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Reducing Vulnerability in Export Performance

The Export
Diversification
Challenge in
Bangladesh



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Reducing Vulnerability in Export Performance: The Export Diversification Challenge in Bangladesh

INTRODUCTION

For the post-war global economy, trade has truly been an engine of growth. Global trade was instrumental in leveraging the demand and resources of the world economy¹ to sustain the longest period of economic expansion the world has ever seen. Bangladesh, which began its journey as a densely populated but resource-poor small economy, is a good example of how trade opens markets, stimulates growth, creates jobs, and supports poverty reduction².

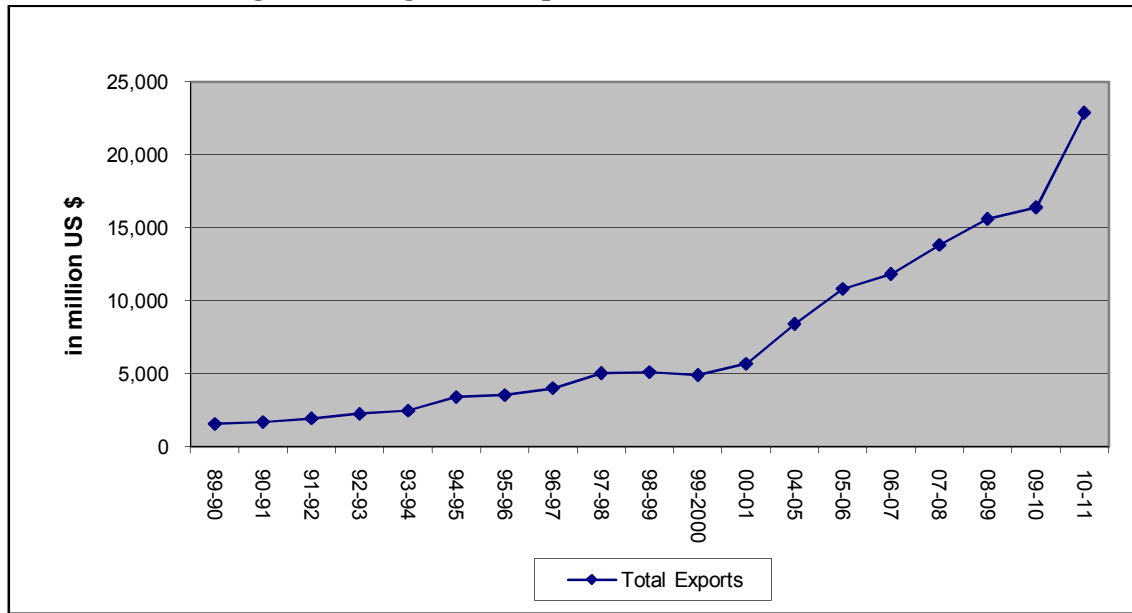
It was the 1990s decade that turned the tide in favor of Bangladesh. After nearly two decades of flirting with inward-looking industrial policies that went nowhere, the economy opened up to world trade. The rest is history. Bangladesh is today a world leader in the export of readymade garments, with substantial share of markets in North America and the European Union, while other markets in South and Southeast Asia, Japan, and China are in the process of opening up. In the past twenty years, Bangladesh's trade-GDP ratio has more than doubled to 45 percent from under 20 percent in 1990. During the same period, the share of exports to GDP has risen from 6.5 percent to 20 percent. The export sector has created millions of manufacturing jobs, and Bangladesh today is unique among LDCs, whose exports are dominated by manufactures (90 percent), rather than primary products.

Over the past two decades, Bangladesh experienced double digit export growth in nominal US dollar terms (figures 1 and 2). However, this superior performance is clouded by the fact that the surge was limited to one product group – readymade garments. With over two million jobs and 77 percent of export earnings from the RMG sector, too much of the country's fortune is riding on this one sector. Export concentration in readymade garments makes the economy, jobs, and income extremely vulnerable to external shocks arising from changes in global demand or prices (terms of trade). The government's focus on export diversification as a cornerstone of its export policy for several years now is no doubt appropriate. But progress has been elusive at best primarily due to, among other things, a lack of proper understanding of the transaction costs of a high tariff regime as it impacts on cost competitiveness of exports.

¹ Nobel Laureate economist Michael Spence (2007) made the argument that sustained high growth of economies has been achieved by leveraging the demand and resources of the world economy through trade.

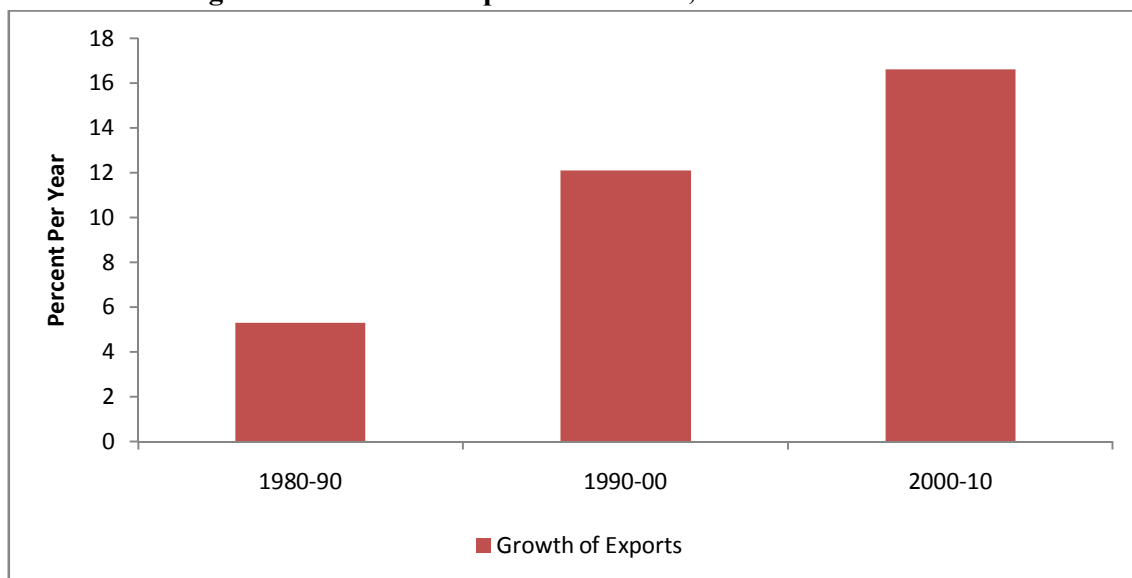
² See Ahmed and Sattar (2003, 2004) for a detailed analysis of trade liberalization and impact on growth and poverty reduction in Bangladesh.

Figure 1: Bangladesh Export Performance 1990-2011



Source: Bangladesh Bank

Figure 2: Growth of Exports 1980-2010, Nominal US Dollars



Source: Bangladesh Bank

Given the country’s restrictive trade and tariff regime, export diversification requires mitigating policy measures to bolster success. This paper seeks to throw light on the typology of export diversification, identifies some of the shortcomings of existing policy regime in supporting export diversification, and offers a roadmap for a more effective pro-diversification incentive and trade regime.

EXPORT CONCENTRATION AND VULNERABILITY

Export concentration is not a new phenomenon for Bangladesh. For many decades prior to the emergence of RMG exports, jute and jute goods dominated the export sector making up 70 percent of exports in 1981. With development practitioners advising the need to diversify exports, developing non-traditional exports became the dominant *mantra* of export policy. Non-traditional exports implied a shift into manufactures. This shift materialized for the Bangladesh economy thanks largely due to an external event – the multi-fiber arrangement of 1974 – that offered a lifeline for the emergence and rapid expansion of the RMG industry. Meanwhile, policy errors domestically and the emergence of jute substitutes globally soon led to a rapid decline in the export of jute and jute goods. The pendulum swung to the other extreme. By 1990, RMG exports had overtaken Bangladesh's traditional exports and, by the close of the 1990s, *export concentration* emerged afresh, with RMG exports reaching a share of 77 percent.

So Bangladesh – a low-income country by World Bank classification – has export concentration of a different kind. It is not a case of export concentration in a primary product, like jute, but in the group of textile manufactures called readymade garments. As Bangladesh has become a global leader in RMG exports and all indications are that there is still plenty of room for expansion in the medium- to long-term (McKinsey 2011), the necessity of diversifying its export basket must be seen in a somewhat different light as compared to another low-income country that is reliant on a narrow base of primary exports. While Bangladesh's export growth for the last two decades could be characterized as robust, a sudden decline in demand for Bangladeshi RMG would send shock waves throughout the economy. Such a prospect can be avoided through the creation of a diversified export basket, raising quality and productivity of existing exports, and securing diversity of destination countries. Herein lies the rationale for an effective strategy for export diversification.

In its international trade, Bangladesh aptly fits the description of a small open economy that is a price taker in the world market, for its exports as well as imports. Consequently, it must face the consequence of adverse movements in its terms of trade (TOT), stemming from exogenous price shocks in its imports or exports. Typically, such exogenous TOT shocks have originated in adverse movements in the prices of imports such as petroleum, foodgrains, and raw materials, such as cotton – a major import of Bangladesh's textile sector. When Bangladesh's exports were dominated by primary products, such as jute and jute goods, and tea, exogenous movements in the prices of these exports often affected export revenues. It was a major weakness in Bangladesh's export trade that prompted all efforts to diversify exports into non-traditional manufactures leading to the emergence and eventual predominance of RMG. With few other manufactures, such as footwear, home textiles, engineering goods, and ocean-going vessels, manufactures now dominate Bangladesh's export basket with the result that TOT shocks emerging from fluctuations in international primary commodity prices no longer occur through adverse price movements in exports but they occur through imports, especially from oil, food and fertilizer prices. Table 1 and figure 3 demonstrate trends in export and import price indices and Bangladesh's TOT from 1996 through 2010.

