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Research Article

An Econometric Analysis of Impact of Foreign Direct Investment (FDI) Inflow on GDP in Nepal

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ABSTRACT

The study examined the impact of FDI inflows on GDP of Nepal, using OLS model for analyzing relationships between FDI and economic growth. The finding revealed a significantly positive impact of Actual Real FDI on Real GDP of Nepal. FDI plays an important role in guiding economic growth and stimulating development across various sectors. The study utilizes secondary data collected from Nepal Rastra Bank and the Ministry of Industry, Commerce, and Supplies over a 28-year period. The study employed annual data from 1996 to 2023, focusing on the key sectors of FDI inflows—Agriculture, Manufacturing, and Services and their impact on economic growth. Using ARDL model, both short-term and long-term relationship between these variables where examined in study. By the examination of potential relationships between the variables, the ARDL bound testing approach facilitated a thorough evaluation of both short-term dynamics and long-term equilibrium. The empirical findings showed a significant long-run relationship between sectoral FDI inflows and economic growth, measured by RGDP, indicating that an increase in sectoral FDI inflows positively influenced economic growth over the long term. However, the short-run analysis showed mixed results, with sectoral FDI inflows having both positive and negative effects on RGDP growth, depending on the lag structure. The study concluded that while sectoral FDI inflows can be an effective tool for promoting economic growth in Nepal, their impact on GDP requires careful consideration

of long-term sustainability and the potential short-term volatility they may introduce across different sectors. Overall, the findings showed a significant relationship between overall FDI inflow and GDP, as well as between inflows sectoral FDI inflows and GDP, highlighting that both sector-specific and total FDI inflows have a meaningful impact on overall economic growth of a nation.

Keywords: FDI; FDI inflow in agriculture; FDI inflow in manufacturing; FDI inflow in service sector and GDP.

INTRODUCTION

FDI is defined as an investment made by a foreign direct investor, resident in one economy, in a foreign affiliate business that is located in another economy, which represents a long-term interest and ownership (UNCTAD, 2022). A straightforward definition that is widely accepted is that FDI is the long-term involvement of country A in country B. Typically, it involves management participation, joint ventures, and the sharing of knowledge and technology. (Agrawal, 2011). FDI may appear in many different forms, such opening an affiliate or subsidiary in the other nation, purchasing a sizable portion of an already-existing foreign business, or joining with a local company to form a joint venture. As the global economy becomes more integrated, foreign direct investment (FDI) creates a new source of resources (Bista, 2005).

The UNCTAD World Investment Report (2024) states that as trade and geopolitical tensions affected on a slowing global economy, global FDI flows fell by 2% to $1.332 trillion in 2023. One major example is the United States-China trade war, which began in 2018 and continues to affect global trade and investment. FDI to developing economies rose by 9% to $464 billion, making up over two-thirds of global FDI. However, FDI in developing nation dropped 7% to $867 billion. Investment in global value chain-intensive sectors like electronics and automobiles grew in regions with easy access to key markets, while many developing nations struggled to attract foreign investment.

Back to 1936, when the first jute mill was built in Biratnagar in partnership with Indian traders, Nepal saw the beginning of foreign private investment. However, at that time, there was no clear government policy to attract foreign capital. It was only after the Sixth Plan that Nepal began to emphasize foreign investment. Starting in 1981, the Government of Nepal (GoN) introduced separate rules, regulations, and attractive incentives to encourage foreign investors. Building on these early efforts, Nepal implemented various measures to attract FDI,

including trade liberalization and market reforms. In 1985, with support from the World Bank and IMF, Nepal launched a structural adjustment program aimed at fostering rapid economic growth through liberalized policies. Additionally, in an effort to create more favorable climate for foreign investment by simplifying procedures and regulations, government of Nepal replaced the Foreign Investment and Technology Transfer Act (FITA), 1992 with FITA, 2019. (Chhetri, 2022).

REVIEW OF LITERATURE

Theoretical models explain the impact of FDI on GDP by boosting investment, productivity, and technology transfer. The Harrod-Domar model links FDI to increased capital and growth. The Exogenous growth model shows FDI enhances GDP through capital accumulation and technological progress. The Endogenous growth model emphasizes FDI's role in innovation and human capital development (Mahembe & Odhiambo, 2014). The IDP model illustrates how FDI drives GDP growth as countries advance economically.

