

STATUS ,POSSIBILITIES AND CHALLANGES OF FOREIGN DIRECT INVESTMENT IN NEPAL

SUBMITTED BY: VIJESH DANGAL
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Vijesh Dangal

Bodo Graduate School of Business

University of Nordland

Norway

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ABBERIVATIONS:

CEO: CHIEF EXECUTIVE OFFICER

FDI: FOREIGN DIRECT INVESTMENT

GDP: GROSS DOMESTIC PRODUCT

IMF: INTERNATIONAL MONETARY FUND

MNC: MULTINATIONAL CORPORATIONS

NEA: NEPAL ELECTRICITY AUTHORITY

NRS: NEPALESE RUPEES

NTC: NEPAL TELECOMMUNICATION CENTRE

NCELL: NEPAL'S TELESONERA INVESTMENT

OECD: ORGANIZATION FOR ECONOMIC COOPERATION & DEVELOPMENT

SWOT: STRENGTH WEAKNESS OPPORTUNITIES & THREAT

UNCTAD: UNITED NATIONS CONFERENCE ON TRADE & DEVELOPMENT

DOI: DEPARTMENT OF INVESTMENT

SEZ: SPECIAL ECONOMIC ZONE

LDC: LEAST DEVELOPED COUNTRY

UTL: UNITED TELECOM

NRN: NON RESIDENCAL NEPALESE

EPZ: EXPORT PROCESSING ZONE

PPP: PURCHASING POWER PARITY

IFC: INTERNATIONAL FINANCIAL COOPERATION

ADB: ASIAN DEVELOPMENT BANK

GON: GOVERNMENT OF NEPAL

IEE: INITIAL ENVIRONMENT EXEMINATION

EIA: ENVIRONMENTAL IMPACT ASSESSMENT

EDC: ENERGY DEVELOPMENT COUNCIL

FNCCI: FEDERATION OF NEPALESE CHAMBER OF COMMERCE AND INDUSTRY

CNI: CONFEDERATION OF NEPALESE INDUSTRY

BIPPA: BILATERAL INVESTMENT PROTECTAION AND PROMOTION AGREEMENT

DTAA: DOUBLE TAX AVOIDANCE AGREEMENT

NIY: NEPAL INVESTMENT YEAR

WTO: WORLD TRADE OGRANIZATION

SAFTA: SOUTH ASIAN FREE TRADE AREA

BIMSTEC: BAY OF BENGAL INITIATIVES FOR MULTI-SECTORS TECHNICAL AND ECONOMIC COOPERATION

SWATEE: SOUTH ASIA WATCH ON TRADE, ECOMOMICS AND ENVIRONMENT.

1. Background of study

Nepal is the mid-himalayan country in South Asia with border to China in the north and India in south east and west. It's a land lock country located between latitude 26 degree 22 minutes north and 30 degree 27 minutes north and longitude 80 degree 4 minutes east to 88 degree 12 minutes east. Its nearest sea access is about 1500 km from the border. Though Nepal is a small country it has been divided into three region i.e .- The mountains - The hills, and - The terai.

Mountains constitutes 15percent of total land which ranges from an altitude of 4877 meter to 8848 meter above the sea level. Numerous snow capped high mountains including Mt.Everest (Sagarmatha) are located in this region.

The hills lies between the altitude of 610meter to 4877 above the sea level. It occupyes 64 percent of total land which have lots of attractive hills lakes valleys basins etc.

The terai is low flat land of Nepal situated in the southern part of Nepal bordering to India . This occupyes 17percent of the total land . it includes fertile land and dense forest.

Over last few decades poor countries like Nepal have been receiving millions of dollars of fund from various external sources in various forms and modes. Normally it includes foreign grants, foreign loans and foreign direct investment. Least developed country do have the characteristics of low investment and low capital formation due to low saving. Hence FDI has become an essential source of economic growth for many developing countries. It is well known that Asian countries continue to influence global economy but most of south Asian countries including Nepal is lagging behind.

Despite of having huge amount of natural resources it is counted as one of The least developed country in the world. Almost 25 percent of its population live below poverty line. Agriculture is the mainstay of economy. But the traditional ay of agriculture practise have not much to the economy of the country. Though Nepal's FDI policy is considered as the most liberal which was revised in 1992 it is unable to attract FDI.

It was isolated and agrarian society from rest of the world until mid 20th century. Political instability, lack of infrastructure and unfavorable geographical situation made Nepal far from the world. Nepal entered into the modern era in 1951 with the restoration of democracy. Newly formed multi party system tried to make some positive changes in the economy through liberalization. But it didn't last for long. Nepalese moist communist party lunched a violent campaign to replace royal parliamentary system with people socialist republic. Monarchy and centralized government policy was considered for uneven distribution of resources and blockage for smooth development of the country. Ten years of civil war had other social causes also. This resulted in the death of people over 12000 and displaced more than 100000. Economic activities which were taking place in a pace suddenly came into null. Many infrastructure were destroyed. Government had to spend a lot into security purpose. Moreover security concern led to decrease tourist which was key source to foreign exchange. Now the scenario has changed, conflict officially ended in 2006 signing a comprehensive peace process resulting replacement of 1990 constitution of kingdom of Nepal by interim constitution of Nepal 2007. In 2008 constituent assembly (CA) was established which ended 240 years old monarchy. Some positive waves were seen in the economy with the peace process. Unfortunately first CA failed to produce the constitution so still there was political instability and suitable environment for economic development was not made. Second CA was established in 2013, it is believed it will able to give new constitution to Nepal and solve this constitutional vacuum and political unrest.

1.1 The problem statement

Sandwiched between two giants economy of the world India and China, Nepal is potentially attractive location for foreign investors. Moreover Nepali do have free access to Indian market and traffics on imported raw materials and other components are relatively low to Nepali compared to other. Huge natural resources and liberalized FDI policy provides niche opportunity to foreign investors in Nepal which is barely being exploited. Nepal has potential of attracting foreign investors in niche sectors like tourism, hydroelectricity, minerals, light manufacturing etc. Despite of liberalized FDI policy in 1992, Nepal has not able to attract the foreign investors, investors are facing obstacles to reach the Nepali market. It is sad to say that with all these possibilities, status of FDI is declining.

We cannot deny the fact that we have our own weakness that restricts us from getting the FDI. Geographical constraints, weak financial sectors and governance

mandate, unstable political situation, lack of rule of law and governance, insecurity among bureaucrats, unclear government policies, corruption are creating blockage for the smooth flow of FDI in Nepal. Addition to that frequent movements and blackouts of various political parties is a serious threat to bilateral and multilateral development projects.

1.2 Purpose of the study

The main purpose of the study is to analysis the current situation of FDI flow in Nepal and its further possibilities and various challenges in Nepalese context. Specific objectives are highlighted below:

- To explore the current situation and trends of FDI in Nepal.
- To study facilities and effort made by Government of Nepal to attract FDI in Nepal.
- To study root cause of poor FDI in Nepal.
- To study possibilities and possible challenges of FDI in Nepal.

1.3 Importance of study

Nepal relatively the least developed country in South Asia with low domestic saving, lack of capital and where development expenditure in large extend depends on foreign aid and FDI, it is very important to study its status and trends, possibilities and challenges of FDI. FDI helps to maintain stable macroeconomic condition and limited restriction on Foreign exchange and a relatively open economy. Further it helps in income and employment generation, technology transfer and increased foreign exchange. The main advantage is that it helps in overall development of the host country which would be not permitted by domestic saving itself.

Thus, if Nepal has to achieve faster economic growth at present context, it is important to create favorable condition and situation to attract FDI.

1.4 Limitation of study

The study has the following limitations:

- study Due to lack of resources and time bound . secondary data are used for analysis and result interpretation.

- Accuracy of findings depends on the reliability of available information from secondary data.

- Lack of overall knowledge of situation of FDI in Nepal, prior to the study.

2. Literature review

The purpose of this chapter to review the literature available of Foreign Direct investment globally and in Nepal's context. This section focus on general overview of FDI,some definitions, merits and dimerits of FDI, various theories of FDI and FDI in context of Nepal.

2.1 FDI Overview

Foreign Direct Investment (FDI) can be defined as the process of controlling business enterprise in one country by an entity based on other country. It may includes merge and acquisition ,building new facilities , reinvestment of profit earned from overseas operation and intra company loans. FDI helps in free movement of capital ,technology and resources. In simple term, foreign direct investment are those investment made by company or entity based on one country to other foreign country. Such investment are typically differ from indirect investment like portfolio investment , where foreign company investment in equity listed in national stock exchange. But here on direct investment investors do have certain degree of control and influence over the company.

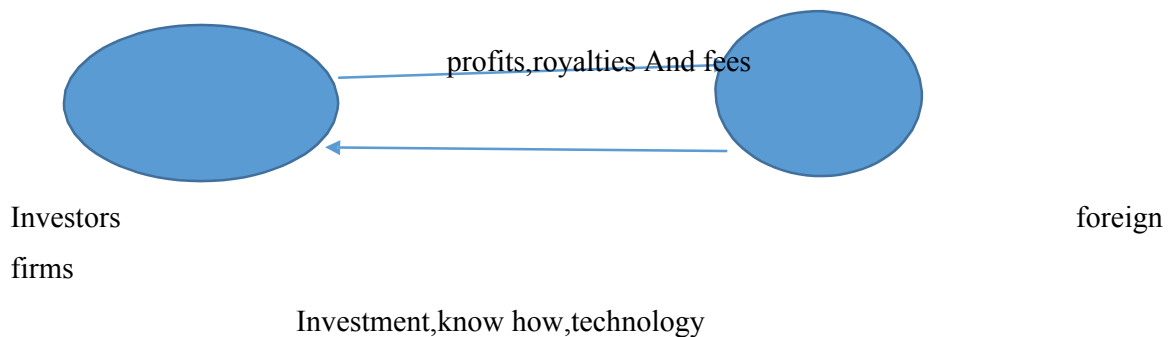


Fig1: illustration of flow in foreign direct investment

General types of FDI are:

1. Horizontal FDI:

This type of FDI occurs where home country Firms duplicates its activity at same value chain with host country.

2. Platform FDI:

When FDI is made by host country to destination country with the propose of exporting to third country.

3. Vertical FDI: Such type of FDI arises when activity between two firms duplicates at different value chain.

Methods of FDI

1. By establishing fully owned subsidiary or company any where.
2. Merge and acquisition
3. Equity joint ventor with another investors or enterprise
4. Reinvesting profit earned from foreign investment.

According to world bank: *“foreign direct investment are the net inflow of investment to acquire a lasting management interest (10percent of voting stock) in an enterprise operating in an economy other than that of investor.”*

It reflects the long term relationship between investors and investing company with the involvement of investors in the management of the company.

According to International monetary fund(IMF):“*an investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, the investor’s purpose being to have an effective voice in the management of the enterprise.*”

FDI here is an important source for developing countries like Nepal where there are plenty of resources but lacks capital, technology and management capabilities.

The united nation world investment report (UNCTAD 1999)defines FDI as“*an investment involving a long term relationship and reflecting a lasting interest and control of a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise, affiliate enterprise or foreign affiliate)*”

Economy watch defines FDI as ” *foreign direct investment is type of investment that involves the injection of foreign funds into an enterprise that operates in different country of origin from the investors. Investors are granted management and voting rights if the level of ownership is greater than or equal to 10 percent of ordinary share. Shares and ownership accounting to less than 10 percent is termed as portfolio investment and is not categorized as FDI.*”

, Foreign investment are categorized into foreign portfolio investment and foreign direct investment .Portfolio investment are equity of investment without control on the management of the entity. Where as FDI are direct investment on the entity with certain degree of control along with the inclusion of technology , skills and other required resources.

FDI is relatively new term for the global economy.It was introduced in early nineteenth century and its growth and development continued over the period since first UN development decade in 1960.Along with its development voice against and for of FDI have been raised. Some argued

that it is totally unhelpful , threat to national sovereignty and culture and most of the time transfer inappropriate technology to the developing country.

Here some merits and demerits of FDI are discussed.

Merits:

- Helps to raise the level of investment. FDI often helps to fulfil the gap of desired investment and locally available saving .Generally in country like Nepal capital for large project cannot be raised locally.
- Technological transfer is an important aspect of foreign direct investment. It helps to upgrade the technological standard in developing countries.

