Can Bangladesh absorb LDC graduation-induced tariff hikes? Evidence using product-specific price elasticities of demand and markups for apparel exports to Europe

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- Over the past several decades, the readymade garment (RMG) industry has been the main driver of Bangladesh's export growth.
- Bangladesh is set to graduate from the group of LDCs in 2026 – a transition that may lead to the loss of trade preferences in the EU, causing the average tariff on imports of apparel products made in Bangladesh to rise from 0% to approximately 12%. This brief utilises elasticity and markup estimates to understand the potential impact of graduation on the country's competitiveness.
- Bangladesh's significant market share in EU and UK apparel sectors implies that tariff introduction on its exports could initially raise garment prices. Still, subsequent market-wide adjustments might offer a buffer to mitigate some direct impacts of the tariff hikes.
- It is recommended that Bangladesh should focus on high-value-added RMG products that inherently offer greater markups; seize opportunities from the "China plus one" strategy by positioning itself as a reliable alternative to China; and make an all-out effort to retain duty-free market access in the EU for apparel products after LDC graduation.

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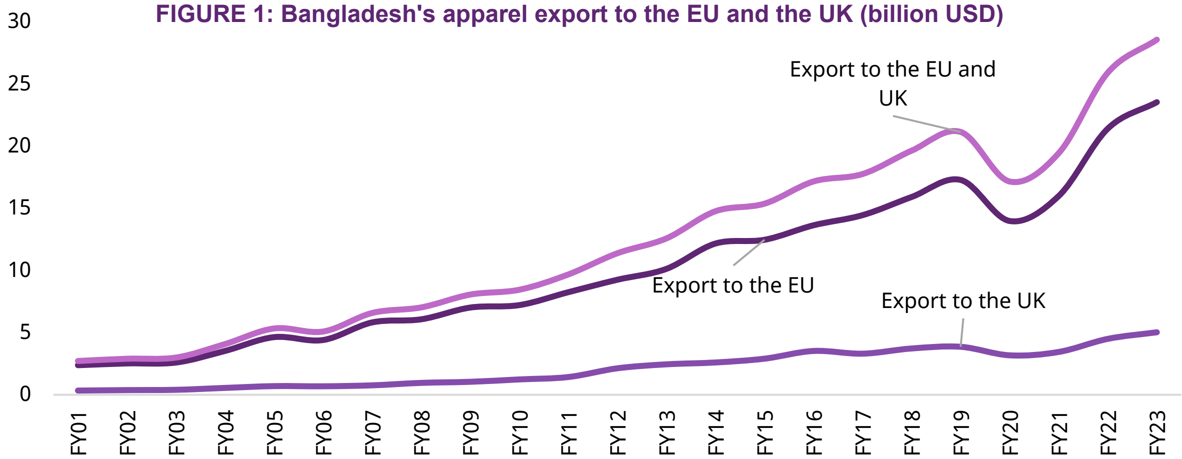
Introduction

Over the past several decades, the readymade garment (RMG) industry has been the main driver of Bangladesh's export growth. Initially, the global trade regime, marked by Multifibre Arrangement (MFA) quotas restricting imports from East Asian suppliers, immensely helped Bangladesh break into apparel markets. Additionally, unilateral trade preferences for least developed countries (LDCs) granted by the European Union greatly aided the export competitiveness of apparel items produced in Bangladesh. The EU GSP scheme provided relaxed rules of origin (RoO) requirements for facilitating duty-free market access, especially with the introduction of the Everything But Arms (EBA) initiative for LDCs in 2001. On the domestic front, various policy support, such as allowing imports of raw materials and intermediate inputs through back-to-back letters of credit, bonded warehouses to import duty-free intermediate inputs, and generous export subsidies created a favourable ecosystem for the RMG industry to thrive.

Taking advantage of EBA preferences, Bangladesh's apparel exports to the EU soared from USD 2 billion in 2001 to about USD 23 billion in 2023 (Figure 1). The UK – first as part of the EU, and then post-Brexit – offered a similar LDC trade scheme and witnessed a rise in Bangladesh's apparel exports from about USD 500 million to USD 5 billion over the same period. The EU and UK together comprise just about 60% of Bangladesh's garment exports. More than 90% of Bangladesh's Europe-bound exports are in clothing items.

