Asia-Pacific Research and Training Network on Trade
Working Paper Series, No. 52, February 2008

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 completed 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).