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Market Diversification and Condition for Benefit Lessons from the Experience of Nepal

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INTRODUCTION

Over the last five decades economists have expressed concern over export instability as it affects not only least developed countries (LDCs) but also developed countries (DCs). However the impact of fluctuations is more pronounced on LDCs. In a study MacBean (1966) found that export instability was 31 percent higher in LDCs than in DCs during 1948-59. In a similar study Massell (1970) discovered that during 1950-66 instability was 50 percent greater in LDCs than in DCs due to the high geographic concentration of their exports. He concluded that high geographic concentration is likely to imply greater economic dependence on few countries. Fluctuations in demand in any recipient country will then have a more pronounced effect on the receipts of the exporting country than if exports were more diversified among countries. Patterns of development that lead to increased diversification of exports would be desirable if one wished to reduce fluctuations in export earnings.

Most of us will agree with the above conclusions. However changing the direction of exports from one market to another market, market diversification, may not be beneficial. First, there are several costs associated with market diversification such as market research and promotion, because tastes and demand preferences vary in different markets and hence extensive research and promotional activities are essential. Second, unless some incentives are offered exporters do not want to go to new markets which are not known to them due to risk factor, social and cultural differences. Balassa (1978) expresses the view that the risk to individual exporters tends to be greater than to the nation that has pursued an export diversification strategy. Therefore, additional incentives be given to new exports or exports going to a new market. Unless these costs are financed by the general expansion of the export sector, at least in the long-run, geographic diversification may not be beneficial.

Most LDCs are diversifying their foreign trade from traditional markets to new markets as they argue that market diversification enables them to obtain better prices for their exports and also permits them to buy from cheap sources. They also believe

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that diversification gives them more flexibility and reduces dependence on few markets which is justified not only on economic but also on political grounds.

MARKET DIVERSIFICATION AND CONDITIONS FOR BENEFIT

Diversifying the destination without expanding the production base may not be economically beneficial. Hence, for market diversification to be beneficial, production of exportable items must be increased with the help of research and development, export-promotion activities and production-oriented incentive policies. In the present competitive world, these three must go together in order to expand the production base and through it the volume of trade. Thus we can conclude that market diversification is the function of output which is directly influenced by the research and development, export promotion activities and the incentive system of the country. In simple term, this can be expressed as follows:

$$D = f(O) \quad \text{(i)}$$
$$O = f(R\ \&\ D, P, E) \quad \text{(ii)}$$

Here, D denotes market diversification, O refers to the production of exportable output, R & D P and E represent research and development, export promotion activities, and production - oriented incentive system respectively.

In the real life, R & D, P and E determine the level of production in a country which influences the volume of trade. R & D helps to identify and develop new products and markets as well as to make products internationally competitive and even cheaper through reducing costs. While E attracts entrepreneurs to get involved in the production and export of commodities of comparative advantage. One can even argue that R & D itself encourages production and export in the long run and hence there is no need to grant any additional incentives. But due to the risk and volatile nature of export markets, exporters are reluctant to go to new markets unless some incentives are offered until these markets have been established. Incentives can be granted in the form of tax concession for the production of exportable items, subsidized finance for productive activities, research and development grants for developing new products and improving the quality of existing products. Incentives can also be granted in the form of a bonus if exporters meet the targets.

At the initial stage of development, Newly Industrialised Economies (NIEs) offered financial incentives in the above forms for expanding the production base and they found a strong association between production - oriented incentive system and export growth. On the contrary, Nepal offered incentives for exporting to new markets rather than for developing new products, building up competitiveness and expanding the production base which did not help to create a strong trade sector.

A Case of Nepal

Nepal, a mountainous country bounded on the south, east and west by India and on the north by China, is primarily dependent on agriculture, although the manufacturing sector is gradually growing. Because of its landlocked position, India had been her major trading partner until 1980s.

Between 1962 to 1981, Nepal introduced two major incentive schemes for changing the direction of its foreign trade from India to overseas countries. It was thought that these export incentive schemes will not only change the direction of its trade but will also encourage the production of exportable items, thus the economy will enjoy benefits form export diversification. However, it did not happen, mainly due to the slow growth in the production of exportable items. The average annual GDP growth during this period was 2.3 percent, most of which was consumed locally (Table 3) and exports were under 2.3 percent of GDP. It means the production of exportable goods was not influenced by the diversification schemes and thus whatever was being exported to the traditional market got diversion to the new markets.

