

# Financial Sector-Specific Determinants of Foreign Direct Investment in Nepal

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## Abstract

This study examines and analyses the impact of financial sector-specific determinants on FDI inflow to Nepal. The Engle-Granger cointegration and error correction models were employed to test the long-run and short-run relationships between the dependent and independent variables using the time series data from 1994 to 2020. The Augmented Dicky Fuller (ADF) test was adopted to test the stationarity of the variables. Similarly, the Breusch-Godfrey serial correlation LM test, the Breusch-Pagan-Godfrey test, the VIF test, and the CUSUM of the square test were employed to detect the presence of autocorrelation, heteroscedasticity, multicollinearity, and the stability of the model. The study's findings revealed a negative significant relation between the NEPSE index and the FDI inflow to Nepal in the short run. All other independent variables are insignificant with FDI inflow in the short run. Similarly, interest rate, broad money supply (M2), and inflation positively correlate with FDI in the long run while the NEPSE index is insignificant in the long run. Broad money supply is found to have the strongest impact on FDI inflow among the independent variables. The study's findings suggest that policymakers should keep increasing the money supply at a stable and sustainable rate maintaining a moderate level of inflation and interest rate in the economy to attract a significant amount of FDI in the fiscal years to come.

*Keywords:* foreign direct investment, money supply, inflation, interest rate, economic growth

## Introduction

### Background of the Study

Foreign Direct Investment (FDI) can be defined as the form of investment done by a foreign individual and company into businesses in another nation with significant control or influence on management and enterprise business activities. FDI plays a crucial role as one of the important sources of filling the saving-investment gap and financing various development activities for the economic growth and overall development of developing countries like Nepal.

FDI is the most stable and crucial form of foreign investment in developing countries like Nepal. It leads to long-term investment in the receiving country resulting in sustainable economic growth and development. It also assists in promoting the contribution of the external sector by improving effectiveness and efficiency and the transfer of modern technology and management skills from advanced economies. It has also been analyzed that countries with the presence of good physical and human infrastructure, larger market sizes, higher trade integration, energy, and skills

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along with a cheaper labour force are more likely to receive more FDI inflows (Gupta & Ahmed, 2018).

Numerous literatures have provided various arguments for FDI in the context of Nepal. The establishment of FDI firms in Nepal brings modern technologies, technological know-how, skilled personnel, a brand, and a more efficient management team along with scale, quality, and quantity. The effect of competitive FDI firms motivates and encourages domestic companies to adopt and explore new technology and management, improving quality, scale, and competition to remain in the market. The entry of FDI firms increases competition in the existing domestic market with the improvement of the competitive capacity in the foreign market and export volume will be expanded. Furthermore, there is a high prospect of enhancing and developing the labour and money market. At the same time, FDI inflow will enhance employment creation, fiscal potential, reduction of twin deficits, availability of various goods and services, competitive price of qualified goods and services, and consumer decisions (Bista, 2017).

Being the least developed country with a relatively underdeveloped infrastructure, Nepal lacks the technical know-how, capital, and managerial skills for the economic growth and overall development of the country. The country is trying to attract FDI through various plans and policies to enhance the economy. Nepal has several prospects that can attract foreign investors: location between the two largest markets in the world—China and India; trainable and cheap labour force; low setting of costs; and better environment for the development of service-related industries like nursing homes, medical colleges, banking industry, tourism industry, insurance companies, agricultural industries and other manufacturing industries.

Nepal has made several institutional, legal, and regulatory reforms and provisions to attract FDI to finance several development activities. At the beginning of the 1990s, several reforms in policy were formulated and implemented in Nepal to expand FDI inflows to Nepal. Foreign Investment and Technology Transfer Act (FITTA) 1992, the Industrial Enterprises Act 1992, the Foreign Investment and One Window Policy 1992, the Industrial Policy 1992, etc. were enacted as legal bases for FDI inflows. The Industrial Policy of 1992 introduced foreign investment promotion as a prominent strategy in achieving the national goals of enhancing industrial production to fulfil the people's fundamental needs, generate various employment opportunities and prepare the necessary conditions for the improvement in the external sector of Nepal. The

Industrial Policy 2010 aids in promoting an industry-friendly, sustainable and favourable investment environment for both domestic as well as foreign investors, employment opportunities creation, raising industrial productivity and production, reducing imports and enhancing exports (Kharel, n.d.).

