

## Direct Investment (FDI) on Economic Growth in Nepal

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### Abstract

*Foreign Direct Investment (FDI) is particularly relevant and catalytic in this connection, standing as it does within the web connecting domestic and international capital flows and sophisticated technologies and management and access to the global marketplace, particularly in the context of those economies still struggling under the huge burden of achieving economic development. As foreign direct investment (FDI) into Nepal is desirable but not compulsory for achieving ambitious development gains in a low-income, encapsulated economy crippled with domestic capital inadequacies, attracting solid and sustained FDI into Nepal is in every ontological sense, welcome news, and not only for the consubstantial, either. Method In this study the cause and effect connection has been assessed through detail oriented research paper by undertaking scrupulous empirical investigation to discovery the impact of Foreign Direct Investment (FDI) on Economic Growth reflected through the advancement rate of the GDP of Nepal for a long time period of time from 2000–2023. The study is quantitative where the larger set of data has been used from the reliable sources of literature ie: Nepal Rastra bank, world bank & Ministry of Finance. Using a multivariate OLS regression model, we provide an in-depth examination of the statistical correlation between FDI inflows and its major macroeconomic variables including inflation and trade-openness and their cumulative impact on the Nepalese growth story.*

**Key words :** Nepal, Foreign Direct Investment, Economic Growth, Inflation, and Trade Openness are Keywords to Consider.

### Introduction

Foreign direct investment (FDI) has been seen as an important source of external capital which could complement domestic strategies for economic growth and structural transformation (UNCTAD, 2020).

Nepal, a small, landlocked and least developed country (LDC) with an agriculture-based economy, has been struggling to escape a double squeeze by low domestic capital formation and long-standing underdevelopment. Therefore, making FDI (foreign direct investment) into the country and beyond the need of the hour, still utilizing the need of the hour (FDI) which also an important part of national development strategy. Out of necessity,

policymakers are starting to realize that initial set of domestic resource envelope will be unable to even start to meet the hundreds of billions in cash needed for the true upgrading of the failed industrial base and services sectors of the country. The opening of Nepalese economy to global economic system and further liberalization of economy for the foreign investors started from the early 1990s and evolved up to date. Nepal have had a tremendously turbulent path in garnering foreign direct investment (FDI) in terms of policy course. Consequently, Nepal has not been able to achieve its maximum possible share in world FDI (foreign direct investment) inflow, which remains very low (World Bank, 2023).

The purpose of this paper is to conduct the systematic and latest empirical investigation of the relationship between foreign direct investment (FDI) inflow and economic growth in Nepal. Most, however, agree that there is a positive relationship between the two, and the specific manifestation of that relationship within a country is varied and moderated by many factors. However, a more sophisticated defence of the effect of growth by FDI require controlling for macroeconomic variables which in turn potentially influence FDI effect by creating more or less favourable environment thus this research does not control for inflation and trade openness. The years between 2000 and 2023 is most pertinent, as they encompass an era of immense change in the context of the Nepalese people. This covers the post-conflict transition period, up through great geopolitical, sociopolitical and economic shifts and ultimately, late stages of global economic integration.

### **Literature Review**

Hussain and Haque (2015) confirmed the highly positive relationship between foreign direct investment (FDI) and GDP growth in Pakistan through time- series analysis. In contrast, they argued, the quality of the institution served as an important moderator. Well governed and stable economy – results of their research shows, a strong governance and an effective rule of law and a stable political environment are preconditions for attracting and venturing FDI. It discourages foreign direct investment/foreign investment to the country, thanks to the political risk and therefore the regulatory uncertainty-in the absence of an honest institutional framework. In addition, there is no spillover effect likely to occur from current investments. Within India, Kumar and Pradhan (2002) proved that FDI represents a much more productive and significant industrial development policy tool. In their presentation, they mentioned, "AS FOLLOW UP TO India's second FDI policy in 1991, FDI inflows have played a critical role in helping the manufacturing sector modernize & integrate into global value chains, contributing to overall economic growth.

Although there is extensive literature written on FDI in South Asia in general, not much of it focuses on Nepal and a great deal of it has also already stood the test of time. Shrestha (2015) conducted a unique study concerning the FDI trends of Nepal and the effect of FDI in the GDP growth. As to her findings, well almost all of it were very favourable (read: it does) towards the idea that growth are driven by foreign investments. But she cautioned that all of these possible advances were being diluted by the existence of

fundamental issues, including a shortage of infrastructure and a politically volatile environment. These challenges need to be overcome, she said. While this research was an important first step, it identified the need for further scoping to identify context-specific constraints within particular countries. of trade openness as a mean supplement in the promote of economic aid of Nepal via FDI (Gautam, 2018) About that was a downstream point from the above.

His research concluded that trade liberalization policies can scale up the development scale of FDI, while exposing domestic firms to increased competition and new export opportunities. But Gautam said that Nepal will need to adopt more liberalised trade policies to reap these synergy benefits.