MEASURES TAKEN TO DIVERSIFY NEPAL'S FOREIGN TRADE IN THE PAST

Exporter's Exchange Entitle (EEE) Scheme

In 1962 the Nepalese Government introduced the EEE Scheme to diversify its exports from India to overseas countries. More specifically the objectives of this scheme were as follows:

- to increase the exports of domestic products by providing incentives to exporters;
- to diversify exports and encourage imports which were not available in India or available only at very high cost;
- to increase the stock of convertible foreign currencies to meet development needs.

The Scheme allowed overseas exporters a bonus in the form of convertible foreign exchange which could be used to import a wide range of goods except some restricted items. It was a very lucrative incentive for exporters as it allowed them to play with convertible foreign currencies which were scarce in the country.

Due to the provision of bonus, Nepal's exports to overseas countries increased under this scheme. Initially a substantial amount was spent to motivate exporters for exporting overseas rather than for increasing the production of commodities of comparative advantage through R & D and production-oriented incentive policies. As a result, exports to India came down from 99 percent in 1964-65 to 84 percent in 1974-75 and to 48 percent in 1977-78 (Table 1). Jute, jute products and some other primary goods which were losing Indian markets, especially between 1962 to 1978, were diverted to overseas markets which was the most welcome achievement of this scheme. However, it should be mentioned that during 1962-63 and 1966-67 Nepal exported more jute an jute products than its domestic production. This implied that there were either hidden imports of jute from India for re-export or there was over-invoicing or both due to the lure of incentives.

Table 1

Direction of Nepal's Exports
1956/57 - 1991

(in percentage)

Year	Exports to India	Exports to Overseas
1956/57	98	2
1960/61	100	Negligible
1964/65	99	1
1968/69	98	2
1970/71	99	1
1971/72	95	5
1974/75	84	16
1975/76	75	25
1976/77	67	33
1977/78	48	52
1978/79	50	50
1979/80	39	61
1980/81	60	40
1981/82	67	33
1982/83	74	26
1984	31	69
1986	26	74
1988	22	78
1990	24	76
1991	6	94

Source: For data between fiscal year 1956/57 to 1982/83, *Nepal Overseas Trade Statistics* (various issues), Trade promotion Centre, Kathmandu, Nepal.

For data between 1984 to 1991, *Direction of Foreign Trade Statistics, Yearbook 1991 & 1992*, International Monetary Fund, Washington.

Since the Scheme encouraged exports to overseas countries, there was a tremendous increase in foreign exchange earnings from overseas trade. For example, total receipts of foreign exchange from exports of merchandise goods to overseas countries rose from 20 percent in 1960-61 to over one-third of the total receipts during 1965-66 to 1977-78. The official foreign exchange reserve rose by almost US$ 160 million during 1960-61 to mid-March 1978, which is mainly attributed to the increment in merchandise exports to overseas countries, brought about by the EEE Scheme (NRB, 1980).

Some changes were also recorded on the import front. Sources of Nepal's imports also diversified because of the Scheme. Its dependence on the imports from India declined from 98 percent in 1964-65 to 81 percent in 1974-75 and to 67 percent in 1977-78 (Table 2).

Table 2

Direction of Nepal's Imports Form 1956/57 to 1991

(in percentage)

Year	Imports from India	Imports from Overseas
1956/57	98	2
1960/61	94	6
1964/65	98	2
1968/69	93	7
1970/71	88	12
1971/72	80	20
1974/75	81	19
1975/76	62	38
1976/77	67	33
1977/78	67	33
1978/79	55	45
1979/80	52	48
1980/81	47	53
1981/82	47	53
1982/83	41	59
1984	25	75
1986	20	80
1988	15	85
1990	20	80
1991	7	93

