure (GPHI) and trade to GDP ratio. A dummy variable representing the trade liberalization period is also shown to be significant, implying that trade liberalization has promoted investment in Nepal. However, other two variables, economic growth and private sector credit to GDP, are shown to be insignificant.

In the above model, DW statistics are very low, reflecting positive serial correlation. Hence, the results shown in table 7 were obtained with first difference in variables in equation.

Table 7 OLS estimate in first difference

Dependent variable: D(LOG(PVTIN))				
Variable	Coefficient	Std. error	t-Statistic	Prob.
C	0.24	0.27	0.89	0.38
Ln(RGDP-RGDP(-1))	-0.02	0.03	-0.63	0.54
D(Ln(GPHI))	0.21	0.22	0.97	0.34
D(Ln(PVTC_GDP))	-0.04	0.27	-0.16	0.87
D(Ln(TTRADE_GDP))	0.90	0.31	2.86	0.01
DUMMY	0.02	0.06	0.42	0.67
R-squared	0.30	F-statistic		1.99
Adjusted R-squared	0.15	Prob (F-statistic)		0.12
Durbin-Watson stat	2.16			

In the first difference equation, only change in trade to GDP ratio is statistically significant. Hence, the positive impact of trade on investment cannot be ruled out in Nepal. However, the explanatory power of the model is not very strong, indicating a poor role of trade in augmenting investment.

C. Foreign direct investment and exportable industries: India and other countries

1. Foreign direct investment

With trade liberalization, FDI is also expected to boost total investment in economies such as Nepal. FDI is considered beneficial in view of its contribution to technological transfers, enhancement of managerial capability and new opportunities for market access. FDI, particularly in the form of equity investment, adds to the capital stock of the country and thus enables the recipient country to achieve faster economic growth through momentum in capital formation. Increases in FDI are also seen as leading to increases in exports by creating international markets through new marketing and organizational skills.

The inflow of FDI in Nepal began in the early 1980s through the gradual opening up of the economy. From 1980 to 1989, FDI inflows to Nepal were minimal with an annual average of US\$ 500,000 (UNCTAD, 2003b). FDI inflow showed a distinct acceleration during the 1990s (table 8), averaging US\$ 11 million per annum during 1990-2000, peaking at US\$ 23 million in 1997 (UNCTAD, 2003b and 2006). This was primarily due to Nepal's more liberal trade policies, which comprised tariff rate reductions, the introduction of a duty drawback scheme, the adoption of a current account convertibility system and liberalization of the exchange rate regime. A reversal in the rising trend took place from the beginning of the 2000s. All in all, FDI inflow is the lowest in Nepal even when compared with other landlocked countries (World Bank, 2003). The low volume of annual inflow has also resulted in meagre FDI stock in Nepal. A comparison of Nepal's FDI inflows per US\$ 1,000 GDP with those of other Asian countries indicates a poor performance (UNCTAD, 2003b). The fact that Nepal is landlocked, coupled with its infrastructure and low level of labour productivity has also constrained FDI inflow into the country.

Table 8 FDI inflows in Nepal

Year	FDI inflow	FDI stocks
1990-2000 (annual average)	11	1
2002	-6	12
2003	15	72
2004	-	125
2005	5	129

Source: UNCTAD, 2006.

Many foreign investors in Nepal are individuals rather than corporate entities. As of April 2006, 1,067 enterprises had been approved for foreign participation. Most (962) were of the equity investment type while 54 were of the technology transfer type. The remaining investments were in the form of both equity investment and technology transfer (Department of Industry, 2006).

Most of the FDI projects are of small size (72 per cent), followed by medium-sized (16.5 per cent) and large-sized industries (11.5 per cent). Much of the FDI inflow is for joint ventures, although 100 per cent equity participation by foreign investors is allowed in almost all the sectors except those on negative list, as mentioned above. The investment structure of joint ventures indicates that foreigners want to minimize non-commercial risks by offering shares to local partners.

Most of the FDI in Nepal is Greenfield-type investment rather than acquisition. FDI is highly concentrated in the manufacturing sector, which accounted for slightly more than 45 per cent of approved FDI projects (table 9). It is also the sector that attracts the highest FDI in terms of investment volume. Within the manufacturing sector, the textile and garment industry accounts for 28 per cent of total foreign investment, followed by the chemical and plastic industries at 25.3 per cent (annex 1). Tourism is second, accounting for almost 25 per cent of total FDI projects, followed by the service sector with 20 per cent of FDI projects. Although the electricity, water and gas sector has just a few FDI projects, it ranks fourth highest in terms of the size of FDI inflow.

Table 9 Sector-wise distribution of all approved FDI projects up to June 2006

Sector	Number of FDI projects	Amount of FDI
Manufacturing	45.4	40.8
Tourism	24.6	16.9
Services	19.3	18.6
Construction	3.2	3.9
Transport and communications	2.5	5.8
Electricity, water and gas	2.1	11.8
Housing and apartments	1.6	0.5
Agriculture and forestry	1.3	1.6

Source: Department of Industry, 2006

Of the total manufacturing units (484) approved for foreign investment, 170 are producing textile and readymade garments. Next are chemical and plastic producers (89), followed by food, beverages and tobacco (75), fabric metal (54), basic metal (25) and paper and paper products (23).