Nepal has facilitated FDI as joint venture operations with Nepalese investors and as 100% foreign-owned enterprises as well. Hydropower development, tourism, agriculture, manufacturing, and construction are Nepal's major sectors of FDI inflows.

### **Statement of the Problems**

Nepal is not being able to receive FDI from advanced economies as expected. We can witness a significantly large gap between approved and actual received FDI in various sectors of the economy. Such gaps are created because of various hindrances and factors influencing FDI inflow in Nepal. Those factors that have significant influence over the FDI inflow must be identified, analyzed and managed properly to attract FDI both in large quantities and in more sectors of the economy for balanced economic growth and development. The degree of FDI inflow to a country is determined by various factors associated with economics, environment, risk, politics, finance, infrastructure, technology and all other quantitative as well as qualitative factors that directly or indirectly hamper the FDI flow. This paper has focused on the financial sector-specific determinants of FDI like interest rate, money supply, tariff rate, and stock market index. The research questions of this study based on the research problems can be listed below:

1. What are the financial sector-specific determinants of Foreign Direct Investment (FDI) in Nepal?
2. What is the impact of financial sector-specific determinants of Foreign Direct Investment (FDI) in Nepal?

### **Objectives of the Study**

Based on the research questions, the objectives of the study can be mentioned as follows:

1. To identify the financial sector-specific determinants of Foreign Direct Investment (FDI) in Nepal.
2. To analyze the impact of the financial sector-specific determinants of Foreign Direct Investment in Nepal.

## **The Hypothesis of the Study**

The hypotheses of the study are formulated as below:

Hypothesis 1

$H_0$ : There is a significant relationship between interest rate and FDI in Nepal.

Hypothesis 2

$H_0$ : There is a significant relationship between money supply and FDI in Nepal.

Hypothesis 3

$H_0$ : There is a significant relationship between the NEPSE index and FDI in Nepal.

Hypothesis 4

$H_0$ : There is a significant relationship between broad money supply and FDI in Nepal.

## **Literature Review**

Various empirical studies have been conducted by economists and researchers around the world based on time series data from specific countries or regions to find out the various financial sector-specific determinants of FDI flow.

Oman Khan (2011) examined the effect of inflation and exchange rate on foreign direct investment and its relationship with economic growth in Nigeria using the time series data of thirty years with the help of a linear regression analysis method. The major findings of the analysis suggested FDI increases with the economic growth supported by export and import which witnessed the establishment of some companies in the sector of telecommunication, but inflation does not affect FDI, but the exchange rate does.

Pervez and Malik (2013) analyzed the relationship between FDI flow and tariff structures to measure and identify how the tariff structures of a nation can influence the FDI inflows along with inflation, gross capital formation, and GDP taken as the control variables that affect the FDI flow. The study was conducted using time series secondary data covering the period 1973 to 2011 using the Augmented Dickey-Fuller Test (ADF) to test stationarity, the Johansen Cointegration Test for data cointegration and the Least Square Regression Analysis method for measuring the impact of explanatory variables on the dependent variable. The study revealed that high GDP, low

tariff rate, and high inflation enhance foreign direct investment, while gross capital formation does not affect foreign direct investment in the Pakistani economy.

Aroh and Shen (2015) studied the impact of interest rates on FDI flow in Sierra Leone using econometrics techniques on time series data from 1985 to 2012 in which various econometric tests were employed to make the model and the results obtained more reliable and valid. The major findings of the study revealed that trade openness (TO) and exchange rates (ER) are the prominent factors of FDI flow with a positive impact on Sierra Leone's economy, while the gross domestic product (GDP), inflation rate, and the rate of interest (IR) were revealed to have an insignificant relationship with FDI flows in Sierra Leone.