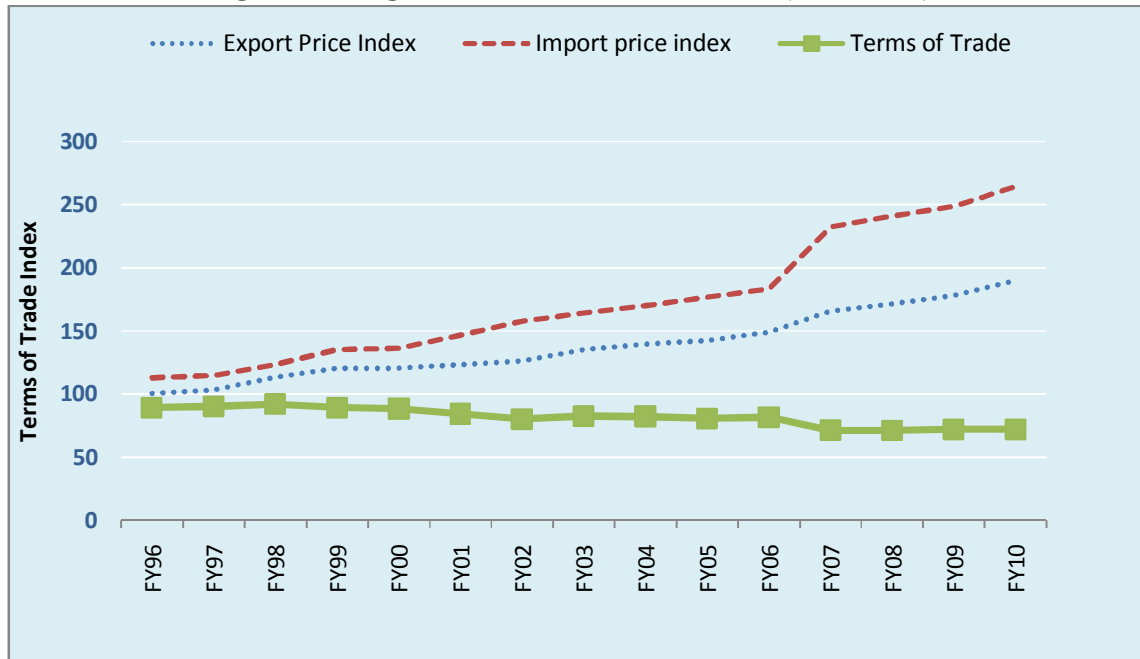
Table 1: Terms of Trade Index (FY96=100)

	Export Price Index	Import price index	Terms of Trade
FY96	100.46	112.75	89.10
FY97	103.31	114.59	90.16
FY98	113.29	123.25	91.91
FY99	120.36	134.98	89.17
FY00	120.31	136.17	88.35
FY01	123.15	146.41	84.11
FY02	126.23	157.76	80.01
FY03	135.19	164.15	82.36
FY04	139.60	169.96	82.14
FY05	142.38	176.66	80.60
FY06	149.28	183.09	81.53
FY07	165.70	232.52	71.26
FY08	171.29	241.15	71.03
FY09	178.23	248.33	71.77
FY10	190.07	264.27	71.92

Source: Bangladesh Bank

Research shows that TOT shocks or variability have adverse impacts on GDP growth [Mendoza (1995), Basu and McLeod (1992)]. Data from 1996 reveal that import price index rose faster than export price index for the entire period resulting in a steady decline in Bangladesh TOT. A significant TOT shock was experienced in 2006-07 largely due to a global commodity price shock that pushed up prices of some of Bangladesh's major imports, such as foodgrains, petroleum, and edible oil, fueled by substantial demand pressure emanating from the rising prosperity of large economies of China, India, and Brazil. The shock reverberated throughout the economy causing negative movements in GDP growth for two consecutive years. What is also clear is that the switch to manufactures and export concentration in RMG, failed to stem the steady decline in Bangladesh's TOT for the 15 years under study.

Figure 3: Bangladesh Terms of Trade Index (FY96=100)



Source: Bangladesh Bank

For developing countries like Bangladesh, external demand (quantity) shocks also appear as the most likely exogenous shocks to affect export performance from time to time. Such shocks are the outcome of cyclical movements in the economies of North America and the European Union, the destinations to which bulk of Bangladesh’s exports are directed. The income effect of these cyclical movements is to stimulate export revenues of trading partners in boom times with its negative counterpart in contractionary periods. There is no way for a developing country relying on developed markets for its exports to mitigate such developments except to provide for insurance cover out of its own fiscal resources. There is hardly any empirical evidence to show that such external income shocks to export performance may have less of an impact on the economy if the export basket is more diversified.

Nevertheless, recent developments in the global economy that has given rise to a new grouping of countries – developed, emerging markets, and developing – should give pause for rethinking. In recent times, the traditional recessions and expansions ingrained in capitalist economic systems of the developed countries has given way to adverse movements of a more severe kind – those resulting from a globalized financial crisis or a sovereign debt crisis in the Eurozone and other OECD countries prompting austerity measures in public spending. If North America and Eurozone countries embark on austerity measures to resolve their fiscal and debt problems, it could mean lower demand for developing country exports across the board. The saving grace might be the emerging market economies (Brazil, India, and China) and Japan. Together, they add up to a market size that is roughly equal to that of the EU or North America. Geographical diversification – one more characteristic of export diversification – into these potential and sizable export markets could help stabilize export

revenues in times of crises or cyclical movements in the traditional markets in developed countries.

TYOLOGY OF EXPORT DIVERSIFICATION

Mere product diversification in the export basket presents a rather narrow understanding of export diversification which could have many different facets, each of which addresses in some sense the vulnerability aspect of export concentration, as summarized below:

- ***Product diversification.*** This appears to be the widely recognized albeit limited mode of export diversification. It describes a process whereby a range of new products is introduced in the export basket – described by Hausmann and Rodrik (2003) as “discovery” -- which gradually assumes significant proportions thereby diluting any export concentration that might have existed.
- ***Geographical diversification.*** This involves widening the range of destination markets for exports of existing products, also referred to as horizontal diversification or diversification at the extensive margin. Research has shown that developing countries tend to do better at this sort of export diversification. As subsequent analysis will show, Bangladesh has made good progress in capturing multiple markets for its export products.
- ***Vertical diversification.*** This refers to the transformation in the export basket from primary products to manufactures, a form of diversification that Bangladesh has successfully managed. Our analysis shows that even after this sort of export diversification is attained, product concentration in manufactures present a new source of vulnerability from export shocks arising from external developments.
- ***Quality diversification.*** This describes the process of upgrading the quality and value of existing products, i.e. moving up market from low end to high end products (described as moving up the value chain). Moving to higher productivity (or higher value added) items in the same product group is also referred to as diversification in the intensive margin. Increasing export growth at the intensive margin requires some combination of productivity improvements to lower costs and quality improvements to differentiate products from those of competitors.
- ***Intermediate goods diversification.*** Product diversification need not imply adding only final consumer goods in the export basket – as is popularly understood in Bangladesh. Taking advantage of global production chains could lead to export diversification of a different kind. There are global opportunities for plugging into the supply chain of export powerhouses like China, something that East Asian economies have done successfully. That requires Bangladesh to diversify its manufacturing base into backward linkage industries producing a wide range of intermediate goods for exports. Most promising among these intermediate goods industries are auto parts and various electronic components.
- ***Goods-to-services diversification.*** Export diversification need not be limited to diversification of goods exports but could very well involve seeking opportunities to expand non-merchandise exports, such as finance, shipping, and transportation services, as well as tourism, ICT, and migrant labor services. In this form of export

diversification new services could be developed or existing services could be exported to new markets. Growth of trade in services could also lower transaction costs of goods exports and lead to better export performance.

Due to the limited mandate of the present study, the focus will remain primarily on the product and geographical export diversification although other forms of export diversification might enter the discussion as issues relevant to the point under discussion.

EXPORT DIVERSIFICATION AND GROWTH

International trade has been the driver of rapid growth in the Newly Industrializing Economies (NIE) of East Asia. That positive experience spurred export-oriented growth policies in many other developing countries since the 1980s and 1990s. The strong positive relationship between export performance and economic growth has, by now, been firmly established as a proven fact. Robust empirical evidence has been provided by many research papers on export orientation and growth (Sachs and Warner, 1995; Bhagwati and Srinivasan, 1999). Hausmann and Rodrik (2006) show that growth is the result of transferring resources from lower productivity activities to the higher-productivity goods identified by the entrepreneurial cost-discovery process – i.e. export activity. Surveying the evidence, economists conclude that rapid and sustained growth is closely associated with a fast pace of export growth (Brenton and Newfarmer, 2007). For most developing countries, with limited domestic markets, export growth has become the key driver of GDP growth. In Bangladesh, as its export orientation intensifies, GDP growth performance is increasingly becoming linked to export performance rather than that of agriculture, which used to be the traditional determining factor.

