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Strategy for Export Diversification 2015-2020

Breaking into new markets with new products

Dr. Zaidi Sattar
Policy Research Institute of Bangladesh

Prepared as a Background paper for the Seventh Five Year Plan

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Acronyms

AIT	Advance Income Tax
ASEAN	Association of South-East Asian Nations
BRICS	Brazil, Russia, India, China and South Africa
CD	Custom Duty
DFQF	Duty Free Quota Free
EU	European Union
EME	Emerging Market Economy
ECR	Export Concentration Ratio
EPB	Export Promotion Bureau
EPZ	Export Processing Zone
ETI	Enabling Trade Index
ERP	Effective Rate of Protection
FTA	Free Trade Agreement
FDI	Foreign Direct Investment
FERA	Foreign Exchange Regulation Act
GDP	Gross Domestic Product
GVC	Global Value Chain
HHI	Herfindahl-Hirschmann Index
H.S.	Harmonized System
ISAC	Industrial Sector Adjustment Credit
IT	Information Technology
ITC	International Trade Centre
ICT	Information and Communication Technologies
LPI	Logistics Performance Index
LC	Line of Credit
LDC	Least Developed Country
MNC	Multinational Companies
MFN	Most Favored Nation

MFA	Multi Fiber Agreement
NIE	Newly Industrialized Economies
NBR	National Board of Revenue
NPR	Net Protection Rate
OECD	Organization for Economic Cooperation and Development
OFDI	Overseas Foreign Direct Investment
QR	Quantitative Restriction
RMG	Ready Made Garments
ROO	Rules of Origin
RCEP	Regional Comprehensive Economic
REER	Real Effective Exchange Rate
RSC	Review Sub Committee
RD	Regulatory Duty
SPS	Sanitary and Phytosanitary
SD	Supplementary Duty
SBW	Special Bonded Warehouse
SEZ	Special Economic Zone
SME	Small Medium Enterprise
TBT	Technical Barriers to Trade
TTIP	Trans Atlantic Partnership
TPP	Trans Pacific Partnership
TTRI	Trade Restrictiveness Index
T&C	Textile and Clothing
TPO	Trade Promotion Organization
VAT	Value Added Tax
VAR	Vector Autoregression
VECM	Vector Error Correction Model
WTO	World Trade Organization

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I. INTRODUCTION

Bangladesh needs to accelerate its growth in an inclusive manner in order to have the maximum poverty reduction impact. The experiences of Taiwan and South Korea in the 1960's and 1970's, Malaysia, Thailand, and Singapore in the 1970's, China in the 1980's, and eventually India in the 1990's, provide strong evidence that exports can play a leading role in supporting rapid growth, boosting the emergence of a modern manufacturing sector, providing employment, and reducing poverty. Robust empirical evidence has been provided by many researchers on export and growth (Sachs and Warner, 1995; Srinivasan and Bhagwati, 1999). Hausmann and Rodrik (2003) 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 GDP growth is closely associated with a fast pace of export growth (Brenton and New farmer, 2007). More generally, Nobel Laureate economist Michael Spence (2007) argued that sustained high growth of economies in the post Second World War period has been achieved by leveraging the demand and resources of the world economy through trade.

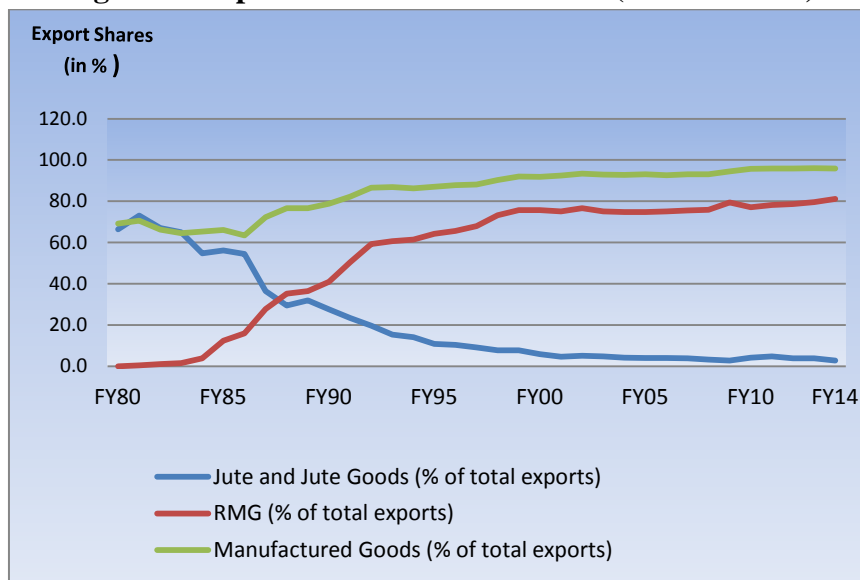
Leveraging the global demand for commodities as well as services through export-oriented development should then be a strategic goal for the Bangladesh economy in its quest to achieve middle income status by 2021. Bangladesh's export performance so far presents signs of strength as well as weakness in its export basket. Export concentration has emerged as a formidable challenge to address and overcome. There is growing consensus in economic literature that countries achieving structural change in exports through increased export diversification also grew rapidly and inclusively. With the labor cost advantage that Bangladesh enjoys, there seems to exist good prospects for extending into exports of labor intensive products other than RMG such as agro-processed industry, food products, other manufactures and assembly operations. By broadening the export base, diversification can stabilize and expand export revenues, enhance value added, and boost economic growth. The 7th Five Year Plan (2015-20) could provide the road map for making that happen.

