EXPORTERS' EXCHANGE ENTITLEMENT SCHEME AS TRADE DIVERSIFICATION MEASURE: A CASE STUDY OF LAND-LOCKED NEPAL

OMKAR LAL SHRESTHA

I. INTRODUCTION

NEPAL's foreign trade sector can, in effect, be categorized into two parts, namely, Nepal's trade with India and its trade with the rest of the world. For geographical as well as for economic reasons, Nepal's trade has been largely concentrated to India especially prior to 1960.

Geographically, Nepal is a land-locked country hemmed in between Tibetan part of China in the north and India in the remaining three sides. It is always bad to be land-locked but it is worse to be land-locked like Nepal. Getting to Tibet from Nepal is easy but the nearest sea-coast from Tibet is still further from Nepal than the nearest sea-port in India. India thus presents itself to Nepal as the only economically viable transit country. For its all commercial traffic flow with the third countries, Nepal is hopelessly dependent on the availability of transit facilities from India. Viewed that way, Nepal is more "India locked" than just land-locked. Indeed no country in the world (excluding next door Bhutan) is so badly land-locked as Nepal, having no option of a transit country other than India and no choice of the sea-port except Calcutta port. The availability of transit facilities and the procedure to be followed for those available facilities in India also play a predominant role in the expansion of Nepalese trade beyond the territories of India. The provision of transit facilities to the Nepalese trade traffic have not always been fully adequate and satisfactory.

Apart from the availability of transit facilities in India, the physical location of the country and the stage of its economic development also have made the Nepalese exportable products less competitive in the international market. Each metric ton of Nepalese jute (the main export to the overseas) costs Rs.300 ($24) more in the world market vis-à-vis the Indian jute. Inefficiency in management combined with its dependence on India for auxiliary parts and products also make the exportable products of Nepal less competitive in the world market when they have to compete with the similar products from India. The internal topography of the country is such that by the time the products are brought to the exporting point the cost has already become quite higher.

Also, Nepal being primarily an agricultural country, its foreign trade structure is such that both its major exports as well as imports constitute heavy and bulky materials such as rice, timber, jute in its export list and coal, iron and steel products, cement, sugar and salt, etc., on its import list. The nature of these products also have posed difficulties for Nepal in expanding its trade with countries other than India. Furthermore, following its restrictive trade policies, price structure in India has been somewhat higher. This has made it more profitable for the Nepalese exporters to export to India rather than to other countries. The high cost that Nepal has to pay for its imports from the overseas, the huge transportation cost involved in trading with the third countries and the poor quality of its export products also have led the Nepalese trade concentration largely with India. Varying from commodity to commodity, the transportation costs from the Calcutta port to the Nepalese border range from 10 per cent to 100 per cent of c.i.f. prices at Calcutta. These factors all combined explain the reasons behind the Nepalese excessive trade concentration with India. Perhaps because the trade centralization with India has been so high, a need to diversify it to the third countries has been equally great. Furthermore, along with the changing stage of economic development, Nepal's need for capital goods, construction materials, and other necessary imports have shown a remarkable growth, and India recently has not been able to meet fully Nepal's import demand. This has been evident on India's growing restrictive trade policy towards Nepal by imposing quotas on development materials like cement, iron and steel products, and so on. But in order to achieve the highly cherished trade diversification, the possible losses to the Nepalese exporters in their export diversion from India to abroad need to be compensated and indeed some extra incentives need to be provided to them to broaden their export market beyond India. It is in this attempt of Nepal to expand its trade with the overseas for the purpose of achieving a growing trade diversification and securing a stable source of hard currency earnings that an incentive scheme became clearly essential. The incentives provided to the exporters exporting to the overseas had at least to be equal to the loss in their revenue resulting from their export shift from India to the third countries. It was in such context with the background just presented above that an Exporters' Exchange Entitlement Scheme (EEE Scheme) was introduced in Nepal in 1961.