Boateng et al. (2015) investigated the impact of various macroeconomic determinants on foreign direct investment (FDI) inflows in Norway using a cointegration regressions equation along with Fully Modified OLS and the vector autoregressive and error correction model. The quarterly time series data were employed for the analysis. The results of this investigation showed that the real Gross Domestic Product (GDP), the foreign exchange rate, sector Gross Domestic Product (GDP), and trade openness have a positively significant cause on FDI. On the other hand, inflation, money supply (M2), rate of unemployment and the rate of interest have significant negative causes on the FDI inflows in Norway.

Bett (2017) examined the impact of interest rates on foreign direct investment inflows in Kenya using time series data from 2007 to 2017 every quarter employing descriptive research design and a multiple linear regression model. Economic growth, exchange rate and inflation were taken as control variables for the analysis and findings of the study revealed that interest rates, growth rates, exchange rates, and inflation are not significant determinants of FDI inflows in Kenya.

Ocharo and Musyoka (2018) estimated the impact of exchange rate, real rate of interest, inflation rate and market competitiveness on FDI flow in Kenya employing annual time series data during the period 1970-2016 using the ordinary least square (OLS) regression method. The findings of the study showed that real rate of interest and foreign exchange rates have a negatively significant impact on FDI inflows, while market competitiveness has a positively significant relation with foreign direct investment inflows. On the other hand, the inflation rate was found to have an insignificant impact on FDI in Kenya.

Dzomonda and Ngwakwe (2020) analyzed the causal relationship between foreign direct investment flow and the Malaysian stock index value using secondary data from the Malaysian stock market history employing the Augmented Dickey-Fuller test and Granger causality tests as data analysis tools. Results from the analysis of the model depicted that the stock market performance impacts FDI inflow, while FDI inflow doesn't cause the stock market index in Malaysia.

Alessa and Mohammad (2020) conducted a study on the effect of money supply using Islamic as well as non-Islamic money supply on FDI flow in the Jordanian economy using a time series data from the period 1980 to 2018 employing the autoregressive distributed lag model and other diagnostic tests. This study showed a significant relation between the Islamic money supply, the money supply, and the FDI flow in Jordan in the both long-term and short-term. The Islamic money supply has a positive influence, while the money supply (M2) hurts the FDI inflows in Jordanian economics.

### **Research Methodology**

Research methodology is the specification of suitable tools and techniques for data collection, estimation, analysis and interpretation of the results obtained to meet the objectives of this paper. The core elements of the research methodology are described in this section.

#### **Research Design**

The researcher has employed quantitative research methodologies to examine and analyze the impact of financial sector-specific determinants of FDI in Nepal. The inferential research design with described econometric tools has been applied to explain the impact of explanatory variables on the explained variable chosen for the study.

The Augmented Dicky Fuller (ADF) test has been applied to test the stationarity of the variables used in the paper. The Engle-Granger cointegration test and error correction model have been chosen to check and describe the long-run and short-run relationship between the dependent and independent variables. Similarly, various coefficient diagnostic tests and residual diagnostic tests have been employed to test the fitness and validity of the model used in the paper.

#### **Conceptual Framework**

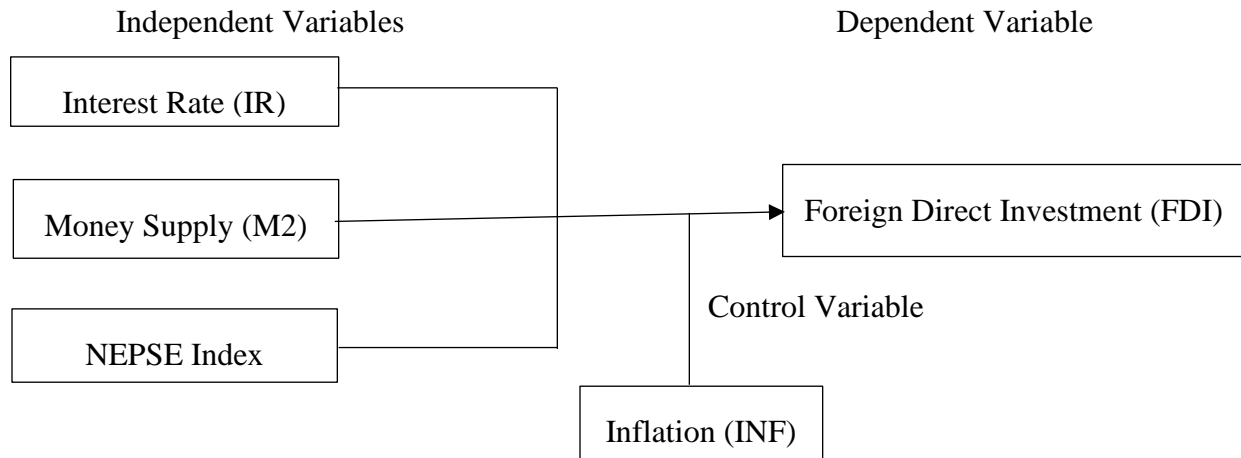
A conceptual framework has been designed based on the literature reviews and self-knowledge of the researcher. FDI is taken as a dependent variable and the interest rate, money