FIGURE 1: Bangladesh's apparel export to the EU and the UK (billion USD)



Source: Authors' presentation using data from the Export Promotion Bureau (EPB), Bangladesh.

Bangladesh's export-oriented apparel industry now stands at a critical juncture as the country is set to graduate from the group of LDCs in 2026. This transition may lead to the loss of trade preferences in the EU, causing the average tariff on imports of apparel products made in Bangladesh to rise from the current 0% to approximately 12%. Given that over 70% of Bangladesh's exports with LDC-related preferences come from European markets, understanding the potential impact of graduation on the country's competitiveness is crucial. Textbook cases typically indicate that an increase in tariff rates on a country's exports can reduce the net prices received by exporters, thereby adversely affecting export performance.

Several studies predict a substantial impact on Bangladesh's exports due to tariff increases following its graduation from LDC status. The extent of this export shock depends on the price responsiveness of export demand. Although studies regularly highlight the potential impact of tariff preference erosion on export competitiveness, the fundamental issues of the price elasticity of demand for Bangladesh's garment exports and associated markups remain unaddressed. Earlier studies indicate small price elasticities, contradicting intuitions about clothing items with many substitutes. Recent global studies report larger elasticities, but data limitations hinder their application to Bangladesh. As Bangladesh's export market share in the EU and UK has increased significantly, questions arise regarding the compatibility of earlier elasticity estimates with the current garment trade dynamics in Europe.

Objectives

This study investigates the impact of Bangladesh's LDC graduation on its RMG sector's export competitiveness. Utilising highly detailed EU import data for apparel products, it estimates the parameters of the demand system, including own-price and cross-price elasticities. These elasticities are then used to compute markups for Bangladesh's top RMG products in the EU and UK markets. The elasticity and markup estimates enable a better understanding of Bangladeshi garment exporters' competitiveness, profitability, and ability to navigate price shocks stemming from potential tariff revisions due to LDC graduation.

Current and post-graduation tariff regimes in the EU and the UK

Under the Everything But Arms (EBA) scheme, Bangladesh's apparel products enjoy duty-free benefits in contrast to the approximately 11.8% Most Favored Nation (MFN) duty imposed on non-LDCs after LDC graduation. Bangladesh will be able to retain all LDC-specific preferences in the EU for an additional three-year period (until November 2029). Post-graduation, it can apply for the next most generous scheme, known as GSP+, which offers duty-free access for 66% of the EU tariff lines including apparel. To qualify for GSP+ preference, graduating Bangladesh must meet two criteria. The vulnerability criteria stipulate that the eligible country must have a non-diversified economy defined as the country's seven largest sections of GSP-covered imports representing more than 75% in value of its total GSP-covered imports to the European Union. The sustainable development criteria, on the other hand, imply that a beneficiary country must ratify and effectively implement 32 international agreements and conventions on human rights, labour rights, environmental protection and climate change, and good governance. Bangladesh meets the vulnerability criteria, and thus, inclusion in GSP+ depends on its compliance with the pre-specified international conventions. Bangladesh has ratified most of the conventions, although their effective implementation is up for discussion.

Even if the graduating Bangladesh is included in GSP+ upon complying with the international conventions, apparel exports will likely be subject to EU safeguard measures resulting in exclusion from any preferential treatment[1]. Bangladesh's current apparel exports are way above the eligibility threshold, as mentioned in the safeguard measures. According to the stipulated provisions, if the combined share of HS Sections 61, 62, and 63 (comprising knitwear, woven and home textile items, and defined as "product group S-11b") from a country exceeds 6% of the total EU imports of the same products, safeguard measures would be triggered to remove duty-free market access for these products. It is estimated that the combined share of Bangladesh's exports of HS Sections 61, 62, and 63 (S-11b) in total extra-EU imports is more than 20% and is thus already above the threshold value of 6%.