Phuyal and Sunuwar (2018) used sectoral data over ten years (2007 to 2016) to examine and evaluate sector specific impact of FDI on Nepal's GDP-based economic growth. In the context of Nepal under study, they conclude that FDI does not yet significantly contribute to economic growth; however, it is gradually establishing its own place in the Nepalese economic context. The entire outcome of the inferential analysis indicated that, throughout the specified period, FDI in the tourism, industry, and agricultural sectors have significantly and positively impact GDP.

Dhungana (2021) investigated the status, trend and composition of FDI inflow, as well as the effect of FDI on economic growth across different sectors and scales with growth measured by GDP for the period 1996-2019. Correlation analysis indicated a moderate negative correlation between FDI and the primary sector, a low positive correlation with the secondary sector and a moderate positive correlation with the tertiary sector. Regression analysis reveals a negative influence of FDI on primary and positive on secondary and tertiary sector where as unidirectional causality found from GDP to FDI.

Gharti (2023) examined the relationship between FDI and RGDP using the data from FY 1994-2021. Employing methodologies such as Error Correction Model (ECM) and Ordinary Least Square (OLS) Method. Study reveals stationary nature of data and long-term co-integrated relationship between FDI and RGDP. This demonstrates the vital role that foreign

investment had in Nepal's economic development, particularly considering the barriers to domestic capital accumulation.

Kaddouri and Benelbar (2024) analyzed the impact of FDI on Algeria's economic growth through OLS method. The bounds test suggests that the variables are bounded together in a long-run relationship where, FDI is the dependent and GDPG (Growth Rate of Gross Domestic Product) is independent variable. The findings also indicate that FDI positively impact economic growth.

DATA AND METHODS

The entire analysis is based on secondary and quantitative data sources, including annual time series data sets published by national and international organizations, as well as governmental and non-governmental organizations, from FY 1996 to FY 2023. The period from 1996 to 2023 is used to analyze FDI inflow in Nepal to capture the effects of liberalization, political changes, and economic reforms on foreign investment trends. The necessary data for the study was obtained from variety of sources, including the quarterly economic bulletin by Nepal Rastra Bank, the survey report on FDI in Nepal by NRB, the Ministry of Industry, Commerce and Supplies, Ministry of Finance, and UNCTADSTAT, along with other relevant government agencies, reports, and authentic publications.

In this study, various statistical tools were employed to analyze the data, including trend analysis, descriptive analysis, unit root tests, co-integration tests, regression analysis, Pairwise granger causality tests and various diagnostic tests to check the validity and reliability of the assumptions of the model. To determine and describe the patterns and trends of both GDP and FDI flow, the analysis employed descriptive statistics. The unit root test uses the ADF test to confirm the stationary nature of the variables.

The initial data were converted into square root and log form since the data tested non-stationary in nature by examining individual time series data. ARDL was applied for regressions as time series data is of mixed stationary. Regression analysis was employed to examine the relationship between RGDP and overall FDI inflow whereas; multiple linear regression model was used for RGDP and FDI inflow in Agriculture, Manufacturing and Service sector.

$$\sqrt{}\,\mathrm{RGDP} = \alpha + \beta\sqrt{}\mathrm{RAFDI} + \varepsilon t \quad (1)$$

$$ln\mathrm{RGDP}_t = \alpha + \beta_1 ln\mathrm{FDI}_{AG',t} + \beta_2 ln\mathrm{FDI}_{Mfg,t} + \beta_3 ln\mathrm{FDI}_{Srv,t} + \epsilon_t \quad (2)$$

Here,

lnRGDP is the natural logarithm of the overall real GDP for the entire economy.

$lnFDI_{AG}$ is the natural logarithm of FDI inflow in Agriculture sector.

$lnFDI_{Mfg}$ is the natural logarithm of FDI inflow in Manufacturing sector.

$lnFDI_{Srv}$ is the natural logarithm of FDI inflow in Service sector.