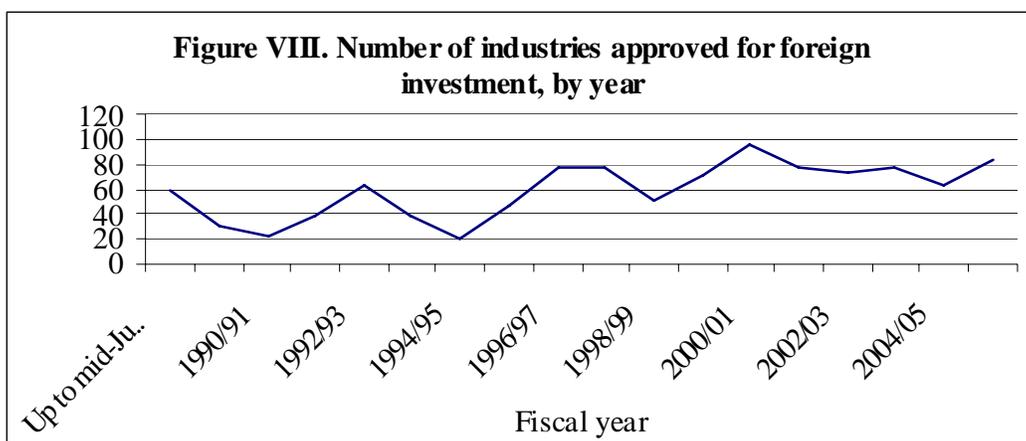
In total, FDI comes from 50 countries. But the scale and number of projects by each country vary considerably. As of mid-April 2006, there were 1,067 FDI projects, worth NRs 28.6 billion in investment approved by the Department of Industry. Of that total, in terms of investment, India alone accounted for more than 40 per cent, followed by the United States and China. Those three countries alone account for two-thirds of cumulative FDI in Nepal (table 10). In terms of number of FDI projects, India ranks first, followed by China, Japan and the United States. Nepalese and Indian nationals do not need passports or visas when travelling between their countries. Similarly, the Indian currency is freely convertible in Nepal. A special relationship with India regarding preferential trade arrangements also provides an additional incentive to Indian investors.

Table 10 Source countries of FDI in Nepal
(Unit: Percentage of total)

Source countries	Share in total FDI	Share in the number of enterprises
India	40.4	31.0
United States	15.8	9.2
China	10.5	11.3
British Virgin Islands	4.5	0.4
Norway	3.7	0.7
Japan	3.4	10.3
Republic of Korea	3.3	5.3
United Kingdom	2.9	4.0
Germany	2.1	4.3
Canada	2.0	0.9

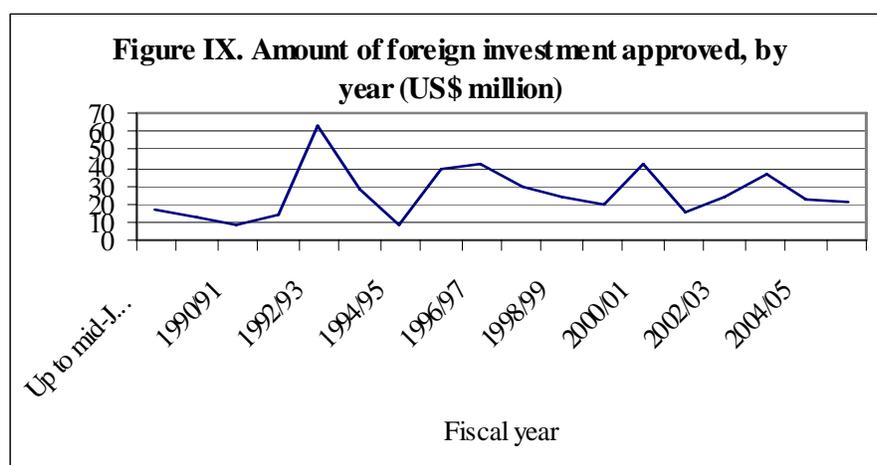
Source: Department of Industry, 2006.

Figure VIII shows the number of FDI approvals each year. Up to 1989, only 59 industries were approved for FDI. The approval rate increased gradually after 1990, despite up and downs each year. The approval rate was 77 in 1996/97 and 1997/98. In 1998/99, a decline in the number of FDI approvals was recorded. Then, in 2000/01, the approval rate reached 96. Since then, the FDI approval rate has remained almost stagnant at around 80.



Source: Department of Industry, 2006.
 * First nine months

Figure IX shows the volume of FDI approvals each year in United States dollar terms. The highest level of FDI approved was in 1992/93, equivalent to US\$ 62.9 million. In 1994/95, it was US\$ 9.5 million, after which the volume hovered within the range of US\$ 20 million to US\$ 40 million.