II. EXPORTERS' EXCHANGE ENTITLEMENT SCHEME

The EEE Scheme is a scheme intended to provide incentives to the exporters to direct their exports from India to the third countries (that is countries other than India). The mechanism of the Scheme works in the following way. The exporters to the overseas countries are required to surrender their export receipts in hard currency to the Nepal Rastra Bank, the central bank at the official buying rate. The exporters, in return, are given a portion of the export receipts as Exporters' Exchange Entitlement ratio (EEE ratio). This ratio varies from the types of commodities exported. The holder of the entitlement is permitted to buy hard currencies at the official selling rate in order to finance imports of variety of goods from the overseas countries. The incentives mechanism start functioning at this point. In the first place, the access to the otherwise inaccessible convertible currency is granted to the entitlement holders at the official selling rate which is substantially lower than the free market exchange rate. The amount of hard currencies granted depend upon the EEE ratio fixed under the Scheme. Wider the margin between the official exchange rate and the market exchange rate of the convertible currencies, higher will be the degree of incentives. Secondly, the automatic granting of import licenses to the entitlement holders enable the holders to import various goods from the overseas countries whereas the non-holders are denied of these privileges. This has the effect of introducing oligopolistic power to the few entitlement holders. The resulting higher price in the domestic market for their imports from the overseas act as another incentive source for the entitlement holders. Thus profit on imports are used as incentive elements under the Scheme. Understandably, the inclusion of wider variety of luxury items in the import list will tend to give higher profit or premiums on the imports of the entitlement holders. Thus, incentives to the overseas exporters have been inseparably linked up with the profit margin on imports allowed under the entitlement. To put the above explanation symbolically,

P_F = Price paid by the foreigners.
E_R = Entitlement ratio.
P_E = Profit or premiums on entitlement.
P_T = Total price received by the exporter.

$$P_T = P_F + P_F \cdot E_R \cdot P_E.$$
$$P_T = P_F\,(1 + E_R \cdot P_E).$$

Numerically, suppose the exporter exports \$8 worth of goods. The official exchange rate of dollar vis-à-vis Nepalese rupees being Rs.12.50, he gets Rs.100 for the commodity he exports. The entitlement ratio or the bonus is 40 per cent of his export earning. If the entitlement can be sold in the market for 200 per cent of its face value, the total price received by the exporter, i.e., P_T, will be Rs.180. Thus, for exporting \$8 worth of goods, he receives in total Rs.180 and hence the effective rate of exchange for his export earning has been Rs.22.5 which is substantially higher than the official rate of exchange at Rs.12.5. It might be noted that the effective exchange rate depends upon the percentage of bonus as well as the prevailing premium in the market. A change in either of them, especially the premium, affects the profitability of exports. The Scheme does enable the exporters to export even at loss in the international market as long as the loss incurred in the external market can be made up domestically through entitlement ratio and premiums on entitlements. In the above numerical example, it is well displayed that, as long as the loss incurred in the international market is lesser than Rs.80, the exporter gets all incentives to export. The exporter wants profit. It is immaterial to him whether it comes from the foreign buyers or the domestic consumers. But at macro level, it makes difference on whom the incidence falls. The Scheme, in that sense, does act or at least can act as subsidizing the foreign consumers and taxing the domestic consumers.

In the above numerical example, the bonus being 40 per cent, the purchaser of the entitlement or the importer has paid Rs.80 for the right to buy \$3.20 or

Rs.40 worth of foreign exchange. In other words, for Rs.40 worth of foreign exchange ($3.20) he is paying, in total Rs.120. The effective exchange rate for the importer thus comes to Rs.37.5 per every dollar. The exporter and the importer thus face different effective or real exchange rate. If the exporter himself holds the entitlement and buys foreign exchange for himself, it would simply indicate that he assigns much more significance to the foreign exchange than the importance attached to it by the official rate. To put it plainly, there is a wide margin between the official exchange rate and the market exchange rate or the domestic currency is overvalued.

As a matter of fact, the actual profit that the exporters make in their export exceed the amount reflected in the formulation of $P_T = P_F(1 + E_R \cdot P_E)$. This is because the exporters usually over-invoice their export value to qualify themselves for higher entitlement ratio. The incentives under the Scheme thus depend on (a) the EEE ratio, (b) the profitability of imports in the market or premiums on entitlements, and (c) the extent of luxury items permitted to import under the Scheme. Higher the EEE ratios and/or higher the premiums, higher will be the incentives to export to the third countries. On top lies the extraterritorial incentives from over-invoicing of the export value.

The EEE ratio given to the exporters, as indicated above, differ from commodities to commodities and the principle that has been followed in fixing the ratio has been to compensate the possible loss to the exporters arising from their export to the overseas at official exchange rate. Thus the high ratio to the export of a particular commodity would simply indicate high differential between the domestic production cost from world price of the commodity and the loss that would result if export earnings were converted into the Nepalese currency at the official exchange rate. The high ratios granted do not necessarily indicate the top priority given to the export of these commodities. In practice, the fixing of the EEE ratios have been dependent more on subjective judgment than on any objective criterion.