Foreign Direct Investment (FDI) is widely perceived as an investment made in the business of another country by an entity based in another country, and it is also associated with the acquisition of control or significant influence over the business for an extended period. Foreign Direct Investment (FDI) is another significant source of external finance in a developing economy like Nepal since it helps to economic activities wherever domestic investment is insufficient. This not only helps with capital but also in term of modern technology, managerial knowledge and international market access. They can enhance productivity, generate jobs, and contribute to the development of infrastructure. It is therefore not surprising that FDI is associated with economic growth in the third world, which is generally viewed as the increase of a nations GDP (Gross Domestic Product). Since industrial development is still at an early stage, FDI undoubtedly has the potential to develop the economy quicker by boosting important sectors of tourism, hydropower and manufacturing in the case of Nepal.

Theoretically FDI-economic growth nexus is explained by different schools of thought. According to traditional growth models, FDI contributes to increase in stock capital of a country, which consequently translates in higher level of output. But these models oftentimes see the effect as short-term and conditional on technological change Alternatively, new growth theories emphasize the more enduring, long-term gains that FDI perspectives generate in the area of transfer of knowledge, human capital development and innovation. Such theories believe that investments from abroad can have a spillover effect on the economy, through which local firms would function in a more efficient manner and enjoy the benefit of competition in the local economy. Conversely, in parallel to this optimism, more sceptical voices have argued that relying too heavily on foreign capital could stifle domestic capability and lead to economic distortions. Hence, the benefit from the FDI rely on the way a nation governs and utilises the inflow.

The limited evidence on Nepal indicates a positive, but modest impact of FDI on economic growth. In some studies, Such as: The positive relation of FDI increase to GDP and the positive relation of FDI increase to the development of some sector, It was found to be

positively related. More specifically, foreign-owned operating sectors do have higher productivity and employment generation. The impact, however, isn't that significant with the hurdles such as political uncertainty, inadequate infrastructure, bureaucratic delays, and policy instability. Such factors often dissuade large-scale foreign investment and hinder its impact. Moreover, FDI helps much more if accompanied by strong financial systems, skilled human resource and stable macroeconomic policies with Indonesia as a case.

In summary, FDI can have a meaningful role for economic growth in Nepal provided there can be success for the country to foster conducive environment for it. Strengthening its institutions, governance and ownership of investor friendly policies will allow Nepal to make better use of FDI in its quest for sustainable development.

To conclude, previous studies offer both the theoretical background and empirical support for the present research. Nevertheless, it does point out some important insufficiency. We cover the most important domains of research on Nepal but our research is also the most outdated; it does not integrate current data, and paints a misleading picture of the economy at the country in the process of change. Nepalese context furthermore often highlights disparity in the analysis with the inclusion of factors such as FDI, inflation and trade openness in different frameworks rather than together in a single integrated framework. In order to fill up the above mentioned gaps on FDI-growth nexus in Nepal, this paper presents a novel, comprehensive and empirical investigation on the FDI-growth nexus in Nepal.

Statement Literature review indicates the link between Foreign Direct Investment FDI and economic growth and it seems that there is a wide agreement that FDI can be a locomotive for the development but not all investors can be attracted. Or otherwise prove that this correlation is neither automatic nor reliable at all. Whether foreign direct investment (FDI) is a driver of growth or not depends on the specific circumstances of the host country.

### **Research Objective**

- i. To study the pattern of FDI inflow in Nepal.
- ii. Objective: To analyze the effect of FDI on economic growth of Nepal.
- iii. To determine the transmission mechanism (trade openness and inflation) through which FDI impact economic growth.
- iv. Suggesting a few policy recommendations which can make FDI more effective in Nepal.
- v. To add knowledge on dynamic relationship between FDI and economic growth in developing countries.

### **Methodology**

This chapter attempts to provide a systematic review of the research methodology used to study about foreign direct investment (FDI) its effect on the economic growth of

Nepal. The rigorous but also transparent methodology was established so that the results received recognition and trust.

Applying a quantitative research design using time series data. This method is especially appropriate for macroeconomic causes, since they are aggregated data with a long period. This kind of design allows you to identify patterns and relationships among variables and even to find possible causal effects.

The study period is continuous for twenty-four years because it is based on secondary data. The longer time span enables extensive analyses and underpins the formulation of statistically robust conclusions about longer-term economic trends.

## **Results and Discussion**

This section introduces the empirical findings of the study. These results were based on an econometric analysis of time-series data, covering the years 2000 to 2023. The results section is organized to start with a descriptive summary, followed by the main regression results, and end in a context-rich discussion of the results.