II. CHALLENGE OF EXPORT DIVERSIFICATION

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 (Figure 1). 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 81 percent in 2014.

Figure 1: Export Concentration Trends (FY1980-2014)



Source: PRI staff estimates based on EPB data

However, the notable development in this evolution was the vertical diversification of its exports (from primary to manufactures) so that by the year 2000 Bangladesh became a unique LDC exporting predominantly manufactures (over 90%). 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 or petroleum, 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. Global demand for clothing will continue to grow with income though occasional slowdown might be expected due to shocks to the global economy.

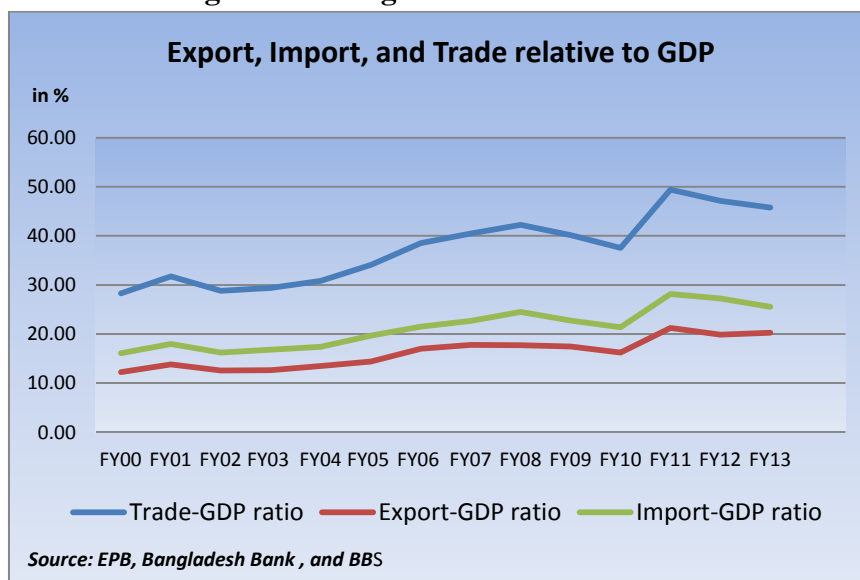
For developing countries like Bangladesh, external demand (quantity) shocks also appear as the most likely exogenous shocks to affect export performance from time to time. Such shocks are the outcome of cyclical movements in the economies of North America and the European Union, the destinations to which 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. 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. 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 Euro zone and other OECD countries prompting austerity measures in public spending. The saving grace might be the emerging market economies (Brazil, Russia, India, China, and South Africa) 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. Herein lies the rationale for an effective strategy for export diversification.

III. EXPORT PERFORMANCE AND PROGRESS OR LACK IN DIVERSIFICATION

Bangladesh exports gathered pace since the early 1990s, as a direct outcome of trade liberalization. The share of trade in GDP has been rising since 1990 when it was only at 19%. As Figure 2 reveals, exports, imports, and overall merchandise trade has been rising to support the contention that Bangladesh has become a trading nation with its rising dependence on international trade for jobs and income.

Figure 2: Rising share of trade in GDP



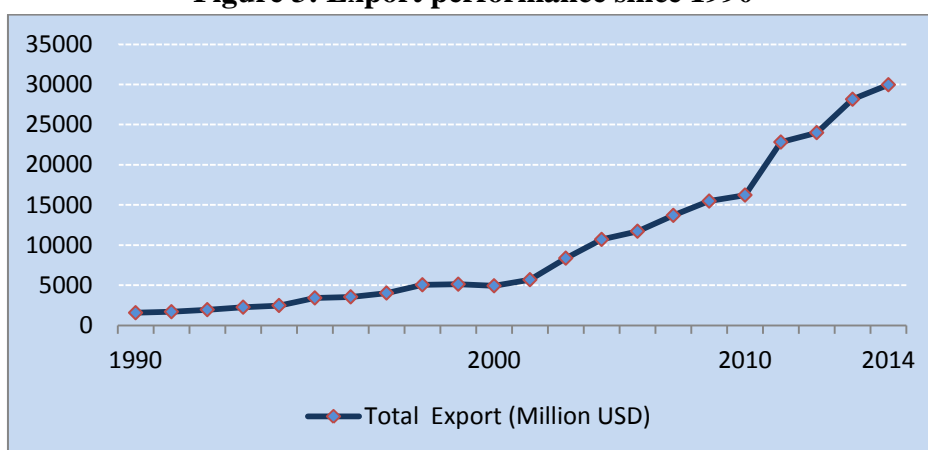
Progress in trade openness slowed down since the mid-1990s, leaving Bangladesh well behind the average trade-GDP ratio of East Asia and Emerging Asia, though above that of South Asia (Table 1).