But export growth without diversification might be problematic. Many economists see export diversification as the channel through which trade fuels growth. This comes about through a process of facilitating improvements in higher productivity, capturing new economies of scale that might be dwindling in a situation of export concentration, and by reducing volatility in export revenues. More importantly, export diversification is tantamount to the widening of comparative advantage: if labor cost, for instance, is the basis of comparative advantage of Bangladesh in RMG products, that comparative advantage must extend to many other labor-intensive products which can be exported. New techniques of production associated with export diversification are likely to benefit other activities through knowledge spillovers, acquisition of new organizational and entrepreneurial skills, and incentives for capital formation. It is in that sense that export diversification, by exploiting the widening of comparative advantage, can fuel growth. Further, export diversification is linked to economic growth via externalities of learning-by-doing and learning-by-exporting fostered by competition in world markets. There is growing empirical evidence to suggest that export diversification has favorable impact on growth. Following Lederman and Maloney (2007), Hesse (2008) offers empirical evidence in support of the hypothesis that export diversification has positive impact on growth of per capita income³. Similarly, Agosin (2007) finds that countries with diversified export structures are able to record consistently higher

³ Countries studied include Malaysia, Thailand, and Chile.

export growth than countries where exports are concentrated in a few products. Hasan and Toda (2004) confirmed this relationship for Bangladesh and Nepal in a study of selected LDCs.

Overall, the evidence is strong that export concentration has been detrimental to the economic growth performance of developing countries in the past decades. In particular, developing countries with narrow export basket tend to suffer from export instability. Unfavorable and declining terms of trade have been cited as the main reason, especially for commodity-dependent countries. Economists have therefore argued for vertical diversification, i.e. moving from primary exports to manufactures, as the defense against adverse movements in TOT. But the transformation should not end there, as the Bangladesh experience suggests. Export concentration in manufactures could be just as problematic as concentration in primary products. And export diversification within manufactures could include product diversification as well as diversification in product categories, such as intermediate goods and final consumer durables.

EMPIRICAL ANALYSIS OF EXPORT CONCENTRATION IN BANGLADESH

Analysts and observers of the Bangladesh economic scene have acknowledged that its export performance of the past two decades is exemplary but suffers from a major weakness – export concentration of an extreme kind, with 75 percent of exports featuring one product group, i.e. readymade garments. That imparts a sufficient degree of vulnerability to macroeconomic performance arising from external shocks.

To study how serious the export concentration is in absolute terms and relative to comparators, we have carried out an empirical analysis applying two alternative measures of export concentration (Chris Meilak, 2008): the *Herfindahl-Hirschmann Index* (HHI) and the *Export Concentration Ratio* (ECR).

The Herfindahl-Hirschmann Index (HHI) is calculated by taking the square of export shares of all export categories in the market⁴:

$$HHI = \sum s_i^2$$

$$i = 1, 2, n$$

The Herfindahl Index is the most commonly used measure of export diversification. It lies between 0 and 1 where being close to 0 indicates well diversified exports.

An alternative measure that has been used is *The Export Concentration Ratio (ECR)*. The Concentration Ratio (CR) measures the export share of only the largest export categories. It is calculated as follows:

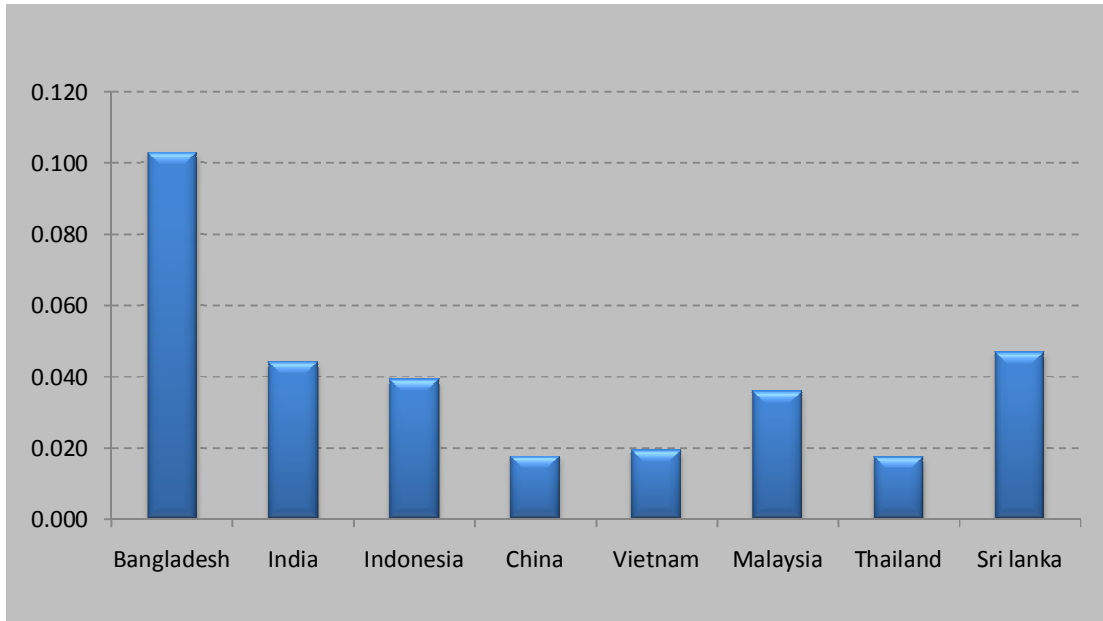
$$CR(x) = \sum s_i; i = 1, 2, \dots, n$$

⁴ This index gives greater weight to the larger export categories and reaches a value of unity when the country exports only one commodity or service (high concentration).

where x is less than the total number of export commodities n .

This ratio gives equal emphasis to the x largest export categories but neglects the remaining categories in the export market. If the ratio value is close to unity, this means that the x categories included in the ratio make up the entire export bill and hence concentration is high⁵.

Figure 4: Relative Export Concentration 2010 HHI - HS4 digit



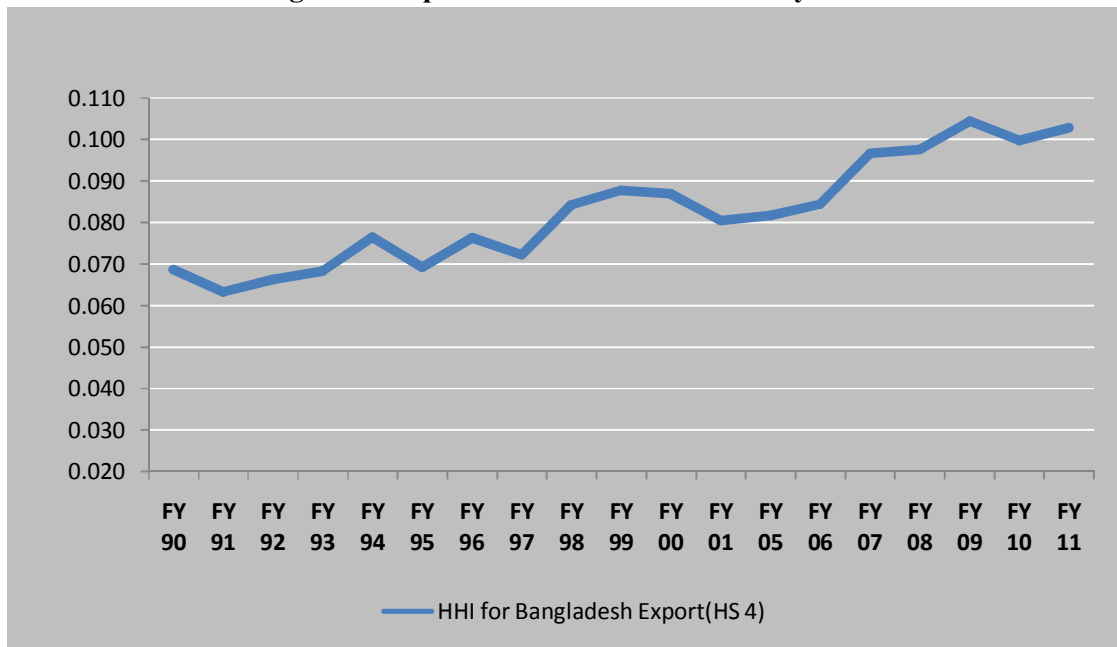
Source: International Trade Centre, Geneva

Figure 4 shows the relative position of Bangladesh and its selected comparator countries (China, India, Indonesia, Thailand, Malaysia, Sri Lanka) in terms of export concentration measured in 2010 using HHI. Bangladesh has the highest export concentration of 0.10 HHI, nearly twice the concentration level of Sri Lanka. What is surprising is that Vietnam, a strong competitor of Bangladesh in the RMG sector, has a fairly diversified export basket, even better than India, though similar to China. Apart from footwear and RMG, it exports a diverse group of manufactures from electronic and electrical goods and to printing machineries, agro-based products such as canned and frozen seafood, and resource-based products like petroleum. It is no surprise that China and India have well diversified export baskets as their production structure is equally diversified with a lot of depth in each of the product categories, like final consumer goods (durable and non-durable), basic industries producing capital goods and machineries, a large intermediate goods industry supplying to domestic and world markets, and an assortment of primary and agricultural products that are basic raw materials for manufactures and agro-based industries. The fact that Sri Lanka also has a fairly

⁵ In most applications CR(4), CR(8) or CR(12) are used, but there is no rule for the determination of the value of x , so that the number of categories included in the Concentration Index is a rather arbitrary decision. This is this ratio's main disadvantage but it is still widely used because of its simplicity of calculation and limited data requirements.