supply (M2), and NEPSE index are taken as independent variables while inflation is taken as a control variable in this study.

The conceptual framework of the study is presented in the figure below:

**Figure 1**

*Conceptual Framework*



**Sources of Data and Time Horizon**

The secondary time series data are collected from the official website of Nepal Rastra Bank (NRB) under the heading of Publication and Statistics with the subheading of Database on Nepalese Economy from 1994 to 2020.

**The Model Specification**

This study paper is carried out based on the supposition that the FDI inflow to Nepal is determined by the interest rate, money supply, NEPSE index, and inflation. Hence the model can be presented as

$$FDI = f (IR, M2, NEPSE, INF) \dots\dots\dots (i)$$

Where,

*FDI* = Foreign Direct Investment

*IR* = Interest Rate

*M2* = Broad Money Supply

$NEPSE = \text{NEPSE Index}$

$INF = \text{Inflation}$

The long run Ordinary Least Square (OLS) form of the equation (i) can be represented as below:

$$\ln FDI = \beta_0 + \beta_1 IR + \beta_2 \ln M + \beta_3 \ln NEPSE + \beta_4 \ln INF + e_i \dots \dots \dots (ii)$$

Where,

$\beta_0$  = the intercept term of the OLS equation

$\beta_1$  = the parameter estimates of interest rate

$\beta_2$  = the parameter estimates of broad money supply

$\beta_3$  = the parameter estimates of the NEPSE index

$\beta_4$  = the parameter estimates of the inflation

The Error Correction Model (ECM) or the short-run OLS form of the equation (ii) can be presented as below:

$$\Delta \ln FDI = \alpha_0 + \alpha_1 \Delta IR + \alpha_2 \Delta \ln M + \alpha_3 \Delta \ln NEPSE + \alpha_4 \Delta \ln INF + \alpha_5 e_{t-1} + \mu_i \dots \dots (iii)$$

Where,

$\alpha_0$  = the intercept of the ECM

$\alpha_1$  = the parameter estimates of the first difference in interest rate

$\alpha_2$  = the parameter estimates of the first difference of broad money supply

$\alpha_3$  = the parameter estimates of the first difference of the NEPSE index

$\alpha_4$  = the parameter estimates of the first difference in inflation

$\alpha_5$  = the parameter estimates of the lag of error term of long run OLS equation

### **Residual and Coefficient Diagnostic Tests**

Various econometric tests have been carried out to test the validity and reliability of the models and the results obtained thereby. The Augmented Dicky Fuller (ADF) test is used to test the stationarity of the variables taken in the study. Breusch-Godfrey (BG) Serial Correlation LM



test and Breusch-Pagan-Godfrey test have been conducted to check the presence of serial auto-correlation and heteroscedasticity in the model employed. VIF test is carried out to test the presence of multicollinearity among the independent variables. Similarly, the CUSUM of the square test is carried out to test the stability of the model.

### Findings and Discussion

This section of the study includes correlational analysis and various econometric tests applied in the research along with the interpretation of results obtained from those tests.