When the threshold of 6% import share is exceeded, it would be possible to obtain GSP preferences if Bangladesh's share of S-11b products (under GSP) as a percentage of all EU GSP-covered imports of the same products were less than 37%. However, the corresponding Bangladesh share is currently estimated to be almost 50%. All this implies that while Bangladesh, after its LDC graduation, can benefit from GSP+ preferential access, its apparel exports will face MFN tariff rates in the EU. That is, if the proposed rules remain unchanged, the average tariff rate on apparel exports from Bangladesh to the EU will rise from the current 0% to, on average, close to 12%.

Bangladesh enjoys duty-free access in the UK market through Comprehensive Preferences under the Developing Countries Trading Scheme (DCTS), with an 11.5% margin of preferences (compared to the MFN rates) for apparel exports. Post-graduation, Bangladesh will receive Enhanced Preferences in the UK, maintaining zero tariffs on apparel items and ensuring continued duty-free exports.[2]

[1] This is based on the proposed EU GSP regime for 2024-34. The current EU GSP regime was set to expire in December 2023 and was supposed to be replaced with a new regime for 2024-2034, but its adoption has been deferred and is expected to be enacted in 2027.
[2] However, the rules of origin requirements in the UK will be more stringent for Bangladesh after LDC graduation. Currently, as an LDC, apparel imports from Bangladesh are allowed duty-free based on single stage transformation. Post-LDC, double transformation (i.e., domestic yarn will have to be used

Bangladesh's export competitiveness is poised to suffer additional setbacks as Vietnam's preferential tariffs are set to be eliminated over the next few years as a result of free trade agreements (FTAs) that it has struck with the EU and UK.

Estimation framework

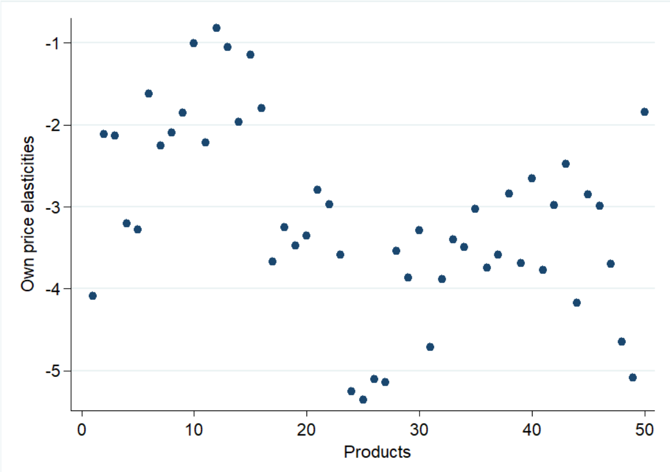
This study uses detailed RMG export data from Bangladesh and 11 other major exporters to the EU and UK markets. Instead of traditional trade frameworks, it adopts the McFadden logit demand model and the Berry, Levinsohn, and Pakes (BLP) framework. This allows for a more flexible estimation of demand parameters and elasticities, considering product characteristics, weight, and prices while accounting for various fixed effects. To address price endogeneity, the paper uses several instruments. Prices are instrumented using exporter-fixed effects, per-item weight, interactions with exporter-fixed effects, and sums of other product characteristics, along with year-fixed effects. To estimate the price elasticities of demand and markups, the paper employs the two-stage least square (2SLS) and generalised method of moments (GMM) methods.

Findings

There are vast variations in the own-price elasticities of the RMG products. The median elasticities in most cases are more than three in absolute values, indicating that most RMG products of Bangladesh have highly elastic demand. This implies that when Bangladesh loses its tariff-free access to the European markets, it is at risk of significant competitive pressure. For a few products, the median elasticities are close to one in absolute values, suggesting that Bangladesh has achieved significant market power in these categories. Therefore, if the prices of these products go up after the LDC graduation, the demand for Bangladesh's RMG products is unlikely to decline sharply.

for knitwear products and locally manufactured fabrics must be used in woven items) is needed for obtaining duty-free market access.