This would simply mean that the EEE Scheme has not been formulated with an objective of promoting genuine indigenous export industries. This would also mean that the Scheme has been adopted just as a short-run policy measure and not as an integral part of the country's long-run trade policy package. By providing incentives to any kind of overseas export, the Scheme is likely to encourage wrong types of export industries irrespective of their factor intensity, multiplier effects, and even their long-run potentiality to earn a good foreign exchange. The Scheme thus can potentially create an inducive atmosphere for the lucrative industries that come up for no other motives than to enjoy the high protection and high entitlement ratios.

III. GROWTH AND ACCOMPLISHMENT OF THE SCHEME

To begin with, there were three entitlement ratios ranging from 40 to 60 per cent of the export proceeds. But the ratios were increased to five in 1965. The traders were distinguished from the industrialists and different ratios were as-signed to them with a view to give more incentives to the industrialists. By 1970, the ratios had increased up to eight ranging from 20 to 100 per cent. The increasing number of export of commodities had made it necessary to fix various ratios. Since the criterion followed in fixing the ratio meant to avoid the losses emanating from their export to overseas instead to India and since these losses varied from commodities to commodities, there was an ever increasing number of ratios to avoid both over and under compensations. Indeed, the number of entitlement ratios thus theoretically could be as numerous as the list of exported commodities themselves. The increasing number of ratios introduced more and more complexity in the Scheme. Another reason that also contributed in the growing number of ratios was India's request to Nepal to fix a list of the export commodities and their respective ratios so that India could keep an eye on the export of Indian products to the overseas through Nepal as Nepalese products.

In 1971, the distinction made between the industrialists and the traders was abandoned. For two years from Apirl 1973 to April 1975, the ratios had increased to nine ranging from 20 per cent to 90 per cent. In April 1975, these ratios were reduced to three at 60 per cent, 75 per cent, and 90 per cent, and in December of the same year the ratios were further reduced to two at 45 per cent and 60 per cent. Currently the ratios have been prevailing at these two rates. This is by any standard a tremendous simplification of the growing complexity of the EEE Scheme.

It is perhaps high time to pause and examine how far the Scheme has been successful in achieving the intended objectives. This can be done by examining the diversification of the country's trade market, its foreign exchange revenue before and after the Scheme implementation and its overall volume of transactions.

Before the implementation of the Scheme in 1961, Nepal's external trade was basically limited to India. The statistical evidence of growing trade with the countries outside India certainly stand in credit of the EEE Scheme. As evident in Table I, the country's imports as well as exports to the overseas recorded a substantial progress over the past fifteen years.

The statistical achievement of the EEE Scheme, however, need to be taken with a pinch of salt. While there was some increase in the nontraditional exports to the third countries, Nepal's main traditional exports of raw jute and jute goods to the third countries seem to have been simply the result of their diversion from India. In that sense, the Scheme does not seem to have helped very much in the expansion of the overall trade volume. This is shown in Table II.

Along with the diversion of traditional exports such as jute from India to the overseas, the increase in nontraditional exports however has resulted into an increase in the foreign exchange earnings of the country. This is presented in Table III.

The export to the third countries reached their peak point in 1968/69. Following India's restrictive steps to stop the entry of the products in India after their minimal processing in Nepal, Nepalese incentives to export to the third countries also declined sharply. The result was reflected in the all time low overseas export in 1970/71. Thus, even the growing foreign exchange

TABLE I

NEPAL'S TRADE WITH INDIA AND OVERSEAS COUNTRIES

(1,000 rupees)

Fiscal Year	Exports					Imports				
	Total	India	Per Cent	Over-seas Coun-tries	Per Cent	Total	India	Per Cent	Over-seas Coun-tries	Per Cent
1960/61	209,737	209,172		NS		397,982	375,112	94.3	19,130	4.8
1965/66	375,106	361,746	96.4	8,756	2.3	781,989	763,506	97.6	11,180	1.4
1974/75*	889,628	746,849	84.0	142,779	16.0	1,814,617	1,475,684	81.3	338,933	18.7
1975/76*	1,185,777	893,691	75.4	292,086	24.6	1,981,717	1,227,124	61.9	754,593	38.1
1976/77*	1,164,759	779,580	66.9	385,179	33.1	2,008,028	1,343,542	66.9	664,486	33.1
1977/78*[a]	846,358	367,066	43.4	479,292	56,6	2,191,358	1,412,582	64.5	778,776	35.5

Source: His Majesty's Government of Nepal, Central Bureau of Statistics, *Foreign Trade Statistics,* FY 1960/61 and 1965/66.

