Challenge and promise of export diversification

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After a record export performance last fiscal year, export pessimism is in the air once again.

And for good reason. When the Eurozone is in the grip of a crisis, Bangladesh exports cannot be immune to that event. Because countries of the European Union (EU) together buy 51% of our exports. Moreover, in an integrated world, a Eurozone crisis can become a global economic crisis in no time.

Yet, these events are beyond our control. For Bangladesh, integrating with the world market is good for the long-term – even along with the ups and downs of the world economy. Access to the wider global economy presents a much larger market for Bangladeshi goods with the potential for job creation and economies of scale that might not be possible from even a growing domestic economy. Recall that we are adding about two million people to our labor force every year, and we have a persistent problem of under-employment. So reliance on exports and efforts at ensuring and strengthening export competitiveness should continue to be the long-term policy strategy to absorb the additional labor force.
That strategy has yielded rich dividends so far. Bangladesh experienced double digit export growth over the past two decades. And 90% of Bangladesh's exports were manufactured goods, making it the only least developed country (LDC) with such a high share of manufactured exports in its export basket. This illustrates its strength in mass manufacturing and cost competitiveness. Yet this superior performance masks the fact that the export surge was limited to one product group — readymade garments (RMG) — aided not least by the Multi-Fibre Arrangement (MFA) regime, a fortuitous global arrangement that was phased out in 2005. With over three million jobs and 76% of export earnings from the RMG sector, too much of the nation'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 for RMG.

Export diversification is one way the economy can come out of this bind. Indeed, it is now a national imperative. The government has correctly set export diversification as the cornerstone of its export policy for several years now. But progress has not been encouraging so far. Therefore, the problem deserves to be re-examined in light of recent analytical research and cross-country experience.

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, light engineering goods, ceramics, and ocean-going vessels, manufactures now dominate Bangladesh’s export basket with the result that TOT shocks no longer occur through adverse price movements in exports, except for the one-off event when the MFA elapsed in 2005.

But TOT shocks do occur through price shock of imports, such as petroleum or food grains and shocks in export demand. Moreover, the switch to manufactures and export concentration in RMG, failed to stem the steady decline in Bangladesh’s TOT for the past 15 years, as the index fell from 90.2 in FY97 to 71.9 in FY10. All this indicates a fair degree of vulnerability from the current structure of exports, which makes it absolutely essential to strive for greater export diversification.

However, product diversification in exports reflects a narrow view of this issue. By moving from heavy reliance on primary products (jute and jute goods) to manufactures, Bangladesh already achieved what is called vertical diversification of exports. But export concentration in manufactures (such as RMG) could be just as problematic as concentration in primary products. Evidence is strong that export concentration has been detrimental to the economic growth performance of developing countries in the past decades, due to export instability and declining terms of trade.

To come out of export concentration phenomenon, Bangladesh could pursue the following diversification options. The most common approach is to go for greater diversity of products. 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 trade economists as “discovery” — which gradually assumes significant proportions thereby diluting any export concentration that might have existed.

Second, export destinations can be diversified. 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.

Third, quality diversification is another option but much more challenging. 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.

One more option could be to go from goods to services exports. Services, with the right skills and training, could be a job creator of the future if, for instance, tourism could become a significant attraction for non-resident Bangladeshis (NRBs) and global tourists alike. Given its strategic geographic location striding South and East Asia, what is preventing Bangladesh from becoming a trading hub of the vast hinterland across several political borders? What is preventing Bangladesh from becoming a Singapore of the future? It is time to look forward and well beyond the present.

The focus of current policies seem to be more on product diversification, and the approach taken is to pick winners, i.e. select “thrust” sectors and promote them with all sorts of incentives in the hope that they will be the RMGs of the future. If we recall, this is not how RMG emerged as the leading export item of Bangladesh; nor, for that matter, was ship-building – a recent success. With the advent of MFA, the right policies were formulated to give RMG production a free trade channel, i.e. by providing duty-free inputs through bonded warehouse and back-to-back LC system. With success, ship-building received duty-free bonded import facility almost instantaneously. International experience suggests that, in a high tariff regime, export success cannot come through subsidies provided to "thrust" sectors. It could, however, come through providing RMG-like free trade channel to existing and potential exports. That is the big policy challenge.

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:

l First, exports need imports. So the import regime must be made seamless to facilitate duty-free imported inputs into exports. Why duty-free? Exports, to be competitive in world markets, must be provided with world-priced inputs. Duty-free makes imported inputs bought at world prices.

l Second, the incentive structure for exports must be set right (i.e. removing anti-export bias) by ensuring that relative incentives for export and import substitute production are about the same;

l Third, lowering the costs of trade-related services (improved trade and transport logistics, and, of course, energy infrastructure) is critical for ensuring export competitiveness;

l 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.

Though progress in product diversification so far has been muted, Bangladesh has made good strides in geographical diversification as the share of exports to top five destinations has fallen significantly over the past decade and exports of over one million dollars reached as many as 112 countries in FY11, compared to only 61 in FY90. The strategy of geographical diversification is expected to yield good dividends as markets open up in Japan plus emerging market economies of Brazil, Russia, India, and China. Likewise, application of technology and improved management techniques will raise productivity and ensure quality diversification, by introducing higher value added exports of existing products like RMG.

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. While the standard prescriptions of improving trade logistics and infrastructure apply in Bangladesh, more important is the need to shape trade policy orientation in favor of existing and potential exports that suffer from anti-export as well as anti-diversification bias within a high tariff regime. Doing nothing while muddling through is not an option. (Dr. Sattar is Chairman, Policy Research Institute of Bangladesh. E-mail: zaidisattar@gmail.com)