FIGURE 2: Own-price elasticities of Bangladesh's top 50 RMG products in Europe



Source: Authors' estimation using EU ComEXT data.

RMG products in Bangladesh vary in markups, with most having low markups. This could potentially pose challenges for exporters in Europe after the LDC period.

The markup estimates range from just under 1% to over 10%. For most of these products, the median markups remain below 4%. This implies that a substantial portion of Bangladesh's RMG products exhibit relatively low markups. Consequently, when Bangladesh's tariff-free access to EU markets diminishes following its LDC graduation, exporters of many of these products could face formidable challenges in adapting to a price shock. A select few products do exhibit large markups, portraying significant market power and thus greater capacity in absorbing graduation-induced tariff-hikes. Therefore, exporters dealing with these products should be better placed to withstand the price increase resulting from erosion.

The high elasticity and low markups of Bangladesh's RMG products are primarily due to labour-intensive production technology, manufacturing low-value-added items, and intense competition within the sector.

Several factors tend to support the findings that most RMG products in Bangladesh have high price elasticities and low markups. Firstly, the production technology for most RMG products in Bangladesh is simple and labour-intensive. Consequently, it is relatively easy and cost-effective to adjust production levels in response to changes in demand. Secondly, Bangladesh primarily manufactures basic RMG products with lower value-added content. As a result, consumers tend to be more price-sensitive when it comes to these products and may switch to alternatives if prices increase significantly. Thirdly, the Bangladeshi

RMG sector faces intense competition, which exerts downward pressure on markups.

Discussion

How does Bangladesh's RMG industry thrive despite these low markups?

The success of Bangladesh's RMG industry can be attributed to several factors. Firstly, its LDC status grants it preferential access to various markets, including the EU and the UK, which allows Bangladeshi RMG exporters to benefit from duty-free access and relaxed rules of origin, providing a competitive edge. Secondly, the Government of Bangladesh offers significant support to the RMG sector through measures like cash incentives (4-7% of FOB export value) and tax concessions, potentially contributing to sustained profitability despite low markups. Thirdly, Bangladesh is a labour-abundant country, giving its RMG producers a substantial cost advantage over other countries, such as China and Vietnam.

Bangladesh's RMG sector could encounter several challenges in the post-LDC era.

The post-LDC era presents challenges for Bangladesh's RMG sector competitiveness due to two important factors. First, the forgone preferential market access will exert pressure on competitiveness. Second, LDC graduation also implies the loss of policy space as export subsidies become prohibited under World Trade Organization (WTO) rules for non-LDC governments. Other factors include increased scrutiny of safety, compliance, and environmental standards in sourcing decisions from Bangladesh.

Trade agreements between the EU and other RMG exporting countries could further erode Bangladesh's export competitiveness.

Another threat to Bangladesh's export competitiveness in the EU is trade agreements between the EU and other RMG-exporting nations. As Bangladesh transitions out of LDC status, it faces an increased risk of preference erosion, particularly as non-LDC countries secure Free Trade Agreements (FTAs). Agreements such as the EU-Vietnam and UK-Vietnam FTAs, which are set to gradually eliminate tariffs on Vietnamese clothing imports, could place Bangladesh at a potential tariff disadvantage in these markets. Any FTA outcome arising from ongoing negotiations between the EU and India and between the EU and Indonesia would pose further challenges for Bangladesh.

To what extent might the sector be adversely affected, and are there underlying opportunities or silver linings amidst these challenges?

Bangladesh has built strong connections with global buyers and brands. It is known for its capacity for bulk production, which may discourage importers from shifting sourcing despite potential tariff increases. The bulk production capabilities enable Bangladesh to offer competitive global prices and manage large orders effectively. Large-scale production allows for cost-effective raw material procurement and better distribution of fixed costs, leading to lower overall production costs. The industry's regional concentration further drives down expenses through shared resources and logistics. This efficiency in production is reflected in lower prices for key export products like cotton T-shirts, compared to the global average. With the top five RMG products constituting about 50% of export earnings and the top 20 accounting for 78%, Bangladesh's bulk production offers a competitive advantage difficult for other countries to replicate, while providing various supply-side benefits.