ARDL test,

When the FDI inflow variables are able to capture both short-term and long-term impacts, the ARDL approach is used to estimate the study's short-term and long-term coefficients as well as estimate whether a long-run relationship exists. ARDL test equation are used as below:

$$\Delta lRGDP_t = \delta_0 + \sum_{i=1}^{p} \Theta_i \Delta lFDI_{Ag,t-}i + \sum_{i=1}^{q} \mu_i \Delta lFDI_{Mfg,}t-i + \sum_{i=1}^{r} \omega_i \Delta lFDI_{Srv,}t-i + \gamma_1 \Delta lFDI_{Ag,t-i} + \gamma_2 \Delta lFDI_{Mfg,t-i} + \gamma_3 \Delta lFDI_{Srv,t-i} + \epsilon_{t\ (3)}$$

Where,

δ_0 = Constant

$\theta_i, \mu_i, \omega_i$ = Long term coefficient of variables

$\gamma_1, \gamma_2, \gamma_3$ = Short term coefficient of variables

ϵ_t = Error term

Δ means first difference which is change in the value of variables between two time periods and p, q, r are the lag length.

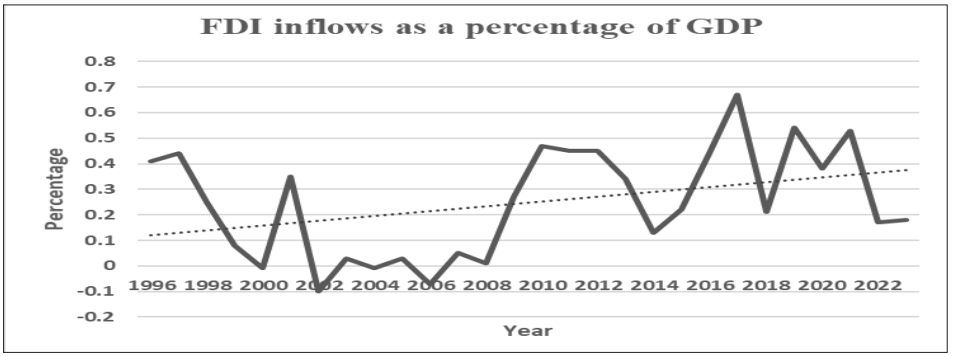
RESULTS AND DISCUSSION

Status of FDI Inflow in Nepal

FDI inflow as a percentage of GDP in Nepal from 1996 to 2023 was analyzed in this study. Although FDI inflows as a percentage of GDP fluctuated sharply over the years, the overall trend indicates a gradual upward movement.

Figure 1

FDI Inflows as a Percentage of GDP



Descriptive Statistics

Descriptive statistics were employed as the initial step in data analysis. To determine the data's status, patterns, and trends prior to complex statistical methods, including mean, SD, and minimum and maximum values, were calculated. The average value of a collected data was represented by the mean, which is a measure of central tendency. Each value in the dataset was added, and the total values contained in the dataset then divides the result. The amount of variance or dispersion of a set of data values was quantified by the standard deviation. It indicates how much individual data points differ from the mean (average) of the dataset.

Table 1

Descriptive Statistics of Sectoral FDI Inflow and GDP

Statistics/variable	*ln*FDI$_{Ag}$	*ln*FDI$_{Mg}$	*ln*FDI$_{Srv}$	*ln*RGDP
Mean	3.658	7.381	7.313	13.7
Median	3.957	7.33	6.917	13.225
Standard Deviation	2.721	1.064	1.536	0.798
Minimum	0	5.322	3.999	12.727
Maximum	7.568	10.18	10.294	14.762
Sum	102.436	206.668	204.755	383.597

Unit Root Test

Stationary is a crucial assumption in time-series regression analysis because they rely on constant means, variances, and covariance over time. A statistical method of determining whether a time series data set is stationary or has a unit root is unit root test. Whereas, ADF test is performed at the first and second differences to check whether the time series data under examination are stationary or not. Table 3 displays the results of a variety of variables at different levels using the ADF test.