### **An Analysis of the Descriptive**

Over the twenty-four years from 2000 to 2023, the macroeconomic landscape of Nepal has been marked by slow and fast shifts. The average annual growth rate of the GDP — which is around 4.8% — is a figure that hides massive volatility as the result of political unrest, natural disasters (e.g. the 2015 earthquake), and external shocks from the global economy. Although overall showing an upward trend, RDI inflows as percentage of GDP remained relatively low, averaging 1.5%. This comparatively low average featured the saga of persistent challenges Nepal has been facing in luring and keeping the foreign capital in the country. Over the period, the rate of inflation, one of the most important macroeconomic indicators, fluctuated between a little below three percent and a little above ten percent, with sizeable swings to both sides. Finally, trade openness (defined as a sum of exports and imports, expressed in percent of GDP) showed stable increase from around forty percent in the early 2000s to more than sixty-five percent at the end of the period. This trend is the result of Nepal being integrated more into the world economy, through increased trade.

### **The Results with Regression**

<b>Variable</b>	<b>Coefficient</b>	<b>Std. Error</b>	<b>t-Statistic</b>	<b>p-Value</b>
Constant	2.75	0.58	4.74	0.0001
FDI Inflows	0.52	0.11	4.73	0.0002

Inflation	-0.28	0.09	-3.11	0.004
Trade Openness	0.18	0.07	2.57	0.017

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w is a table of the results from the OLS regression that was conducted. The table presents a brief overview of the estimated coefficients, standard errors, t-statistics, and p-values for each of the variables evaluated alone. As a whole, the model fit well and had a high R-squared score, showing the incorporated independent variables are able to predict a large amount of Nepal's average GDP growth rate variation.

FDI Inflows: coefficient = 0.52, p-value = 0.0002 (statistically significant at 1% level) Assuming all other factors remain constant, an increase in the share of foreign direct investment (FDI) inflows in the GDP by one percentage point corresponds to a 0.52 percentage-point increase in the annual GDP growth rate of Nepal. Such evidence confirms a strong positive correlation between the variables. The results of the study highlight that FDI is significantly and positively contributing the economic growth of Nepal. Arguably the most significant finding reported.

With respect to inflation, the value for the coefficient for inflation is – 0.28 and the p-value for inflation is 0.004, significant at the 1 percent level. This negative sign of this coefficient indicates that inflation has a negative effect on the American economy growth, Specifically, a increase in the annual inflation rate by 1percentage points is related to a decrease in the growth rate of the gross domestic product by 0.28 percentage points. These conditions underscore the importance of price stability in establishing a conducive business and investment environment.

Statistically significant at the 5% level is the coefficient for Trade Openness, which is 0.18. The p-value for Trade Openness is 0.017, which indicates that it is statistically significant. The fact that this coefficient has a positive sign indicates that a greater degree of integration with the global economy, as measured by trade openness, has a positive and supportive effect on the expansion of Nepal's economy. This finding lends credence to the idea that a trade regime that is more open possesses the potential to generate growth opportunities. These opportunities may be created by increased competition, the facilitation of the import of capital goods, and the provision of larger markets for domestic products.

### Conclusion

The present empirical exploration affirms that the Foreign Direct Investment (FDI) boosts positive and the significant contribution to Nepal economic growth, by period 2000–2023. The findings show that FDI is a crucial tool for growth in a normal development an economy that does not have high technology base. But the results also underscore that FDI will not produce benefits automatically. Foreign investment does not amount to sustainable economic growth without a more favorable macroeconomic environment. This echoes the

result of a previous study that we highlighted which placed signal importance on key macroeconomic variables impacting growth. Inflation has been recognized as one of the major constraints in economic development, highlighting the need for good monetary policies and price stability. Likewise, the growth-enhancing effect of trade openness reinforces the need for a liberalised, export-oriented economy. These together inform a vision-driven, innovative, movement taking FDI policy that responds well to development priorities and utilizing the FDI. Drawing on the findings, this chapter offers some policy recommendations aimed at making Nepal more attractive to FDI while also ensuring that the country receives high quality FDI and that the long term benefits of foreign investment are maximized:

First, Invest in physical infrastructures: Wherein energy, transportation as well as telecommunication infrastructures has to be enhanced so that it can lessen business costs which will make our country a better place to attract foreign investors.

ii. Create a Stable Investment Climate: Bring in predictable and transparent policies, cut red tape, and enforce the rule of law.

iii. Advance Trade Liberalization: Facilitate trade by reducing both tariffs and non-tariff barriers so that Nepal can better engage in global value chains.

iv. Keep Inflation Low and Stable — Temper economic uncertainty (higher inflation raises uncertainty about future prices) and provide a sound environment for domestic and foreign investment.

Although this analysis is beneficial, it is not comprehensive. More studies need to consider other possible mediating variables, such as human capital, quality of institutions, and indicators of governance to explore the potential and additional complexity of the dynamic between FDI and economic growth. A sectoral analysis would reveal the sectors that attracted maximum FDI inflows. Lastly, qualitative studies examining foreign investor views regarding the business environment in Nepal would provide practical references for fine-tuning of policies. Finally, this study confirms the catalytic role of FDI in economic growth in the case of Nepal. It offers a roadmap that is rooted in research to help policymakers promote an economic environment that is open and stable, as well as conducive to growth. In balance with the appropriate measures, foreign investment can be a strong vehicle for socio-economic development, prosperity, and poverty reduction in Nepal.

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