



Case for addressing anti-export bias in FY 2013-14 budget

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By *Dr. Zaidi Sattar*

Over the past two decades, Bangladesh has emerged as the second largest

readymade garments {RMG} exporter in the world after China. Driven by this one product group, exports have averaged comfortable double digit growth for the entire period. Prospects for sustained high export performance are bright, though vulnerabilities remain. One primary source of vulnerability arises from “export concentration” characterized by the extreme reliance of export earnings on just one product – RMG.

The problem has been duly identified by analysts and policymakers alike, and the need for export diversification is well recognized by the government which, to be fair, has made it a cornerstone of trade policy. But, judging from the record thus far, results are modest. Though the number of export products has increased over time, the share of RMG in the export basket has remained steady at 75-79% for the past decade. This is partly due to the approach taken to address the challenge, which has been to identify products with strong past growth record or assessment of potential comparative advantage using some indicator like revealed comparative advantage (RCA), and to include these among the “thrust sectors” in industrial or export policy to give them all kinds of support in preference to other sectors not so identified.

The emphasis of trade or industrial policy based on the principle of thrust sectors has its merits and demerits. It is a fact that RMG was never a thrust sector at its inception three decades ago. Most recently, ship building has emerged as a viable and prospective export sector to everyone's surprise. The thrust sector approach is largely a post facto device to distribute public resources rather than an effective criterion to diversify production or exports going forward.

What is missing in this approach is a proper diagnostic of what generates the momentum for export concentration in one product to the exclusion of others. To be sure, any strategy for export diversification should not create conditions to stem the existing momentum associated with the lead product but contain adequate incentives to generate momentum for the emergence and expansion of other products. A study by Policy Research Institute (PRI) of Bangladesh — 2012 PRI study for the World Bank, "Assessment of Effective Rates of Protection 2012 survey of selected manufacturing enterprises" — has revealed that, in the ultimate analysis, it is a matter of relative incentives that determine resource allocation across competing activities in production for domestic sales or exports. It also established that while non-RMG exports suffered from significant anti-export bias of incentives (resulting in exports of a product being less profitable than its domestic sales propped up by high protection), RMG sector - being a 100% export-oriented sector — was largely immune to it. The consequence of this structure of relative incentives seemed to accentuate the uni-product export concentration.

Policies and institutions that favour export expansion will also be conducive to export diversification. Bangladesh is probably a unique case where this proposition might not hold. This is because the high reliance on RMG exports has put in place institutions and policies that give high priority to this sector resulting in an asymmetry of policy support that accentuates the existing uni-product export concentration, on the one hand, and also hinders the emergence and growth of non-RMG exports, on the other. Given the size of the global market for textiles and clothing, Bangladesh's strong market position in RMG is unlikely to diminish anytime soon. Given that (a) China is moving away from basic garments to high-value products, (b) Japan, the second largest apparel market in the world, has opened up to Bangladeshi garment exports, and (c) emerging markets are becoming significant buyers of Bangladeshi garments, McKinsey and Company - "Bangladesh's Readymade Garments Landscape: The Challenge of Growth" - project (2011) that Bangladesh RMG exports will

double by 2015, and triple by 2020. Nevertheless, the case for diversifying Bangladesh's export basket in the interests of reducing vulnerability from industry-specific shocks has been made.

The following policy and institutional mechanisms need to be put in place if export diversification is to be attained within a reasonable period:

I Trade policy bias against exports must be eliminated. As for the trade policy regime, PRI research in the past year has highlighted the fact that the tariff structure is generally skewed in favour of import-substituting activities with a substantial anti-export bias. Because of the essentially "free trade enclave" created for RMG production — a 100% export-oriented industry — it is not affected so much by the anti-export bias of the incentive regime as are other exports.

However, in recent years, the government has taken some steps to selectively provide such facilities like special bonded warehouse or SBW (previously restricted for 100% export-oriented firms like RMG) to exporting firms that satisfy a critical minimum export volume, thus mitigating some of the anti-export bias. We find that an increasing number of non-RMG exporting firms are now making use of this facility which is the principal means by which the dis-incentives from a high-tariff regime can be mitigated. This process needs to be sustained and made more effective.

Nevertheless, a major challenge in the forthcoming budget of fiscal year (FY) 2013-14 will be to address the issue of anti-export bias in the tariff structure because it hurts emerging and potential exports, thus serving as a policy constraint to export diversification. It is imperative that the unusually high effective rate of protection (ERP) for import-substitute production needs to be scaled down. The process needs to start with the FY2013-14 budget by reversing the growing wedge between output and input tariffs.

I Efficiency of customs administration. A transparent and efficient customs administration is ideal for export success. Again, it is not enough to provide green channel clearance for RMG cargo while leaving the remaining exports at the mercy of an archaic and incompetent customs administration. All exports must be brought within the fold of automated clearance mechanism that is equipped with state of the art hardware and software.