- Helps in the employment generation with the establishment of larger projects.
- Provide benefits to the local customer with new, innovative and quality products
- Helps in the proper utilization of unused resources.
- With the industrial development ,export of the developing countries increases which helps in balance of payment.
- Finally FDI helps to generate revenue to host country government through various taxes.

Demerits:

- Can hamper in the growth and development of local industries.
- Benefits to host country might be very less due to liberal tax policy, investment allowance, tariff protection etc.
- Foreign firm may over exploit the available natural resources.
- Sometimes foreign firm do have negative impact on the socio- cultural aspect of host country.
- With large size and huge capital ,they have bargaining power with the government of host can influence the political decision. Moreover in developing countries they can be close to certain political party to have undue favour. Hence it can be threat to national sovereignty

2.2 Theory of FDI

After the end of second world war , FDI started taking its pace. Various theories were developed during those period explaining trends in FDI, determinants in FDI, merits and demerits on host and parent country, MNCs as FDI and many more. But still there is no single universally applicable and accepted theory.

(Moosa 2002)has explained four categoies pf FDI in brief.

1. Theories assuming perfect market.
2. Theories assuming imperfect market.
3. Other theories
4. Theories based on other variables.

2.2.1 Theories assuming perfect market

According to (Moosa 2002) theories assuming perfect market are sub divided into:

- The differential rate of return
- The diversification hypothesis,and
- Market size hypothesis.

- **The differential rate of return:**

This theory explains that FDI is the result of capital flow from the country with low rate of marginal return to other country where marginal rate of return to marginal cost capital of capital. Here basic assumption is the marginal rate of return and only variable affecting the flow of capital. This theory suggest to invest abroad if the rate of return is high. This theory went as viral in early days but soon it failed to address various issues in FDI.

- The diversification hypothesis:

This theory was developed to address the limitation of previous theory. As return hypothesis failed to address other risk factor associated with the FDI. It tries to explain that while investing analysis of both risk and return are equally important. So any investment should be backed by proper analysis of risk and return .

- market size hypothesis:

This theory explains that FDI is affected by the size and growth of market in the host country. As the market grows ,there will be higher space for FDI.

According to (Moosa 2002) , the volume of FDI in the host country depends on its market.

2.2.2 Theory assuming imperfect market:

This theory was developed to address the limitation of previous theory which lacked the information of market failure. (Hymer 1976)found out that structure and characteristics of the firm are vital in defining FDI.

This theory is sub divided into :

internalization hypothesis

industrial hypothesis

location hypothesis

electic hypothesis and product life cycle hypothesis

- internalization theory:

This theory can be regarded as the general theory of FDI. (Moosa 2002)assumes that when a firm tries to replace market transaction with internal transaction FDI arise . Moreover explanation regarding explanation of import and export of firm in terms of FDI is also done.

- The industrial organization hypothesis:

This theory tries to explain various barriers of the foreign investment like cultural difference, legal and political framework, language, foreign exchange etc in host country plays vital role in determining the flow of FDI.

- location hypothesis:

The limitation of industrial organizational hypothesis to explain the motivation for choosing FDI is fulfilled by location hypothesis. This theory explains various benefits in host country like capital management, technology marketing, bargaining power etc could be the motivating factor for FDI.

- Eclectic hypothesis:

It was developed by (Dunning 1988) Integration of previous theory i.e. industrial organization hypothesis, internalization theory and location hypothesis.

This theory suggest that following three condition should be fulfilled to involve in FDI:

- comparative advantage of selling rather than leasing of other firm.

Advantage of ownership.

- Should be beneficial to use these advantage with atleast some factor imputed located abroad.

- **product life cycle hypothesis:**

This theory was developed by Vernon in 1966 to explain various types of FDI, where he claims that product goes through four stages:

- Innovation
- Growth
- Maturity
- Decline

Mosa (2002) explained that product life cycle hypothesis predicts that innovative products first appear at home country and switch to other country through exporting.

2.2.3 other theories:

- utilization of profit in expanding in same country termed as **Internal financing hypothesis**.
- Assumption that MNC provides diversification opportunities and barriers to capital flow which is the **current area hypothesis and affect of exchange rate**.
- **Kajima hypothesis** is another type of theory which relies in two sections, trade oriented and anti-trade oriented. Here trade oriented establishes improvement and promotes trade whereas the other one has an adverse effect on trade in both countries.

2.2.4 Theories based on other variables:

Political situation of the host country directly affects on the growth and development of FDI in foreign country. Unstable political situation have adverse effect, so political factor is one of the variable for determining the flow of capital as FDI.

- Geographical situation also have impact on FDI, due to unfavourable geographical condition there might be unnecessary transportation cost.
- Tax policy and legal framework of host country are also vital determinants of FDI. Such legal framework either encourage or discourage the flow of FDI.
- Provide benefits to the local customer with new, innovative and quality products.

2.3 FDI in Nepalese context

Till now Nepal had attracted modest FDI in niche sectors such as tourism, herbal products, mineral deposits (lime stone), and light manufacturing apparel; hydro power and that it had positive impacts on exports, particularly garments. Similarly FDI has also facilitated the country to export non-traditional manufactured products such as micro-transformers and personal consumer products (Te Velde and by UNCTAD 2006) Investment is basically concentrated in low-technology and labor-intensive production. The impact of FDI had in job creation is below

moderate. According to the study, the inflow of FDI has been constrained by political instability, geographical structure, rigid labour regulations and poor physical infrastructure. This situation remains current due to political instability and phase of political transition.

Foreign investment in Nepal is regulated, monitored and controlled by Foreign investment and technological transfer and industrial enterprise act. The department of industry (DOI) is responsible to implement and administrate foreign investment and technology transfer act in Nepal. Foreign investment in Nepal can be in various forms as listed below:

1. Equity/ investment in share
2. Reinvestment of earning from dividend
3. Investment in kinds. Eg: equipment and machineries
4. Investment made in forms of loan and loan facility

Any investment below US dollar 50,000 (NRP 50000000) per investors is not approved for investment. By act there are some defined sectors where 100% equity share cannot be obtained by foreign investors. They are:

1. Cottage industry
2. Personal service business
3. Radio active materials
4. Real state.(except construction)
5. Flim
6. Security printing
7. Arms and ammunition
8. Bank notes and coins
9. Retail except international chain retail
10. Tobacco
11. International courier
12. Atomic
13. Poultry
14. Fishery
15. Bee keeping

16. Processing of food grains
17. Consultancy
18. Local catering service
19. Rural tourism

Each investors should go through certain procedure to set up the entity. Brief of procedure are as:

- Need to obtain of Department of industry for foreign Investment.
- Incorporate the company at company register's office.
- Industry register in department of industry.
- Obtain PAN from inland revenue office
- Register trademark, design, patent etc. at DOI.

.ministry of industry, government of Nepal.

<http://www.doind.gov.np/>

3. RESEARCH METHODOLOGY

3.1 Introduction

Given a particular research area has been identified, research problem defined, and review of the related literature in the area; the subsequent step in the direction of the objective is to set research methodology. Research methodology is the way to systematically solve the research problem. It is the process of arriving at the solution of the problem through planned and systematic dealing with the collection, analysis and interpretation of facts and figures.

Research is a systematic and organized effort to investigate a specific problem that needs a solution (Perry 1998) This process of investigation entails a series of carefully planned activities of gathering, recording, analyzing and interpreting the data with the purpose of finding answers to the problem. Thus, research can be viewed as the entire process by which we attempt to solve problems or search the answers to questions.

Research generates new knowledge, which can be used for various purposes. It can be used to build a theory, develop policies, support decision-making and solve problems. Research is undertaken not only to solve a problem existing in the work setting, but also to add or contribute to the general body of knowledge in a particular area of interest to the researcher, research is thus a knowledge building process.

The basic objective of this study “Status, Possibilities and Challenges of Foreign Direct Investment in Nepal” is to identify the existing status of foreign direct investment in Nepal, the challenges faced and its future possibilities and associated future challenges.

3.2 The Research Design

The best research method to use for a study depends on that studies research purposes and the accompanying research question(Yin 1994)The research approach is regularly either quantitative or qualitative. Selectivity and distance to the purpose of research characterize a quantitative approach where as a qualitative approach is characterized by closeness to the object of research. Both approaches have their strength and weaknesses and neither one of the approaches can be held better than other one.

Research design will get detailed information to describe the understanding of the objective of the research, which is based in the problem of the statement of this study above. It will use the frame of reference and will aim to acquire an extensive understanding of this phenomenon as well as analyze the data in the form of numbers statistically.

This research is based on both quantitative and qualitative data. The account of the current status of FDI in Nepal, the historical background of FDI and description of different opinions of experts on challenges and opportunities of FDI are all qualitative information. Whereas, the numerical data of inflows of FDI in Nepal, and the graphical representation of facts and figures are the quantitative information. Hence, disposition towards both qualitative and quantitative will be made.

3.3 Methods of Data Collection

Data collection can be done through various sources. Predominantly interviews, archival records, direct observations, questionnaires, documentation, etc are used as methods of data collection. Author can use email, formal interviews, and other observation as source of data collection, which falls within the scope of research.

3.4 Sources of Data Collection

There are two major sources for data collection.

- Secondary Data
- Primary Data

3.4.1 Source of Secondary Data

The data which have already been collected by someone else and have gone through the statistical process are termed as secondary data. The secondary data are gathered in the form of reports from various national and international organizations, data from Department of Industry, economic reports, various journals, research papers, articles and publication dealing in the subject matter of the study, various websites and online forums etc.

The data which are collected for the first time having its originality is termed primary data. Interviews, questionnaires, observations, etc can be used as tools for the collection of primary data.

But because of various constraints, only secondary data. Analysis and interpretations in this study are solely based on the data acquired through secondary source.

3.5 Data Gathering Procedure

The researcher collected the trends of FDI inflow from Governmental Agencies like Department of Industry, Ministry of Industry and related books and research papers. World Bank websites and reports, Nepal-India Chamber of Commerce and Industry (NICCI) websites and reports, Reports from UNCTAD, and other independent research institutions like South Asia Watch on Trade, Economics and Environment (SAWTEE) have also served as the key sources of crucial data required for the research.

As stated earlier, the researcher was not able to have direct access to primary data because of various constraints like time, finance etc. Gathering of first hand data could have helped to provide more clear insight on the matter.

3.6 Data Analysis

The goal of analyzing the data is to handle the evidence fairly, to produce convincing logical conclusion and to rule out alternative interpretations. Data analysis involves turning a series of recorded observation into descriptive statements (Yin 1994).

Hence, the next step, after the data is collected from different sources, is to process, analyze and interpret them to derive meaningful conclusion. Various relevant data collected from different sources have been compiled, condensed, analyzed and presented in the form of tables and diagrams, graphs and chart with the help of assisting tools like Numbers, Microsoft Excel.

I. Current status

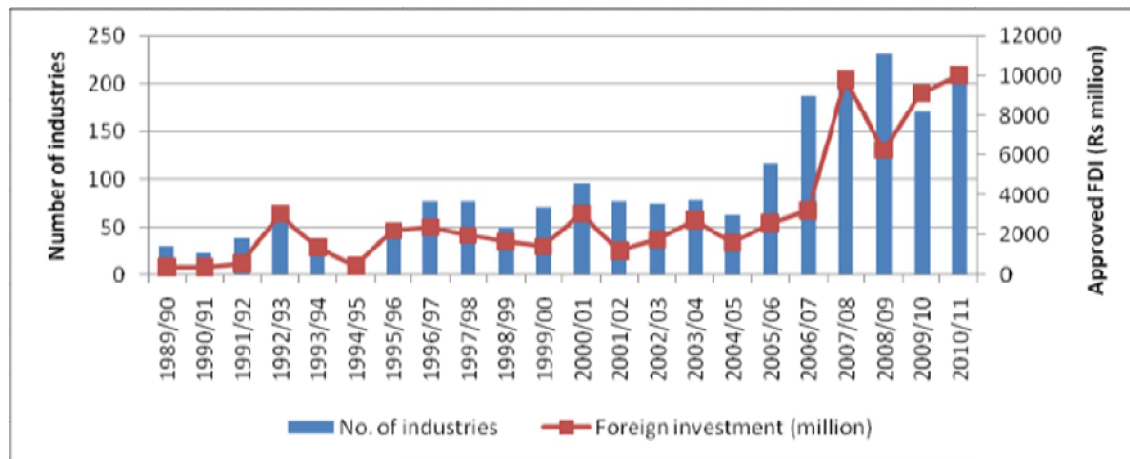
As per World Investment Report 2014 “Cautious optimism returns to global foreign direct investment (FDI). After the 2012 slump, global FDI returned to growth, with inflows rising 9 per cent in 2013, to \$1.45 trillion. UNCTAD projects that FDI flows could rise to \$1.6 trillion in 2014, \$1.7 trillion in 2015 and \$1.8 trillion in 2016, with relatively larger increases in

developed countries.” The report does not provide specific information regarding Nepalese market but it has stated that there is overall decline in FDI in Landlocked developing countries (LLDCs)(UNCTAD 2006). FDI remains an important source of finance there in relation to the size of their economies, and their capital formation.