Table 1: Bangladesh: 2013 Trade Openness in Asia (Trade-GDP ratio)			
	Exports	Imports	Total
Bangladesh	20.2	25.6	45.8
South Asia	16.0	24.6	40.6
East Asia*	29.2	28.5	57.7
Emerging Asia**	25.6	24.8	50.5
Low Income countries	18.1	30.5	48.6

*GDP of Myanmar was collected from CIA World Factbook
 ** This group consists of China, India, Indonesia, Malaysia, Thailand and Vietnam
 Source: WTO, WDI database of World Bank

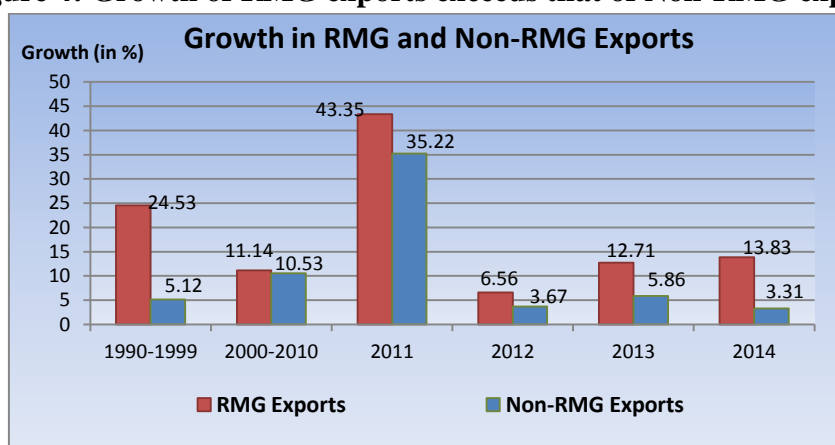
Compared to the previous two decades, export performance was exemplary, averaging double digit growth rates annually for nearly 25 years. In FY2014, total exports stood at US\$30 billion, which was five times exports of FY2000 (Figure 3).

Figure 3: Export performance since 1990



The notable feature in this evolving trading pattern is the emergence of readymade garment exports and RMG industry as the leading sector of the economy. The fact that RMG exports continue to grow at an average annual rate of 15% while non-RMG exports grow at a much slower pace of barely 3-4% recently (Figure 4), helps to increase the share of RMG leading to further concentration of exports.

Figure 4: Growth of RMG exports exceeds that of Non-RMG exports



How has Bangladesh fared in the quest for achieving a diversified export basket that contains more of non-RMG products?

To study how serious the export concentration is in absolute terms and relative to comparators, two alternative measures of export concentration (Chris Meilak, 2008) could be used: *Export Concentration Ratio (ECR)* and the *Herfindahl-Hirschmann Index (HHI)*¹.

The *Export Concentration Ratio (ECR)* is the simplest approach used to measure export concentration. The Concentration Ratio (CR) measures the export share of only the largest export categories. It is calculated as follows:

$$CR(x) = \sum_{i=1}^x s_i$$

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 high².