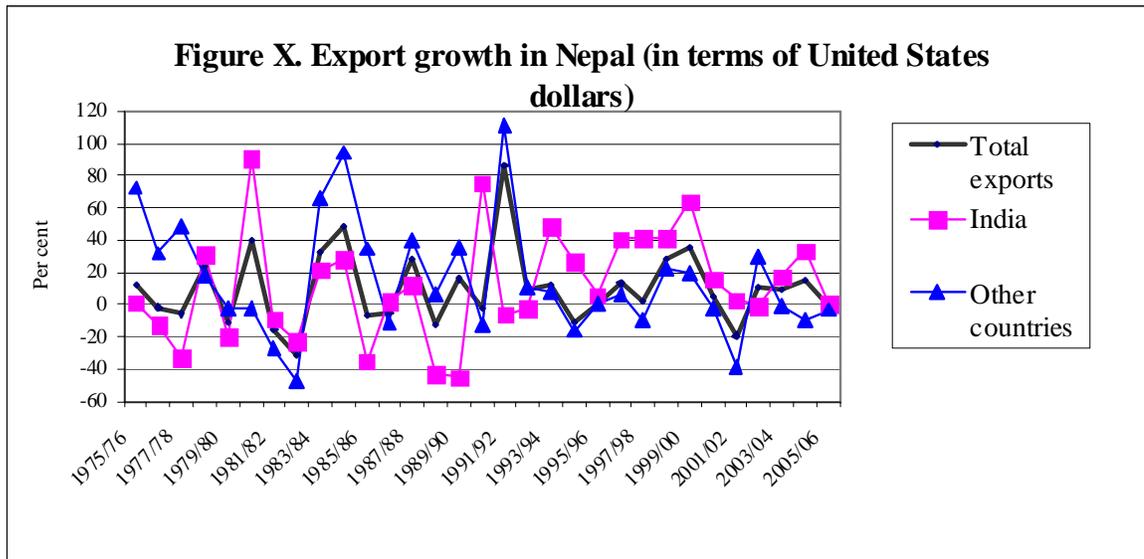


Source: Department of Industry, 2006.
 * First nine months.

2. Export performance

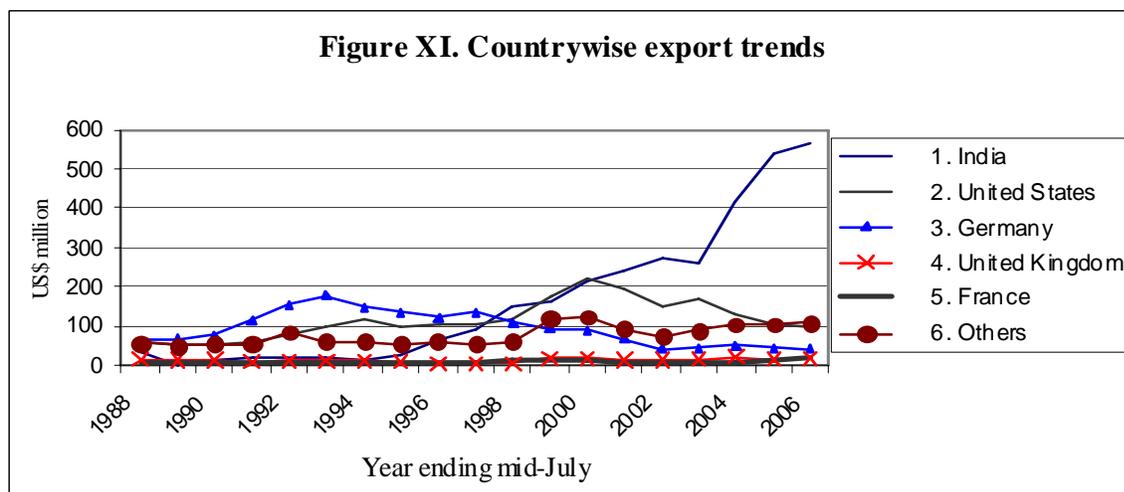
Exports grew phenomenally together with FDI inflow in the 1990s. Total merchandise exports in United States dollars grew by 12.1 per cent on average between 1990/91 and 2005/06 compared with 7.4 per cent between 1974/75 and 1989/90. In Nepalese rupees, exports increased by 18.7 per cent annually on average from 1991 to 2006 compared with a growth rate of 15 per cent from 1975 to 1990. The growth, however, was very volatile (figure X). In 1991 and 1992, immediately after the beginning of trade liberalization, exports to countries other than India grew by 110 per cent. Thereafter, total exports to India and other countries declined gradually picking up in the late 1990s. This was due, in particular, to a surge in exports to India after the liberal trade treaty in 1996. After 2001/02, exports to other countries declined continuously, although a

slight increase was recorded in 2002/03. Exports to India, despite registering substantial growth in 2003/04 and 2004/05, declined again in 2005/06.



Source: Nepal Rastra Bank, 2006.

During the liberalization period, exports to India grew substantially. As a result, export share to India reached more than two-thirds in 2005/06. After India, the United States was the second largest trading partner, followed by Germany, the United Kingdom and France. Those five countries accounted for 87 per cent of Nepal’s exports in 2005/06, despite the fact that Nepal was trading with 151 countries throughout the World. From the mid-1990s, exports to the United States and Germany started declining while exports to India rose sharply (figure XI).