#### Correlational Analysis of Study Variables

The correlation coefficient shows the degree of relationship among the variables. The correlation coefficient varies from -1 to +1. The results of the correlation among the variables are shown in Table 1 below:

**Table 1**

*Correlation Analysis among Variables*

	$\ln FDI$	$\ln INF$	IR	$\ln M2$	$\ln NEPSE$
$\ln FDI$	1				
$\ln INF$	0.2307	1			
IR	-0.2353	0.0894	1		
$\ln M2$	0.7780	-0.0242	-0.5604	1	
$\ln NEPSE$	0.6871	-0.0126	-0.3351	0.8954	1

Table 1 shows the correlation coefficient between FDI inflows and inflation is 0.2307 indicating a weak and positive relation between them. On the other hand, interest rates and FDI inflows have a correlation coefficient of -0.2353 indicating a weak and negative correlation between these two variables. Similarly, the correlation coefficient between money supply (M2) and FDI inflows is 0.7780 indicating a strong and positive correlation between them. Finally, the NEPSE index and the FDI inflows have a strong and positive correlation between them. Among all the independent variables broad money supply has the strongest correlation with the FDI inflows.

### Unit Root Test of the Variables

Unit root test or the stationarity test of the variables has been carried out using the Augmented Dicky Fuller (ADF) test. The results of this test have been presented in Table 2 below:

**Table 2**

*Augmented Dicky Fuller Test*

Variables	Order of integration	<i>p</i> -value*	Order of integration	<i>p</i> -value*
lnFDI	I (0)	0.8118	I (1)	0.0000
IR	I (0)	0.1592	I (1)	0.0004
lnM2	I (0)	0.9985	I (1)	0.0285
lnNEPSE	I (0)	0.8264	I (1)	0.0149
lnINF	I (0)	0.1885	I (1)	0.0001

Table 2 shows that all the variables included in the study are stationary at first difference. This suggests that variables are ready for the Engle-Granger test of cointegration.

### Error Correction Model (ECM)

ECM is designed to further confirm the presence of a long-run relationship between the dependent and independent variables in the model. Moreover, the coefficients of the variables estimated through the ECM describe the short-run relationship between dependent and independent variables. Before going for ECM, the stationarity of the residual term obtained from the long-run cointegrating OLS regression equation is confirmed. The results of the ECM are presented through Model 1.

#### Model 1

*Short-Run Relationship Between FDI and Financial Indicators*

$$\Delta \ln FDI = -0.028 + 0.089 \Delta IR + 1.641 \Delta \ln M2 - 1.084 \Delta \ln NEPSE + 0.344 \Delta \ln INF - 0.957 e_{t-1}$$

$$t\text{-statistics} \quad -0.0472 \quad 1.1177 \quad 0.4591 \quad -1.8296 \quad 0.7865 \quad -4.5377$$

$$R^2 = 0.5353, \quad F = 4.6085, \quad DW = 2.0747, \quad n = 27$$

The negatively significant coefficient value of  $e_{t-1}$  in ECM has confirmed the presence of long-run cointegration between the dependent variable and the independent variables. The coefficient of the lag of error term ( $e_{t-1}$ ) of the long-run OLS equation is -0.957. This signifies the short-term disturbances in the model correct 95.7% every period to return to the equilibrium

condition in the long run. So, it takes 1.045 years for Model 4.1 to return to the equilibrium condition if any external disturbances are seen in the short run.

All the independent variables except the NEPSE index are insignificant with FDI inflow to Nepal in the short run. NEPSE index is negatively significant with FDI inflow in the short run at a 10% level of significance. The coefficient of the NEPSE index shows that a 1% increase in the NEPSE index results in a 1.084% decrease in FDI inflow to Nepal in the short run. The  $R^2$  value of the ECM is 0.5353 which indicates 53.53% change in FDI is described by the independent variables and the rest is described by other variables not included in the study.

### **Long Run Cointegration Model**

The long-run cointegration model is simply the OLS regression equation of dependent variable on independent and control variables taken in the study. The results of this equation show the long-run relationship between the dependent variable and the independent variables along with the control variable. The results of the long run cointegration equation are presented in Model 2.