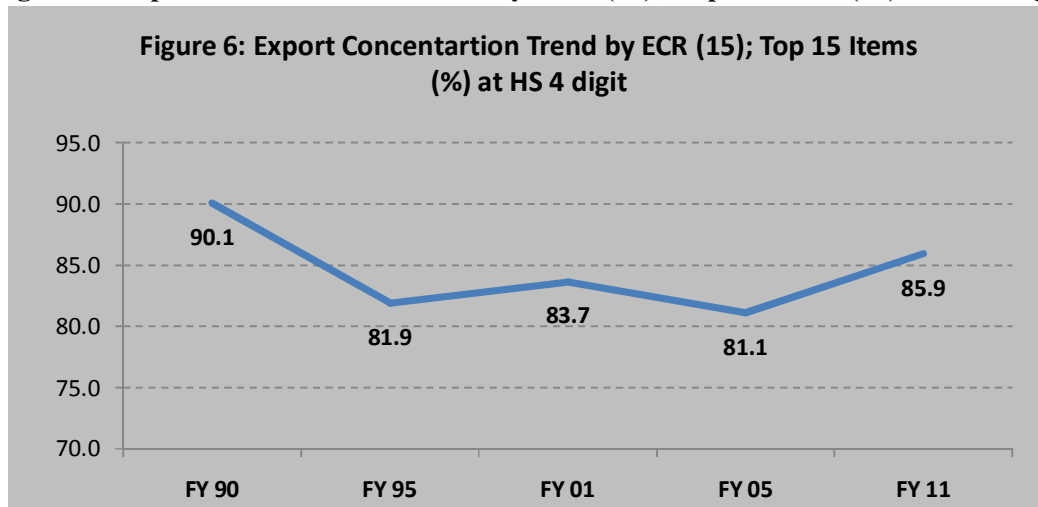
diversified export basket goes to show that small open economies need not rely overwhelmingly on any one product groups for export income.

Figure 5: Export Concentration Trends by HHI



Source: ASYCUDA database, NBR

Figure 6: Export Concentration Trend by ECR (15); Top 15 Items (%) at HS 4 digit

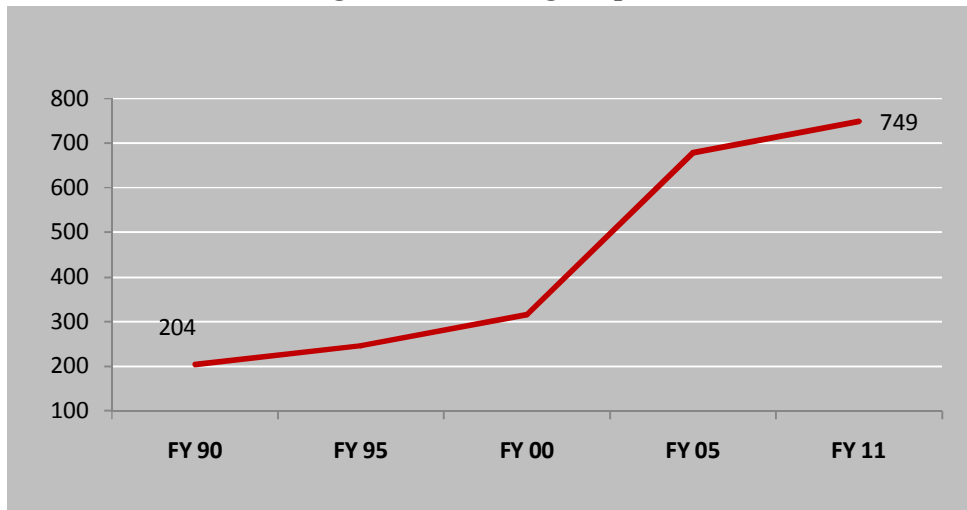


Source: ASYCUDA database, NBR

What is disconcerting is that when one studies export concentration trend in Bangladesh exports for the past two decades, there is no discernible improvement in the situation. If anything, there is a slight increase in the concentration index however it is measured (HHI or ECR), as revealed in the two charts above (figures 4 and 5). This is not to say that Bangladesh's export basket was devoid of new products over the years. Quite the contrary, when the number of export items is tallied at HS4-digit (figures 6 and 7), one observes substantial increase in export items over time (204 to 749). These results suggest that export

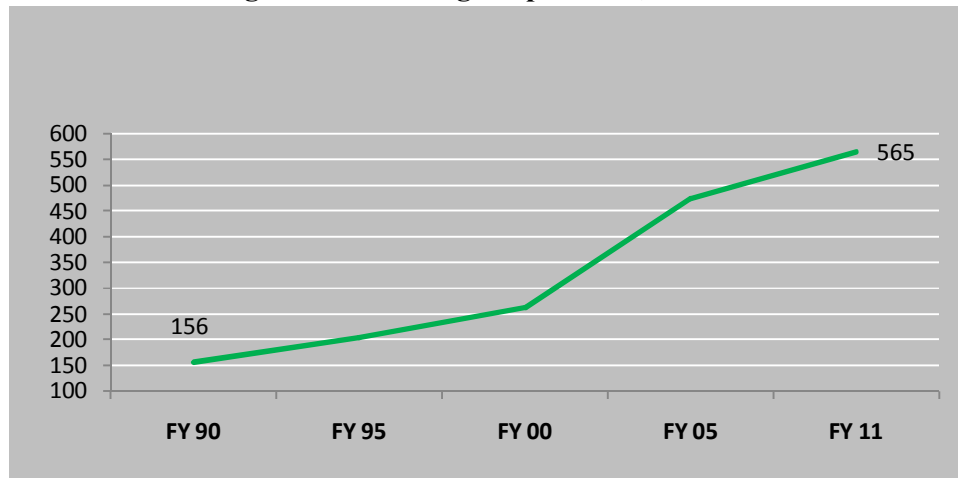
concentration remains as acute a problem as before even though numerous new items entered the export basket. The new entrants have not shown dynamism and as such are small in quantitative terms and their shares in total exports are insignificant. The fact that emergence of these smaller export items failed to have an impact on the export structure suggests some policy-related constraint that impedes growth of new exports. This issue will have to be explained and will be dealt with subsequently.

Figure 7: #HS4- digit exports



Source: ASYCUDA database, NBR

Figure 8: #HS4- digit exports >10,000 US \$

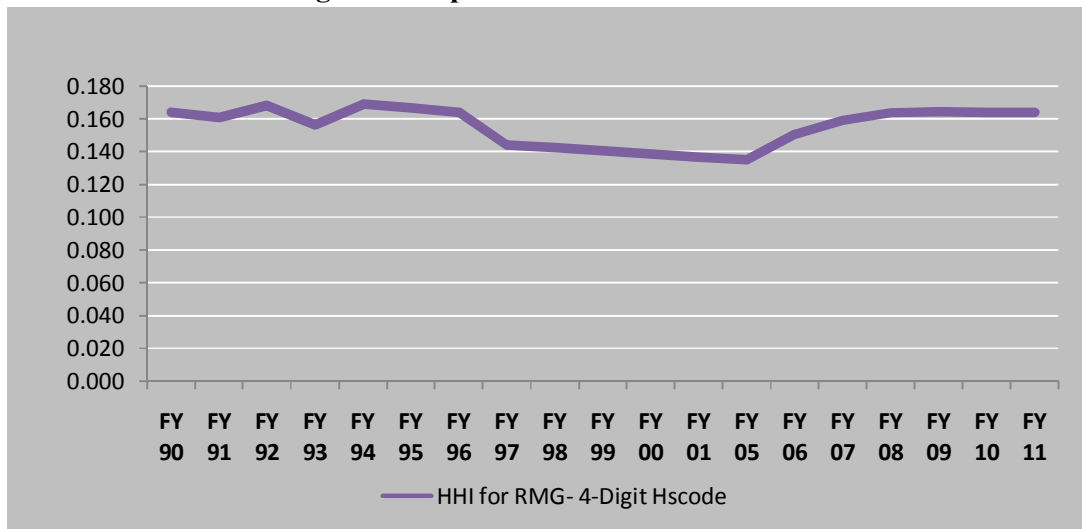


Source: ASYCUDA database, NBR

It has been argued that RMG is not one product but a product group consisting of a wide variety of products based on style, garment category, and so on. By that reckoning, one could look at the trends in product diversification within this group at the HS-4 digit level. Figure 9 shows that export concentration in RMG has practically remained unchanged for two decades though many new RMG products entered the export basket (figure 10) raising the number of HS-6 RMG products from 114 to 216. This progress in intensive margin was not sufficient to tilt the balance towards diversification simply because Bangladesh continued to produce and

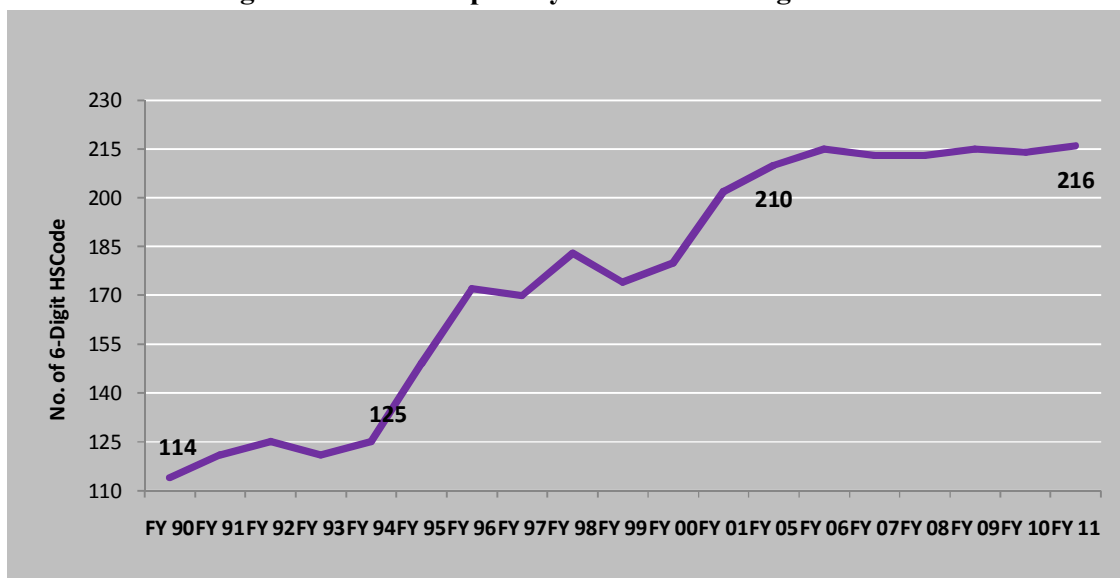
export RMG basics in progressively higher quantities while fashion garments and higher value added items remained a small portion of total exports.