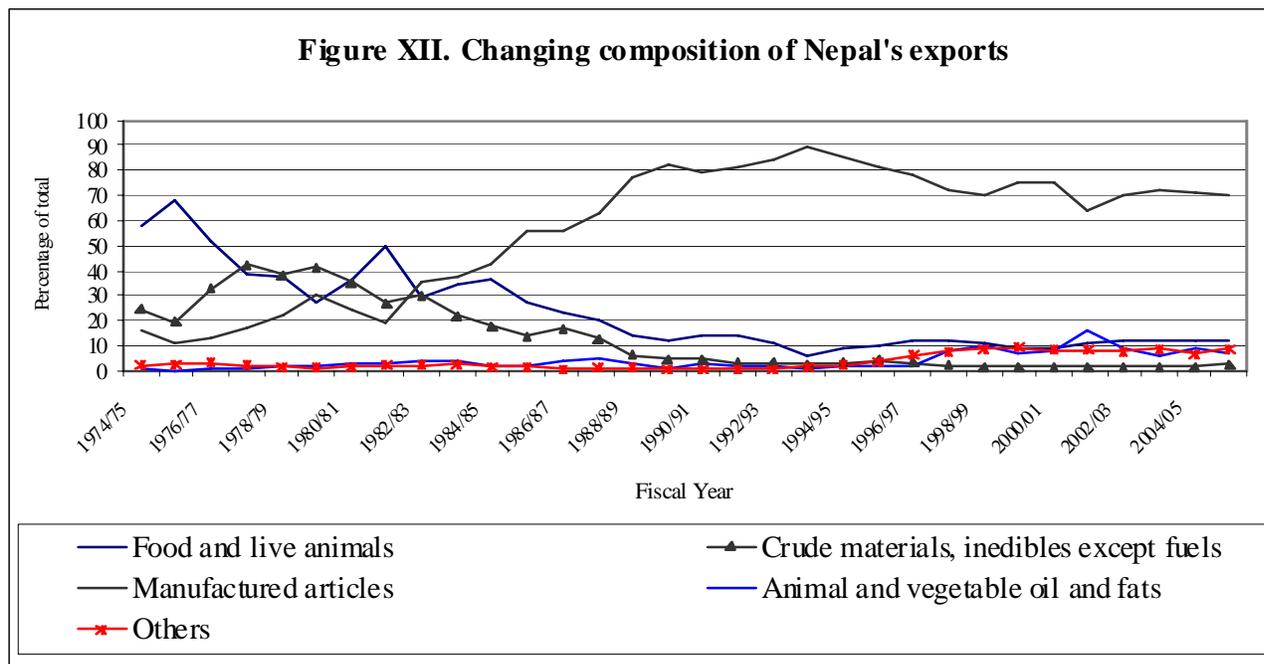


Source: Asian Development Bank, 2006.

The structure of trade has been changing gradually (figure XII). In 1974/75, food and live animal exports constituted the highest share of total exports at 58.2 per cent, followed by a decline to 11.9 per cent in 1989/90. In the post-liberalization period, exports of food and live animal hovered at around 10.8 per cent. Exports of crude materials declined substantially over time, reaching at 2.2 per cent in the post-liberalization period.

The contribution by manufactured articles, which was about 15 per cent of total exports in 1974/75, increased gradually to outpace the contribution by other items, particularly from 1982/83. The share of manufactured items in total exports reached almost 90 per cent in 1993/94 before experiencing a decline to around 70 per cent in 2005/06. Much of the growth in exports in the post-liberalization period has been due to the contribution by the manufacturing sector, which attracted large share of FDI. Among the manufactured products, textile and garments – which attract the second largest FDI – contributed markedly to the rise in exports.

Exports of animal and vegetable oils and fats were almost negligible in 1974/75, but they increased substantially from 1997/98 and accounted for 15.8 per cent of total exports in 2001/02. After the quota restriction on exports of vegetable ghee to India, following the Nepal-India Trade Treaty of 2002, the export share started to decline to reach 7 per cent of total exports in 2005/06. The contribution of other items as per SITC classification, which includes tobacco and beverages, minerals, fuels and lubricants, chemicals and drugs, machinery and transportation, and unclassified commodities, has remained low.



Source: Nepal Rastra Bank, 2006.

The top 10 commodities that constituted more than half of the exports to India in 2005/06 were vegetable ghee, polyester yarn, jute goods, zinc sheets, textiles, thread, wire, juice, readymade garments and chemicals. Despite declines in recent years, readymade garment and woollen carpets are still two major items exported to the countries other than India. They alone contribute about 60 per cent of exports to those countries in 2005/06. Other major items

exported to countries other than India include pasmina, handicrafts, tanned skinned, silverware and jewellery, Nepalese paper and paper products, and pulses.

IV. Business perception of the investment environment

A. Survey methodology

Primary information was collected from relevant stakeholders in the private sector with regard to their perception of coherence between trade and investment policies as a way of enhancing the investment climate. An attempt was made to identify the potential for conflicts between trade and investment policies/regulations. A structured survey, with some open-ended questions, was used to collect business perception of the trade and investment climate in Nepal (annex 3). A survey instrument was developed in coordination/consultation with the ARTNeT Secretariat, with reference to chapter 3 of the OECD Policy Framework for Investment.

The survey questionnaire was sent by mail to 15 respondents who were involved in production and trading activities, followed by phone/interviews and selected face-to-face interviews, with the expectation that systematic/useful information, and feedback and anecdotal evidence (of the need for trade and investment policy coordination in various sectors) could be obtained from them.

B. Survey results

A small-scale perception survey was carried out among investors, importers and exporters in order to obtain their views on the importance of trade- and investment-related policies and their coordination in Nepal in improving the overall investment climate. The survey included domestic, foreign and joint-venture companies. Of the 12 respondents, eight were private domestic companies, three were foreign joint ventures and one was a subsidiary of a foreign company. The number of employees in the respondent companies ranged between 14 and 750.

Of the 12 respondents, 10 were found to be involved in manufacturing processes at different levels. With regard to import content in their products, four business units had 60-80 per cent, three units had 40-60 per cent, two units had less than 20 per cent and one unit had more than 80 per cent. Of the total respondents, only one business unit was exporting more than 80 per cent of its output. Two units reported that they exported 60-80 per cent. Similarly, the number of business units exporting 40-60 per cent and 20-40 per cent were one and three, respectively. Three units were exporting less than 20 per cent. The remaining two units reported that they served only the domestic market.

1. Perceived level of importance of different policies in investment decisions

The survey found that the majority of respondents considered trade policies such as tariffs, licensing and customs procedures to be the most important (table 11). The average score

derived for trade policy is 4.8.⁶ This is followed by tax policy (4.4) and policies included in others (4.3), which comprises free flow of capital, legal protection, industrial policy, economic policy, an investment-friendly labour policy, peace and security, and political non-intervention. The respondents regarded infrastructure and financial sector development to be of equal importance (4.2). Human resources development and corporate policies ranked fourth, with an average score of 3.9 out of 5, followed by public governance policy with an average score of 3.8. Competition policy achieved the lowest score (3.3) on importance in investment decisions.