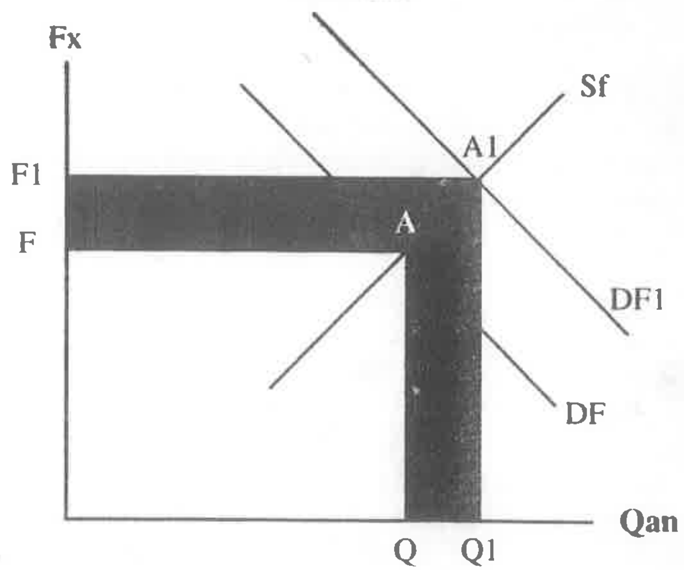
Source: As per table 1

The EEE scheme succeeded in changing the direction of Nepal's foreign trade from India to overseas countries albeit not succeeded in creating a strong trade sector capable of supporting the economy on a stable basis. In fact whatever was being exported to India got diverted to countries other than India because of the attractive incentives provided by the government for overseas exports. As a consequence, in some cases exporters started to export below cost in order to be able to sell their products in overseas markets and to import foreign goods from the bonus certificate obtained.

Imports of luxurious foreign goods increased tremendously as a result of the bonus system. These imported goods could offer huge profit margins, up to 300 percent, than the imports of raw materials and capital goods for expanding the production base. It was estimated that over 50 percent of these imported items were re-exported to India through unauthorised channels which were difficult to control due to the 500 miles open border between these two countries. Foreign goods were very popular in India because of its inward-oriented trade policy and re-entry of luxurious goods always became one of the issues in every trade talk between these two countries.

The effects of smuggling, which was the outcome of the EEE scheme, on Nepal's foreign exchange position and terms of trade is explained with the help of the following diagram.

Diagram



Assuming that before introducing the EEE Scheme, Nepal's demand for and supply of foreign goods, goods made in countries other than India, are represented by DF and SF curves respectively and the country is in equilibrium at point A. When the

EEE Scheme was introduced that permitted exporters to use part of their export earnings for importation of foreign goods. As a consequence, imports of foreign goods increased from Q to Q1 because they were very attractive not only among Nepalese but also among Indian tourists and customers. Thus demand curve shifts from DF to DF1 and the new equilibrium point is attained (A1). The negative effects of smuggling on the foreign exchange position and the terms of trade are shown by the shaded areas. Area F, F1, A & A1 represents the loss in foreign exchange while A, A1, Q & Q1 shows the increase in the quantity imported for smuggling as a consequence of the EEE Scheme.

Dual Exchange Rate System

In 1978 the EEE Scheme was replaced by the Dual Exchange Rate System because of the abuse of the facilities and also because of its negative effects on the country's terms of trade.

The purpose of the Dual Exchange Rate System was the same as the previous one. However it also had an additional aim of controlling the imports of luxurious goods. In order to diversify trade to overseas markets and control the imports of luxurious goods with a view to improve deteriorating terms of trade two exchange rates were introduced under this system. The first rate was Rs. 11.90 per US$ and the second rate was Rs. 15.90 per US$.

All earnings from overseas exports were converted at the second rate for encouraging exports. On the other hand, imports of certain development goods such as petroleum products, chemicals, fertilizers, certain raw materials and machinery were made available at the basic exchange rate with a view to increase the production of exportable items.

Under this system, incentives were granted not only for exports but also for expanding the production base. That is the reason for granting foreign currencies at the basic rate for the importation of development goods. Unfortunately export incentives were more generous than the incentives for production which did not help to expand the production base. Similarly, there were no policies for market promotion and incentives for R&D activities. As a result, this scheme of market diversification only changed the direction of export from India to overseas without expanding the production base. Due to the generous incentives, products which were more profitably exported to India got diverted to overseas. Consequentially foreign exchange earnings from overseas trade increased, but there was a severe shortage of Indian currency in the country because her exports to India declined more rapidly than imports despite the fact that she was still a major supplier of various goods to Nepal (Table 1 and 2).