Figure 5: Relative Export Concentration 2011

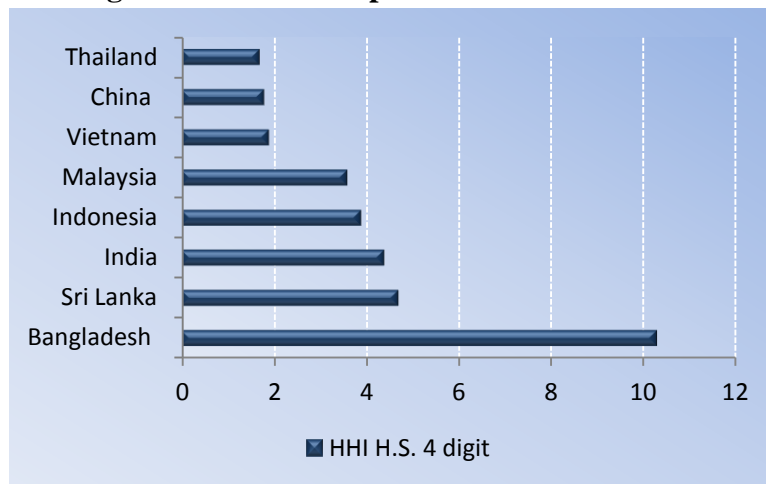


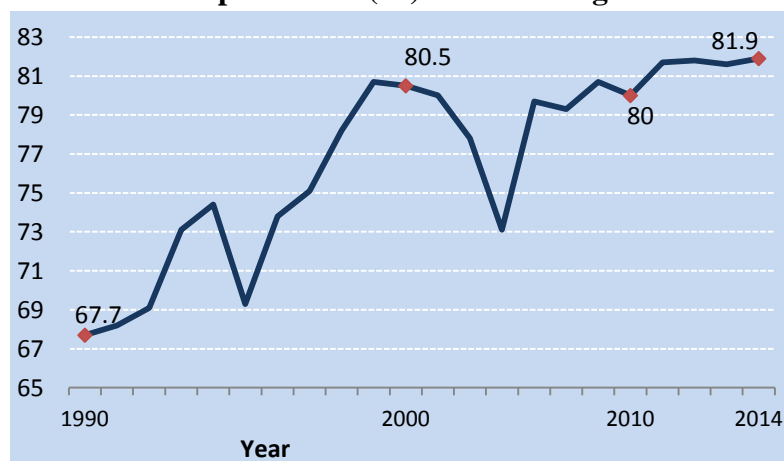
Figure 5 shows the relative position of Bangladesh and its selected comparator countries (China, India, Indonesia, Thailand, Malaysia, Sri Lanka) in terms of export concentration measured by HHI using 2011 HS-4 Digit data. Bangladesh has the highest export concentration of 1000 HHI, nearly twice the concentration level of Sri Lanka. What is

¹The Herfindahl-Hirschmann Index (HHI) is calculated by taking the square of export shares of all export categories in the market¹: $HHI = \sum_{i=1}^n s_i^2$, $i = 1, 2, n$. 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. It is also the convention to scale up the HH Index by multiples of 100 or 1000, so that a fraction of 0.04 can be restated as 40 or 400.

²In most applications CR (4), CR (8) or CR (12) is used, but there is no rule for choosing the value of x . As such, the number of categories included in the Concentration Index is rather arbitrary. This is the main disadvantage of this measure, but it is still widely used because of its simplicity of calculation and limited data requirements.

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

**Figure 6: Export Concentration Trend by ECR
Top 15 Items (%) at H.S. 6- digit**

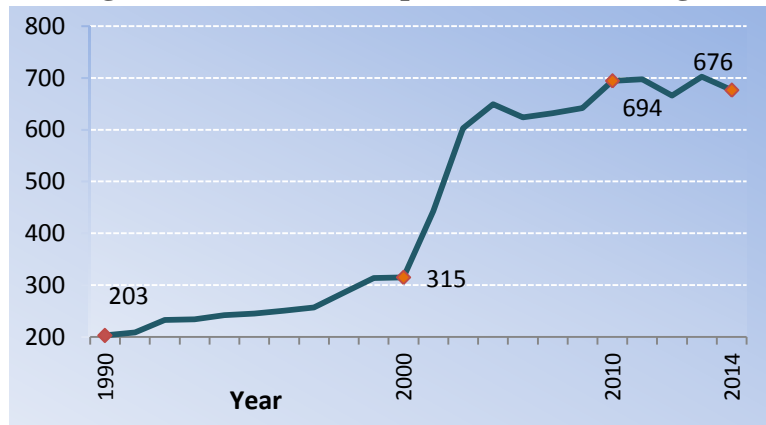


Source: ASYCUDA database, NBR

This fact is supported by the figure above (Figure 6), depicting export concentration trend of the top 15 items at the HS 4-digit level. The share of the top 15 export items in 1990 was 68 percent of the export basket and this value now stands at 82 percent. This implies Bangladesh is increasing its concentration in the export of these selected items.

Despite the growing dependence on certain export items, Bangladesh has been successful in increasing the number of export items within these broad categories (Figure 7). Studying the number of exported products at the H.S. 4-digit level show an expansion in the number of export items from 203 in FY 90 to 676 in FY 14. However, disaggregating this data for export items at HS 4-digit level that have reached a minimum threshold (greater than US \$500,000) are considered, the expansion in the number of products is much more modest (Figure 8).

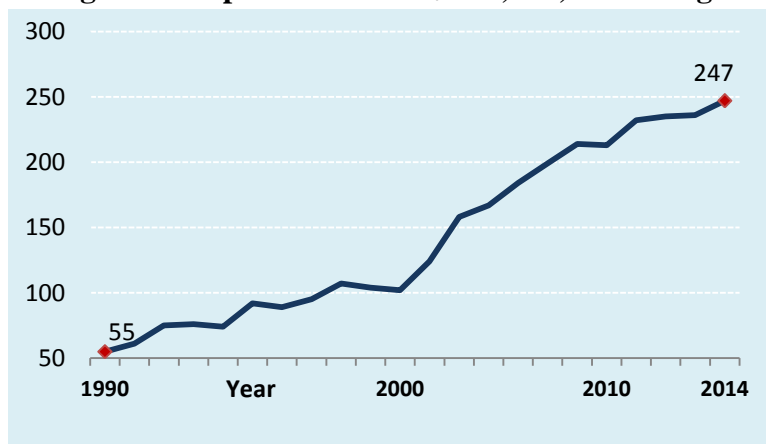
Figure 7: Number of Export items; H.S. 4 digit



Source: ASYCUDA database, NBR

These results suggest that the reason why export concentration remains an acute problem even though numerous new items entered the export basket is because the new entrants have not shown dynamism. As such they 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 that there are policy-related constraint that impedes growth of new exports. This issue will be revisited in greater detail later in the paper.