Table 11 Private sector perception of level of importance of different policies in investment decisions

Policies	Average score (out of 5)	Standard deviation
Trade policy	4.8	0.62
Competition policy	3.3	1.14
Tax policy	4.4	0.67
Corporate governance policy	3.9	1.08
Responsible business conduct policies	3.6	1.24
Public governance	3.8	1.14
Infrastructure and financial sector development	4.2	0.72
Human resources development policies	3.9	0.79
Others*	4.3	1.11

Source: Sample Survey, 2007.

Note: 1 = not important; 2 = somewhat important 3 = important; 4 = very important; 5 = most important.

* Includes free flow of capital, legal protection, industrial policy, economic policy, investment-friendly labour policy, peace and security (no strikes and lockouts) and political non-intervention.

2. Policy coordination

More than 80 per cent of the respondents agreed that policies related to trade in goods and services could support more and better quality investment by expanding opportunities to reap scale economies and by facilitating integration into global supply chains, thus boosting productivity and rates of return on investment. However, regarding satisfaction, none of the respondents were fully satisfied with the existing investment environment. They felt that government efforts as well as existing trade- and investment-related policies and procedures were highly inadequate. As a result, the average score for the level of satisfaction was relatively low in all the conditions (table 12). The highest average score of satisfaction (2.4 out of 5) was found in the conditions of trade policy, and regulatory certainty and predictability. This was followed by government support for export finance and import insurance schemes in the financial/insurance sectors. Respondents also reported that government efforts to implement

⁶ The perception among domestic private and joint-venture companies regarding the importance of trade policy was somewhat similar. Only one joint-venture company ranked trade policy as “important” (3) while one domestic company considered it “very important” (4).

WTO commitments were mainly confined to paper. Thus, investors were only “somewhat satisfied” with the existing investment environment.

Table 12 Private sector satisfaction levels

Conditions	Average score (out of 5)	Standard deviation
Customs, regulatory and administrative procedures at the border and related compliance costs	2.1	0.79
Level of trade policy, and regulatory certainty and predictability	2.4	0.79
Mechanisms in place to consult investors and other interested parties on planned changes to trade policy	2.0	1.04
Government efforts to enter into market-expanding international trade agreements (including implementation of WTO commitments)	2.1	0.90
Measures seeking to address weaknesses in sectors of importance to traders (e.g., government support for export finance and import insurance schemes in the financial/insurance sectors)	2.3	0.78

Source: Sample Survey 2007.

Note: 1 = not satisfied; 2 = somewhat satisfied; 3= satisfied; 4 = very satisfied; 5 = fully satisfied.

3. Action/measures for improving national policy framework for investment

Table 13 shows the priority ranking of the actions prescribed by the respondents. The suggestions were guided by the objective of improving the overall national policy framework for investment. According to the survey findings, the private sector gives the highest priority to reducing the compliance costs of the customs, regulatory and administrative procedures. Of the 12 respondents, six listed these measures as the first priority. The next priority was given to reducing the uncertainty of trade policy. The respondents suggested avoidance of rapid and unpredictable changes, followed by consultation with investors and other interested parties during the changes in trade policy. One respondent gave first priority to government support in terms of export finance and import insurance schemes. Very few respondents listed other policy measures as the first priority. As per the average ranking, measure (a) ranked top, followed by measure (b) and measure (c) (table 13).

Table 13 Priority of measures**(Unit: Number of respondents)**

Measures	First priority	Second priority	Third priority
(a) Reduce the compliance costs of customs, regulatory and administrative procedures at the border	6	3	2
(b) Reduce trade policy uncertainty by avoiding rapid and unpredictable changes	3	6	2
(c) Consult investors and other interested parties on planned changes to trade policy	2	3	3
(d) Increase investment opportunities through market-expanding international trade agreements (including implementation of WTO commitments)	0	-	3
(e) Implement trade policy measures that address sectoral weaknesses in the country (e.g., Gov. support to export finance and import insurance schemes in the financial/insurance sectors)	1	0	2

Source: Sample Survey, 2007.

Of the 12 respondents, 10 reported that existing trade policies and the related environment had unnecessarily raised the cost of inputs for production, thereby discouraging further investment in that industry/sector. One respondent considered that there had been no such cost increase while one did not comment. Export duty of 8 per cent on *vanaspati ghee (vegetable fat)*, unauthorized tax collection on highways, strikes and lockouts, shortages of petroleum, a weak law and order situation, administrative hurdles, inconsistent classification of imported capital goods for customs duty, and delays in VAT refunds and government decisions were some examples cited by the respondents.

As reported by the survey respondents, the lack of coordination between trade and investment policies was also resulting in reduced competitiveness and low investment levels. Other major hurdles (see box article) cited by the respondents included:

- (a) An unsupportive attitude among government bureaucrats;
- (b) The lack of a clear-cut industrial development policy;
- (c) A conservative customs policy;
- (d) Departmental conflicts between the Ministry of Industry and the Ministry of Finance;
- (e) The lack of coordination between the Department of Industry and the Electricity Authority in supplying electricity;
- (f) Conflicting regulations;
- (g) The lack of a competition law; and
- (h) Weak compliance and an absence of timely legal protection.

Moreover, almost all the respondents felt that policy harmonization of investment incentives and regulations across countries constituted a very important factor. However, they did not elaborate on that view.