Figure 9: Export Concentration in RMG



Source: ASYCUDA database, NBR

Figure 10: RMG Export by Number of 6-digit HSCode

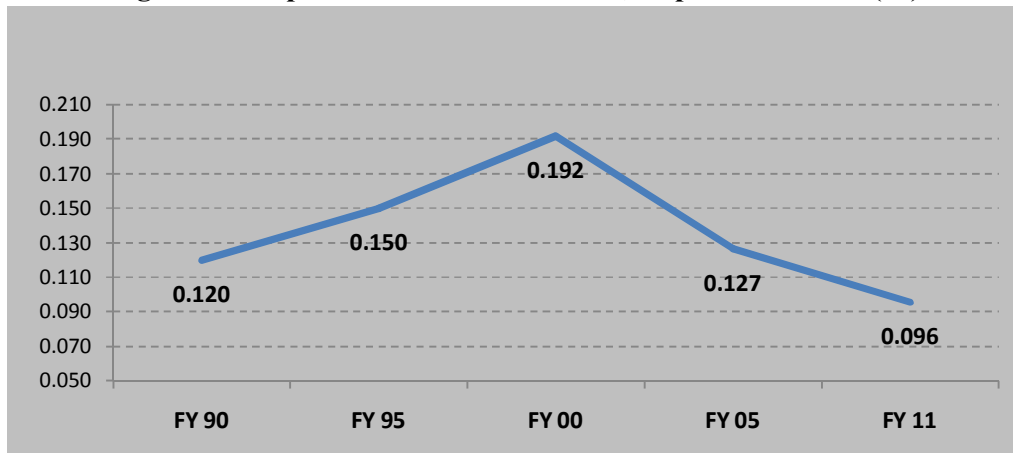


Source: ASYCUDA database, NBR

Geographical diversification: One important facet of export diversification is the geographical diversity of export destination countries. Disaggregated export data from BBS and NBR allows us to estimate the export concentration (diversification) trends on the basis of destination countries for the period 1990 through 2011. Latest export figures with respect to destination reveal that some 80 percent of our exports are destined for the block of countries in North America and Europe. In the case of RMG, concentration in these destinations are even more with roughly 90 percent RMG exports going to these countries. Bangladesh exports are now destined for some 200 countries, but there is significant

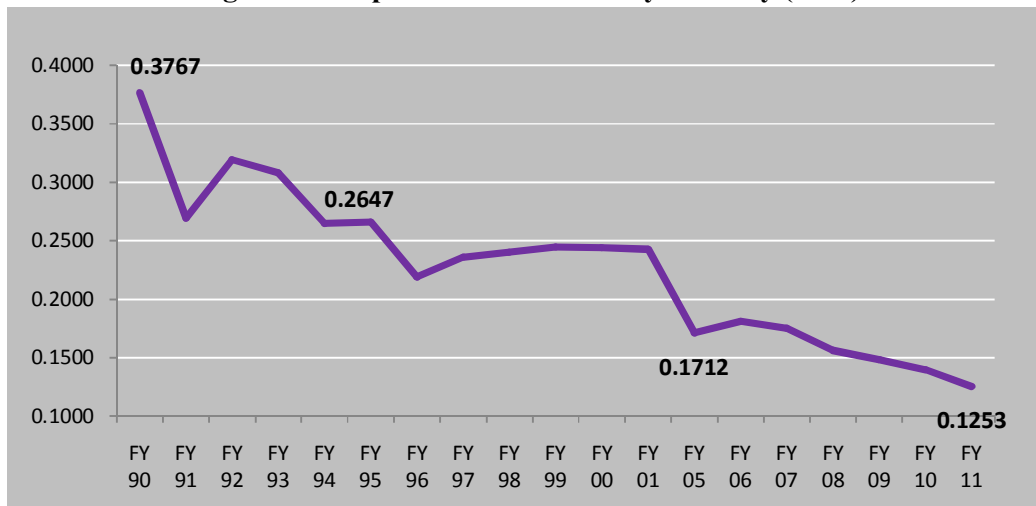
concentration of exports going to the OECD countries in North America and EU. However, reviewing export trends to destination countries for the past two decades (1990-2011) reveals some albeit modest progress in geographical diversification of Bangladesh exports, including RMG products.

Figure 11: Export Concentration Trend; Top 15 Countries (%)



Source: BBS and NBR Asycuda database

Figure 12: Export Concentration by Country (HHI)



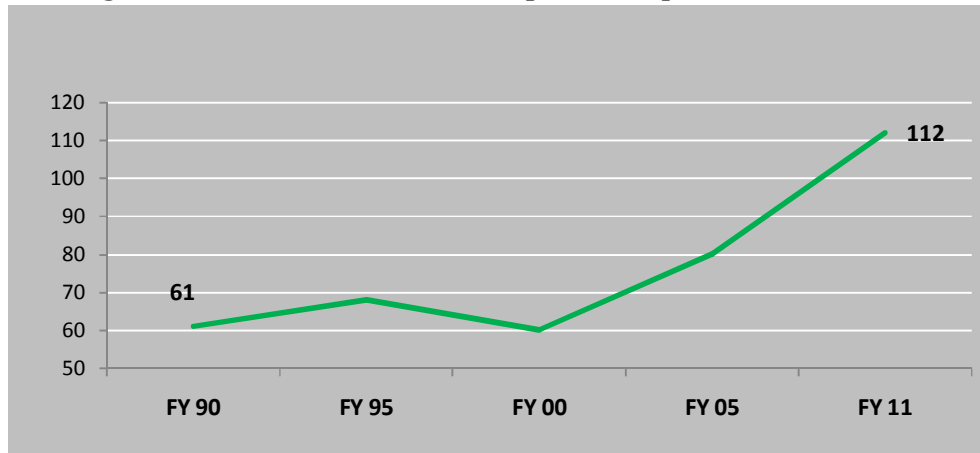
Source: BBS and NBR Asycuda database

Figures 11-12 reveal trends in geographical concentration of Bangladesh exports. Two alternative measures of concentration (ECR and HHI) are used in the figures for the period 1990-2011. Both measures indicate that geographical concentration is gradually on the decline⁶. Two inferences may be drawn from this trend: (a) Bangladesh exports are becoming more universally competitive, and (b) vulnerability from cyclical or other shocks due to economic crisis in OECD countries is being gradually reduced. In terms of number of

⁶ FY00 is one year in which there was a sharp rise of exports to USA (40%). Together with Germany, UK, and France, these four countries accounted for 65% of total exports in FY00. This concentration gradually declined in subsequent years.

countries to which exports (>US\$1 million) are destined, it has grown from 61 to 112 (Figure 13).

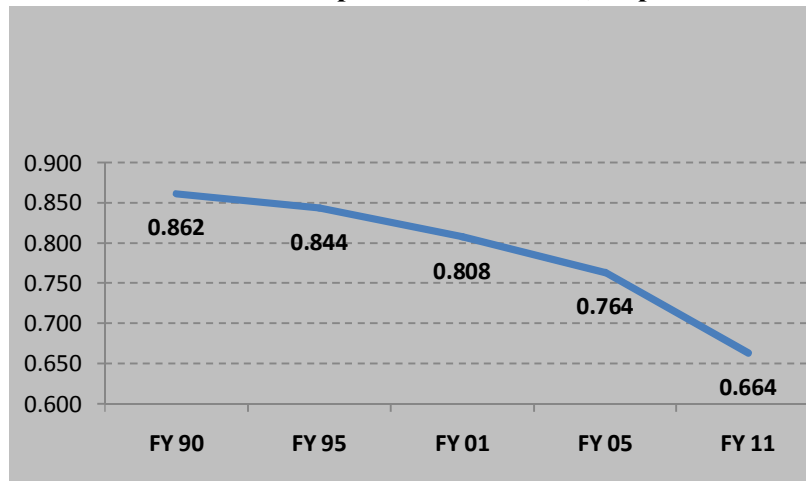
Figure13: Number of Countries exported, Exports >US \$1 million



Source: BBS and NBR Asycuda database

Somewhat similar inference can be drawn from reviewing RMG export trends in destination countries (Figures 14-15), implying that these exports are not limited to a few countries like USA and Germany but are destined for all the countries of EU and beyond. The share of RMG exports to the top 5 countries (USA, Germany, UK, France, and Netherlands/Italy) has dwindled from 86 percent in 1990 to only 66 percent in 2011. The number of countries which imported RMG worth more than a million dollars increased from 15 to 66 during this period.