[a] Provisional. For first eleven months.

* Nepal Rastra Bank, *Quarterly Economic Bulletin,* Mid-April and Mid-July 1978.

TABLE II

NEPAL'S EXPORT OF MANUFACTURED JUTE GOODS

(Metric tons)

Fiscal Year	Exports			Percentage of Export to the Overseas	Production
	India	Overseas	Total		
1964/65	14,081	4,663	18,744	25	19,035
1965/66	9,554	5,032	14,586	35	17,325
1966/67	383	11,667	12,052	97	12,191
1967/68	387	13,317	13,701	97	12,179
1968/69	—	—	—	—	13,958
1969/70	—	—	—	—	10,507
1970/71	—	—	—	—	13,502
1971/72	—	—	—	—	12,939
1972/73	—	10,026	10,026	100	13,709
1973/74	—	9,080	9,080	100	12,888
1974/75	—	5,754	5,754	100	12,265
1975/76	—	9,520	9,520	100	15,994
1976/77	—	10,500	10,500	100	16,803
1977/78[a]	—	8,558	8,558	100	12,152

Sources: (a) His Majesty's Government of Nepal, Ministry of Finance, *Economic Survey*; (b) Nepal Rastra Bank, Balance of Payments Division, Data sheet for internal distribution; (c) Jute Development and Trading Corporation of Nepal, Data sheet for internal distribution.

[a] First eleven months provisional data.

TABLE III

FOREIGN EXCHANGE EARNING OF THE COUNTRY BEFORE AND AFTER THE SCHEME
(1,000 rupees)

(1)	Net Earning from EEE Scheme (3) – (5) (2)	Overseas Exports (3)	Total Imports from Overseas (4)	Of Which Imports under the Scheme (5)
1959/60		271	362	
1960/61		4,948	9,184	
1961/62		6,889	10,275	
1962/63		2,380	12,963	
1963/64		3,869	13,563	
1964/65		10,853	25,486	
1965/66		28,232	18,523	
1966/67		57,309	51,092	
1967/68		88,799	78,111	
1968/69		136,769	76,177	
1969/70		108,772	134,750	
1970/71	42,700	87,429	79,286	44,729
1971/72	34,667	89,384	112,402	54,717
1972/73	74,734	151,637	197,509	76,903
1973/74	39,534	130,306	177,298	90,772
1974/75	36,867	119,450	463,269	82,583
1975/76	98,532	194,644	417,340	96,112
1976/77	164,843	321,095	503,143	156,252

Source: Nepal Rastra Bank, *Quarterly Economic Bulletin,* Mid-July 1977–Mid-January 1978.

revenue from the EEE Scheme was not independent of the market availability in India for re-export from Nepal. While one of the objectives of the Scheme was to liquidate Nepal's dependence on India for foreign trade, the growing volume of trade with the overseas, however, had not achieved the aim. The survival and the growth of trade with the overseas still uneasily, ironically and precariously depended on the availability of Indian market for re-export. Thus the trade diversification in a genuine sense had not been accomplished yet. Until 1969, there was hardly any restrictions on imports under the Scheme. Understandably, there was an import of only those goods that promised high profit. These commodities imported from the overseas got their market in India at a rewarding price because, in India, imports of such commodities had been banned. During 1967–72, the rate of profit on such products reportedly amounted to 125 to 130 per cent of their c.i.f. prices. In effect, the Scheme meant the expenditure of hard earned convertible currency in the nonessential imports from the overseas just to re-export them to India to receive Indian currency in return. Thus, it involved a sale of convertible currency to purchase inconvertible Indian currency through contraband trade. The wisdom of such policy, as such, is questionable even though the importance of Indian currency for Nepal is undeniable.

The Scheme appears to have been unsuccessful in achieving most of the intended objectives. The Scheme also seems to inherit with it host of other weaknesses.