I Efficiency of import-export procedures. It would be foolish to think that improving trade infrastructure means focusing on rapid clearance of export cargo. Export and imports are intricately linked so that export performance depends critically on simplification of import procedures as well. Modernization of import clearance by installing the latest machinery and equipment along with information technology (IT) software's is absolutely critical to achieve export diversification.

I Transparency and efficiency of behind-the-border services. Besides providing the support of modern banking and financial institutions to trade, industrial and investment policies need to be brought in line with those of trading partners and comparators so that a dynamic export sector can be sustained for the long-term.

I Availability and quality of transport infrastructure and services. Improving trade logistics will definitely enhance competitiveness of exports. First, land and sea ports must be equipped with state of the art facilities – container depots, gantry cranes, IT-enabled port clearance services, etc. — for rapid clearance of import-export cargo. Road, rail, river, and air transports linking the hinterland to the ports must be developed to the highest level of sophistication so that transaction time and costs are minimal, to ensure export competitiveness.

I Availability and use of IT. Export success along with export diversification calls for rapidly installing state of the art IT equipment and software for handling activities at the ports but also inland for as much of the behind-the-border activities as are related to trade. Export competitiveness in the 21st century is as much a matter of producing at the lowest cost as it is about producing with the support of the best and latest technology. In this regard, it is critical to run and stay with the latest versions of hardware and software, or else export success could be short-lived.

Promoting export diversification

This write-up primarily seeks to provide a diagnostic of the tariff-related constraints to export diversification by examining existing incentive regimes in the manufacturing sector of the Bangladesh economy, and identification of trade policy biases, besides taking note of the standard issues of cost-competitiveness and inadequacies of trade infrastructure. While

making a strong case for eliminating anti-export bias for non-readymade garments (RMG) exports by rationalizing the tariff structure, some critical barriers related to export diversification that were not raised or adequately discussed in the past, are being highlighted here. The forthcoming budget for fiscal year (FY) 2013-14 might be a good opportunity to take some of the recommendations for tariff adjustments on board.

Vulnerability from export concentration: 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 per cent of exports in 1981. In the post-1990 period, however, 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 77-80 percent.



In terms of 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, food grains, and raw materials, such as cotton – a major import of Bangladesh's textile sector. Research shows that TOT shocks or variability have adverse impacts on gross domestic product (GDP) growth.

For developing countries like Bangladesh, external demand (quantity) shocks appear as a more serious threat. Such shocks are the outcome of cyclical movements in the economies of North America and the European Union (EU), the destinations to which bulk of Bangladesh's exports are directed. The income effect of these cyclical movements is to stimulate export revenues from trading partners in boom times with its negative counterpart in contractionary periods. While a developing country cannot escape fully from the adverse effects of a global crisis, a diversified export market can help soften the impact considerably. If North America and Euro zone countries embark on austerity measures to resolve their fiscal and debt problems, it could mean lower demand for developing country exports across the board.

This is illustrated, for example from the 2012 experience when the export growth in nominal US dollars dipped to only 6.0%, as compared with a target of 14% in the Sixth Five Year Plan, owing to the adverse effects of the European Debt crisis. The saving grace, in such scenarios, might be demand from the emerging market economies (Brazil, India, and China) and Japan. Together, these economies 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.

Trade policy bias as key constraint: A wide range of constraints undermine Bangladesh's prospects to diversify its export base. These constraints can be categorized into several themes like (a) adverse incentives for export diversification, (b) role of cost competitiveness, (c) ease of doing business, (d) availability of skills, (e) Foreign Direct Investment (FDI) inflows into export sectors, and many more. This write-up mainly focuses on a scarcely discussed issue of trade policy bias arising from adverse incentives, while taking note of some of the standard issues like cost competitiveness and ease of doing business.

Incentives for exports versus production for domestic sales: This concerns the attractiveness of investors to go into exports vis-à-vis domestic production. The main incentive policies arising from the trade regime relate to exchange rate management and the tariff structure.

I Exchange rate management: Exchange rate is a critical determinant of export incentives and as such sound exchange rate management is very important for maintaining export competitiveness, particularly for non-RMG exports. RMG exports are partly shielded from exchange rate movements because of the special import credit system (back-to-back letters of credits or LC) that covers import costs from export proceeds so that any nominal exchange rate depreciation affects costs and returns proportionately. As a long-term strategy for export diversification, the appropriate exchange rate management would be to avoid rigidity or real appreciation of Real Effective Exchange Rate or REER; a moderately depreciating REER would work better to sustain competitiveness of exports, particularly non-RMG exports.