Investment climate in Nepal

Some earlier assessments of the investment environment in Nepal are available. The United States Commercial Service (2007), for example, assessed the environment in Nepal for doing business. The report mentioned that implementation of the FDI policy is often distorted by bureaucratic delays and inefficiency, although the policy is open and liberal.

According to the report, Nepal lacks a law to guarantee free competition or to restrict unfair forms of competition. Moreover, Nepal does not automatically recognize patents awarded by other nations, and foreign investors face a non-transparent legal system. Furthermore, legislation banning foreign investment in financial, legal and accounting services has made it difficult for investors to find tackling legal issues.

The World Bank's "Doing Business Survey" (2006)⁷ also noted that the business environment was not conducive in Nepal, and that it had worsening in 2006 compared to 2005. The country's overall rank was 100 in 2006, a drop from 90 in 2005. The report noted that licensing procedures for doing business were quite cumbersome, time-consuming and costly, and that laying off employees was particularly difficult and costly.

Access to credit is perceived by Nepalese firms as one of the greatest barriers to doing business, due to the weak legal rights for claiming and collecting collateral. Moreover, despite the existence of a credit bureau, the information index in Nepal is weak. Disclosure standards for companies are close to non-existence and directors are permitted to influence the companies' actions for their own benefit with impunity.

Although tax rates are not high, the compliance requirements are cumbersome and time-consuming. Trading across borders is cumbersome in Nepal, constrained by its status as a landlocked country as well as the lack of adequate infrastructure. Moreover, enforcing contracts is not easy; it takes 28 procedures and 590 days to enforce a simple commercial debt contract at a cost of 24.4 per cent of the value of the debt. Last, even closing a business is not straightforward. After a firm becomes insolvent in Nepal, it takes almost five years to close the business.

Nepal's geography is equally a major constraint to investment and trade. The nearest seaport is 660 miles away in India. As a result, not only are transportation costs high, external trade in Nepal is nearly completely dependent on India for transit routes. Nepal's narrow range of exports and the concentration on only a few countries makes it vulnerable. Another challenge was posed by the phasing out of the Multi-Fibre Arrangement (MFA) in 2005, substantially setting back the garment industry. In addition, the more restrictive Nepal-India Trade Treaty of

⁷ The Doing Business Database provides objective measures of business regulations and their enforcement relative to 175 economies. The measures indicate the regulatory costs of business and can be used to analyse specific regulations that enhance or constrain investment, productivity, and growth.

2002, compared to that of 1996, has hindered export flow to India. Many non-tariff barriers imposed by State governments in India are creating additional obstacles to Nepal's exports.

Customs and trans-shipment delays can account for as much as 55 per cent of the logistics costs of sending certain types of goods from Kathmandu to Kolkata, instead of the typical 25 per cent for other international routes (World Bank, 2003). The labour market is also not conducive to investment, as it suffers from the poor quality education system. A decade-long internal conflict, including political instability and a deteriorating security environment, has lowered the Nepal's competitiveness in trade and investment.

VI. Conclusion and policy recommendations

A. Conclusion

Nepal embarked on intensive economic liberalization policies in the early 1990s, following the introduction of some market orientation policies in the mid-1980s after the implementation of SAP. Trade liberalization constituted one of the important ingredients of overall liberalization. Now Nepal, in terms of the average tariff rate and openness, is one of South Asia's most open economies. The introduction of highly liberal trade and investment policies aimed at encouraging investment, including FDI and exports, has made this possible. Both trade and investment grew rapidly in the aftermath of trade liberalization. However, the momentum of growth could not be maintained for long. At the same time, volatility in trade and investment circumscribed the scope for driving a higher economic growth rate in the longer term. The Granger Causality Test carried out to find the direction of causality reveals that it is mainly from investment to trade. This is probably the reason for Nepal's inability to sustain growth in trade and the economy. Although investment function estimated shows a positive relationship between trade and investment, that relationship is weak. Examination of lagged effects further indicates that there is no strong dynamic effect from investment in the Nepalese context.

Attempts made to identify the role of trade liberalization in total factor productivity found that even though in the post-liberalization period there had been some improvement, the total factor productivity was still negative. This means that the role of capital and labour has been vital in augmenting economic growth in Nepal. After an abrupt jump in exports at the start of the post-liberalization period, exports have declined considerably in recent years. In addition, a long-term phenomenon of a narrow export base and concentration on a few countries has not changed much in the post-liberalization period. At the same time, volatility has continued. The decline in export competitiveness as a result of high transaction costs has made the problem even more pervasive while the decline in labour productivity and the business environment has had adverse effects on FDI.

Similar to the overall trends in the economy, FDI inflow went up massively in the post-trade liberalization period. The manufacturing sector attracted the majority of FDI inflow in Nepal. However, FDI has also declined sharply in recent years, creating an adverse effect on exporting industries. In view of Granger Causality indicating causation from investment to trade,

the lowest flow of FDI, even when compared with other least-developed countries, has had an adverse effect on capital accumulation and investment.

Experiences among other countries indicate that trade liberalization can promote investment, including FDI and exports, only when there is suitable investment climate and business environment. Trade or investment policy requires strong market institutions which include a guarantee of property rights and a stable policy environment backed by suitable organizations including bureaucratic institutions. On the whole, a friendly investment and business environment is a must. This has to be supplemented by better policy coordination to ensure timely and non-cumbersome procedures in obtaining the services and other facilities laid down in the rules or policies. Various studies undertaken to assess the investment and business environment indicate that undertaking business and investment in Nepal is a very difficult and complicated task despite the very liberal policies.