Given Bangladesh’s dominant market share in the EU and UK, if tariffs are imposed on Bangladeshi garment exports and if both exporters and international buyers are unable to absorb these hikes, such tariffs could raise overall apparel prices. This rise in global prices could potentially offset some of the adverse financial impacts of the tariffs on Bangladesh.

Evidence suggests that the importers retain a significant portion of tariff preferences given to supplying countries (Cirera, 2014). Consequently, with the introduction of tariffs, importers might be compelled to relinquish some of these previously enjoyed preference rents, thereby absorbing a portion of price shocks due to the tariff rise easing the adjustment pressure for Bangladeshi exporters.

The global apparel market is undergoing a significant transformation, with China's once-dominant share declining for several reasons. Factors such as rising wages in China, a strategic shift towards more technology-intensive products, and evolving market dynamics are contributing to this change. Concurrently, many western countries are adopting the "China Plus One" strategy, aiming to diversify their supply sources beyond China. This strategic shift is driven by the desire to mitigate risks associated with over-reliance on a single country, especially in the context of recent geopolitical tensions and supply chain disruptions.

As the European apparel market continues to grow, the diminishing significance of China in this domain opens up substantial opportunities for other suppliers. Bangladesh, with its vast capacity for bulk production and established networks with global buyers and brands, is particularly well-positioned to benefit from this shift.

Policy recommendations

To minimise adverse effects and prepare the RMG sector for challenges in the post-LDC graduation phase, it is imperative to strategise and adapt. This study underscores several policy recommendations that can aid in sustaining the competitiveness of Bangladesh's RMG exports.

Take initiatives to increase markups for Bangladesh's current RMG product range.

This can be achieved by capitalising on cost efficiencies across various fronts. Investments in modernising infrastructure, optimising power and utility resources, improving the skills of the employed workforce, fostering adept management practices, adopting cutting-edge technologies, and implementing advanced supply-chain management techniques are essential. These endeavours reduce production costs and enhance the overall value of Bangladeshi RMG products in the global market.

Strategically focus on high-value-added RMG products that inherently offer greater profit margins.

By transitioning towards more sophisticated and niche market segments, exporters can command higher prices, mitigating the impact of preference erosion. This approach entails investments in research and development, fostering innovation, aligning the sector with evolving consumer preferences, and working more closely with the brands in product development.

Make an all-out effort to retain duty-free market access in the EU for apparel products after LDC graduation.

LDC graduation does not imply the end of preferences. In fact, there are provisions for preferences extended beyond LDC graduation and preferences designated for non-LDC developing countries. As a graduating LDC, Bangladesh should look for the most generous options available. A proactive engagement with the EU for relaxing its safeguard measures against clothing products under its GSP facilities will be extremely helpful in retaining export competitiveness. The UK's DCTS is an example of a simplified and relaxed system, and diplomatic efforts can be made to secure similar treatment from the EU. The deferment of the adoption of the new EU GSP proposals for 2024-34 until 2027 provides a strategic window of opportunity for Bangladesh to request amendments in the draft law.

Seize opportunities from the China Plus One strategy by positioning itself as a reliable alternative to China, capitalising on changing global trade dynamics.

As European countries are pursuing the policy of diversifying their supply chains beyond China, Bangladesh can proactively look for expanding exporting opportunities, positioning itself as a reliable alternative. Attracting foreign direct investment and providing incentives to firms that are trying to relocate their production from China can help Bangladesh expand supply-side capacity and take advantage of the benefits associated with FDI.

Strengthen backward linkages to improve competitiveness in apparel exports, contributing to higher markups.

Strengthening backward linkages emerges as a vital strategy to elevate both domestic value addition and export capabilities significantly. In this respect, Bangladesh needs to expand its fabric production capacity. Investing in the textile sector with the objective of feeding the export-oriented production can improve efficiency rather than supporting the backward linage production units with tariff protection. This can partially address the anticipated challenges arising from the escalation of tariff rates post-LDC graduation, enabling the country to enhance markups and improve profitability.

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