Figure 8: Export items > US \$ 500,000; H.S. 4-digit

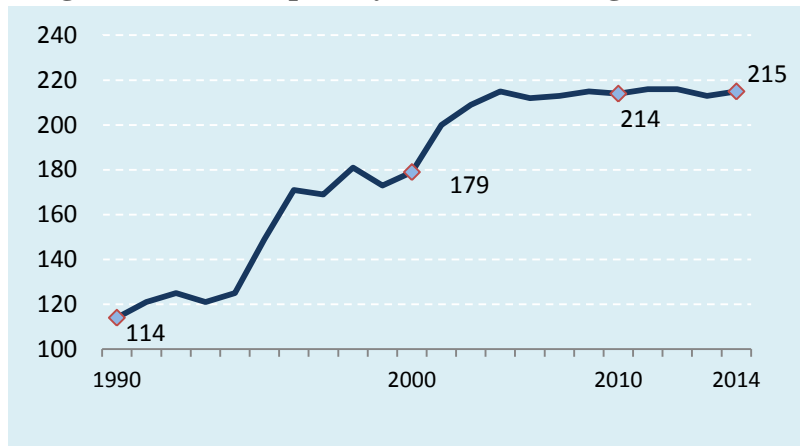


Source: ASYCUDA database, NBR

These results suggest that the reason why export concentration remains an acute problem despite numerous items entering the export basket is because the new entrants have not shown dynamism in terms of their shares in total exports. Policy-related constraint is the main reason behind the stagnant export which impedes new exports growth.

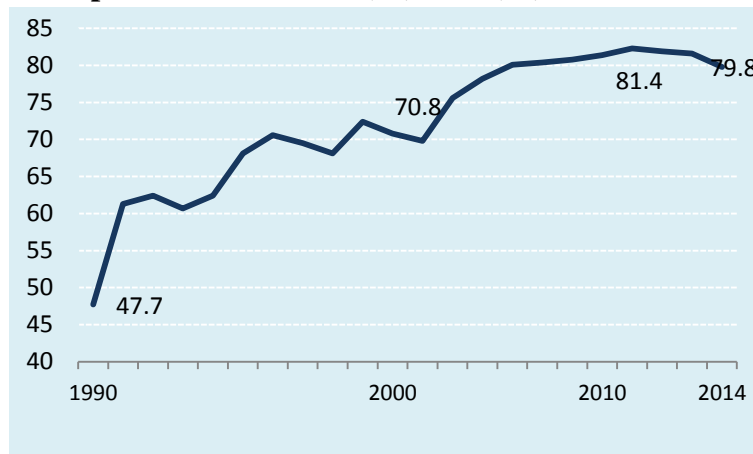
It has been argued that RMG is not one product but a product group consisting of a wide variety of products based on style, garment category, and so on. By that reckoning, one could look at the trends in product diversification within this group at the HS-6 digit level. Figure 9 shows that many new RMG products entered the export basket raising the number of HS-6 RMG products from 114 to 215 in 2014. Nevertheless, export concentration in RMG rose from 48% in 1990 to 80% in 2014 (Figure 10). This was 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: RMG Export by Number of 6-digit H.S. Code



Source: ASYCUDA database, NBR

Figure 10: Export Concentration (%) ECR(15) in RMG at H.S. 6-Digit

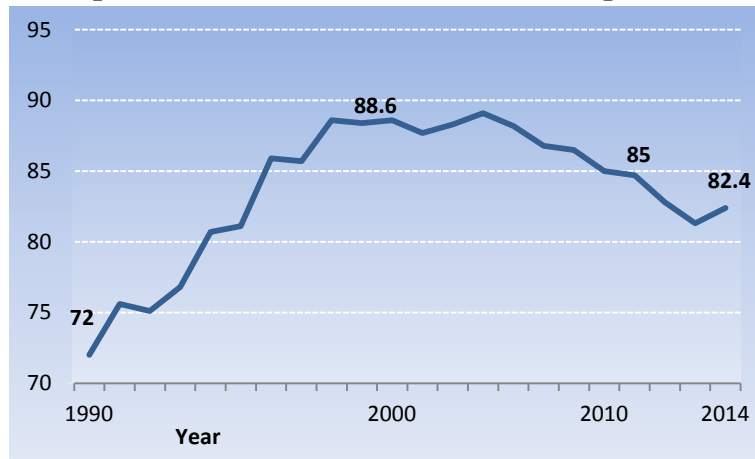


Source: ASYCUDA database, NBR

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 2014. 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. Figure 11 which shows share of exports to top 15 destination countries revealing the trend in geographical concentration of Bangladesh exports. The ECR indicates that geographical concentration is gradually on the decline³.

³ 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.