Table 3

Unit Root Tests for Variables

Variables	Level		First Difference		Remarks
	Intercept	Trend and intercept	Intercept	Trend and intercept	
*ln*RGDP	0.8801	0.5599	0.0004***	0.0026***	I(1)
*ln*FDI$_{Ag}$	0.3467	0.0404**	0.0000***	0.0003***	I(1)
*ln*FDI$_{Mg}$	0.8433	0.0002*	0.0000***	0.0001***	I(1)
*ln*FDI$_{Srv}$	0.9623	0.0012***	0.0000***	0.0000***	I(1)

Notes: (*) Significant at 10%; (**) Significant at 5%; (***) Significant at 1.

All variables are non-stationary at the level with p-values greater than 0.05, with the exception of *ln*FDIAg, which is significant at the 5% level when a constant and trend are considered. At first difference, the unit root null hypothesis is rejected when all variables become stationary and p-value is less than 0.05. This implies that when the data is differencing, the variables become stationary.

Lag Selection Criteria

Lag selection determined the optimal number of lags in the model. Proper lag length avoids ignoring dynamics or losing efficiency. The optimal number of lags in time series models can be found using statistical methods. Table 4 displays the outcomes of a time series model's lag order selection criterion. Lag 4 was selected as the best overall based on FPE, AIC, and HQ criteria.

Table 4

Lag Order Selection Criteria

Lag	LogL	LR	FPE	AIC	SC	HQ
0	-115.3518	NA	0.245285	9.945981	10.14232	9.998071
1	-73.76460	65.84636*	0.029806	7.813717	8.795428*	8.074165
2	-57.71608	20.06065	0.033776	7.809674	9.576754	8.278481
3	-42.58515	13.87002	0.052305	7.882096	10.43455	8.559262
4	-5.954909	21.36764	0.022718*	6.162909*	9.500728	7.048433*

Note: An asterisk (*) indicates lag order selected by the criterion under likelihood ratio- LR, final prediction error- FPE, Akaike information criterion-AIC, Schwarz criterion- SC, and Hannan-Quinn criterion-HQ.

Autoregressive Distributed Lag (ARDL) Bound Test

The ARDL model was frequently used in time series analysis for examining the impact of one or two independent factors on the dependent variable. This approach integrated both short-term and long-term phenomena by including lags of both independent and dependent variables. The greatest number of lags for both types of variables was determined using the AIC criteria, and the findings indicated that four is the minimum lag for both variables. Through the usage of E-Views, ARDL (4,3,1,2) model was selected among 500 evaluated model and estimation of bound test for ARDL model is shown in table 4.5.

Table 5

Estimation of Bound Test for ARDL Model

F-Bounds Test	Null Hypothesis: No levels relationship			
Test Statistic	Value	Level of Significance	Lower Bound Value I(0)	Upper Bound Value I(1)
F-statistic	8.164744	10%	2.37	3.2
K	3	5%	2.79	3.67
		2.50%	3.15	4.08
		1%	3.65	4.66

Table 5 presents the outcomes of the F-Bounds Test applied to the ARDL cointegration model. The calculated F-statistic, which stands at 8.164744, exceeded the upper bound critical values across all conventional significance levels. As a result, the null hypothesis of no cointegration was rejected. This finding confirms the existence of a significant long-run equilibrium relationship among the variables included in the model.

Coefficient of Long-Run Form in the ARDL

The coefficient of the long run form in ARDL model represent the long-term impact of FDI inflow in Agriculture, Manufacturing and Service sector on RGDP, as presented in table 6.

Table 6

Coefficient of Long-Run Form in the ARDL (4,3,1,2)

Variable	Coefficient	Std.Error	t-statistic	Prob.
$ln\text{FDI}_{Ag}$	0.123311	0.036398	3.387848	0.0069
$ln\text{FDI}_{Mg}$	0.146312	0.05983	2.445464	0.0345
$ln\text{FDI}_{Srv}$	0.249092	0.069867	3.5 65240	0.0051
Intercept	10.3884	0.48274	21.51964	0

The t-statistic (3.387848), p-value (0.0069), and coefficient of *ln*FDIAg are all positive (0.123311), suggesting that agricultural FDI has a significant positive long-term impacts on GDP. $ln\text{FDI}_{Mg}$ is also positive (0.146312), with a t-statistic (2.445464) and p-value (0.0345), suggesting significant positive long-run impact of manufacturing FDI. $ln\text{FDI}_{Srv}$ shows a positive impact (0.249092), t-statistic (3.565240), and p-value (0.0051), confirming significance in the services sector in the long run. The intercept (10.3884) reflected the baseline GDP level, influenced by other variables.