The data from UNCTAD positions Nepal as one of the worst performers in the region despite sturdy growth of 125 percent attained in 2011. Nepal ranks the lowest in the region, i.e., 175 out of 182 countries ranked globally, in terms of the FDI potential index.

Contradictory to this, if we look at the country-level data for FDI approval as provided in Figure 1, the picture does not look that grim. Particularly from 2006/07 onwards after the end of the armed conflict we can see rise in FDI, though some reduction in approval can be seen in 2008/09. Pace in the approval can be observed in 2009/10, despite the fact that the number of industries registered went down in 2009/10.

Figure 1: FDI in Nepal (No. of industries and approved amount) (1989/90 – 2010/11)



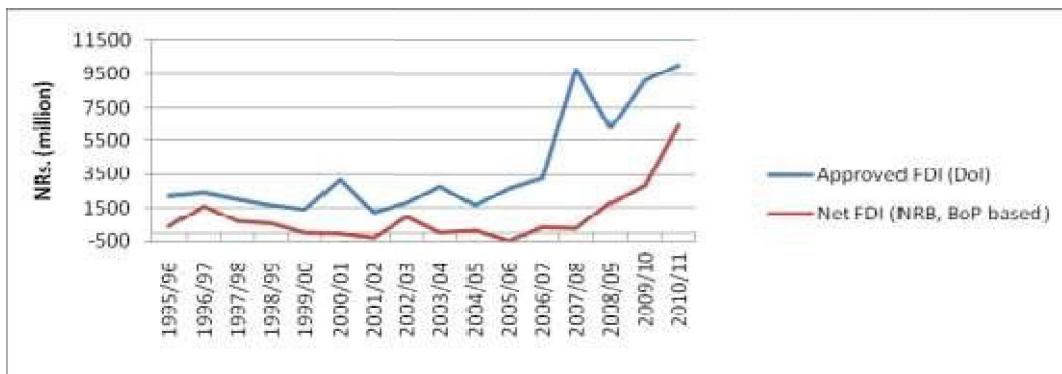
Source: (Adhikari) author calculation based on DOI. 2011. Industrial Statistics: Fiscal Year 2010/11

Nevertheless, it is to be understood that given figure do not provide data for actual receipt of FDI. This is because the Department of Industry (DOI) lacks necessary resources and expertise to follow up with the foreign investors and see whether the committed investment, employment and technology transfer has been realized in reality or not.⁷ Hence, thenet FDI

figures have been extracted from the Balance of Payment (BoP) data prepared by the Nepal Rastra Bank (NRB)—the Central Bank of Nepal.

The figures show that the FDI receipt tends to follow the trend of FDI approval, with a wide variation between the two which can be noticed in Figure 2. These figures seem to be closer to the FDI inflow figures prepared by UNCTAD, which has been presented below in Figure 3.

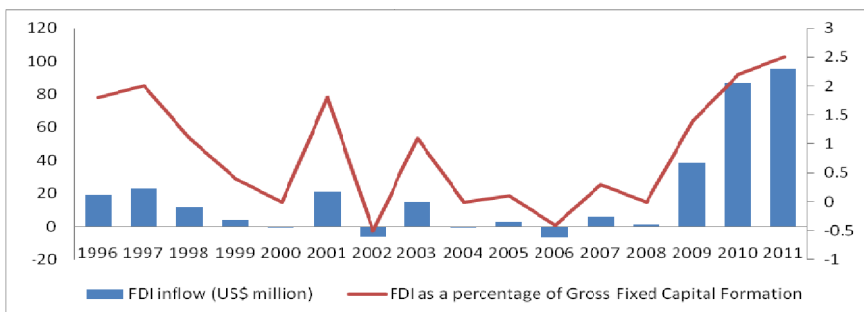
Figure 2: Approved and realized FDI (1995/96 – 2010/11)



Source: Calculations based on SAWTEE, DOI (2011),(Adhikari)

For a country like Nepal with a low capital base, the contribution of FDI in terms of gross fixed capital formation (GFCF) is seen as an indicator to judge the development implication of FDI. Reference has been taken from the figures compiled by UNCTAD; the only reliable source for such data. 1996 has been as the cut-off point though the compilation began from 1990 because of several missing figures between 1990 and 1996.

Figure 3: FDI inflow and FDI as percentage of gross fixed capital formation, 1996-2011



Source: Calculated from (UNCTAD 2006)

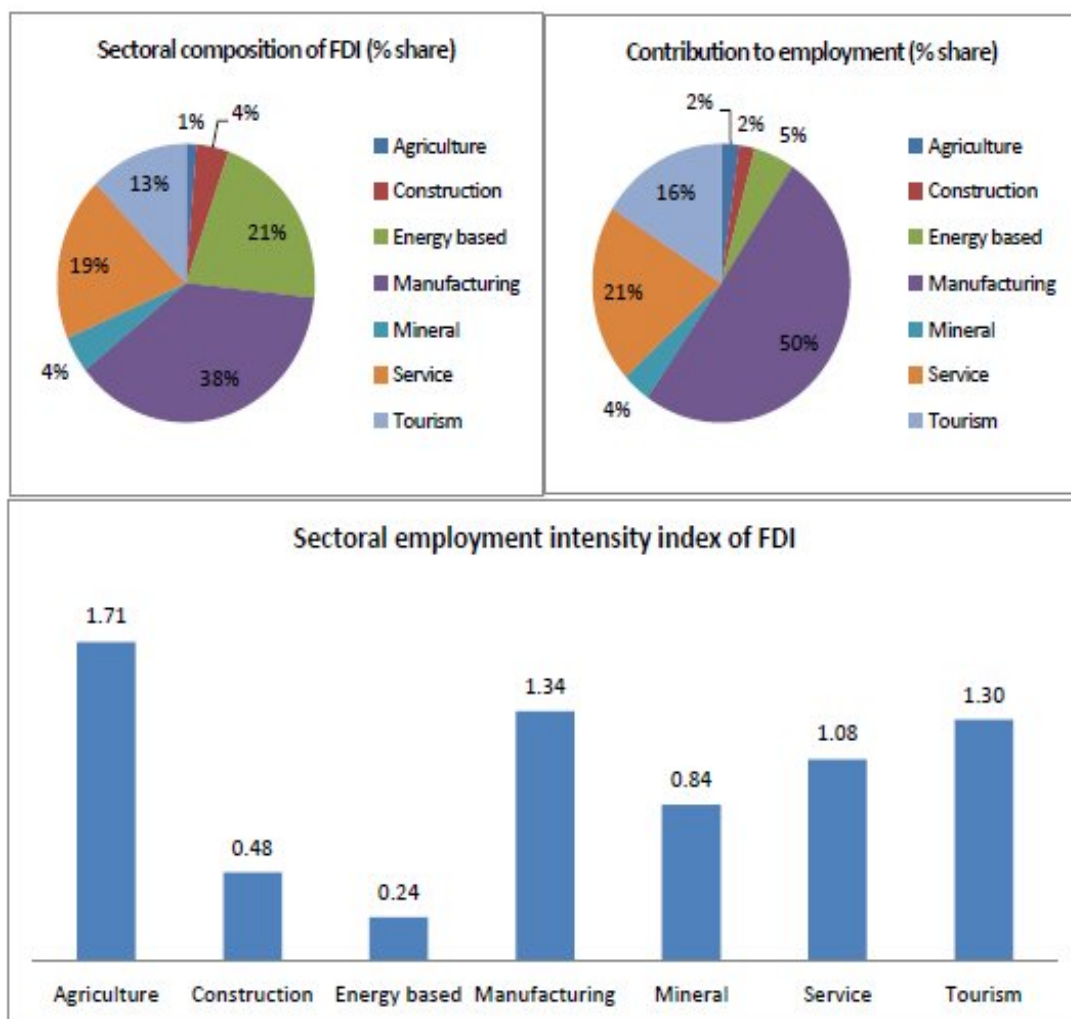
Figure 3 shows the FDI (actual) inflow into Nepal on the left hand vertical axis and FDI as a percentage of GFCF in the right hand vertical axis. As per the figure, GFCF follows the similar pattern as FDI inflow with the recent surge in FDI pushing the GFCF to 2.5 percent, which is the highest ever recorded, despite the fact that this figure is much lower than other neighboring countries in South Asia. In 2011, while Maldives received FDI equivalent to 72.4 percent of its GFCF, other neighbors, like India (6.4 percent), Pakistan (5.3 percent) and Bangladesh (4 percent) turned out much better compared to Nepal. Only three countries in the region, viz. Sri Lanka (2.1 percent), Bhutan (2.1 percent) and Afghanistan (2 percent) had their FDI as percentage of GFCF lower than that of Nepal.

As per the report prepared by SAWTEE(Adhikari), a leading economic Think-tank, suspicion regarding the anomaly of data has been stated. Some of the major investments have gone unreported not only in the DOI data but also in the NRB data. If that is true, this is an anomaly that needs to be addressed. For example, during the discussion with SAWTEE officials, Program Coordinator of the Embassy of Finland in Kathmandu mentioned that TeliaSonera—a Finnish-Swedish public sector joint venture—invested between US\$200 million and US\$300 million in the past couple of years for the acquisition of 51 percent stake in erstwhile Spice Nepal which now known as Ncell.

This investment does not match with the data of DOI because the approved investment in transport and communication sectors up-to 2010/11 was NRs. 187 million (approximately US\$ 2.7 million at the then prevailing exchange rate) and the combined investment of Finland and Sweden was a meager NRs. 39 million (approximately US\$558,000).

Figure 4 shows the Sector-wise FDI approval data, which indicates that manufacturing sector has highest investment (38 percent), followed by energy-based (21 percent), services (19 percent) and tourism (13 percent) sectors, while for the agriculture sector it is the lowest (1 percent). But, the contribution of FDI (approved) to employment in these sectors varies considerably. As shown in figure below, employment is the highest in the manufacturing sector (50 percent) followed by services (21 percent) and tourism (14 percent), while the contribution of agriculture and construction sectors are the lowest (2 percent each).

Figure 4: Sectorial composition of FDI, employment share and employment intensity index based on cumulative FDI data up to 2010/11



Source: Author's calculation based on DOI (2011),(Adhikari)

The next step involves calculation of employment intensity index of FDI which is derived by simply dividing percentage of employment (proposed to be) generated by FDI by the total

amount of (approved) FDI. It turns out that, FDI in the agriculture sector tends to have the highest employment intensity (1.71), followed by manufacturing (1.34) and services (1.3), whereas energy-based and construction sectors with indices of 0.24 and 0.48 have the lowest and the second-lowest employment intensity respectively.