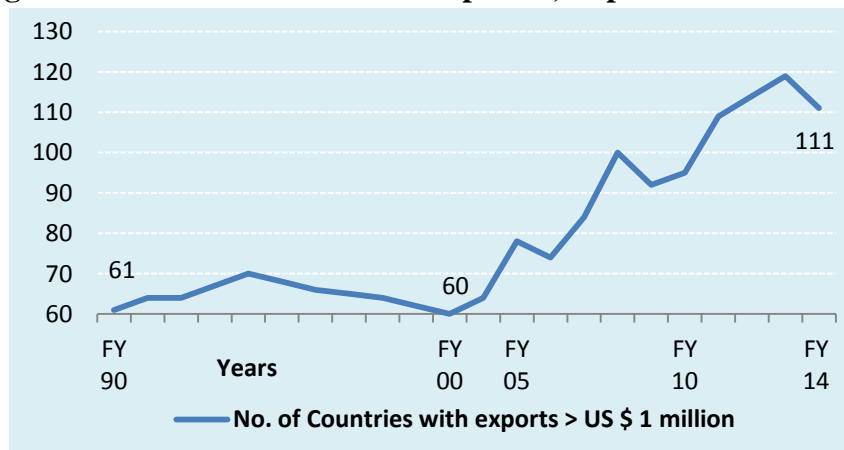
Figure 11: Export Concentration Trend (ECR); Top 15 Countries (%)



Source: BBS and NBR Asycuda database

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 countries to which exports (>US\$1 million) are destined, it has grown from 61 to 111 (Figure 12).

Figure 12: Number of Countries Exported, Exports >US \$1 million

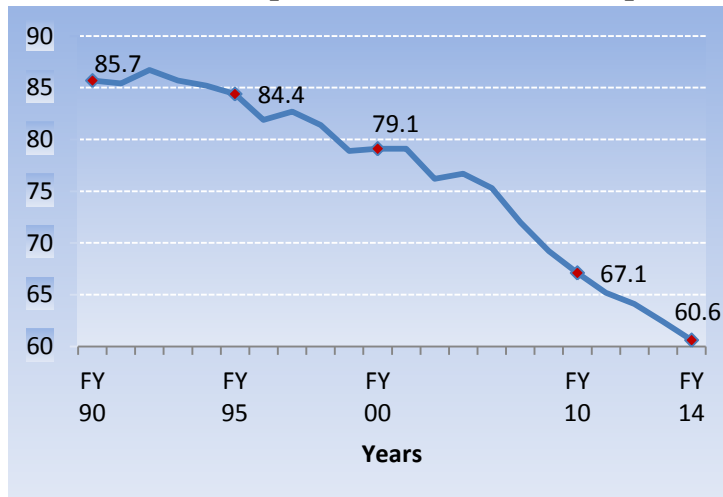


Source: BBS and NBR Asycuda Database

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 (1990-2014) reveals some albeit modest progress in geographical diversification of Bangladesh exports, including RMG products.

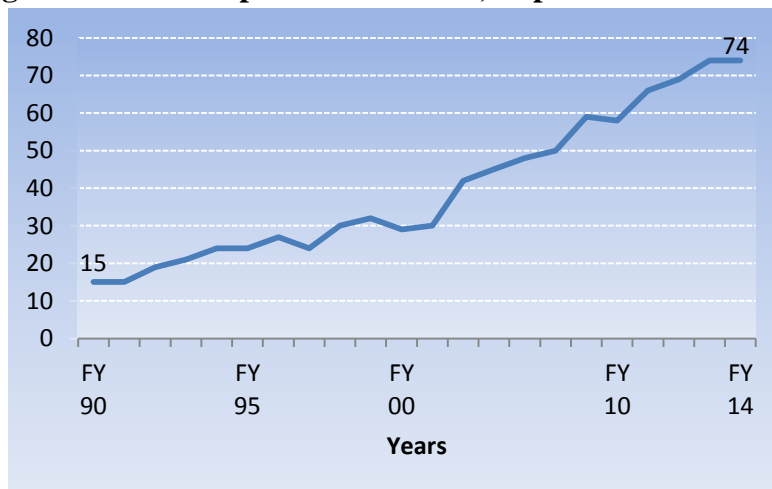
Somewhat similar results follow from a review of RMG export trends in destination countries (Figure 13-14) implying that these exports are not limited to a few countries like USA and Germany but are destined for all the countries of EU and beyond. The share of RMG exports to the top 5 countries (USA, Germany, UK, France, and Netherlands/Italy) has fallen from 86 percent in 1990 to 61 percent in 2014. The number of countries which imported RMG worth more than a million dollars increased from 15 to 74 during this period.