Error Correction Version of ARDL Model

ECM was applied to assess the long-term relationship between variables as well as the short-term dynamics in the context of time series data. ECM utilized in this study to assess the short-run impact; details are shown in table 7.

Table 7

Coefficient of Short-Run Form in the ARDL

Variable	Coefficient	Std.Error	t-statistic	Probability
D(*ln*RGDP(-1))	0.550374	0.126757	4.341978	0.0015
D(*ln*RGDP(-2))	0.432172	0.141278	3.059024	0.0121
D(*ln*RGDP(-3))	0.193221	0.108566	1.779753	0.1055
D(*ln*FDI_{Ag})	0.030537	0.015102	2.022051	0.0707
D(*ln*FDI_{Ag}(-1))	-0.148111	0.022238	-6.660154	0.0001
D(*ln*FDI_{Ag}(-2))	-0.058648	0.021048	-2.786324	0.0192
D(*ln*FDI_{Mg})	0.033844	0.026172	1.293134	0.2250
D(*ln*FDI_{Srv})	0.106468	0.036847	2.889477	0.0161
D(*ln*FDI_{Srv}(-1))	-0.193134	0.036575	-5.280524	0.0004
CointEq(-1)*	-1.101833	0.145746	-7.559974	0.0000

Table 7 presents the primary outcomes derived from the short-run model; reveals significant positive effects from the first and second lags of real GDP, while the third lag is insignificant. FDI in agriculture showed marginally positive current effect but significant negative lagged impacts; FDI in manufacturing was insignificant, whereas FDI in services had mixed effects—positive currently and negative in the past. The highly significant error correction term (-1.101833) indicates a rapid return to long-run equilibrium, and the model demonstrates strong explanatory power ($R^2 = 0.85$, adjusted $R^2 = 0.76$).

Pairwise Granger Causality Test

The Pairwise Granger Causality Test is an essential technique for evaluating and analyzing directional causal relationships between variable pairs in time series analysis. It is useful for exploring how variables relate to one another and determine whether FDI in particular industries can increase GDP or not. This study used the Pairwise Granger Causality Test, which is shown in table 8, to examine potential causal relationships between variable pairs in our dataset.

Table 8

Pairwise Granger Causality Tests

Null Hypothesis	Obs	F-Statistics	p-Value
*ln*FDI$_{Ag}$ does not Granger Cause *ln*RGDP	27	0.00016	0.99
*ln*RGDP does not Granger Cause *ln*FDI$_{Ag}$		9.62916	0.0049
*ln*FDI$_{Mg}$ does not Granger Cause *ln*RGDP	27	1.95005	0.1754
*ln*RGDP does not Granger Cause *ln*FDI$_{Mg}$		13.8167	0.0011
*ln*FDI$_{Srv}$ does not Granger Cause *ln*RGDP	27	0.06522	0.8006
*ln*RGDP does not Granger Cause *ln*FDI$_{Srv}$		34.1517	5.E-06

Table 8 shows that FDI in the agricultural, manufacturing, and service sectors had a significant unidirectional causal relationship with real GDP. This suggests that fluctuation in FDI within certain sectors could impact the growth and performance of the national economy.

Diagnostic Test

To find the BLUE, the ARDL model requires diagnostic tests to ensure statistically robust results.

Normality Test

The Jarque-Bera (JB) test was conducted to assess whether the distribution of the model's variables aligns with the assumption of normality. The results indicated a skewness of 0.212336, a kurtosis of 2.359816, and a JB statistic of 0.590182, with a corresponding p-value of 0.744464. Since the p-value of 0.744 and the Jarque-Bera test statistic of 0.590 show that there is no significant evidence against normality, meaning the data likely followed a normal distribution.