The small-scale perception survey shows that trade policies such as tariffs, licensing and custom procedures are considered most important, followed by taxation policies. Foreign capital inflow and legal protection policies, industrial policy, peace and security, and political non-intervention are also important in taking investment decisions. Trade policy is also important to supporting more and better quality investment. However, the perception survey results show that existing policies and the investment environment are not satisfactory. Government efforts as well as prevailing policies and procedures, including policy coordination related to trade and investment, are either highly ineffective or inadequate.

B. Policy implications

The slowdown in the economic growth rate of Nepal in recent years indicates the necessity to undertake reviews of ongoing trade and investment policies as well as the trade and business environment in the Nepalese context. In view of the growing importance of institutional mechanisms and policy coordination, a review of policies from these perspectives is critically important. This may also be necessary from an international policy coordination point of view. Based on the above conclusions, the following policy implications can be drawn.

Of foremost importance in the Nepalese context is the need for policy packages laid down in trade and investment to be implemented effectively. The system of unaccountability or indecisiveness has to be completely eradicated at the different institutional levels. The One-Window Committee has to be made effective in encouraging both domestic and foreign private investment.

Trade and investment policies cannot be framed and implemented in isolation. Therefore, policies need to be implemented in a comprehensive way with topmost priority being given to policy coherency. As the survey findings have shown, it is crucial that the compliance costs of customs, regulatory and administrative procedures be reduced in order to improve the national policy framework for investment. Delays and the cumbersome procedure have made doing business highly non-competitive. Policy stability should also be ensured by avoiding unpredictable changes, and trade policy should be framed or changed following consultation with investors and other interested parties.

As reflected in the survey findings, there is a lack of adequate coordination between trade and investment policies, which should be resolved. Trade and investment promotion should be undertaken in an integrated manner. As such, government bureaucrats and agencies should be supportive of efforts to enhance investment, and they should make policies and procedures transparent. Conflicting regulations as well as harassment of investors should be eradicated. However, this needs to be accompanied by policy coordination at the highest level. In this regard, encouragement of policy coordination by the various international agencies concerned is also a key aspect, given the differing views of the features and sequencing of policies.

In Nepal's context, restoration of peace and improvement of security is also equally essential. Only in a peaceful environment can both domestic and foreign investment be fostered in Nepal. At the same time, over-unionization, threats and intimidation are still a serious problem. Therefore, the creation of a friendly business and investment environment in Nepal depends to a high degree on the extent to which the country is able to ensure peace and guarantee the rule of law.

Annexes

Annex 1 Johansen Co-integration Test

Sample (adjusted): 1977-2006

Included observations: 30 after adjusting endpoints

Trend assumption: No deterministic trend

Series: LOG(PVTIN) LOG(RGDP) LOG(PVTC_GDP) LOG(TTRADE_GDP) LOG(GPHI)

Lags interval (in first differences): 1 to 1

Unrestricted Co-integration Rank Test

Hypothesized No. of CE(s)	Eigenvalue	Trace statistic	5 per cent critical value	1 per cent critical value
None **	0.919670	113.6015	59.46	66.52
At most 1	0.457431	37.95326	39.89	45.58
At most 2	0.315340	19.61007	24.31	29.75
At most 3	0.220734	8.245093	12.53	16.31
At most 4	0.025113	0.763016	3.84	6.51

*(**) denotes rejection of the hypothesis at the 5% (1%) level.

Trace test indicates one co-integrating equation(s) at 5 % and 1% levels.

Hypothesized No. of CE(s)	Eigenvalue	Max-eigen statistic	5 per cent critical value	1 per cent critical value
None **	0.919670	75.64824	30.04	35.17
At most 1	0.457431	18.34318	23.80	28.82
At most 2	0.315340	11.36498	17.89	22.99
At most 3	0.220734	7.482077	11.44	15.69
At most 4	0.025113	0.763016	3.84	6.51

*(**) Denotes rejection of the hypothesis at the 5% (1%) level.

Max-eigenvalue test indicates one co-integrating equation(s) at 5 % and 1 % levels.

Annex 2 Number of industries approved for foreign investment by sector, until April 2006
(NRs million)

Sector	No. of industries	Total project cost	Total fixed cost	Foreign investment
Agriculture and forestry	14	1 682.1	1 521.3	461.6
Manufacturing	484	37 199.1	27 013.6	11 661.2
Food, beverages and tobacco	75	9 180.3	7 968.8	2 205.3
Textiles and readymade garments	170	8 848.2	5 607.1	3 262.7
Wood and wood products	8	116.4	89.9	41.5
Paper and paper products	23	1 824.5	1 542.4	334.0
Chemical and plastic products	89	7 158.3	5 222.6	2 954.0
Non-metal mineral products	20	3 831.6	2 314.4	1 116.0
Basic metal products	25	2 200.0	1 443.9	693.0
Fabric metal	54	3 174.1	2 205.9	848.3
Other manufacturing units	20	865.7	618.6	206.4
Electricity, water, gas	22	19 866.8	18 087.1	3 372.6
Construction	34	1 841.3	1 371.3	1 119.5
Tourism	263	16 222.4	15 285.8	4 828.8
Transport and communications	27	4 206.7	2 908.3	1 670.4
Housing and apartment	17	256.4	105.2	145.5
Service industries	206	11 556.1	10 587.9	5 318.2
Total	1 067	92 830.9	76 880.5	28 577.8

Sources: Department of Industry, 2006.