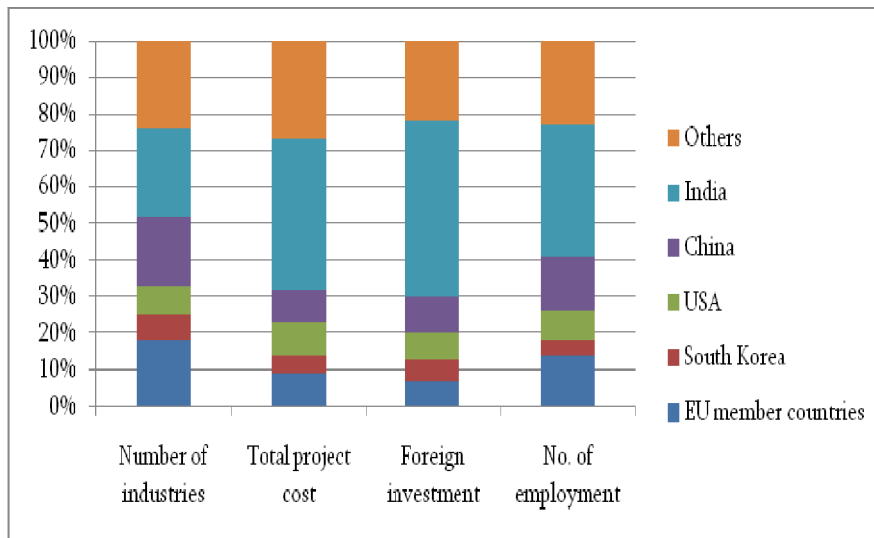
Per dollar of FDI in agriculture can be seen to be worth more than per dollar FDI in any other

sector in terms of potential employment opportunity, which has a major policy implication for development policy discourse. However, the above conclusion should be considered as tentative at best because the figures included in the analysis are of approved FDI and prospective investment and employment.

Regarding the origin of FDI; Nepal received a magnitude of its FDI from its southern neighbour, India. India accounts for 48 percent of all FDI in Nepal. This can be attributed to various factors, some being; Nepal has a bilateral trade agreement with India, which is effective since the 1950s in various forms, and there are several Indian companies that have established their commercial presence in Nepal to exploit the investment-trade connections. Second, Nepal and India share historical and cultural ties, which make the flow of foreign investment more obliging. Third, Nepal shares an open border with India.

The other major FDI source countries for Nepal are China, the EU member countries, the United States (US) and South Korea. These top five investors account for 78 percent of approved FDI and 77 percent of employment potentials.

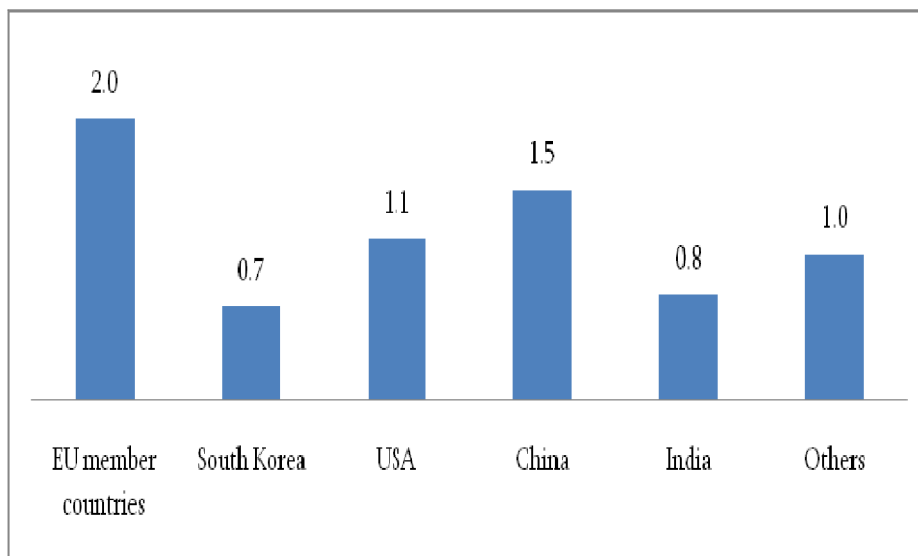
Figure 5: FDI-related indicators for the top five foreign investors in Nepal (based on cumulative figure, in percentage, up-to 2010/11)



Source: Author's calculations based on DOI (2011), (Adhikari).

EU member countries have the highest employment intensity (2), though they are only the third largest in terms of approved FDI figures, amongst all the foreign investors, compared to China (1.5) and India (0.8). In-fact, they surpass South Korea, the fifth largest foreign investor in Nepal almost by a factor of three (Figure 6)

Figure 6: Employment intensity index of the top five foreign investors in Nepal (based on cumulative figure up-to 2010/11)



Source: Author's calculations based on DOI (2011), (Adhikari)

It has been a point from EU delegations, that it would be in the interest of Nepal to attract investment from the small and medium enterprises from Europe rather than focusing on giant multinationals, which would find it more profitable to establish their presence in neighboring countries such as China and India (based on R. Adhikari's Interview with Dr. Giap Dang, European Delegation to Nepal on 29, June 2012, Kathmandu) (Adhikari) Nepal is not regarded as the best place to do business and that the political environment has had a dampening effect on the investment climate. For instance, at least one project aimed at promoting investment in Nepal through the development of business incubation on information technology was dropped because of this.

DFID-Nepal Office suggested that the UK government normally does not mix development assistance with commercial considerations, it sees more and more aid being tied to commercial transactions in the future taking a cue from the strategy adopted by the Chinese government.(Adhikari 2011) Nonetheless, it can be thought of less likely as it means returning back to the era where aid used to be principally commercially driven. Besides, following the Paris Declaration, Accra Agenda of Action and Busan Partnership for Effective Development Cooperation, it has become extremely difficult to follow this path. Only the Chinese government, which is not bound by these international commitments as a donor, can and may continue to do so.

A senior official from the Danish Embassy in Kathmandu in conversation with SAWTEE (Adhikari 2011) considered it as an old-fashioned way of handling development cooperation. Describing the success of the Danish Business Partnership (DBP) programme, which supports commercial ideas and projects originating from Nepalese and Danish enterprises, exhibited the importance of fostering collaboration between the private sectors of the two countries as a viable mode of promoting investment as well as facilitating technology transfer. Matchmaking, transfer of know-how, capacity building and export promotion are the components of programme, seven such partnerships has been developed so far and the Embassy is willing to expand it to between 20 and 30 in the coming years (Adhikari 2011).

Partnership of such kind could be a useful modality for other development partners to pursue, provided development assistance is leveraged to promote investment - both domestic and foreign.(Adhikari 2011) Particular importance of this can be in the context of the fact that domestic investment can assemble foreign investment, as an investment expert mentioned:— Attracting domestic investment is a must for attracting Indians, the largest group of investors

in Nepal;and Indian investment is a must for other investors, in particular from Western countries, to invest in Nepal.(based on R. Adhikari Interview with Mr. Keshab Acharya, Former Advisor, Ministry of Finance, and an investment expert)(Adhikari 2011)

II. Opportunities and Challenges

The idea that the recent surge in FDI has brightened the prospects for attracting more FDI has been a subject of discussion amongst multilateral institutions, bureaucrats and researchers alike(Ghimire and Poudel 2012) Various experts and stakeholders, have a view that the investment prospects is not likely to improve in the short to medium term due to the prevailing political situation and policy fluidity(Adhikari)This observation may have been stronger by the failure of the government to draft the constitution. Enlisted below are the opportunities and challenges, faced by investment climate in general and Nepal government in pursuit of attracting FDI.

Opportunities for expanding investment

Comprehensive opportunities can be differentiated into three clusters, viz. : comparative advantage, market size and policy initiatives.

Comparative advantage

Comparative advantage has an important role to play in predicting the flow of FDI; and resource endowment of any country molds the comparative advantage, In the context of international trade(Qiu 2003) we surmise that it should apply to FDI predominantly targeting domestic market. Despite the fact that there are different views regarding comparative advantage of Nepal, we rely on published studies and reports(Adhikari) to determine the major sectors where Nepal has notable comparative advantage and/or where investment potentials are huge. Simple methodology to arrive at the final list can be seen in the table below.

Table 1: Sectors/sub-sectors with comparative advantage and investment potential

Sector/sub-sector	Included in the studies/reports/publications					Suggested by experts	Score	Categorization of potential sector/sub-
	SAWTEE/AAN (2007)	ITC (2007)	MoCS (2009)	MoCS (2010)	Mol/MoCS (2009)			
Hydro-electricity							3	II
Tourism							5	I
Health							4	I
Education							3	II
ICT (including BPO)							5	I
Carpets and woolen products							3	II
Readymade garments							2	II
Pashmina and silk products							2	II
Handicrafts							3	II
Tea							4	I
Large cardamom							4	I
Ginger							3	II
Pulses (incl. lentil)							3	II
Vegetable (incl. seeds)							2	II
Herbs and essential oils							5	I
Leather (raw and finished)							4	I
Handmade paper/							3	II
Mining/mine-based							2	II

Source: SAWTEE and ActionAid Nepal (2007), Note 23; ITC (2007), Note 24; MOCS (2009), Note 25;

Mol, MoCS and ENTREC (2009), Note 26; MOCS (2010), Note 27.

First, list the major sectors (and sub-sectors) identified by various studies/reports that have identified products in which Nepal has comparative advantage and/or are identified as sectors/sub-sector having investment prospects in columns 2 to 6 of Table 1. These studies/reports are: a study on export diversification prepared by SAWTEE and Action Aid

Nepal(Adhikari and Dahal 2007); a study on assessment of export potential conducted by the International Trade Center(Adhikari 2011); Trade Policy of the Government of Nepal(Athukorala and Sharma 2006); a report on foreign investment opportunity prepared by the Government of Nepal(Adhikari); and Nepal Trade Integration Strategy(MoCS 2010). In order to reduce the length of the list, only those sectors/sub- sectors have been included that have been identified at least by two studies/reports as having export potential. Second, the list is then matched with the list we prepared based on our interviews with experts in column 7 of the table. Third, by counting each of them scores are provided in column 8 of the table. Equal weight is provided to all the studies as well as to experts' opinions, which is less controversial. At last, list is prepared by organizing them into category I (with scores of 4 and 5); and category II (with scores of 2 and 3).

Table 1: Sectors/sub-sectors with comparative advantage and investment potential

Sector/sub-sector	Included in the studies/reports/publications					Suggested by experts	Score	Categorization of potential sector/sub-sector
	SAWTEE/AAN (2007)	ITC (2007)	MoCS (2009)	MoCS (2010)	MoI/MoCS (2009)			
Hydro-electricity				√	√	√	3	II
Tourism	√		√	√	√	√	5	I
Health			√	√	√	√	4	I
Education			√	√		√	3	II
ICT (including BPO)	√		√			√	5	I
Carpets and woolen products			√	√	√		3	II
Readymade garments			√				2	II
Pashmina and silk products		√	√		√		2	II
Handicrafts		√	√	√			3	II
Tea	√		√	√				I
Large cardamom		√	√	√		√	4	I

Ginger		√	√	√			3	II
Pulses (incl. lentil)		√	√				3	II
Vegetable (incl. seeds)			√		√		2	II
Herbs and essential oils	√	√	√			√	5	I
Leather (raw and finished)	√	√	√		√		4	I
Handmade paper/products thereof		√	√	√			3	II
Mining/mine-based						√	2	II

Source:(MoCS 2010) (;MOCS 2009), ; (Adhikari)

The concluding list produced shows that out of the 18 sectors/sub-sectors included in the table, seven sectors/sub-sectors fall under category I, and 11sectors/sub-sectors fall into category II. One of the major drawback of the above exercise is that the ITC (2007) study does not include services sector at all. Certain services such as hydro-electricity and education sectors which can be seen as having very high prospects could have made it to a higher order in the list if service was included.

Size of Market

Nepalese market is considered relatively small when we compare it to populous neighbors such as India, China, Bangladesh and Pakistan. But it is still a market of nearly 28 million people

with a growing middle class. As per the study conducted by the Asian Development Bank(CHAPTER 2010), based on a 2004 survey, Nepal had a middle and higher class population of 23.36 percent with a combined annual expenditure of US\$10.72 billion in purchasing power parity (PPP) terms. Though, due to lack of data, it is not possible to calculate recent expenditure figure, the income figure has markedly increased in the recent period not least because 55.8 percent of the total households receive remittances from abroad, according to the latest Nepal Living Standard Survey(Vibh ga 2011).As per the data from Central Bureau of Statistics (CBS), annual income of the richest 20 percent of the population has increased from NRs. 40,486 in 2004 to NRs. 94,149 in 2011, showing a growth of 133 percent.(Vibh ga 2011)Based on these figures, calculation shows that the richest 20 percent population in the country had a combined income of US\$7.26 billion in 2011. Converted in PPP terms, as done by the ADB study discussed above, this would translate into a combined annual income of US\$ 14.68 billion.(Group 2012) Though this is not the disposable income, it shows that as a country, Nepal has a huge purchasing power.