I Tariff structure and relative incentives: Perhaps the single most important determinant of export competitiveness is the incentive regime emerging from trade policy. Bangladesh like other South Asian countries started with an autarkic trade policy regime with a host of quantitative restrictions and high tariffs. This complex system of anti-trade and anti-export

regime slowly got dismantled, especially since 1990. Yet, a substantial anti-export bias of the trade policy remains due to a structure of tariffs that raise profitability of domestic sales relative to exports, particularly for firms engaged in production both for domestic and external markets, thus serving as a hindrance to non-RMG and emerging exports.

Cost competitiveness: Except for RMG, for most of the products that Bangladesh exports, it faces a virtually infinitely elastic demand curve. Bangladesh is a very small player in the global market for non-RMG exports and its presence or absence does not create any impact on the world price of that product. While there may be tariff or non-tariff barriers in individual countries, these are likely to apply uniformly for all exporters. So, for all practical purposes, Bangladesh is a price taker in the global non-RMG export market. Market access to these products is by and large limited by cost competitiveness of Bangladeshi suppliers.

The enabling environment for trade is a key determinant of cost competitiveness of exports. In recognition of its importance considerable attention is now being paid by various countries to this factor. Globally, several indicators of this enabling environment have been prepared that are regularly updated on an annual basis to track progress relative to competitors. Two commonly used indicators are the Enabling Trade Index (ETI) and the Trade Logistics Performance Index (LPI). In addition, Bangladesh does poorly on most of the indicators included in this index, but scores especially low on transport. This is not surprising as transport and power have emerged as serious constraints to manufacturing sector in general. Export competitiveness is sharply reduced by the high transaction costs relative to competitors related to transport services as well as the inefficiencies of custom procedures.

Ease of doing business: The regulatory environment for doing business in a country is yet another indicator of broad-based export competitiveness. The regulatory regime can raise the transaction cost of doing business and hurt exports. In the highly competitive global markets the ability to respond swiftly and timely to business opportunities and commitments can be critical factor underlying export competitiveness.

Importantly, the regulatory environment is a major determinant of FDI inflows that can also substantially influence the domestic supply capacity to respond to the world export markets. Historically, the business environment of South Asia has been intrusive with high transaction costs. Deregulatory efforts in South Asian countries, especially in Bangladesh and India,

started in earnest only since the 1990s. While progress has been made, there is still a long way to go. In terms of specific regulatory constraints, investors in Bangladesh face a particularly difficult challenge in getting electricity; in registering property; and in enforcing contracts. Bangladesh, however, does a good job in protecting investors.

On the whole, despite a series of deregulatory reforms since the 1990s, the overall business environment in Bangladesh is difficult relative to competitors that tends to increase the transaction cost and lowers competitiveness. Considerably more progress is needed for making the Bangladeshi investment climate much more attractive for attracting foreign investment and improving export competitiveness.

The important point is that while these constraints could be generic to all exports, they hurt non-RMG exports and emerging or potential exports even more thus inhibiting their expansion.

Anti-export bias of the incentive regime and trade policy: An in-depth analysis of the critical role of the anti-export bias in trade policy shows how it works as a constraint to export diversification. Bangladesh like other South Asian countries started with an autarkic trade policy regime with a host of quantitative restrictions and high tariffs. This complex system of anti-trade and anti-export regime slowly got dismantled, especially since 1990. Yet, a substantial anti-export bias of the trade policy remains.

While quantitative restrictions have been largely eliminated and customs duties reduced and simplified, tariff reforms, incomplete though they are, have stalled in recent years. Over the past 13 years, average customs duty has come down; but average nominal rate (NPR) has not, due to the emergence of para-tariffs, such as supplementary and regulatory duties. What is striking is the growing wedge between output and input tariffs resulting in higher effective protection (ERP) for domestic producers at a cost to non-RMG exporters, in particular, who face anti-export bias in export expansion and diversification. RMG firms, being 100% export-oriented, are immune to this bias of the tariff regime, thanks to the duty-free regime they operate in.

Structure of nominal tariffs: The analysis of relative incentives for exports and domestic sales would have to begin with an analysis of nominal protection to various categories of products imported under the tariff and import tax regime. It turns out that with progressive trade

openness, and virtual elimination of trade-related quantitative restrictions (QRs), tariffs on imports are now the single most important determinant of trade protection. Whereas tariffs and QRs together determined the extent of openness or restrictiveness of trade policy in the 1990s and before, the QR slate has been wiped pretty much clean since FY2005, leaving tariffs as the main instrument of trade policy and protection.

The tariff structure has been simplified by moving to only four non-zero tariff slabs – 3.0%, 5.0%, 12% and 25%. Although the average customs duty has come down over the past 13 years, the average nominal protection rate (NPR) shows mixed trend (Table 1). It initially declined between FY01 and FY09 and then started rising again over FY10-FY13.



Two aspects of the tariff structure and its trend are particularly noteworthy: (b) proliferation of para-tariffs, and (a) perceptible divergence between the top NPR rate (which moved up since FY01) and the average NPR, and a growing wedge between output and input tariffs.