Figure 13: Trend in RMG Export Destination; ECR Top 5 Countries (%)



Source: BBS and NBR Asycuda Database

Figure 14: RMG exports to countries, Exports >US \$1 million

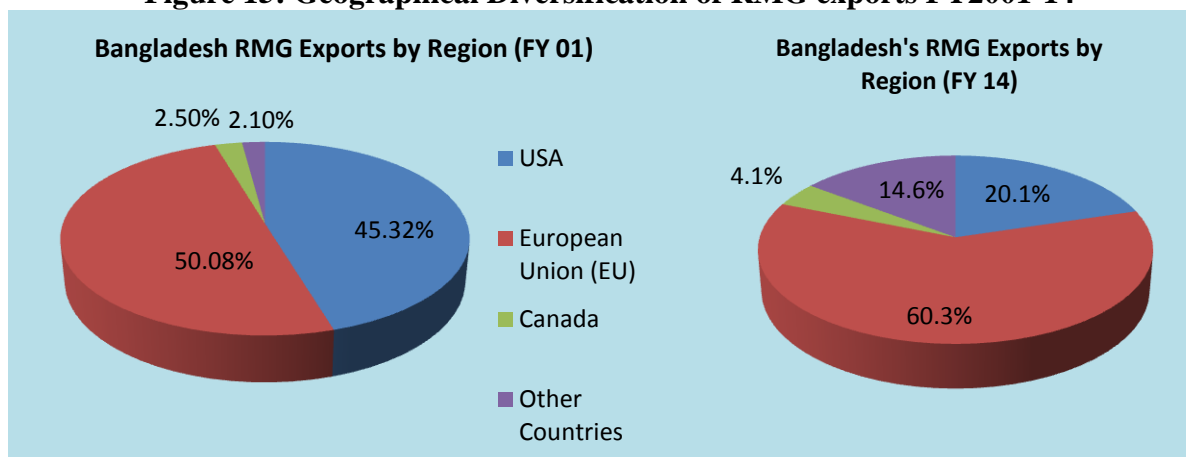


Source: BBS and NBR Asycuda database

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. These results suggest that from a geographical distribution perspective Bangladesh exports are slowly becoming more universally competitive and the vulnerability from cyclical or other shocks due to economic crisis in OECD countries is getting reduced. However, the pace of progress is slow and a more aggressive diversification strategy is needed.

Two pie charts in Figure 15 give a summary of the regional diversification of destination countries. While EU, the biggest destination of RMG exports, had a share of 50.1% in FY01, that share rose to 60% in FY14; but this increase masks the fact that several new countries joined EU during this period bringing its total membership to 28 countries. Also notable is the increase in the share of “Others”, from only 2.1% to 14.6%, and this rise is attributed to growing exports to Japan and other emerging market economies.

Figure 15: Geographical Diversification of RMG exports FY2001-14



Source: Bangladesh Bank

As a single country exporter, Bangladesh is now second only to China in RMG exports globally. “Made in Bangladesh” is now a known brand name in markets around the world, big and small. The most promising markets for Bangladesh RMG exports in the medium to long-term lie in the countries of North America, EU, Japan, and the emerging market economies (EME). Thus far, it appears that Bangladesh has gained a strong foothold in terms of its RMG exports in the markets of North America (USA and Canada) and EU, and is making inroads into Japan and the EMEs. But other countries such as Australia, Brazil, Chile, China, India, South Korea, Mexico, Russia, South Africa and Turkey are looking to be the more promising markets, followed by Malaysia, New Zealand, Norway, Saudi Arabia and Thailand.

Thus disaggregated analysis of export data reveals that Bangladesh has made some progress in geographical diversification of its export basket, both in RMG and non-RMG exports. However, further diversification into new markets like Japan and the BRICS (Brazil, Russia, India, China, South Africa) EMEs would be necessary to sustain a superior export performance for the long haul. That means Bangladesh entrepreneurs must overcome the initial entry barriers to these markets by addressing market access challenges in the following aspects: (a) ensuring cost competitiveness, (b) meeting WTO and country specific standards and certification requirements, and (c) seeking preferential access via membership in regional trading arrangements, or by invoking its LDC status and seeking DFQF⁴.

All of the countries and country groups that are prospective destination for growing Bangladesh exports in the near future have fairly open trade regimes. Many are also offering preferential tariffs to Bangladesh. As an LDC, Bangladesh has been accorded DFQF or extremely low preferential rates (Table 2) with a fairly wide coverage of manufacturing goods in several countries and country groups (e.g. EU). This is a window of opportunity though for a limited time only as Bangladesh could soon graduate out of its LDC status.

⁴ Note that Bangladesh may soon graduate out of its LDC status over the next few years and preferential market access might have a short time span. Preferential window should be used as a time for learning-by-doing and gaining competitiveness.

Table 2: List of countries offering Preferential tariffs to Bangladesh

Country	Tariff Year	Simple Average	%Tariff lines
India	2012	0	78.6
Australia	2011	0	2.0
Belarus	2011	0	
Canada	2010	0	0.8
Taiwan, China	2011	0	0.9
Iceland	2011	0	
Kazakhstan	2011	0	
Kyrgyz Republic	2011	0	
New Zealand	2010	0	0.5
Norway	2011	0	
Russian Federation	2011	0	0.1
Switzerland	2011	0	
Turkey	2011	0	
European Union	2011	0	100
Japan	2011	0.03	0.7
Korea, Rep.	2010	0.57	4.4
China	2011	1.36	13.5
United States	2011	1.42	3.7
Nepal	2011	8.8	
Sri Lanka	2011	11.39	
All countries	2011	0.84	4.8