Furthermore, due to the various trade integration arrangements Nepal has entered into, the market size of Nepal is not restricted to its geographical boundary. Nepal being a member of the World Trade Organization (WTO), Agreement on South Asian Free Trade Area (SAFTA) and Bay of Bengal Initiative for Multi-sectoral Technical and Economic Cooperation (BIMSTEC) means that goods or services of Nepal have a very wide market access.(Adhikari and Kharel 2011),...

Nepal has also the advantage of being a least developed country (LDC) on duty free quota free market access in most countries belonging to Organization for Economic Cooperation and Development(OECD). Undoubtedly due to these favorable and wide

market access arrangements, the Global Enabling Trade Report (Schwab) considered Nepal as the third best indicator in destination markets' among 132 countries based on margin of preference. Nepal's score was 67.9 out of 100 against the country with the highest score Malawi (93.8 out of 100) and the second highest score of Mauritius (72.4 out of 100), respectively. This score shows that Nepal offers remarkable prospects for using trade investment relationship by playing the role of transit country. Two factors explaining the interest of Indian investors to establish their companies in Nepal are the signing of a relatively more favorable Indo-Nepal Trade Treaty in 1996, and the economic liberalization reforms in Nepal. The target was indeed to hit the vast Indian market. Given the fact that the speedily growing neighboring countries—India and China, and bordering Indian states in particular, are power hungry, there is a strong likelihood of FDI coming from these two countries as well as from Indian states like Bihar. Entries of Chinese company viz. China Three Gorges Corporation along with Indian companies viz. GMR (a private sector venture) and Satluj Jal Vidyut Nigam (a public sector undertaking) in Nepal are considered as precursors to the trend that is likely to set in. (Adhikari 2011)

Policy initiatives

Reforms have paid off despite the fact that the pace of reform has been slow because of the nagging post-conflict transitional phase. For instance, paying taxes and obtaining business permits in Nepal are becoming less complex (Afram and Del Pero 2012). Furthermore, three notable developments in the policy scene are likely to provide the much needed exposure for attracting investment—both local and foreign—specially in the hydroelectricity sector.

First, the GoN has announced 2012/2013 as Nepal Investment Year (NIY), with a target of attracting US\$1 billion worth of FDI in a year (Dikshit 2013). The figure definitely seems quite ambitious; even going by the approved investment data, Nepal will have to attract seven times more FDI than it did in 2010/11. Still, this has sent a strong signal to the market that the government is serious about promoting FDI in the country.

Second, the government has established the Investment Board, chaired by the Prime Minister in order to provide fast-track approval for mega projects—both local and foreign—and

facilitate their thrust into the Nepalese business scene. The Board plans to offer one-window solution to investors by getting all issues, such as registration, licensing, immigration issues and bill clearance to even acquiring a mobile sim card, resolved from the same place (see www.whynepal.com/entrepreneurship/what-is-investment-board-nepal-ceo-radhesh-pant-answers/). Third, the GoN established the Hydropower Investment and Development Company in 2011, in order to provide financing to medium to bigger size hydroelectricity projects (in excess of 25 MW) and construction of transmission and distribution lines, with participation of the Central Bank and other public sectors institutions. Although the company has started its operation with effect from 30 July 2012, in the initial stage, it is planning to lend to hydropower projects as a part of consortium financing together with other banks and financial institutions in the country.

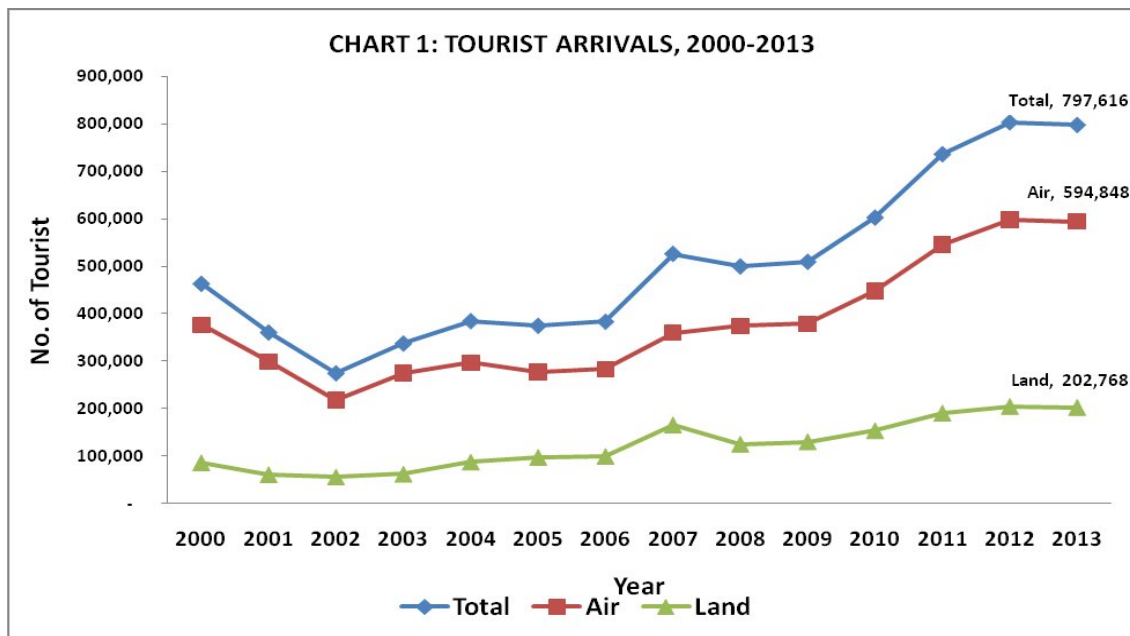
Besides these initiatives taken at the national level, the GoN also recently signed the Bilateral Investment Protection and Promotion Agreement (BIPPA) and Double Tax Avoidance Agreement (DTAA) with India, the country having largest stake in Nepal in terms of FDI. While these agreements alone may not help in attracting FDI and they are no substitute for better investment climate, they are still important in the sense that they do send some positive message to the business community outside Nepal that GoN is committed to protect their investment. In addition to this Nepal is also actively engaged in the negotiations of the investment protection and promotion agreement within SAFTA. Success in making agreement can help Nepal send positive signal to investors from other countries in the region, beyond India.

Tourism

Tourism sector is the Nepal's most important sector with a natural comparative advantage. Tourism has already contributed a lot to the economic development of Nepal. Tourism sector remains one of the country's most budding sectors for attracting FDI because of its various tourist attractions, unparalleled natural assets, scenic beauty, and religious sites. Nepal being home to 12 world heritage sites and eight out of the ten highest peaks in the world,

offers diverse tourist attractions to its visitors. The government realizes the fact that tourism can make numerous contributions in national economic development. Tourism from neighboring countries such as India and China is the most in terms of volume, followed by Sri Lanka, the United States, and the United Kingdom.

Figure 7: Tourist Arrival in Nepal



source: Nepal Tourism Board 2013

The touristic appeal of Nepal is not only because of natural beauty but also the various activities offered such as mountaineering, trekking, mountain biking, mountain marathon, rock climbing, rafting, kayaking, fishing, paragliding, and skydiving. This sector holds tremendous opportunity and has the potential to attract huge amount on FDI, the only prerequisite being stable political situation and end to civil unrest.

Hydro-power

Water resource has been one of the most important natural resources for the Nepal's economic development. Hydropower is a sector full of huge possibilities to attract FDI. The

estimated volume of generation production is 83,000 megawatts, more than half of which has been identified are economically feasible to develop. Nevertheless, Nepal has been successful to generate only about 652 MW(Surendra, Khanal et al. 2011). The demand for electricity continues to increase faster than country's generating capacity. The Nepalese government opened the hydropower generation sector to private development and allowed foreign ownership. In August 2011, the Ministry of Energy declared the new Hydropower License Management Procedure. (Adhikari 2012)

As per new investor friendly Electricity Act, all hydropower projects are allowed to have an income tax holiday for the first ten years. The value added tax regime is also aiming towards the "zero" goal line rapidly. Corporate tax rate is only around 20 % and only 1% customs duty is levied on the import of any hydropower equipment into the country. Government has even allowed 100% repatriation on foreign investments on hydropower projects and also signed the agreement of double taxation treaties with several countries. Environmental Impact Assessments on projects 50 megawatt and below has been completely waived. Hydropower projects with capacity to generate more than 10 MW through competitive process are assured to obtain award licenses by the government. (Adhikari 2012)

To facilitate foreign investors to make large scale investments safely into the country, New board of Investment has been formed under the chairmanship of Prime Minister. Hydropower sector has been declared as top-most priority sector of the nation by all political parties and intellectual community such as an autonomous body of the Confederation of Nepalese Industries (CNI), Federation of Nepalese Chamber of Commerce and Industries (FNCCI), and The Energy Development Council (EDC) (Hasan and Kim 2014).

Challenges to leverage investment for development

Nepal faces most of common challenges as each post conflict least developed countries face in terms of attracting and holding investment. Besides, significant factors such as changes in investment regime, global economic downturn and financial instability are always affecting inflow of investment in Nepal. There is no doubt that conflict and turmoil political situation have been the crucial cause that sliding down its once rising FDI. This situation seems to prove that FDI in the country is extremely challenged by war and political instability. Nepal faces certain constraints that are neither common nor explained by any theory. Given the fact that there is need to utilize FDI to achieve the development objectives such as poverty

alleviation and inclusive economic growth pursued by the Government, these challenges become even starker. For our purpose, these challenges can be broadly divided into four categories: i) political and governance- related; ii) legal, institutional and policy-related; iii) infrastructure-related; and iv) resource-related.

Political and governance-related

Government policies can be the most crucial in motivating FDI location by altering the relative attractiveness of the host country to foreign investors .Regulatory and legal frameworks, poor accounting practicesand strategic policies, and political uncertainty to a large extent has hindered foreign investments in Nepal.

The World Investment Prospects Survey reports 2007-2012, bespeaks “war and political instability□ as most highlighted factor posing most adverse threat to investors in Nepal. Prolongation of the political transition has dissuaded Nepalese as well as foreign investors from making investments in Nepal due to the uncertainty. This feeling has become widespread, particularly after the failure of the government to write a new constitution, which was expected to chart out a new political course for the country to move towards a credible development course.

A constant deterioration in the quality of governance indicators creates uncertainty as well as impacts on the competitiveness of enterprises,and perpetuates the culture of impunity(Ghimire and Poudel 2012). This latter tendency can be exemplified in the state seizure by interest groups, which can go to any extent to declare strikes (bandhs) and resort toviolence with extremism, to make their demand met. The organizers of these strikesare either unaware of the costs of their actions to the economy in general, and production loss as well as the message they send to investors in particular, or they are encouraged by the impunity surrounding political order.What is surprising is that these kinds of activities are considered perfectly legitimate not only by strike enforcers, but also by public at large.

As if this was not enough, donation and extortion rises with the formation of each new political party, with the private sector getting jittery each time a party splits.With the judiciary, considered a sacred institution in the past, too having come under the shadow of

suspicion, there is a limited possibility for the governance situation to get any better any time soon.(Adhikari)

According to International Finance Corporation (IFC) “Doing Business” report 2013 executed by World Bank(Enterprises 2013) said that Nepal seems to have a sort of heightened political instability and political corruption is common. In fact, unexpected political transition discouraged both domestic and foreign investors from making investment decisions in Nepal. Given this political situation, foreign investors are less likely to increase their investment (Ghimire and Poudel, 2012).

Legal, institutional and policy-related

Degradation in the quality of investment climate in Nepal can be collectively attributed to overlapping and often contradictory laws and institutional arrangements, differing priorities of various departments of the government, paired with serious gaps between policies and their actual implementation on the ground. These are not pointed out directly as the obstacles by the IFC enterprise survey, but, they are discussed in other literature and are confirmed as serious problems by experts and stakeholders. For instance, an Implementation Evaluation of Foreign Direct Investment Policy in Nepal, assigned by the Economic Policy Network—a joint initiative of the Ministry of Finance and the ADB—reveals that the fiscal incentives, including income tax relief provided by the Foreign Investment and Technology Transfer Act, 1992 and Industrial Enterprises Act, 1992, are nullified by the provisions of the amended Revenue Act and the New Income Tax Act (see Rana, Madhukar SJB and Stalin Man Pradhan. 2005. Implementation Evaluation of Foreign Direct Investment Policy in Nepal). Correspondingly, even if concerned foreign investors fulfill all the requirements and the DOI recommends for the provision of visa for those investors and their dependent family members, provision of visas in prompt manner is not made by the Department of Immigration under the Ministry of Home.