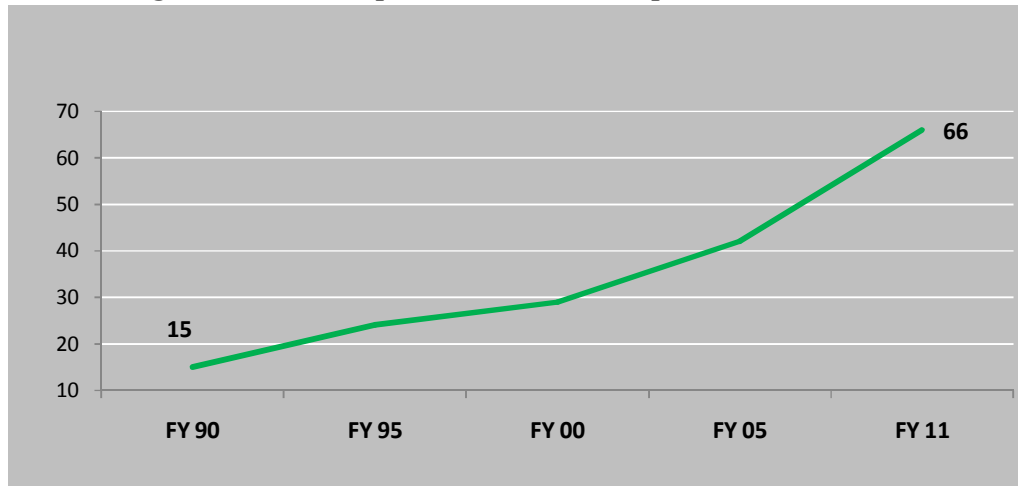
Figure 14: RMG Trend in Export Concentration; Top 5 Countries (%)



Source: BBS and NBR Asycuda Database

As mentioned earlier, emerging market economies are becoming large potential markets for Bangladesh RMG exports in particular which are making slow but steady inroads into these destinations.

Figure 15: RMG exports to countries, Exports >US \$1 million



Source: BBS and NBR Asycuda database

In summary, the empirical analysis of export trends in Bangladesh reveal lack of product diversification which has remained practically unchanged, if not slightly worsened, for the

past two decades. This contrasts with progress in export diversification attained by most developing countries studied by Chandra, Boccardo, and Osorio (2008). They find that some 60 percent of developing countries managed to diversify their export baskets to some extent over the past 30 years. Although Bangladesh successfully came out of the early years of primary export concentration in jute and jute products through a process of vertical export diversification, i.e. a process of moving from primary exports to manufactures, the economy seems to have fallen back into the concentration regime with RMG featuring over 75 percent of its exports. However, the silver lining lies in progress in geographical or horizontal diversification – diversity of destination countries. That, to some extent, helps to reduce vulnerability from export shocks. But the main challenge of product diversification remains.

TRADE POLICY AND EXPORT DIVERSIFICATION CHALLENGE

Export performance, and its offshoot, progress in export diversification, are the outcome of the trade policy regime governing export production and trade. If export diversification is positively linked to growth, its absence must pose a hindrance to rapid growth in Bangladesh. So, what are the main constraints impeding export diversification in Bangladesh? A review of international evidence as well as evidence from Bangladesh suggests that a whole host of factors affect exports performance. These include demand factors affecting market access and output prices and supply factors affecting incentives, the cost of production and productivity.

On the demand side Bangladesh can be considered as a price taker in the international market and by and large, with few exceptions, the world demand for Bangladeshi exports is fairly unconstrained. While fluctuations in world demand owing to business cycle and global shocks in terms of international financial crisis or the most recent European debt crisis will affect Bangladeshi export earnings, the transmission will work mainly through output price effects. The adverse effects on quantity of Bangladeshi exports will likely be minimal

because of the miniscule share of Bangladeshi exports in world trade. So, much of the determinants of export performance are on the supply side that are largely determined by domestic policy.

On the supply side, incentives are a key consideration underlying export growth and diversification. Producers have a choice to produce for domestic market or for exports. When incentives are more favorable for domestic production, more resources will flow there and constrain export growth. Two key policy variables that affect incentives are the exchange rate and trade protection. The more over-valued the exchange rate and higher the rate of Bangladesh export production.

Quality of infrastructure, the ease of technology acquisition and adoption, the cost of labor, the productivity of labor, and regulations affecting export markets are also important determinants of export performance. The easier the regulatory regime, the lower the cost of labor, the easier the access to better technology, the better the quality of infrastructure, and the more trained the labor force, the better are the prospects for export diversification and growth of exports.

The role of these various factors in explaining the growth of RMG exports illustrates their importance. The key factors and policies that explain the dynamism of RMG exports include the following.

- **Multifibre Agreement (MFA) 1974-2005:** The MFA provided the initial impetus. Faced with quota restrictions, Korean firm Daewoo entered into partnership with Dosh Garments of Bangladesh to produce garments in Bangladesh using the underused Bangladesh quota in the USA and Europe. The seeds of a dynamic industry were thus sown by improved market access to US and European markets. Soon other entrepreneurs started entering the profitable venture.
- **Bonded Warehouse System:** To provide world-priced inputs and support the nascent garment industry the Bangladesh government allowed duty free access to imports for the RMG sector through the bonded warehouse system. This created a duty-free environment for the RMG sector even though the rest of the economy faced huge tariff and non-tariff barriers. This trade liberalization policy for the RMG sector has been a leading factor for spurring the growth of RMG exports.
- **Back-to-back Line of Credit (LC):** The RMG sector was able to lower its cost of production by having a system of back-to-back LC by which inputs were procured against export orders. This saved the industry substantial working capital cost.
- **Low Cost Labor:** Bangladesh being a labor surplus country, RMG investors were able to tap into this huge surplus labor. In particular, the RMG sector has relied on female labor that has low participation rates and as such has low reservation wages. Additionally, this labor is very reliable and disciplined. In more recent years, this access to low cost labor relative to China, India, Sri Lanka and Vietnam has increased tremendously the prospects for expansion of the RMG sector as labor cost increases, particularly in China, makes Bangladesh a much more attractive destination for RMG export production.

- **Labor Training:** RMG labor requires minimum training that could be easily provided in-house and honed in on the job.
- **Technology:** The initial technology transfer happened to Korean investors who came to Bangladesh to take advantage of the quota owned by Bangladesh. The technology being relatively simple was quickly adapted and transferred to other investors through competitive buying of managers and trained labor.
- **Infrastructure:** Here policy progress has been limited, both in power and in transport. As for power, RMG producers have tended to adjust to the realities of power outages and rationing by having back-up generators. But this is potentially a factor that will hurt the future expansion of RMG unless actions are taken to improve infrastructure
- **Fiscal Policy:** The government has taken a very liberal attitude towards taxation of earnings from RMG by having a very low effective tax rate.

The important role of trade liberalization in spurring RMG exports was suggested above. In the next section, we will review the trade policy developments and the key features of current and past trade policies that facilitated or impeded the diversification of exports. The main thrust of our argument here is that while deficiencies in trade and transport infrastructure hurt exports in general, Bangladesh trade policy has had built-in bias against the emergence of new products in the export basket.

Trade Policy in the Early Years

In 1972, Bangladesh inherited a trade regime reminiscent of the 1950s Prebisch-Singer [1949, 1950] approach towards import-substituting industrialization (ISI) -- high tariffs, pervasive bans and quantitative restrictions on imports along with an overvalued exchange rate characterized this regime. It was highly restrictive, and inward-looking, with little debate about its relevance to the new economy whose lifeline was actually an export sector—jute and jute goods. The inherent anti-export bias of an ISI regime went unnoticed as Bangladesh chose a path of import substituting industrialization with minimal impact on industrial development. By the 1980s, the shortcomings of ISI policies became all too evident globally and the strategic importance of export-oriented policies began to be realized, particularly in developing economies trying to enter markets for labor-intensive manufactures. Though Bangladesh began dismantling its ISI orientation in the early 1990s, to this day, the last vestiges of ISI continue to haunt policymakers and many economists alike, with strong backing from the emerging entrepreneurial class in Bangladesh.

Trade Policy Developments in the 21st Century

By the turn of the century, it was all too evident that trade liberalization, which began in right earnest in the early 1990s, had slowed down. Thus although customs duties kept coming down, para-tariffs (e.g. supplementary duties, regulatory duties) emerged and soon assumed importance as protective instruments, so much so that by FY04, nearly a third of nominal protection was being derived from these add-on tariffs. This soon became the main challenge impeding tariff rationalization.

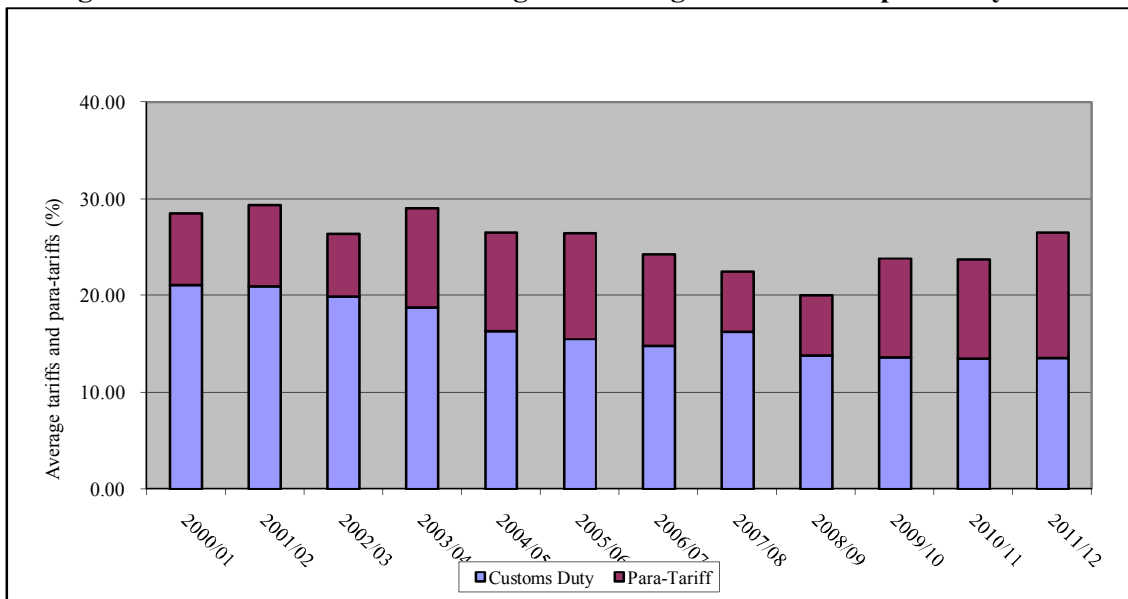
The one positive development in recent trade policy was the complete elimination of a key barrier to imports – quantitative restrictions. By 2007, the last vestige of QRs applied for protective purposes was done away with. The last of the textile QRs were replaced with tariffs and the minor QRs that remained (salt and eggs) were phased out over the next couple of years. Thus, in the first decade of the 21st century, tariffs remained the main instrument of protection, but the principal agency responsible for articulating and implementing protection policies is now the revenue authority, NBR, rather than the statutory agency set up for the purpose, the Bangladesh Tariff Commission. A summary of tariff and protection trends during FY01-12 is presented in Table 2 and figure 16 below.