### **Model 2**

#### *Long Run Relationship Between FDI and Financial Indicators*

$$\ln FDI = -11.6596 + 0.2062IR + 1.6232\ln M2 - 0.7388\ln NEPSE + 0.7999\ln INF$$

<i>t</i> -statistics	-4.157083	2.378685	4.144093	-1.292024	2.054576
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$R^2 = 0.7361$ ,  $F = 15.3427$ ,  $DW = 1.8176$ ,  $n = 27$

Model 2 shows all the independent variables except the NEPSE index have a positively significant relation with FDI in the long run. The coefficient of interest rate shows that a one-unit change in interest rate brings about a 0.2062% change in FDI inflow to Nepal in the long run. Likewise, a 1% change in broad money supply ( $M_2$ ) results in a 1.6232% change in the FDI inflow to Nepal in the long run. Similarly, a 1% change in inflation, a control variable, brings about a 0.7999% change in FDI inflow to Nepal in the long run. In contrast, the NEPSE index has a negatively insignificant relation with FDI inflow to Nepal in the long run. From this analysis, it is concluded that broad money supply ( $M_2$ ) has the largest impact among the variables on FDI inflow to Nepal in the long run.

The  $R^2$  value of the model is 0.7361 which indicates a 73.61% change in FDI inflow to Nepal is explained by the independent variables and the rest is explained by other variables not included in the model. Moreover, the F-statistic value of 15.3427 indicates the overall fitness of the model and the DW value of 1.8176 signifies the absence of an autocorrelation problem in the model.

### **Breusch-Godfrey Serial Correlation LM Test**

Breusch-Godfrey serial correlation LM test is carried out to detect the presence of autocorrelation in the model. The results of this test are shown in Table 3.

**Table 3**

*Breusch-Godfrey Serial Correlation LM Test*

<i>F</i> -statistic	0.624358	Prob. <i>F</i> (2, 20)	0.5457
Obs* <i>R</i> -squared	1.586700	Prob. chi-squared (2)	0.4523

Table 3 shows the probability values of *F*-statistic and observed  $R^2$  are 0.5457 and 0.4523 respectively which are greater than 0.05 indicating the absence of autocorrelation in the model.

### **Breusch-Pagan-Godfrey Test for Heteroskedasticity**

Breusch-Pagan-Godfrey test has been employed to check the presence of heteroskedasticity in the model. The results of this test are shown in Table 4.

**Table 4**

*Breusch-Pagan-Godfrey Test for Heteroskedasticity*

<i>F</i> -statistic	0.490644	Prob. <i>F</i> (4, 22)	0.7426
Obs* $R^2$	2.211347	Prob. Chi-Square (4)	0.6970
Scaled explained SS	6.860453	Prob. Chi-Square (4)	0.1434

Table 4 reveals that the probability values of *F*-statistic, Observed  $R^2$ , and scaled explained SS are 0.7426, 0.6970 and 0.1434 respectively which are greater than 0.05 indicating the absence of heteroskedasticity in the model.

### **VIF Test for Multicollinearity**

Multicollinearity is a situation in which explanatory variables are strongly correlated with each other. This problem leads to invalid and unreliable outcomes that may result in wrong

interpretations and inferences. VIF test has been applied to test the presence of multicollinearity in the model. The results of the VIF are shown in Table 5.

**Table 5**

*VIF Test for Multicollinearity*

Variable	Coefficient Variance	Uncentered VIF	Centered VIF
lnINF	0.151590	19.09005	1.009621
lnM2	0.153425	932.9323	8.218673
lnNEPSE	0.326992	426.2087	6.346494
IR	0.007515	5.748645	1.848337
C	7.866616	268.9776	NA

Table 5 shows the values of centered VIF for all the independent variables are less than 10 indicating the absence of multicollinearity in the model.

**CUSUM of Square Test for Stability of Model**

CUSUM of the square test is used to show the stability of coefficients  $\beta$  in a multiple regression model. This method is used for detecting structural changes due to various disturbances in time series data. The result of the stability test of the model using the CUSUM of the square test has been presented in Figure 2.