The main reason for these situations are the differing priorities of the different government agencies. A feeling that it is the sole responsibility of the Ministry of Industry or the DOI to attract and retain foreign investors exists. Example of Ministry of Finance can be taken here, which is singularly concerned about revenue generation with its Department of Customs and Department of Internal Revenue both of which remain recalcitrant while providing fiscal incentives to foreign investors.(Adhikari 2013)

As far as institutional arrangement is concerned one window policy has been around for more than a decade, and the DOI was responsible to provide one stop facility to all the foreign investors but this has never been the practice, because making recommendations is all that DOI can do. Foreign investors have to visit the Department of Immigration for the purpose of visa, the Department of Revenue/Customs for obtaining fiscal incentives/exemptions promised by various legislation and the Ministry of Environment for conducting Environmental Impact Assessment (EIA) or Initial Environmental Examination (IEE). With the establishment of the Investment Board, there have been discussions going on as to whether it offers one window facility to foreign investors. (Adhikari 2013)

Policy side problems can be viewed as being two-fold. Firstly, the absence of policy stability in the country, which can be partly accredited to prolonged political conflict. Secondly, though policies are formulated, they are hardly implemented (Ghimire and Poudel 2012). This predicament is aptly captured by Rana and Pradhan (2005) in the following words: —Government listens but no actions are taken. The gap between policy and implementation is due to a combination of factors as highlighted in a study focusing on South Asian LDCs, including Nepal. First, policy itself could be faulty, if the implementation is found lacking even after repeated attempts. Second, public officials choose not to implement some policies, either because the policies are top-down or externally driven and the public officials do not own them or because they do not have the capacity to implement the policies. (Adhikari 2011)

Infrastructure-related

A host country's infrastructure represents the investment environment of a country by the means of transportation system, port facilities, utilities, energy. Adequate infrastructure facilities influence the investors while making investment decisions (Othman 2003). Studies have found that electricity and transportation as the major constraints for investment creation. Both the factors dampen investors' confidence and deter them from making or retaining, let alone increasing, investment in Nepal because they severely erode the competitiveness of enterprises due to the higher transaction costs they inflict.

As the problem of electricity shortage seems to be a long term problem and can't be resolved soon, investment in captive generators is the available alternative, but these are very expensive to run due to rocketing fuel prices. In addition to this problem, Nepal Oil

Table 2: Availability and quality of transport infrastructure in South Asia

Country/Indicators (N = 132)	Bangladesh		India		Nepal		Pakistan		Sri Lanka	
		S	R	S	R	S	R	S	R	S
Transport infrastructure (overall)	126	2.7	76	4.0	96	3.5	75	4.1	58	4.4
Airport density, number per million population	132	0.0	128	0.1	42	0.9	116	0.2	131	0.0

Corporation, the public sector monopoly has remained incapable of supplying diesel in a timely manner due to the loss it has been incurring in the supply of fuels. Industry can't operate anymore when there is a shortage of fuel. But in the case for some industries involved in manufacturing vaccine and medicine, iron and steel, utensils, plastic, where power interruption cannot be tolerated even for a short period of time, there is no option but acquire fuels from black market. (Adhikari)

Regarding the transport infrastructure, the underdeveloped nature of Nepal's transport sector, coupled with the shabby nature of its road infrastructure, has been emphasized by a number of global reports, including the Global Competitiveness Report (Schwab and Sala-i-Martin 2011), Global Enabling Trade Report and Global Logistics Performance Index. For instance, as per

Global Enabling Trade Report 2012, though Nepal's overall ranking seems reasonably good (preferable than Bangladesh), it has to work a lot on two indicators. First, airport density is

bound to be higher in a country with mountainous topography like Nepal, where road network is rudimentary and not yet fully connected to all the district headquarters.

Note: R = Ranking; S = Score

Source: SAWTEE's compilation based on World Economic Forum (2012a).

Second, while the percentage of paved road in Nepal is stated to be 55.5 percent, it is because of the fact that the total road length itself is limited in the case of Nepal. Furthermore, the stated figure ignores the condition of the road, which means even shabby roads are categorized as paved road, irrespective of their condition.

As most of Nepal's trade is carried out via roads, the most crucial index for us is the quality of roads, in which Nepal is at the bottom of the list with a score of 2.5 out of 7, and ranking of 119 out of 132 countries included in the report. This is cleared by a study which asserts that most of the road traffic from Kathmandu (the capital city) and major business centers to all major border points to India has to travel through 36 km Mungling- Narayanghat road, which is the major bottleneck due to poor road conditions and frequent landslides during rainy seasons (Rajkarnikar 2010). Moreover, a number of bridges along the Hetauda to Pathalैया sector, used by east-bound cargos, could become a major constraint as traffic increases because of single lane (Rajkarnikar 2010)

According to the field survey conducted by SAWTEE in January 2012 (Adhikari) to assess trade-related constraints faced by Nepal, most of the respondents, including customs officials, customs agents, freight forwarders and traders complained of the narrowness as well as poor quality of road. Chief of Birgunj Customs Office, during the same survey informed that the GoN has set aside a budget of NRs. 900 million for the widening and repair of road, but the Department of Road, which is responsible for these tasks, has been moving at a snail's pace, thereby leading to further deterioration in the quality of road.

First-hand inspection of the road condition was also carried out during the survey, which helped further verify that the condition of road is not only poor, but also deteriorating which can be attributed to heavy traffic load on the one hand and a lack of proper maintenance on the other. Condition of road at the other side of the border was found to be worse than what exists on the Birgunj side. Kakarvitta-Panitanki and Biratnagar-Jogbani border points are evidential to know that roads are too narrow on the Indian side and there are no truck yards.

Existence of cartel among truck operators, is another undeniable factor that affects transportation costs in Nepal, who have formed a syndicate and rotation system for the operation of trucks. As these syndicates possess market power to a greater extent, they are able to charge near-monopoly fares for the transportation service provided. GoN has failed to put these syndicates behind the bar of justice despite their actions being illegal as per the

provisions of the two Acts (Consumer Protection Act and Competition Promotion and Market Protection Act) as well as denounced by the Supreme Court. The whole mess is generated not only because of weak government lacking will, but also because of the physical threat exerted by transport entrepreneurs and violence they resort to.

Resource-related

Even though there are various problems under this category that investors face. However we focus on three key resources viz. financial resources, human resources and technological resources.

Financial resources

As far as the financial resources are concerned, IFC (2009) finds that only 74 percent of the firms have a bank account and 39 percent have a line of credit or a loan from a financial institution. It also states that most firms rely on internal funds to finance the bulk of their investments and their working capital needs. Three years on, some improvement in the situation is shown by the Doing Business Report. However, it is still a bit nuanced and has to be understood differently depending on the size and origin of the company. While there is little problem in terms of access to finance (in particular obtaining credit from banks) for relatively large companies and companies of foreign origin, according to a survey of small and medium enterprises conducted in 2011, it is highly restricted in the case of micro, small and medium enterprises. According to the survey, the major reasons for the reluctance of these enterprises to obtain loan from banks are in the following order: high interest rate; collateral-related problems; and lengthy and burdensome process.

Access to finance should still be considered a minor hindrance for foreign investors in establishing their presence in Nepal due to two major reasons. First, foreign investors—particularly multinational corporations—are generally considered cash rich and having deep pockets. The whole idea of investing in another country is to utilize the excess funds they have to access foreign markets or exploit other comparative advantages of the host country.

Second, as noted above, banks and financial institutions in Nepal are generally more inclined to offer loans to foreign investors at cheaper rates as compared to local entrepreneurs. This is admittedly due to risk perception, as Nepalese bankers believe that foreign investors are less likely to default due to their generally well-established reputation and credibility in the national as well as international markets.

However, there could be occasions when foreign investors would like to make use of the local financial market for financing their projects as well as meet their working capital requirements. In such a situation, the Nepalese market is not considered attractive for those investors because the capital market in the country is relatively under-developed, and when it comes to obtaining large amount of loan, even banks and financial institutions are constrained due to the single borrower limit imposed by the Central Bank of the country. Since the single borrow limit is 25 percent for funded facilities (such as loans and advances) and 50 percent for non-funded facilities (such as letter of credit and bank guarantee) and the several class —A□ commercial banks still have their core capital below NRs. 2 billion, the maximum amount of funded-facility they can provide to an enterprise or a group is less than NRs. 500 million. This amount is not at all enough for large infrastructure projects such as hydropower (for which cost of generating one kilowatt of power on average is NRs. 150 million) and other projects such as road, rail or airport construction.

Human Resources

There are several levels at which the issue of human resource constraints should be looked at. First, Nepal does not have enough educated human resources endowed with skills required for being productively employed in manufacturing and services sectors. Although there has been some improvement in the general level of literacy as well as education in the country due to higher levels of investment made in the education sector, Nepal has a long way to go before achieving the quantitative as well as qualitative targets on education. Even those who are educated have already migrated abroad in search of greener pasture. This is vindicated by the fact that Nepal has the highest incidence of brain drain in South Asia, followed by Bangladesh, as revealed by the Global Competitiveness Report.

Second, but related issue is that although most industries are operating below capacity due to electricity and other problems, the situation has arisen whereby the industrialists are mulling

over scaling down their production due to acute shortage of human resources. Due to the shortage of workers, wages have shot up such that Nepal has become the country with the highest wage overhead in South Asia.

Finally, those workers that have been left behind are heavily unionized and are apt at demanding higher wages and facilities without making commensurate increase in their own productivity. They are politically motivated, and operate more as sister wings of their political parties than as a productive force concerned about enhancing the productivity of the enterprise, letting business survive in the fiercely competitive market and wait to share the reward later, let alone struggling for the emancipation of workers.

Technological resources

As for the issue of technology, based on various indicators prepared by international organizations, such as the Global Competitiveness Report at the macro level, or the IFC Enterprise Survey at the micro-level, Nepal ranks the lowest in the region. For the macro level analysis, we take two indicators included in the Global Competitiveness Report. The first one is —technological readiness□, which —measures the agility with which an economy adopts existing technologies to enhance the productivity of its industries□ . The second indicator relates to —innovation□, which is —particularly important for [developing] economies as they approach the frontiers of knowledge and the possibility of generating more value by only integrating and adapting exogenous technologies tends to disappear□ . Table 3 provides a comparative picture of these indicators for South Asian countries.

The table shows that two developing countries of the region, namely India and Sri Lanka, are well placed in the technological frontiers because they have better indicators than many other developing countries outside the region (not shown here). Although Pakistan's ranking and score for the —technological readiness□ indicator may not be considered good enough for a developing economy, its ranking on the innovation front is satisfactory. However, two LDCs in the region—Bangladesh and Nepal—lag far behind other countries, but Nepal is the worst performer in the region along both the indicators presented in the table. In terms of innovation, Nepal ranks 11th from the bottom, although it is marginally better placed in terms of technological readiness on which it ranks 15th from the bottom.

Similarly, at the micro-level, based on the data compiled by IFC, (Adhikari) provides four indicators of technological sophistication for South Asian countries and compares them with global as well as East-Asia and the Pacific averages (Table 4). While the table paints a bleak picture for South Asian countries in general, it shows that Nepal is a laggard in all the categories but one relating to the percentage of firms using e-mail to interact with client suppliers. Although it does not perform well on the indicator relating to firms having their own website, its figure is slightly better than Bangladesh and Pakistan.

Although FDI is used as a means to transfer technology, this too has not been encouraging in the context of South Asia in general, and Nepal in particular. For example, as provided for in the Global Competitiveness Report 2012-2013, Nepal and Pakistan, with a score of 3.8/7 each, are the two countries in the region that have not been able to leverage FDI for technology transfer, while India and Sri Lanka, with a score of 4.9/7 each, have done much better on this front. Despite being an LDC, Bangladesh, with a score of 4/7, is an average performer on this front and certainly better than Pakistan. The country level data prepared by DOI (Adhikari) shows that during the seven-year period between 2004/05–2010/11, only 5 percent of the foreign investors made a commitment to transfer their technologies to Nepal. However, these were only commitments and whether or not they have been realized is not clear because the DOI does not have any mechanism in place to monitor whether the commitments made by foreign investors were actually materialized or not.