Annex 3 Private sector survey instrument

This survey was conducted by IPRAD as part of a research study aiming at assessing the need to coordinate trade and investment (particularly FDI) policies, in order to improve the overall investment climate in Nepal and the region. The purpose of the survey was to collect the views of private sector stakeholders regarding this issue, on the basis of which the policy recommendations would be formulated. Answers will remain confidential and the survey results will only be reported in aggregate form.

1. Your company is (check the one that describes your company most closely):

- a. A state-owned company
- b. A private domestic company
- c. A subsidiary/affiliate/branch of a foreign company
- d. A joint venture (percentage of foreign ownership: _____)

2. Primary sector/industry/product: _____

3. Number of employees: _____

4. On average, what is the import content of the products you manufacture (in per cent of product value)?

- Less than 20% 20 to 40% 40 to 60% 60 to 80% More than 80%

5. On average, what percentage of your production is exported

- Less than 20% 20 to 40% 40 to 60% 60 to 80% More than 80%

6. For the purpose of this survey, do you consider yourself as representing. (Circle all that apply, i.e., you may circle more than one):

- a. A foreign investor
- b. A domestic investor
- c. An exporter
- d. An importer
- e. An entire industry
- f. Other (please specify): _____

PART I – IMPORTANCE OF SELECTED POLICIES AND ISSUES ON INVESTMENT DECISIONS

A. Many factors affect your company’s/your industry’s ability and willingness to invest in the COUNTRY. Investment decisions are affected by various policies and issues which go beyond a country’s basic investment policy. Please rate the importance you attach to the following policies/issues when making investment decisions. (Circle the appropriate number: 1 = not important; 2 = somewhat important; 3 = important; 4 = very important; 5 = most important)

a. Trade Policy (<i>Policies related to import and export of goods and services, such as tariffs, licensing, customs procedure.</i>)	1 2 3 4 5
b. Competition Policy (<i>Competition policy generally helps to ensure that companies operate in more competitive markets, as opposed to more monopolistic markets.</i>)	1 2 3 4 5
c. Tax Policy (<i>The level of the tax burden and the design of tax policy, including the way it is administered, directly influence business costs and returns on investment.</i>)	1 2 3 4 5
d. Corporate Governance Policies (<i>The existence of a corporate governance framework that sets basic principles for sound corporate governance, possibly leading to reduced cost of capital and better functioning of domestic financial markets.</i>)	1 2 3 4 5
e. Responsible Business Conduct Policies (<i>Policies that lead to the effective enforcement of laws on environmental protection, labour relations, financial accountability and human rights.</i>)	1 2 3 4 5
f. Public Governance (<i>Regulatory quality/clarity and public sector integrity – i.e., absence of corruption – are two important elements of public governance.</i>)	1 2 3 4 5
g. Infrastructure and Financial Sector Development (<i>Lack of infrastructure and/or a stable financial sector may impede the realization of investment.</i>)	1 2 3 4 5
h. Human Resources Development Policies (<i>Policies that develop and/or maintain a skilled, adaptable and healthy population.</i>)	1 2 3 4 5
i. Other (<i>please specify</i>): _____	1 2 3 4 5

B. Of the above listed issues, which stand out as most important? _____

Please elaborate:

PART II – TRADE AND INVESTMENT POLICY COORDINATION

A. It has been argued that “policies related to trade in goods and services can support more and better quality investment by expanding opportunities to reap scale economies and by facilitating integration into global supply chains, boosting productivity and rates of return on investment”. Do you agree with the above statement?

Strongly disagree disagree no opinion agree strongly agree

B. As an investor (or recipient of investment), to what extent are you satisfied with the following (circle the appropriate number: 1 = not satisfied; 2 = somewhat satisfied; 3 = satisfied; 4 = very satisfied; 5 = fully satisfied):

a. The customs, regulatory and administrative procedures at the border and related compliance costs	1 2 3 4 5
b. The level of trade policy and regulatory certainty and predictability	1 2 3 4 5
c. The mechanisms in place to consult investors and other interested parties on planned changes to trade policy	1 2 3 4 5
d. Government efforts to enter into market-expanding international trade agreements (including implementation of WTO commitments)	1 2 3 4 5
e. The measures seeking to address weaknesses in sectors of importance to traders (e.g., government support for export finance and import insurance schemes in the financial/insurance sectors)	1 2 3 4 5

C. Which of the following actions should be taken by trade policy makers in priority to improve the overall national policy framework for investment? (Please rank top three, with “1” as the most important of the three top priority actions.)

Action/measure	Priority rank
a. Reduce the compliance costs of customs, regulatory and administrative procedures at the border	
b. Reduce trade policy uncertainty by avoiding rapid and unpredictable changes	
c. Consult investors and other interested parties on planned changes to trade policy	
d. Increase investment opportunities through market-expanding international trade agreements (including implementation of WTO commitments)	
e. Implement trade policy measures that address sectoral weaknesses in the country (e.g., Gov. support to export finance and import insurance schemes in the financial/insurance sectors)	

D. Do you feel existing trade policies in your industry/sector unnecessarily raise the cost of input of goods and services, thereby discouraging further investment in that industry/sector?

Yes No

E. If yes, please provide some specific examples of a trade policy or regulatory measure in your sector/industry:

F. Based on your experience, can you illustrate the importance (or/and lack of) coordination between trade and investment policies in your industry/sector, possibly resulting in reduced competitiveness and investment, and give a specific example of conflicting policy/regulation/action:

G. From your perspective, how important is harmonization of investment incentives and regulations across countries (e.g., multilaterally or regionally agreed level or a cap on tax rebates given to foreign investors)?

Not important Somewhat important Important Very important Don't know

Please elaborate:

PART III (optional)

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