**Figure 2**

*CUSUM of Square Test for Stability of Model*

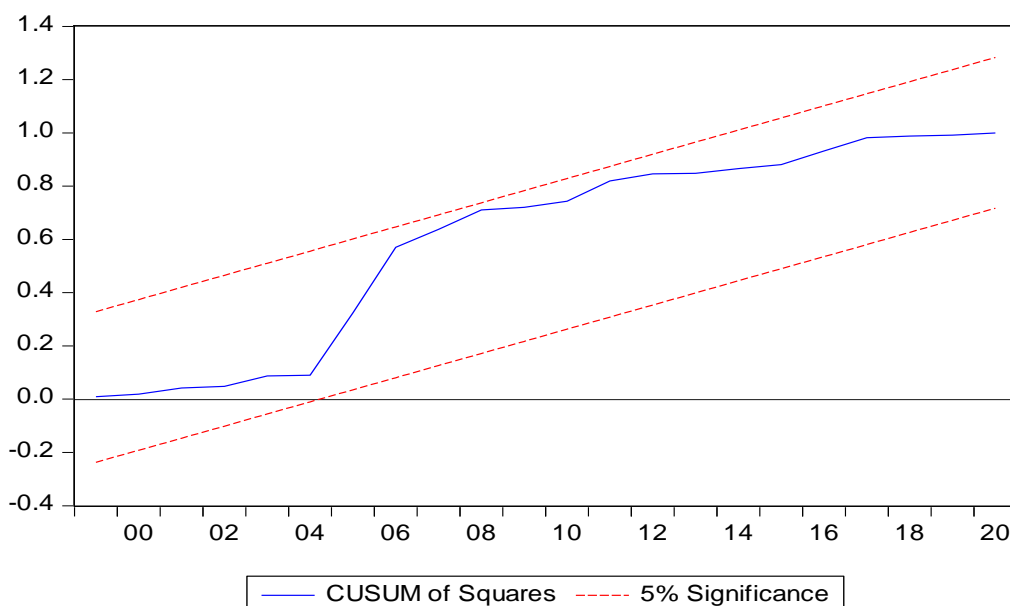


Figure 2 reveals the model of the study is stable because the line representing the model fits within the upper and lower boundary at a 5% level of confidence.

### **Conclusions**

The conclusions have been drawn based on the findings of the study paper. The main concern of the study paper was to examine and analyze the impact of financial sector-specific factors on the FDI inflow to Nepal. T-bill rate of 91 days as a proxy to interest rate, broad money supply, and NEPSE index were taken as major financial indicators while inflation was taken as a control variable affecting FDI inflow to Nepal. The NEPSE index is found to have a negatively significant relation with FDI inflow to Nepal in the short run. The reason behind this relation may be because when the market price of the company or business is low more foreign investors get attracted towards the reputed companies and buy shares of such businesses to get good profit in future.

The interest rate in Nepal is found to have a positive significant relation with FDI inflow in the long run. This finding is in favour of theories and some previous empirical studies. Particularly, foreign investors don't prefer to borrow funds from the host country instead they manage the capital from their own country so the liability of the cost of capital due to a rise in interest rate in the host country doesn't hamper them. So, when the interest rate in the host country goes up foreign capital inflows increase to capture the return on the higher interest rate which ultimately increases FDI in the host country in the long run. Similarly, a higher interest rate motivates reinvestment of the return on investment made by foreign investors in the host nation for a longer period.

Broad money supply on the other hand has shown a positively significant relation with the FDI inflow to Nepal in the long run. This finding is also supported by different theories and empirical results around the world. Money supply directly impacts the economic growth and development of the country thereby increasing developmental activities like industrialization, market development, infrastructure development, human capital development, and so on. These factors directly affect the FDI inflow in any nation. Moreover, the money supply is found to have the strongest significant relation with FDI inflow among the independent variables.

Inflation as a control variable in this study is also positively significant with FDI inflow to Nepal in the long run. The positive coefficient signifies that considerably mild inflation enhances

foreign investments as it provides some incentives to investors to start a new business or to expand an existing one. Various empirical findings suggest that 4-5% inflation is desirable in developing economies like Nepal to boost investment for economic growth and development.

The study's findings suggest that policymakers should keep increasing the money supply at a stable and sustainable rate maintaining a moderate level of inflation and interest rate in the economy to attract a significant amount of FDI in the fiscal years to come.

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