Given the fact that Nepal is currently passing through political transition and it faces serious resource constraints, it is not possible to solve all the problems simultaneously in the short run. However, there are some low hanging fruits that can be picked provided there is a political will to leverage FDI for achieving the country's development objectives. One such fruit is the establishment of special economic zones (SEZs) that will help alleviate the constraints relating to power shortage, conditions of other infrastructure such as road infrastructure, militancy of trade unions, and restricted access to credit. However, constraints such as absence of requisite human capital and technology, which are equally necessary to attract foreign investment in Nepal may not be resolved merely through the establishment of these zones. While separate incentive mechanism should be put in place to overcome these latter constraints, SEZs can become powerful new route to enhancing productivity as well as

competitiveness of export-oriented manufacturing enterprises, where foreign investors tend to be attracted.

As discussed in SAWTEE (2012), the problem, however, lies with the inability of the Government to pass the SEZ Bill from the Parliament, despite the fact that establishing SEZs was mentioned explicitly in the new Industrial Policy of 2010. The cabinet endorsed the SEZ Bill in January 2009 and it was registered at the Parliament Secretariat on 31 March 2009 and presented at the full house of Parliament on 19 April 2009. One of the plausible explanations for this apathy is ideological. Since a large majority of members of the now dissolved Constituent Assembly, which also acted as the Parliament of the country, were either leftist or left-leaning, they viewed SEZs as one more ploy from the —capitalists□ to exploit —labour.

However, as noted by SAWTEE (2012), this perception is ill-founded at least for two reasons. First, mean wages of workers in SEZs or export processing zones (EPZs) globally are higher than their counterparts working in industries catering mainly to the domestic market. Similar to wages, reports of benefits generally show that EPZs are more likely to provide benefits, such as health care and social security, than other sectors of the economy. Second, the SEZ Bill merely seeks to balance the rights and obligations of workers vis-à-vis their employers and create some predictability in industrial climate. It is perfectly logical, within the ambit of the SEZ, for workers and their employers to enter into a compact whereby workers would be provided with decent wages, benefits as well as social security measures in return for their contribution to enhancing productivity of the factory and refraining from resorting to harsh measures such as strikes to make their grievances redressed, should they occur. Indeed the new Industrial Policy of the Government of Nepal has already envisaged the adoption of flexible labour policy as well as introduction of —no work no pay□ policy, and the SEZ Bill is just an extension of that provision.

Possible investment sectors: Areas of opportunities:

Nepal with its area of 147,181 Sq.km and a population around 28 million (census 2010) can play a trade bridge between two giant economy India and China. There are several luring areas of investment for foreign investors. Despite of having plane fertile land in lower belt of the country it has failed to attract foreign money in the field of agro industry. Same goes with hydro sector. Similarly Tourism, technical manufacturing etc can be other sectors that can

attract the investors. On the basis of UNCTAD article. Crucial area for possibilities and opportunities are listed as agricultural and related industry, tourism, telecommunication and internet, hydroelectricity etc.

-Agriculture and related industries:

This sector has massive demand at international level at any given period of time. Nepal's soil is favorable for various agricultural product. Rice ,millet , maze, barley can be taken as the main food crops and mustard and rap seed as the main oil seed (UNCTAD, investment policy review Nepal). Similarly Other vital agricultural as printed by (NRN associations) are “sunflower, sesame and groundnut in oilseeds; asparagus, French beans, green peas, snow peas, chick peas, pigeon peas, black gram and grass peas; okra, lettuce, onion, garlic, ginger, cauliflower, broccoli, cabbage, sweet peppers, mushrooms and tomatoes in vegetables; roses, carnations, orchids, chrysanthemums and ornamental plants in floriculture. Apple ,pear, walnut, peach, plum, apricot, persimmon, pomegranate and almond are the major winter fruits, while mango, banana, guava, papaya, jackfruit, pineapple, lychee and coconut are the major summer fruits, in addition to citrus, which includes orange, sweet orange, lime and lemon”. Sheep farming is another relevant investment as the raw wool is a high demand for carpet industries. Nepal has suitable climate condition to various types of fruits, crops, vegetables. ,So that there areas could be a fruitful area of investment.

- Hydro Electricity:

Nepal has been gifted with many fast flowing river originated from high Himalayas.It holds Despite of having Forty four thousand megawatt of electricity economically feasible, Nepal has been able to produce mere Five hundred twenty eight megawatt (UNCTAD, Investment Policy Review Nepal). This sector could choice of foreign investors as the demand of electricity is high in Nepal and India. The government is highly encouraging foreign investors to jump into Hydro-electricity

These are the list of current hydro projects in Nepal.

-Kali Gandaki

-Middle Marsyangdi

-Kulekhani I

-Upper Bhote Koshi

- Kulekhani II
- Trishuli
- Gandak
- Modi Khola
- Devighat
- Sunkoshi

Source: Nepal Electricity Authority

- **Tourism:** In terms of number of employment generation tourism is second largest sector after agriculture in Nepal. The scenic natural beauty, several religious and historical place, high Himalayas including highest peak of the world Mt. Everest are more than enough to attract the tourist from all over the world. Combination of Mountains, hills, lake, springs, caves, etc have made Nepal as one of the best destination for visiting. Birth place of Gautam Buddha Lumbini and sacred temple of Hindu faith Pasupatinath can attract pilgrimage tourism.

.- **Internet and telecommunications:** This sector possesses significant influence to foreign investors. There was the monopoly of Nepal telecome for more than a decade. . However with the introduction of UTL and Spice Nepal(which later TELIASONERA bought), NTC has lost its single monopoly overthe market.but still a lot to be done in this sector as people in remote area still do not have access to proper communication. A country with a population of 28 million seeks massive investmentin this sector. 'NCELL', which is an investment by TELIASONERA group of Finland, has been able to identify the opportunity area of investment . . Nepal still lacks high-speed internet facilities.

4.Conclusion and recommendations

From the above analysis despite we see the growing salience of FDI, not only for traditional business- related activities but also for financing development, LDCs in general have not been able to grab this opportunity. All the South Asian countries as a whole has been receiving reasonably good amount of FDI, which shows the total FDI received by the region represents a meager 2.6 percent of the global FDI inflow. Among this all 80 percent of FDI

went to India, leaving other seven countries in the region with a share of remaining just 20 percent. It is unfortunate to note that despite a recent growth in FDI achieved by Nepal, the country still receives the lowest amount of FDI in the region.

Nepal's FDI potential is heavily under-exploited, despite the fact that the country offers a huge potential not only for market seeking investors but also resource seeking ones. A country of with the population of nearly 28 million , where the richest 20 percent of the population has a combined income of US\$ 7.26 billion, is not a small market in any sense. Besides, because of t favourable market access opportunities it has got , in the European and Indian markets, investors should find it worthwhile to invest in Nepal. Similarly Resource-seeking investors can invest in Nepal to exploit the immense hydropower potentials. Besides this , investment in other infrastructure projects such as road, rail and airport construction.

On the contrary , Nepal does not seem to offer a pleasant investment climate for foreign investors. Although there are several reasons that could lure investors from making long term investment in Nepal, there are three main problems to be noted. First, the political instability , legal uncertainty and lack of rules of law which make foreign investors think twice before making any investment. Second, poor infrastructure on transportation and energy increases the cost of investment. Third, power of trade unions, which have become emboldened particularly in the after the declaration of Nepal as a republic, has created a certain amount of threat for the overall business climate of the country. Their never-ending demand for increased benefits/facilities, which, according to them, should not necessarily be linked to their productivity, coupled with their cavalier attitude towards work and poor work ethics, means that foreign investors would most likely invest in other countries or locations (such as those Indian states which are Nepal's immediate neighbours) where they can lead a comfortable life as well as earn a reasonable amount of profit. (Adhikari)

Following recommendation are suggested to resolve the challenges and create more smooth FDI environment in Nepal.

-In order to attract the foreign investors and foreign investment Nepal should come forward to create Special economic zone (SEZ) and special investment zone(SIZ). Which can minimize the legal procedure and other lengthy procedures .

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- Power crisis should be solved through minimizing leakage and corruption . Special emphasis should be given to complete ongoing and stopped hydro projects. Alternatives sources of energy should be identified.
- Board of Investment should be given power for providing fast track approval to big projects. Contradictory of lengthy procedure which encourage for big investors.
- Created a peaceful environment and maintain political stability.
- More emphasize on marketing of different investment sectors.
- Vocational and training institute should be developed rapidly to produce technically skilled labor.
- Development of infrastructure facilities

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List of tables and figures

Figure 1..FDI in Nepal(No. of industry approved)

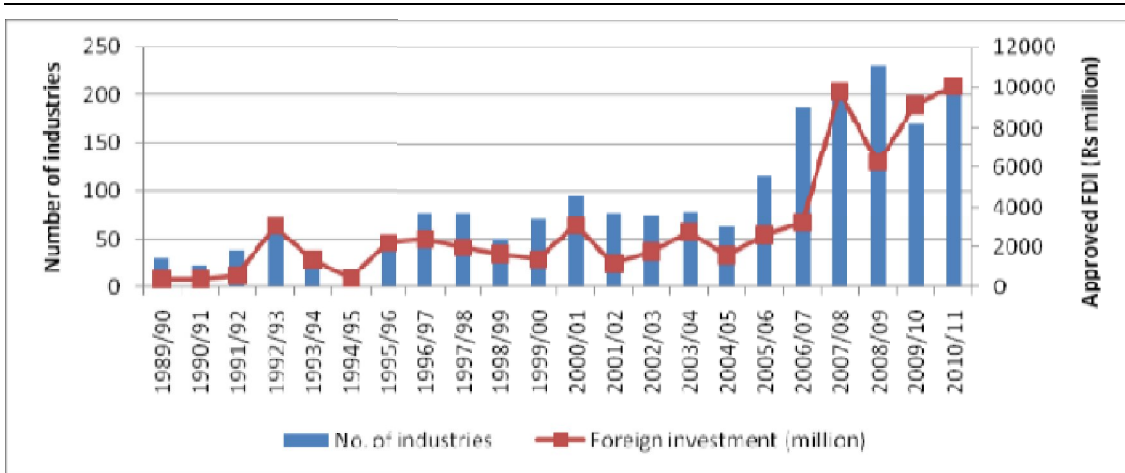


Figure 2. Approved and realized FDI(1995/96-2010/11)