Table 2: Progress in Tariff Rationalization FY01-12

Tariffs	FY01	FY05	FY07	FY08	FY09	FY10	FY11	FY12
Average CD (un-weighted)	21.1	16.3	14.8	16.3	13.8	13.7	13.5	13.6
Average Nominal protection	28.5	26.5	24.3	22.5	20.1	23.9	23.7	26.5
Top CD rate	37.5	25.0	25.0	25.0	25.0	25.0	25.0	25.0
Tariff slabs (non-zero)	4.0	3.0	3.0	3.0	4.0	4.0	4.0	4.0

Source: NBR tariff database and PRI staff estimates

Figure 16: 2000/01 - 2011/12 Un-weighted Average Protective Import Duty Rates



Source: NBR tariff database and PRI staff estimates

There are two notable trends for the recent past decade: (a) the top CD rate is stuck at 25 percent and stubbornly resistant to any reduction; (b) average nominal protection showed a modest but gradual decline but rose sharply in the last three years⁷. The overall outcome over

⁷ This was the first time that average NPR has increased ever since the declining trend in tariff protection began in the early 1990s.

the two decades of liberalization is as follows: while Bangladesh reduced tariffs, -- rapidly at first, and gradually later -- other countries in the South Asia region and across the globe moved much faster. Consequently, despite two decades of liberalization, judged by the level of average protective tariffs, Bangladesh today has among the most restrictive trade regimes in South Asia, if not in the world (Table 3).

Table 3: Current Trade Regimes in South Asian Countries

Policies	India (FY09)	Pakistan (FY08)	Bangladesh (FY10)	Sri Lanka (FY09)	Nepal (FY08)
Some QRs on imports	Yes	Yes	No	Yes (minor)	Yes (minor)
Some direct export subsidies	Yes	No	Yes	Yes	No
Indirect exports subsidies	Yes	Yes	Yes	Yes	Yes
Floating Exchange rate regime	Yes, managed	Yes, managed	Yes, managed	Yes, managed	(*)
Trade/GDP (%)	33.4	28.1	41.9	40.9	32.5
Avg. Custom duty	10	n.a	13.6	n.a	n.a
Customs duty+ Other Para-tariffs	10	16	26.5**	27	12.5

Source: Policy Research Institute Database; () linked to Indian Rupee; (**) as of June 2011.*

Only a couple of years ago, India would have claimed that distinction. But after the removal of all QRs in April 2001, India has brought down its tariff levels substantially – the top general level of non-agricultural tariffs in India as of February, 2007, is at 10 percent, though agricultural tariffs are still higher. India’s average protective tariff now is around 15 percent compared to Bangladesh’s average of 26.5 percent and Sri Lanka’s 27 percent. Sri Lanka is a surprising case of trade policy reversal in South Asia. Sri Lanka was the first to embark on trade liberalization back in the late 1970s. Until 2004, it remained the most open economy in South Asia. In November 2004, Sri Lanka reversed its relatively open trade policies and now has one of the world’s most complex and protective import regimes. This has been done by deploying a variety of para-tariffs over and above customs duties, the significance of which appears to have escaped the notice of most of Sri Lanka’s trading partners, including India. Though Bangladesh’s top customs duty rate has been scaled down to 25 percent in FY05, it gives a misleading impression of protection levels. A significant number of consumer goods (e.g. dairy and bakery products, beverages, sugar, dry cell batteries, textile fabrics, toys and furniture) are subject to extremely high protective tariffs, ranging from 50 to 100 percent, owing to the imposition of supplementary duties.

Table 4 gives a snapshot of the current trade regime in Bangladesh. The most significant items to note are the absence of trade QRs, a floating (albeit managed) exchange rate system, two para-tariffs (SD & RD), fewer tariff slabs (4), and a high trade-GDP ratio.

Table 4: Snapshot of Bangladesh Trade Regime 2011

Policy Instrument	Status
Exchange Rate Regime	Unified, Managed Float
Payment convertibility	
Current account	Yes, some limits
Capital account	No
Import restrictions	
Import licensing	No
QRs on imports	Trade QRs gone WTO compliant QRs remain
Tariff structure	
Top CD rate	25
Average protective rate	26.5
Tariff slabs (customs duty)	3, 5, 12, 25
Para-tariffs	RD and SD*
Trade openness, trade-GDP ratio (%) 2011	43.4

Source: NBR, Ministry of Commerce and PRI staff estimates

One worrisome development in Bangladesh budgetary management and tariff policy is the growing importance of a range of supplementary duties (para-tariffs) that have grown in significance and are almost inversely correlated with the reduction in custom duties (figure 16). These para-tariffs have tended to offset much of the gains intended for raising productivity and competitiveness of exports through the impact of lower customs duties on protection. The large dispersion of both customs and supplementary duties tends to distort production incentives through high rates of effective protection. Importantly, the current tariff regime undermines export competitiveness and impedes growth of new exports, thus inhibiting progress in export diversification.

But the economy does face a challenge. The vision of attaining middle income country status by 2021 is predicated upon a lifting of the economy's growth rate to an average of 8-10 percent for the present decade. Can that sort of high performance be achieved with a trade regime that is internationally ranked among the most restrictive? Only very open economies with low tariffs have been able to reach that kind of high performance on a sustainable basis. It is highly unlikely that Bangladesh can be an exception. So if the objective of high sustainable growth is to be realized, and export diversification is one of the policy instruments that propel growth, what are the policy options available for Bangladesh?

STRATEGIES FOR EXPORT DIVERSIFICATION

Doing nothing and simply muddling through the status quo of trade policy that seems to lack focus is not an option that will allow Bangladesh to become a high performing export-oriented economy in the medium- or the long-term. A proactive stance that keeps exports (including potential exports) internationally competitive and facilitates trade is the only viable option for the future. Failing which Bangladesh is destined to remain a one product export (RMG) economy for the foreseeable future.

To sustain the high performance in overall export, there is no alternative to investing in and modernizing trade and transport logistics, and infrastructure. But this is only a start. While there is no magic recipe to promote diversification, a broad array of policies might be needed to create and sustain new export products. The important point to note is that the diversification challenge might be unique to each country context though some commonalities can always be identified. The Bangladesh context, for one, might call for some customized approach to addressing the problem, namely:

- First, the import regime must be made seamless to facilitate imported inputs into exports;
- Second, the incentive structure for exports must be set right (i.e. removing anti-export bias);
- Third, lowering the costs of trade-related services (improved trade and transport logistics) is critical for ensuring export competitiveness;
- Fourth, proactive policies, such as helping exporters upgrade existing products, break into geographic markets, and launch and consolidate new line of business abroad, might be important in view of serious governance deficiencies;
- Finally, even subsidies of the kind advised by Rodrik (2004, 2007), calling for strategic government intervention and/or carrots-and-sticks incentives that encourage investment in bottleneck areas or non-traditional domains, might be required, but those must have sunset provisions to weed out investments that fail.

Taming the import regime: Bangladesh's high tariff and relatively restrictive import regime is an impediment to export diversification. This needs to change radically. In the present scheme of globalized production structure, exports need not rely on only domestic source for inputs. Production could be typically broken down into several stages of fabrication with each stage located where there is comparative advantage. The leading export powerhouses of the world (e.g. China and India) are also leading importers of intermediate inputs and raw materials. Bangladesh trade policy needs to be re-designed to ensure a seamless import regime for all export production. With trade-related QRs gone, tariffs, and weak customs administration remain the principal stumbling block.

The anti-diversification bias of the trade regime is unique for Bangladesh and needs some elaboration. Bangladesh continues to have a high tariff and protective regime that undermine export competitiveness. But the RMG sector and its exports are kept out of this regime through a package of RMG-focused interventions. The high tariff regime which shows no

sign of easing, however, applies to non-RMG exports. What other options remain if protective tariffs are expected to remain stubbornly high in the near future? Some lessons could be drawn from the East Asian experience – one that was pursued by Korea and Taiwan for a limited period of time. That was a policy of retaining some of the protection for selected industries while removing any anti-export bias with a package of supportive policies to keep sufficient incentives for export production. More specifically, Bangladesh can adopt the route that was taken by the Korean economy in the 1970s: protecting specific industries on the one hand, but promoting exports by developing policy regimes that provided incentives to exporters comparable to import-competing sectors despite protection (David Tarr, 2002) and balancing out incentives to exports by support policies that minimized the anti-export bias of protectionist policies (Fujita and James, 1989). Here it is important to note a major caveat. Such a complex balancing of incentives requires policy intervention of the highest quality and policy making agencies must be staffed by the most competent, honest and committed functionaries. In the absence of such institutional strength, there is little or no guarantee of success of these policies.