The Scheme needed Indian market for its survival and growth and, when the door to the Indian market was closed in 1969/70, the speed of Nepal's trade expansion with the third countries also came to its slower pace.[1] It was indeed a strange trade diversification that, despite its statistically growing trade volume with the third countries, its dependence on India did not decrease.

Besides, as noted above, the EEE Scheme was never used as a tool to encourage genuine export industries. The entitlement was granted for the export of any commodities irrespective of their factor intensity, value added, foreign exchange earning capacity, and so on. As such, the EEE ratios were revised practically every year since 1964. The frequent alteration of the ratios and the ever changing premium rate had the effect of introducing uncertainty to the exporters creating an adverse effect on the export. Furthermore, there was a confusing complexity in the entitlement structure, e.g., by 1974, the number of EEE ratios had reached nine.

The Scheme has also introduced elements of distortion in the country's resource allocation. It was the EEE Scheme that created a conducive atmosphere in the country for the establishment of less useful industries like stainless steel and nylon synthetics which were almost entirely based on the imported inputs. Their value-added was negligible to the country and indeed their whole establishment was Indian market oriented. The contribution of these industries to the domestic economy was nominal in terms of generating income, employment, and output. The EEE ratios were used in the imports of stainless steel and synthetic textiles which after their nominal processing in Nepal got exported to the high priced market in India where imports of the same from other countries were banned. This was a classic example of an inconsistency in the country's trade policy and industrial policy. The need to meet stricter conditions for the Nepalese exportables in order to get an access to the Indian market in the 1971 treaty appears to be mainly due to the trade deflection just mentioned above.[2] In the 1971 treaty India banned the entry of all Nepalese manufactures that contain more than 50 per cent materials from countries other than Nepal and India.

On import front, the Scheme encouraged more of nonessentials and luxury imports than the imports of development goods. Incentives depended on the profitability of imports. The profit rested more on the import of nonessential goods while for development, the country needed more of the imports of capital goods. Thus the inherent built-in-bias for the import of nonessential goods under the Scheme seemed to be inconsistent with Nepal's development policy. Thus, there was a misallocation of resources both on import side as well as on export

1 Following India's recent import liberalization policy after emergency, the Indian market that has been assured so far is likely to dwindle automatically.

2 Trade between Nepal and India is guided by the bilateral Trade and Transit Treaty signed between the two countries in 1971. The treaty expired in August 1976. Both countries have agreed to follow 1971 treaty until a new treaty is signed agreeable to both.

side. Over the past few years, for instance, roughly 90 per cent of the total imports made under the EEE Scheme were in the form of consumer goods.

The incentives to export to the third countries did not just depend on the EEE ratios, profit on imports and production cost of the exportable products but also on its price in India, its price in the international market, and the exchange rate of the Nepalese currency vis-à-vis Indian currency and the third currencies. At the absence of all the above information in detail, it becomes difficult to make a proper assessment of the Scheme. It also becomes nothing more than a guessing game to fix entitlement ratios for the export of various products. On top, the frequent changes in the EEE ratios tend to introduce more of a confusion and make it difficult to quantify the effects of the ratios. Furthermore, the incentives for export promotion basically seems to fall on the traders who import and make profit out of it. The incentives did not get up to the exporters quite adequately who actually export and who in a real sense need the incentives and bonus. An increase or a decrease in the country's exports to the overseas thus depended more on the premium rates fixed by the importers than by the exporters themselves.

The Scheme also tends to encourage misrecording of the trade volume. In exports to the third countries, there is likely to be temptation to over-invoice the exported amount in order to earn higher entitlement ratios. On import side, the temptation could be to under-invoice the volume to evade custom duties. The re-export to India of goods imported from the third countries also goes all unrecorded. Policy based on inaccurate data is likely to have their own limitations.

The unavailability of data on profit and loss from imports and exports make it difficult to assess the true income position of the importers and exporters. Consequently, the income taxation on them has been a guess work resulting into a loss of revenue to the government.

By giving incentives to the export to overseas, the Scheme has in effect, been a discrimination against export to India. As shown in the table above, a huge percentage of Nepal's imports and exports are still concentrated to India. The EEE Scheme thus ignored a large portion of the country's foreign trade.

Finally, under the Scheme higher EEE ratio amounted to higher profit. But higher ratios were allotted to the export of the commodity that incurred higher losses in their trade with the overseas. Thus less efficient export industries enjoyed larger benefits from the Scheme whereas the genuine export industries that needed least spoon-feeding were furnished with lower ratios. The Scheme thus did not give adequate incentives to the deserving export industries.