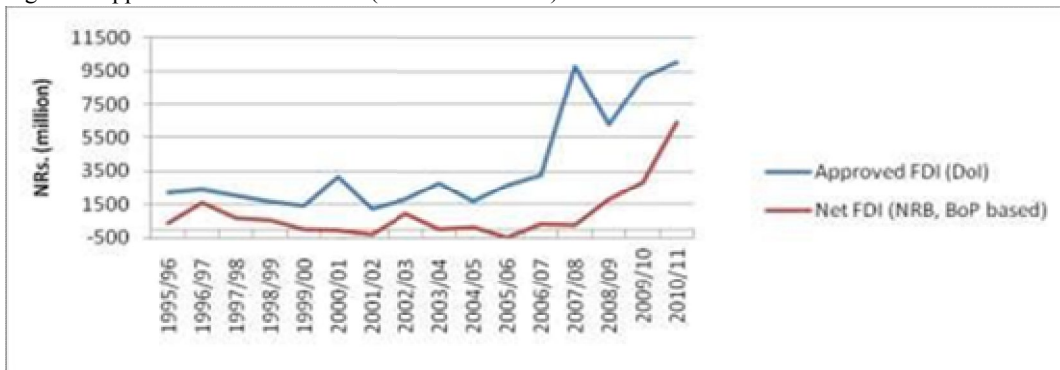


Figure 3: FDI inflow as percentage of gross fixed capital

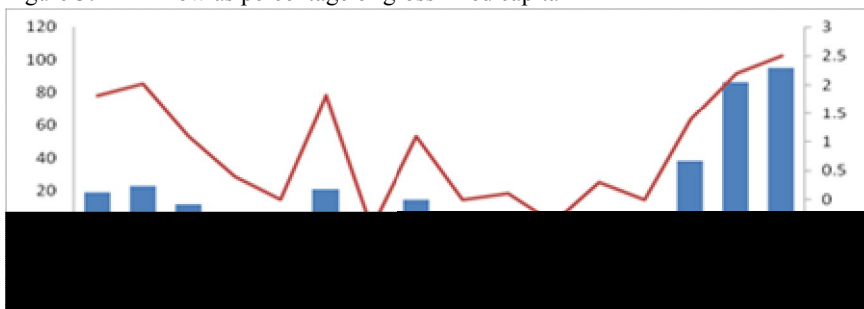


Fig4: sectorial composition of FDI

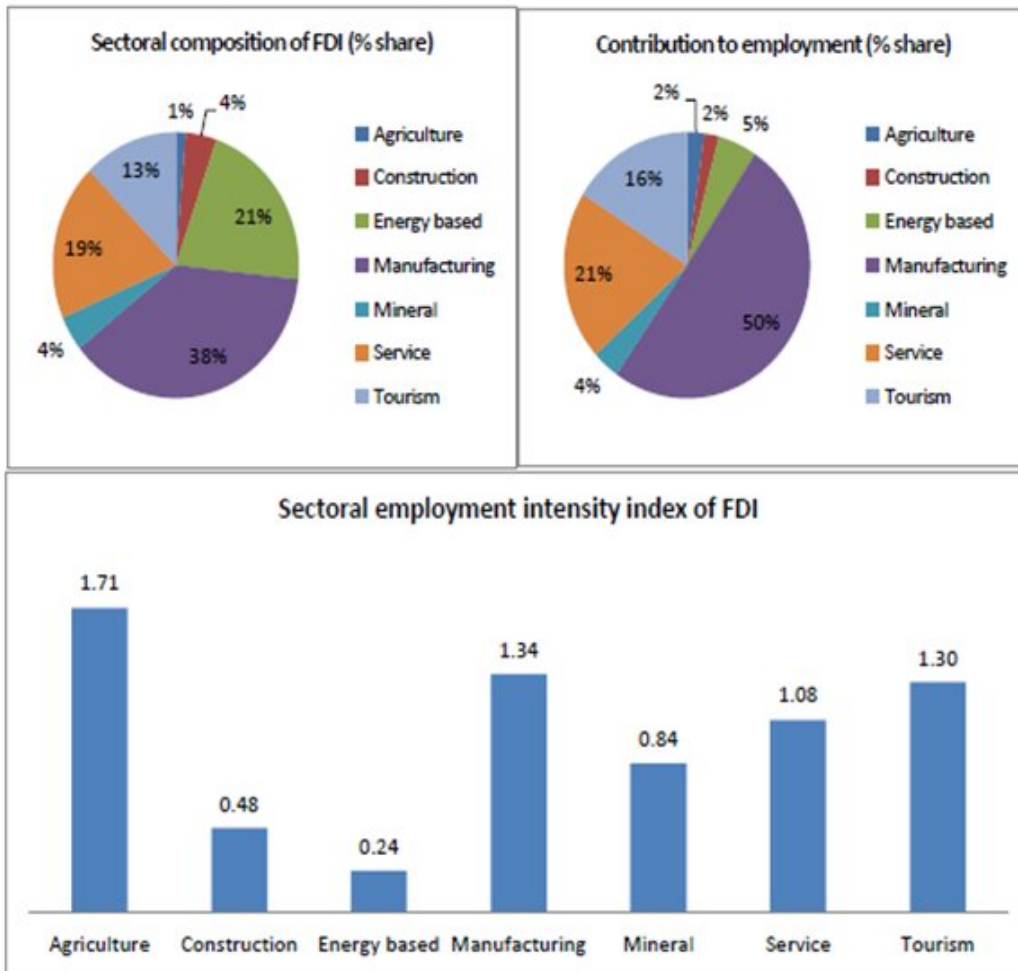


Fig5:FDI- related indicators for the top five foreign investors in Nepal.

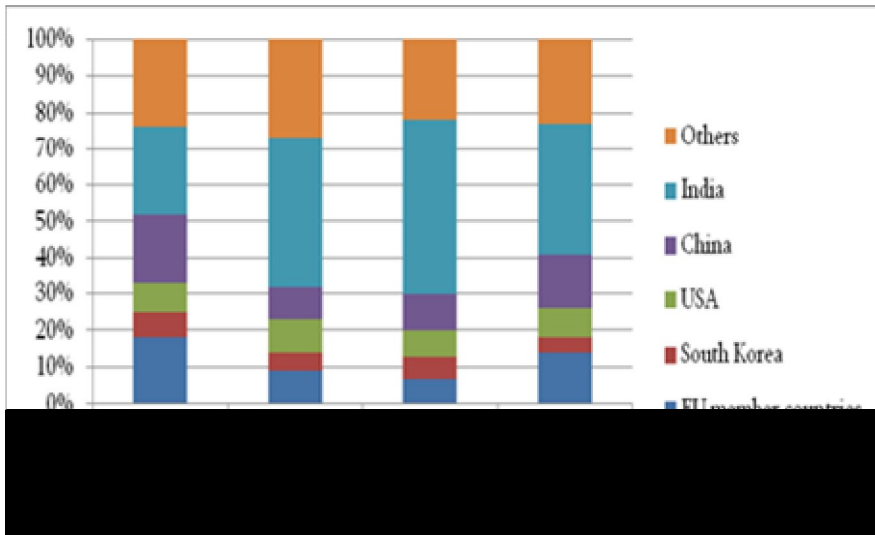


Fig6: employment indicators for top five foreign investors in Nepal.

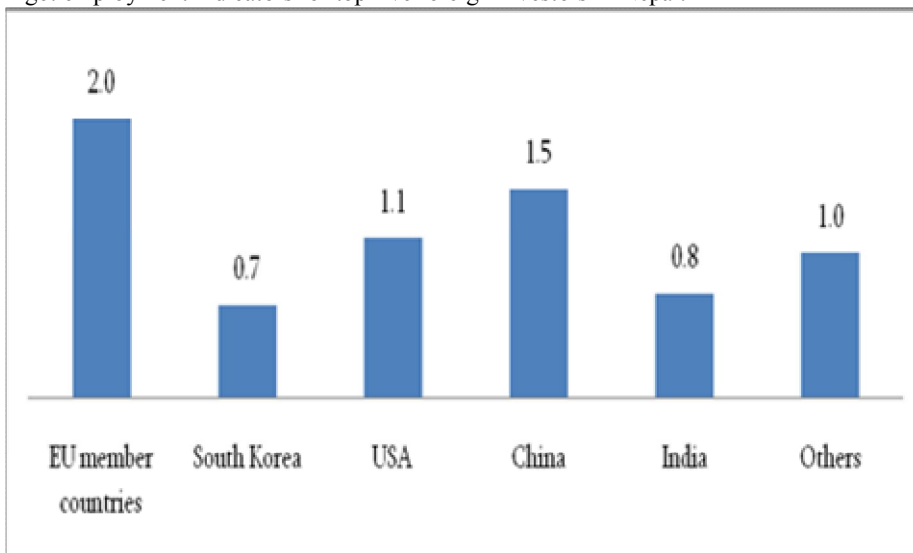


Fig7:tourist arrival in Nepal.

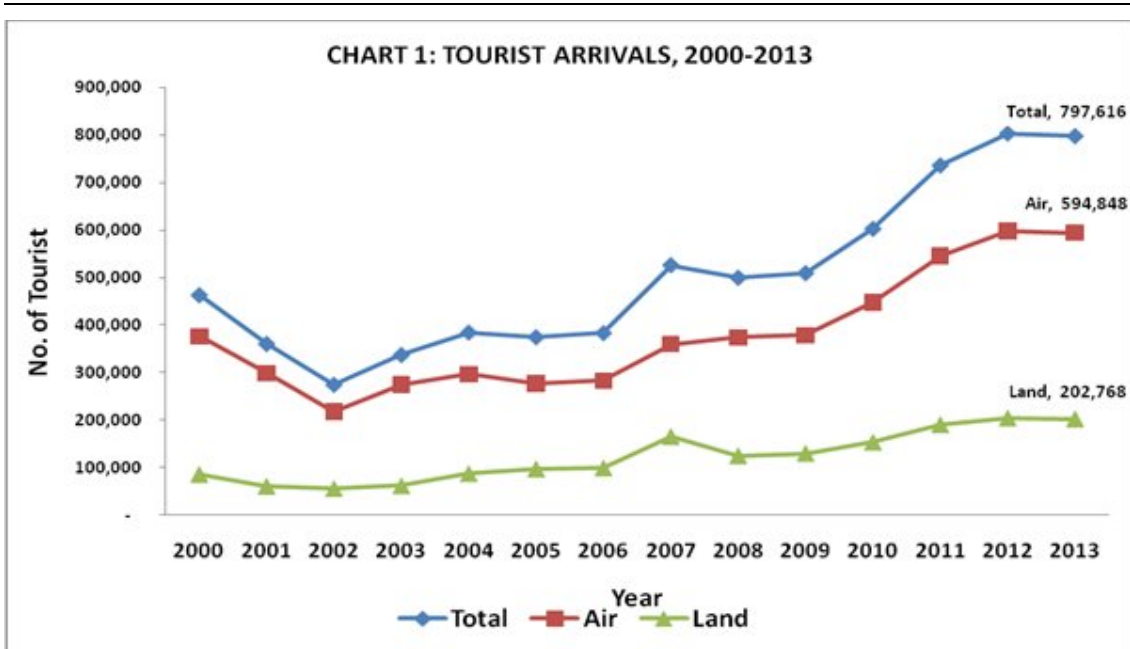


Table 1: Sectors/sub-sectors with comparative advantage and investment potential

Sector/sub-sector	Included in the studies/reports/publications					Suggested by experts	Score	Categorization of potential sector/sub-sector
	SAWTEE/AAN (2007)	ITC (2007)	MoCS (2009)	MoCS (2010)	MoI/MoCS (2009)			
Hydro-electricity				√	√	√	3	II
Tourism	√		√	√	√	√	5	I
Health			√	√	√	√	4	I
Education			√	√		√	3	II
ICT (including BPO)	√		√	√	√	√	5	I
Carpets and woolen products			√	√	√		3	II
Readymade garments			√		√		2	II
Pashmina and silk products		√	√		√		2	II
Handicrafts		√	√	√			3	II
Tea	√	√	√	√			4	I
Large cardamom		√	√	√		√	4	I
Ginger		√	√	√			3	II
Pulses (incl. lentil)		√	√	√			3	II
Vegetable (incl. seeds)			√		√		2	II
Herbs and essential oils	√	√	√	√	√	√	5	I
Leather (raw and finished)	√	√	√		√		4	I
Handmade paper/products thereof		√	√	√			3	II
Mining/mine-based					√	√	2	II

Source: SAWTEE and ActionAid Nepal (2007), Note 23; ITC (2007), Note 24; MOCS (2009), Note 25; MoI, MoCS and ENTREC (2009), Note 26; MOCS (2010), Note 27.

Table 2: Sectors/sub-sectors with comparative advantage and investment potential

Sector/sub-sector	Included in the studies/reports/publications	Suggested by experts	Score	Categorization of potential sector/sub-sector
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	SAWTEE/ AAN (2007)	ITC (2007)	MoCS (2009)	MoCS (2010)	MoI/MoCS (2009)			
Hydro-electricity				√	√	√	3	II
Tourism	√		√	√	√	√	5	I
Health			√	√	√	√	4	I
Education			√	√		√	3	II
ICT (including BPO)	√		√			√	5	I
Carpets and woolen products			√	√	√		3	II
Readymade garments			√				2	II
Pashmina and silk products		√	√		√		2	II
Handicrafts		√	√	√			3	II
Tea	√		√	√				I
Large cardamom		√	√	√		√	4	I
Ginger		√	√	√			3	II
Pulses (incl. lentil)		√	√				3	II

Vegetable (incl. seeds)			√		√		2	II
Herbs and essential oils	√	√	√			√	5	I
Leather (raw and finished)	√	√	√		√		4	I
Handmade paper/products thereof		√	√	√			3	II
Mining/mine-based						√	2	II

Table 3: Availability and quality of transport infrastructure in South Asia

Country/Indicators (N = 132)	Bangladesh		India		Nepal		Pakistan		Sri Lanka	
		S	R	S	R	S	R	S	R	S
Transport infrastructure (overall)	126	2.7	76	4.0	96	3.5	75	4.1	58	4.4
Airport density, number per million population	132	0.0	128	0.1	42	0.9	116	0.2	131	0.0