Removing anti-export bias: The prevailing protective regime produces an incentive bias favoring production for the domestic market and against exports – anti-export bias. Table 5 and figure 17 present an account of trends in anti-export bias of trade policies which, in the ultimate analysis, has the effect of making domestic production of import competing goods more profitable than that of exports⁸. Starting with a 58 percent unfavorable bias against exports in

Table 5: Measuring Anti-Export Bias of trade policies

Fiscal Year	Nominal Exchange Rate in Tk.	Effective ER		Anti-export Bias
		Imports	Exports	
1991-92	38.15	60.84	38.53	1.58
1992-93	39.14	58.35	39.76	1.47
1993-94	40.00	55.04	40.50	1.36
1994-95	40.20	51.55	40.52	1.27
1995-96	40.84	50.95	41.24	1.24
1996-97	42.70	53.05	43.17	1.23
1997-98	45.46	57.15	46.06	1.24
1998-99	48.06	60.12	49.10	1.22
1999-00	50.31	61.48	51.82	1.19
2000-01	53.96	66.30	55.50	1.19
2001-02	57.43	71.09	59.16	1.20
2002-03	57.90	70.43	59.62	1.18
2003-04	58.94	73.43	60.22	1.22

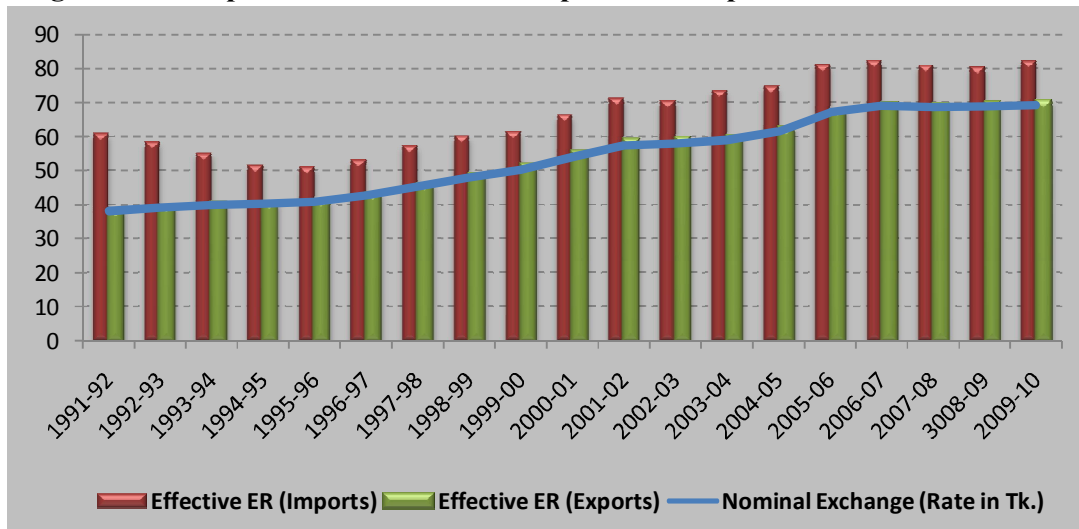
⁸ A leading Bangladeshi entrepreneur of footwear and leather products, who exports 80% of his production and sells the remaining 20% in the domestic market, stated that his profit margins on domestic sales are much higher than in exports. (Statement by Mr. Manzur Elahi, Chairman, Apex Group, at a public exchange meeting organized by FBCCI in February 2012).

Fiscal Year	Nominal Exchange Rate in Tk.	Effective ER		Anti-export Bias
		Imports	Exports	
2004-05	61.39	74.69	62.53	1.19
2005-06	67.08	81.10	67.75	1.20
2006-07	69.03	82.34	69.76	1.18
2007-08	68.60	80.83	69.62	1.16
2008-09	68.80	80.39	69.89	1.15
2009-10	69.18	82.07	70.35	1.17
2010-11	71.18	84.28	72.14	1.17

Source: NBR, Bangladesh Bank, and PRI staff estimates.

1991-92, the decline in protective tariffs and implementation of many export support policies have led to the decline in anti-export bias, but it still remains stubbornly significant at about 17-20 percent since 2000⁹. That sort of incentive bias is enough to take the dynamism out of any emerging exports that must face many logistic hassles in addition to earning a relatively low return on investment and having to fight cut throat competition in world markets.

Figure 17: Comparative Incentives for Exports and Import Substitute Production



Source: NBR, BB, MOC, and PRI staff estimates

The first-best option for eliminating anti-export bias of course is to get average tariffs down to low levels of under 10 percent in the near to medium-term while taking all the measures to remove any remaining anti-export bias in trade policy.

The policy regime governing RMG exports reviewed earlier is instructive. Thanks to the Korean investors in the late 1970s, Bangladesh took a leaf out of the Korean book, so to say. The anti-export bias of a highly protective regime was neutralized by a number of innovative

⁹ Only nominal protective tariffs have been considered in measuring incentives to import substitute production. Actual incentives are measured by effective tariff protection which is much higher. As such, the figures in this table under-estimate actual anti-export bias.

measures: bonded warehouse system for duty-free imported inputs, back-to-back LC for import finance, customs green channel for rapid import-export cargo clearance, and an overall free trade channel for RMG production, in EPZ or domestic economy. So the RMG sector was tactfully kept out of the ambit of an inhibiting import regime. True, the MFA opened markets for Bangladeshi exports, but that in itself could not have guaranteed the phenomenal success of RMG exports without the elimination of anti-export bias regime at home. As a result, in a global market of some \$350 billion, Bangladesh has now become the second largest clothing exporter, after China, with RMG exports of \$19 billion in FY2011, thanks to the innovative policies adopted early on.

Although the export market of RMG remains wide open, it is unlikely that Bangladesh can expect to become a high performing economy riding on the shoulders of one export product. Higher growth will have to be export driven, particularly in manufactures, but more products will have to emerge in the export basket. The case for export product diversification is thus made. But it would have to rest on a package of policies that are directed to overcome the significant anti-export bias that prevails in the policy environment. One way to do that is to allow duty-free bonded imports of inputs to all potential and emerging exports. Lately, footwear exports and ship-building have been given similar treatment with duty-free imported inputs within the bonded warehouse system and the results are becoming evident with the rapid expansion of footwear exports and the surprising emergence of exports of ocean-going ships. Other exports are waiting in the wings to emerge taking advantage of Bangladesh's unparalleled labor cost competitiveness. Duty-free imported inputs (within a bonded system) coupled with a package of incentives to overcome anti-export bias has become the need of the hour.

Upgrading trade and transport logistics: Export competitiveness is undermined by poor trade and transport infrastructure and an inhibiting regulatory regime for doing business. Export diversification requires more intensive use of modern and efficient backbone services in order for new products to compete and capture foreign markets. Therefore, provision of lower cost and efficient telecommunications, road and rail transport, energy, and security services are critical for the emergence and sustainability of new products in the export basket.

Proactive policies to support trade: Though generally a low-tariff regime is favorable to the growth of exports, it might not be enough in a low-income country like Bangladesh where both market and government failures persist to create impediments to the emergence of new and internationally competitive export products. Proactive policies are needed to overcome market and government failures. These include strengthening export promotion agencies, commercial and export orientation of embassies, adding export processing zones and special economic zones, equipping standards institutes, supporting agencies to promote innovation, and modernizing customs, to name a few. It is important to acknowledge that policies need not be limited to addressing only border barriers; there are enough behind-the-border constraints that need to be dealt with and overcome.

CONCLUDING REMARKS

Cross country evidence and empirical research has shown that, on average, export diversification has a positive impact on export performance and also on economic growth. The transmission mechanism is through the reduction of vulnerability from potential export shocks that emanate from cyclical movements or demand shocks in the economies of developed countries which happen to be the principal destination for exports of low-income countries like Bangladesh.

However, the approach to export diversification need not follow any set pattern but must be crafted by taking into account the special country context. Bangladesh presents a unique case of a trade policy regime that tends to perpetuate export concentration. It stems from the prevalence of a high tariff regime which required the creation of a free trade channel for imported inputs coupled with special incentives within a virtual production enclave for RMG. The outcome of this policy is to create an anti-export and anti-diversification bias for the rest of current or potential exports. The appropriate strategy in this case would be to remove the anti-diversification bias by offering a uniform trade regime to both RMG and non-RMG exports.

Cross-country experience suggests that the strategy of picking winners, i.e. focusing preferential policies on so-called thrust sectors, is unlikely to pay dividends in terms of export diversification. More important is to create an enabling policy environment that attracts investment into sectors with potential comparative advantage while providing support agencies and cost-effective trade and transport logistics, energy and telecommunications services.

While export concentration in RMG shows no sign of abating, there has been reasonable progress in geographical diversification in terms of destination markets, a process described as diversification on an extensive margin. Further progress is expected as Bangladesh exporters foray into markets of emerging market economies (e.g. China, India, and Brazil) and Japan. Together, they represent markets whose size approaches that of the USA or EU.

That said, there is more to expect from Bangladesh's growing strength in RMG exports. Thus far, Bangladesh has captured barely 6 percent of the global market for RMG. McKinsey (2011) has projected Bangladesh exports reaching \$40 billion by 2020. There is also scope for export diversification on an intensive margin through productivity improvements in RMG production and moving up market into fashion garments and other value-added products.

All in all, export diversification in its various forms and phases remains a complex process. There is no magic recipe for diversifying exports, and each country, faced with the challenge, needs to mould policies and practices befitting the unique country context. Although there is ample evidence to support the notion that export diversification (by product) has a favorable impact on economic growth of developing countries, there appears to be no justification for an overriding policy focus on this one objective by ignoring the scope for harnessing the gains from productivity improvements and spillover effects of adequate attention to growth in the intensive and extensive margins, as the prospects for future RMG export growth indicate for Bangladesh.

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