IV. PROPOSAL OF THE DUAL EXCHANGE RATE SYSTEM

Weighing against all these weaknesses, it has become almost an imperative that the EEE Scheme be replaced by some other method that will continue to provide incentives to the overseas exports but without carrying with it so many deficiencies that almost defeat the very purpose for which the Scheme had been implemented. What follows in this section will precisely by an investigation of such method.

It need to be realized that an expansion of Nepal's trade with the overseas is of paramount importance both for trade diversification as well as for a steady and increasing foreign exchange earnings to the country. It also need to be equally clear that the trade expansion with the third countries should not be merely a redirection of trade from India. Trade with India is just as important or even more. Because for the country's imports of several commodities (basically bulky materials), India holds a definite edge over the third countries and also the increasing need for Indian currency ought to be met by increasing Nepalese exports to India. Sale of hard currencies to buy Indian currency and Stand-by Credit arrangement with India do not promise a long-run solution to Nepal's trade deficits with India.[3] Hence while the need for foreign exchange is so obvious for Nepal and hence its trade expansion with the overseas, this should not come as a substitute for our trade with India. The new incentive mechanism need to play a role such that it will help promote genuine export to the countries outside India thus ensuring a steady foreign exchange earning in consonance with the development plan of the country without at the same time inheriting the deficiencies of the present Scheme.

The better criterion, for instance, could probably be to encourage those export industries that will generate more income, employment, and output to the country or that which stand the test of the principle of comparative advantage. Adoption of this principle will eliminate straight away entitlement privileges to the export of several commodities. This is likely to bring a genuine trade diversification that will indeed relieve Nepal of the pressure of its precarious dependence on India. This will at the same time increase the entire trade volume of the country. This will be a true trade diversification and a real trade expansion.

The suggested mechanism to replace the present EEE Scheme is a Dual Exchange Rate System. The Dual Exchange Rate (DER) System will work in the following way. Under the DER System, there will be two exchange rates for buying and selling of foreign currencies, one at official rate and the other at a depreciated rate. For instance, the overseas exporters now would be required to surrender their foreign exchange to the Rastra Bank as before. In return they would be paid the Nepalese currency at a depreciated rate. This obviously makes an implicit assumption that the Nepalese currency is overvalued at the present exchange rate and left to itself, it act as impediment to the export growth. Under the DER System, the importers are given freedom to import as long as they are willing to buy hard currencies at depreciated rate. It is to be noted that under the EEE Scheme, import was restricted only to the entitlement holders. Several other importers, despite their willingness to import had been denied of it. Under the DER System, importers are likely to regulated by the market price and not by the entitlement holdings. The oligopolistic situation bred by

[3] Indo-Nepal trade is conducted in Indian currency. At several times, Nepal had to sell hard currencies (U.S. dollars, sterling pound) to buy Indian currency to meet the trade deficits with India. Since February 1973, Nepal made a Stand-by Credit arrangement with India for an amount of 100 million Indian rupees at 7 per cent interest rate and 0.5 per cent commitment charge. The arrangement had to be renewed after every six months and it has been terminated in July 1977.

the EEE Scheme will now be dismantled. In other words, imports now will be liberalized without any adverse effects on export promotion.

Besides, under the EEE Scheme, there was an inherent built-in contradiction in the sense that the incentives to export were derived from the profit on imports from the overseas. But profit was larger on imports of luxuries than on the imports of development necessities yet what was more required for the country's development was what was giving relatively less profit. Exports and imports had been kept inseparable and this link had not only encouraged more imports, it had encouraged an imports of wrong kind, namely, the nonessentials. There was thus an obvious self-contradiction in the export promotion through the Scheme and the economic growth itself. The proposed DER System is likely to remove this inconsistency by delinking imports from exports.

Under the EEE Scheme, the incidence of the incentives had fallen basically on the importers and traders and not on the exporters yet it was the exporters who, in a real sense, had to be provided the incentives with. Thus there was, in a way, misallocation of incentives. Under the DER System, the benefit of the incentives fall straight on the exporters themselves and there is no chance for the importers to make profit out of the exporter's export.