Model Specification Test

A model specification test used in statistical analysis to determine whether a model has been correctly specified. For model specification, Ramsey RESET Test was performed and results are represented in table 9.

Table 9

Ramsey RESET Test

	Value	df	Probability
t-statistic	0.407471	9	0.6932
F-statistic	0.166033	(1,9)	0.6932
Likelihood ratio	0.43872	1	0.5077

The t-statistic (0.407471), F-statistic (0.166033), and Likelihood Ratio statistic (0.43872) all have high p-values (0.6932 and 0.5077), which are much larger than 5% level of significance which indicate no significant evidence of model misspecification.

Serial Correlation Test

The Breusch-Godfrey Serial Correlation LM test was conducted to check for the presence of serial correlation within the model. The results show an F-statistic of 0.014107 with a corresponding p-value of 0.9860, and an Obs*R-squared value of 0.084343 with a p-value of 0.9587.Since, p-value is 0.9860 and the F-statistic is 0.014107, both of which are significantly higher than usual significance levels. Additionally, the Obs*R-squared is 0.084343, and its p-value of 0.9587 shows no significant autocorrelation.

Heteroscedasticity Test

The Breusch-Pagan-Godfrey test was performed for assessing whether heteroscedasticity is present in residuals of the regression model. The results are summarized in the corresponding table.

Table 10

Heteroscedasticity Test: Breusch-Pagan-Godfrey

F-statistic	1.111135	Prob.F(13,10)	0.4417
Obs*R-squared	14.18194	Prob. Chi-Square(13)	0.3612
Scaled explained SS	1.674031	Prob. Chi-Square(13)	0.9999

The Breusch-Pagan-Godfrey test results show high p-values (0.3612 for Obs*R-squared, 0.4417 for the F-statistic, and 0.9999 for Scaled explained SS, all of which are much higher than typical significance levels (e.g., 0.05). This indicates that there is no significant evidence of heteroscedasticity in the model.

Stability Test

After estimating an ARDL model, it is essential to verify the stability of its coefficients over time. This can be assessed using the CUSUM (Cumulative Sum) test and the CUSUM of Squares (CUSUMSQ) test.

CUSUM (Cumulative Sum) Test

The CUSUM Test examines the cumulative sum of residuals from ARDL model to test for the stability of the model's coefficients, shown in figure 2.

Figure 2

CUCUM Test

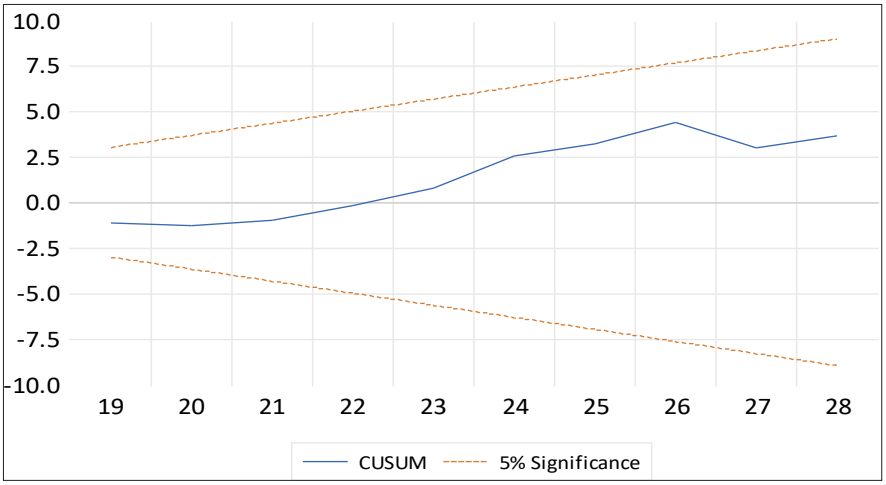


Figure 2 shows that the model's coefficients are stable as cumulative sum remains within the critical lines at a 5% significance level.