Nepal had to sell convertible currencies to buy Indian rupees in order to settle its payment problems with India. Between April 1978 to the end of 1979, Nepal sold over NRs. 2000 million worth of convertible currencies to buy Indian rupees. Until the downward revision of the second rate in February 1980, Nepal Rastra Bank, the Central Bank of Nepal, purchased convertible currencies from exporters at a rate of Rs 15.90 for one US$ and sold such currency to India at a rate of Rs 11.90 to obtain Indian rupees, thus incurring a loss of at least Rs 4 for every dollar transacted. Thus, the Dual Exchange Rate System like the previous scheme, EEE, of trade diversification did not succeed in expanding the production base for changing the direction of trade in a beneficial manner and therefore, was dropped in September 1981 (Thapa, 1981).

In the late 1970s and early 1980s, the Nepalese government undertook some major reforms including the decision to establish an organisation for undertaking market research, product identification and development activities with a view to boost up overseas trade, known as Trade Promotion Centre. Commercial banks were also directed to encourage investments in productive sectors to expand the country's production base. By the middle of 1980s they were asked to direct at least 7 percent of their investments toward production-oriented activities. Loans were made available at a lower interest rates, around at 7 percent, for production and export - oriented activities while for other purposes it was around 14 percent. In order to encourage overseas exports, a subsidy of 10 percent of FOB value was also granted to meet part of the transportation cost. Due to the land-locked position of the country, the costs of overseas exports have always been very high. Unless some assistance is given to meet part of these costs, exports will not be attractive in international markets.

As a result of these measures, which included the provisions of market promotion, R&D and production oriented incentive system, some improvements are seen on the production and export fronts (Table 3). During 1980s and 1990, average annual growth in output was 4.4 percent per annum as compared to 2.1 percent during the period of the Exporter's Exchange Entitle Scheme, 1962-77, and 3.2 percent during the Dual Exchange Rate period, 1978-91. According to the Trade Promotion Centre, new export items have been added to the export list of the country in the recent years.

Similarly, the ratio of export as a percentage of Gross Domestic Products (GDP) increased form 2 percent during the Exporter's Exchange Entitle Scheme to 3.5 percent during the Dual Exchange Rate System and to 6.5 percent during 1982-90 (Table 3). The rise in export/GDP ratio during 1982-90 was the result of increased domestic output due to the R&D activities, market promotion and production-oriented incentive measures undertaken during the late 1970s and 1980s. The expansion in the production level served the purpose of diversifying the country's trade more intensively among overseas countries without creating any payment problem with India, its traditional trade partner (Table 1 & 2).

Table 3

Nepal's GDP, Exports and Exports as a percentage of GDP

(Value in Millions of Nepalese Rupees)

Year	GDP*	% Change in GDP	Exports	Exports as a % of GDP
1962	24252	-	265	1.1
1963	23966	-1.2	287	1.2
1964	24440	2.0	331	1.3
1965	25053	2.5	435	1.7
1966	26815	7.0	390	1.4
1967	26394	-1.6	398	1.5
1968	26573	0.7	491	1.8
1969	27758	4.3	550	2.0
1970	28474	2.6	430	1.5
1971	28134	-1.2	483	1.7
1972	29011	3.1	587	2.0
1973	28872	-0.5	659	2.3
1974	30701	6.3	698	2.3
1975	31148	1.4	1097	3.5
1976	32519	4.4	1229	3.8
1977	33500	3.0	1007	3.0
1978	34975	4.4	1100	3.1
1979	35804	2.4	1306	3.6
1980	34973	-2.3	964	2.7
1981	37891	8.3	1731	4.6
1982	39323	3.8	1161	2.9
1983	38152	-2.9	1361	3.6
1984	41846	9.7	2109	5.0
1985	44415	6.1	2195	4.9
1986	46325	4.3	3005	6.5
1987	48152	3.9	3290	6.8
1988	51644	7.2	4433	8.6
1989	53639	3.9	4303	8.0
1990	55564	3.6	6160	11.1

* 1985 Prices

Source: *International Financial Statistics Yearbook*, International Monetary Fund. 1992.

CONCLUSION

Nepal's experience suggests that any measures to change the direction of trade from one region to another is not beneficial unless the production base is expanded through production-oriented incentives, R&D and market promotion activities. Thus, these variables should be considered as a part of the diversification scheme, if it has to be effective.

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