The DER System is likely to simplify the whole procedure of giving incentives. Unlike under the EEE Scheme, there is now no need to devise ways of assigning different entitlement ratios on the export of different commodities. The exporters are given adequate incentives when they hand over their entire export earnings to the Nepal Rastra Bank and receive Nepalese currency at a depreciated rate of exchange is substantially higher than the official exchange rate.

The continuous modification and revision of the entitlement ratios and the ever changing premium rate in the market had been a source of uncertainty and risk to the exporters under the EEE Scheme. The country's total exports to the overseas under the EEE Scheme had thus been dictated more by the most uncertain premium rates than by anything else. By removing the uncertainty, the DER System is likely to create an atmosphere of stability so much required for a healthy growth of exports. Indeed this would be the single most important contribution of the proposed DER System. Besides, the incentives provided under the EEE Scheme has encouraged only lucrative types of export industries that promised quick profit than anything else. Since the prospective and genuine industries could compete in the international market even with small incentives, these had been given small entitlement ratios as opposed to those host of inefficient industries that needed a substantial spoon-feeding for their survival in the market. The EEE Scheme thus had been providing an ideal atmosphere for breeding just the useless and inefficient industries. The DER System is likely to bring a new atmosphere conducive to the growth of genuinely promising export industries.

As noted above, under the EEE Scheme the incentives provided through profits on imports and their reexport to India in effect meant a situation of sale of convertible currency to buy inconvertible currency. In itself, it was an expensive bargain. Even though it is hard to substantiate with statistics, there is every likelihood that the non-Nepalese (basically the Indian traders) dealing in this business would prefer to preserve their Indian currency earning from re-export to India in India itself instead of bringing them back into Nepal. This is, as already noted, a possibility but with a high probability. In such cases, the EEE Scheme has not just been an expensive bargain of convertible currency for Indian currency, it has also been a source of capital drain out of the country in each case where the Indian currency resulting from re-export to India remained in India and never came back to Nepal. This kind of situation will be put to an end by the proposed DER System.

Understandably, by imposing high import license fees, the overseas imports of luxurious items under the DER System can be made more expensive. Thus, apart from lowering the unnecessary and avoidable imports, this System also will provide the government with an additional source of revenue.

Finally, the EEE Scheme when started had been adopted as a short-run policy just to give a boost to the prospective export industries. It had never meant to be an integral part of the country's long-run trade policy package. Besides, the growing complexity that it has assumed along with the growth of time has proved that the Scheme has lost the very objective with which it was started. A substitute to the Scheme has been, as a result, a long overdue. It is to fill up this vacuum that the DER System has been proposed.

V. POSSIBLE IMPACTS OF THE PROPOSED SYSTEM

The new proposition however ought to be placed into the hottest fire of analysis regarding its possible impacts on various aspects like price, production, and employment level in the country before it is granted an approval for implementation. This is precisely the subject matter of the present concluding section.

What happens to the price level after the implementation of the DER System would largely depend upon the magnitude of exchange rate depreciation under it. A lower depreciated rate under the DER System vis-à-vis the effective exchange rate under the EEE Scheme would mean a likelihood of a lower price level and vice versa.

The price effect of DER System in the Nepalese context however is conditional to several factors. The state trading agency of Nepal, namely, the National Trading Ltd., imports basically raw-materials, capital and machineries, and essential consumer goods from the overseas. For their imports, the National Trading Ltd. is provided the convertible currency at official rate. The adoption of DER thus would have definitely meant an increase in the price level of the goods being imported by the National Trading Ltd., since the depreciated rate under the DER System is automatically going to be higher than the official rate under the EEE Scheme. But the close similarity in the selling price of the goods imported by the National Trading Ltd. and goods imported by other private parties at effective exchange rate under the EEE Scheme leads one to believe that the new price level under the DER System is not likely to be all that significantly unfavorable. In other words, price of the capital as well as consumer goods under the DER System is not going to be much affected from the EEE Scheme. It is likely to be nominal.

The essential imports made by other state-controlled agencies however will be affected seriously by the implementation of the DER System since their imports under the EEE Scheme have been made by their respective agencies at official rate of exchange. Such immediately affected imports will be the imports of petroleum and fertilizers, both highly essential and instrumental inputs. The neutralization of the possible inflationary impacts on the above imports would require that some subsidies (direct or indirect) be given to ease their imports under the DER System.