CUSUMSQ (Cumulative Sum of Square) Test

The CUSUMSQ Test is an extension of CUSUM test. Instead of focusing on residuals directly, it examines the squared residuals. This test is useful for detecting instability in the variance of the residuals, which might indicate volatility changes over time. The CUSUMSQ test is shown in the Figure.

Figure3

CUSUM of Squares Test

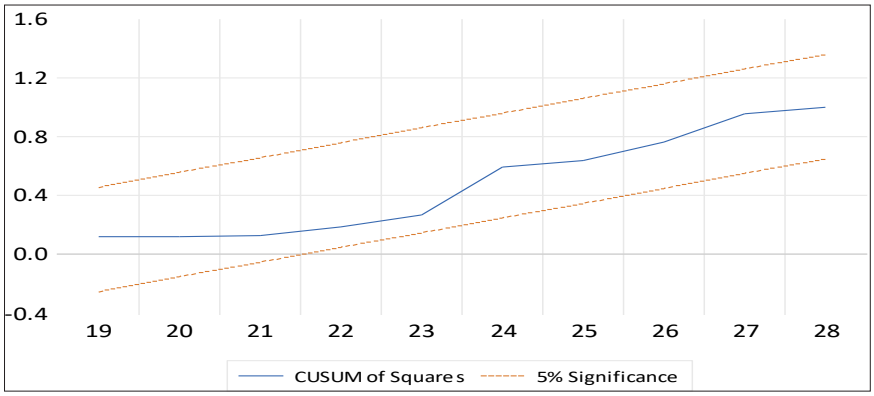


Figure 3 shows the CUSUMSQ plotted against a 5% significance level. In addition, model's coefficients are stable as cumulative sum remains within the critical lines at 5% significance level.

FDI inflows in Nepal's manufacturing, agriculture, and service sectors contributed positively to GDP of Nepal. This discussion synthesized insights from recent literature on how FDI inflow in these each sector influenced Nepal's Gross Domestic Product (GDP).These findings contradicted Alfaro (2003), who showed that FDI in the primary sector adversely affects growth, FDI in service sector remain unclear and varies, whereas the manufacturing had a positive impact on growth.

The positive long-run impact of sectoral FDI on Nepal's GDP aligned with the Harrod-Domar model, which states that investment drives economic growth. In this study, FDI acts as external capital, increasing productive capacity and contributing to GDP growth.

However, the causality test in this study revealed a significant unidirectional causality from FDI inflows in given sectors to real GDP, a result that aligns with the findings of Aryal et al. (2024). The high R-squared value reflects strong explanatory power and reliability. The significant F-statistic further supports the robustness of the model, D-W statistic indicates minimal autocorrelation in residuals, which enhances the credibility of the results.

CONCLUSION

The findings of this study revealed that while FDI inflows and RGDP in Nepal have showed an increasing trend, Nepal's share of global FDI inflows remained low, with FDI as a percentage

of GDP being the lowest in South Asia, after Bhutan. Despite Nepal's relatively low share of FDI within the South Asian region, the trend of actual FDI inflow increased, with India and China as major contributors.

The study indicated positive and high correlation between RAFDI and RGDP and high value are statistically significant. The findings from the OLS regression analysis conclude the Real Actual FDI positively impacted Nepal's economic growth as measured by RGDP after testing for normality (Jarque-Bera) and model specification (Ramsey RESET). The OLS regression results showed that Real Actual FDI positively impacted RGDP, confirmed by the significance of high correlation values after testing for normality and model specification.

The ARDL model confirmed a significant long-term impact of FDIAg, FDIMg, and FDISrv on RGDP, highlighting their contributions to productivity, employment, innovation, and economic output, consistent with the Harrod-Domar model, as sectoral FDI supplements domestic investment and promotes long-term economic growth in Nepal. These outcomes emphasize the importance of sector-specific FDI inflows as a crucial driver of Nepal's economic growth and call for strategic, evidence-based FDI policies to ensure sustainable and inclusive development. The analysis showed that economic growth in Nepal depends on more than just FDI. Other factors like infrastructure, education, and political stability also play a key role. While attracting FDI through better business conditions can help, a broader approach is needed. Future studies should look into more factors and models to guide effective growth strategies.

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