



Why trade policy is inhibiting export diversification

Tuesday, Jan 8, 2019

By *Dr. Zaidi Sattar*

Export concentration in garment makes the economy, jobs and income extremely vulnerable to external shocks.

Export diversification must be a formidable challenge: we have been talking about it for over two decades without nearing a solution, with dependency on garment only getting worse by the year.

Of the \$36.7 billion exported in fiscal 2017-18, garment alone raked in \$30.6 billion, which is

83 percent of the total.

The time for talking is over. Doing something concrete is now a national imperative.

One needs to take a closer look at our trade policy to figure out that it has been stifling rather than facilitating export diversification.

What trade policy am I talking about? There is enough research evidence around the globe to show that subsidies on exports are not the answer.

In Bangladesh, there are other policies that counter the modest encouragement from subsidies to a selection of exports.

In the particular context of our export diversification challenge, the trade policy at issue is the package of incentives that encourage or discourage exports vis-à-vis domestic sales.

Note that investors and producers have only two markets to choose from: exports and domestic market.

They will be driven to either of these two markets depending on where profitability is the highest or the prospect of sales revenue (and therefore profit volumes) is greater.

Starting in the 1990s garment exports grew at double digits for two decades. In contrast, non-garment exports, of which there were many, seemed to lag behind.

And the result was export concentration.

Garment exports, which were 40 percent in fiscal 1989-90, rose to 76 percent in fiscal 1999-00 and to 83 percent in fiscal 2017-18.

Export concentration in garment makes the economy, jobs and income extremely vulnerable to external shocks arising from changes in global demand for apparel.

But export diversification is one way through which the economy can come out of this bind,

the clamour for which has grown louder by the year.

Quite appropriately, export diversification has been the cornerstone of our export policy for several years now. But, progress has not been encouraging so far, suggesting re-examination of the problem in light of recent analytical research.

To come out of the export concentration phenomenon, Bangladesh could pursue several diversification options, with product diversification being one.

It describes a process whereby a range of new products is introduced to the export basket, thereby diluting any export concentration that might have existed.

While fiscal 2017-18's export data reveals that Bangladesh currently exports more than 200 types of apparel, our export basket comprised of upwards of 1,200-1,400 distinct non-garment tradable products that have been exported to nearly 200 countries since 2005.

That looks promising, but 75 percent of these non-garment products are still fetching less than \$1 million, meaning that they started small and are failing to become significant in our export basket. Why?

First, cost competitiveness is essential. The fact that we have been exporting such a vast number of non-garment products shows that we have a fairly wide range of products with good export potential.

The inference is that if we have such a strong competitive advantage in a labour-intensive product like garment, what is stopping us from having it in other labour-intensive products?

Research shows that we do have competitive advantage in numerous products but something is keeping our producers from exploiting that competitive advantage in the world market.

That brings us to the main point of this analysis: competitive advantage is not enough for those export products that also have a domestic market.

Outside the garment sector all production has a choice of the domestic or export market. What matters for producers and investors are the prevailing relative incentives for exports versus domestic sales.

Incentive for exports comes from cash subsidies, low cost credit, exchange rate under-valuation and so on.

For Bangladeshi exporters, there is no tariff protection that can prop up prices of Bangladeshi exports. So trade policies must be such as to leave sufficient incentive for producers to opt for export rather than sell in the domestic market.

Unfortunately, that is not how the trade policy is laid out: incentives are heavily skewed in favour of import-substitute production for sale in the domestic market.

Bangladesh has one of the highest protective tariffs (and para-tariffs) in South Asia. Tariff on competing imports of consumer goods that are domestically produced typically ranges from 70 percent (e.g. cosmetics) to 113 percent (e.g. plastic tableware).

These protective tariffs are indirect subsidies on import substitutes; not to mention that at such high rates they often serve as de facto ban on imports.

The net result is that profitability in domestic sales is artificially raised by these protective tariffs, far higher than if these same products were to be exported.

Profit margins in export are razor thin. It is only the massive sales volume and augmented revenues that would attract producers to export markets. In this circumstance, what would producers choose: export or sell in the domestic market? You guess.

Furthermore, an important requirement for exporters in a high tariff economy is the facility of duty-free imported inputs — a critical trade policy component.

In fiscal 2017-18, all of the 3,700 garment exporters had the duty-free import option of Special Bonded Warehouse (SBW). Of the 3,000 exporters of non-garment products, not even 500 were given that facility.

Without duty-free import of inputs, exporters cannot be competitive in the world market.

Duty drawback — which is an obsolete and dysfunctional scheme — is no substitute for the SBW system. As a result, non-garment exports are stifled and export diversification is going nowhere.

The focus of current export policies seems to be to pick winners, i.e. select “thrust” sectors and promote them with all sorts of incentives in the hope that they will flourish like garment in future.

If we recall, this is not how garment emerged as the leading export item of Bangladesh.

With the advent of Multi-Fibre Arrangement (MFA) in 1974, the right policies were formulated to give garment production a free trade channel, i.e. by providing duty-free inputs through bonded warehouse and back-to-back letters of credit system.

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 garment-like competitive environment to existing and potential exports.

While there is no magic recipe to promoting diversification, a broad array of policies might help, including:

1. Facilitating duty-free imported inputs for exports. Zero duty makes the imported inputs the same as the global prices, which is needed for exports to be competitive in world markets;
2. Making the incentive structure for exports the same as for import-substitute production for domestic sales, or slightly tilted in favour of exports;
3. Lowering the costs of trade-related services (improved trade and transport logistics, and, of course, energy infrastructure) is critical for ensuring export competitiveness;
4. Checking appreciation of the real effective exchange such that the exchange rate ensures export competitiveness;

5. Introducing proactive policies, such as helping exporters to: upgrade existing products, break into geographic markets and launch and consolidate new line of business abroad.

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 5 destinations has fallen significantly over the past decade.

The strategy of geographical diversification is expected to yield good dividends as markets open up in Japan, China, India, Canada, Brazil and Russia.

To conclude, there is no magic recipe for diversifying exports. But the trade policy needs to be tilted more in favour of exports rather than import-substitute production.