The possible effects of DER System on production depends upon whether the imports of fertilizers are allowed at the previous exchange rate prevaling under the EEE Scheme. If the exchange rate under the DER System for the imports of fertilizers are made at depreciated rate higher than the exchange rate under which imports had been made under the EEE Scheme, production of those agricultural crops needing more use of fertilizers is likely to show a decline. A shift to agricultural crops needing less use of fertilizers is a possibility under the DER System. The production effect would however be different from above if the new exchange rate under the DER System is maintained at the same level for the basic inputs as under the EEE Scheme.

The effects of the DER System on the production of industrial goods however is likely to be encouraging. The DER System can be expected to give a boost to the production of those industries that make more use of the indigenous raw materials. Industries using more of the imported raw materials are likely to find their cost of production going up because of the high import cost of their inputs. The production of the country's exportables such as curios and the handicrafts are likely to go up for the reason that the profit from their export under the DER System has been made more certain and stable now. The profit certainty was not there under the EEE Scheme due to frequently changing premium rate on the bonus.

To the extent production goes up, the DER System is likely to increase employment also. An increase in production under the DER System is likely to have a favorable effect on employment as well.

The proposed DER System is not without some of its own deficiencies. It also carries with it some of the similar defects of the EEE Scheme. The adoption and implementation of DER System ought to be judged against all these weaknesses before discarding the EEE Scheme.

The most difficult problem under the DER System would lie in fixing the proper rate of depreciation. The fixation of the proper rate might take a trial and error method of changing the depreciation rate several times.

Under the DER System, imports and exports are left entirely to the private sector. Hence, unlike the EEE Scheme which directly controls imports and exports, the DER System if adopted would mean a partial sacrifice of control over the balance of payments of the country. If the new exchange rate under the DER System is higher than the effective rate under the EEE Scheme, imports from India will be liberalized. This is likely to impose a possible threat of worsening the already deficit balance of trade position of Nepal with India. A high tariff against the imports from India is not likely to be effective due to free and open border with India. A high tariff would simply mean an increase in smuggling across the border. This has been substantiated several times in the past.

If the new depreciated rate under the DER System is fixed lower than the effective exchange rate under the EEE Scheme, more imports will be encouraged from the overseas. These overseas goods are likely to move across the border in India and thus the issue of smuggling that had been a major irritation between the two countries under the EEE Scheme is likely to continue under the DER System as well. One possible step to check it would be to impose a high tariff or license fees on imports from the overseas.

There is also the possibility of an emergence of de facto crossed rate under the DER System. Since such an emergence makes the transaction in currency profitable, this will create a conducive atmosphere for speculation in one currency against another. A speculation on Indian currency against the Nepalese currency is likely to put a tremendous pressure on the already shaky Indian currency reserves of the Nepal Rastra Bank.

Furthermore, the problem of under-invoicing and over-invoicing that has affected the EEE Scheme so badly is likely to afflict the DER System as well. Under the DER System also like under the EEE Scheme, there is every incentive to the traders to under-invoice the imports and over-invoice exports. Under-invoicing in the imports still spare the traders from the brunt of custom duties and over-invoicing of export promises them windfall gains in terms of exchange facilities at the depreciated rate. Thus the DER System is not itself free of some of the deficiencies that it seeks to remove from the existing EEE Scheme. Meanwhile, realizing the problem of excessive over-invoicing of export, the government has introduced, in August 1977, a new system of bonus to the exporters. Accordingly, the bonus would be given on the basis of "price actually fetched by the goods in international market" and not on the basis of exaggerated price quoted in the export invoice bill. The new System of bonus appears to be a wise step in solving the problem of excessive over-invoicing of the country's exports.

It is against the background of all these arguments that the proposed DER System ought to be judged. Even though the DER System leaves many questions unanswered, it appears to be less of an evil than the existing EEE Scheme.[4]

[4] After the author completed this paper, the EEE Scheme was replaced by Dual Exchange Rate System effective March 30, 1978. The depreciated rate of exchange under the DER system has been fixed at Rs. 16 for one U.S. dollar (against the official rate at Rs. 12 for one U.S. dollar). For surrendering their foreign exchange to the Rastra Bank, the overseas exporters would be paid Nepalese currency at depreciated rate. For the imports of certain development and construction materials, foreign exchange would be released at the official rate. Seventeen commodities of luxurious nature have been put into quantitative restriction. The rest could be imported automatically at depreciated rate of foreign exchange. It is still too early and will take some more time before one can make an assessment of the actual effects of the DER System.