Source: UNCTAD TRAINS Database accessed through WITS

huge scope for market expansion. Nevertheless, geographical diversification would be facilitated if Bangladesh makes the best use of this limited-time opportunity, while striving hard to maintain and enhance competitiveness in labor-intensive manufacturing products beyond RMG, where tariff rates are generally rather low in most countries that are potential destination for Bangladesh exports. As Table 3 shows, average non-agricultural tariffs are 9.7% for BRICS, 6.75% in ASEAN, 2-5% in Canada, Australia, New Zealand, USA, and EU. Tariffs are typically higher on agricultural and agro-based products which are also subject to stringent WTO-compliant SPS and TBT measures. Bangladesh exporters face the challenge of meeting such compliance while remaining competitive. Apart from frozen fish, agro-based products are being exported to ethnic markets that are limited in size. Only when they can ensure high standards of quality control can they seize the vast opportunities that lie ahead in opening markets for agro-based products thus further diversifying the export basket.

Table 3: MFN Applied Tariff Rates in potential export destination

Countries/Groups	Tariff Year	Simple Average (Agricultural Goods)	Simple Average (Non-Agricultural/Industrial)
BRICS:		15.06	9.70
Brazil	2010	10.4	14.19
China	2009	15.67	8.65
India	2009	31.85	9.43
Russia	2009	8.48	8.81
South Africa	2010	8.91	7.43
ASEAN:		11.0	6.75
Brunei	2010	0.02	2.9
Cambodia	2008	18.1	13.64
Indonesia	2009	8.39	6.56
Laos	2008	19.5	8.22
Malaysia	2009	2.45	7.6
Myanmar	2008	8.66	5.14
Philippines	2010	9.78	5.75
Singapore	2010	0	0
Thailand	2009	24.06	8.06
Vietnam	2008	18.89	9.6
Australia	2010	1.2	2.99
Canada	2010	3.05	2.6
Korea, Rep.	2010	48.5	6.56
New Zealand	2010	1.44	2.18
United States	2010	7.22	3.34
EU	2010	6.23	4

Source: UNCTAD TRAINS Database accessed through WITS

Table 4: RoO for Preferential tariffs to Bangladesh

Country	Tariff Year	Processing stage / Value addition requirement
India	2012	30% value addition
Australia	2011	50% value addition
Canada	2010	40% value addition
European Union	2011	single stage processing
Korea, Rep.	2010	50% value addition
China	2011	40% value addition
Japan	2011	two stage processing

Source: UNCTAD TRAINS Database accessed through WITS

Bangladesh is predominantly an exporter of manufactures (90% of export). Cost competitiveness based on low wages that has been recognized in RMG production also exists in other manufactured goods. Though USA does not offer preferential tariffs on RMG imports from Bangladesh, other countries (e.g. Canada, Japan, EU) do offer even zero duties on RMG and other exports, though subject to certain rules of origin (ROO) requirements which are often difficult to meet (Table 4). EU and Japan offer the simplest ROO. To take advantage of preferential rates, Bangladesh must meet the ROO criteria, which often becomes a barrier to export expansion in the near term. For most manufactured exports, presently, EU,

Japan, and Canada, have fairly relaxed ROO requirements in terms of minimum value addition requirement or stages of processing. Recent export growth to Japan and Canada has been phenomenal, and expansion is expected to be sustained. However, when it comes to diversification into agricultural or agro-based exports, there are WTO-compliant and stringent certification and standards requirement (SPS and TBT) from all OECD, ASEAN, as well as EMEs, which serve as barriers to entry in new markets. With support from development partners (e.g. EU Trade Support Program), efforts are on to improve compliance in Bangladesh manufactures as well as agro-based industries.

Exploiting Non-traditional Markets for Exports

Bangladesh exported \$27 billion worth of goods in FY2012-13 to over 150 countries of the world. Although geographical diversification of export destinations has been taking place, the fact remains that some 80% of our exports went to USA and Canada in North America, the 27 member countries of the European Union, and Japan. So, for the foreseeable future, it is important to recognize that our main export market for RMG and non-RMG products lies in the developed countries of the world – in the East or in the West. These countries together make up more than one-half of the world’s GDP of about US\$60 trillion, also accounting for the bulk of the \$300 billion market for readymade garments. So the prospects of expanding Bangladesh RMG exports to these markets remain substantial as it now exports merely \$25 billion worth. It is not clear whether McKinsey LLC’s projection of Bangladesh RMG exports doubling in the next few years took note of markets other than in OECD countries.

So where are the next significant markets for Bangladesh’s exports? A cursory review of the growing RMG exports in emerging market economies shown in Table 5 gives a good idea of where to look for future markets. While RMG is one product whose demand grows in tandem with income in developed and developing countries alike, in practical terms, if we are looking for substantial volume growth, it would be logical to look for economies with sizable GDPs (i.e sizable markets) that give an indication of potential demand. The BRICS, Japan,

Table 5: Non-Traditional markets for RMG exports

	FY 11	FY 12	FY 13	GDP (US\$ Billion)
Brazil	94.6	127.8	171.8	2252.7
Russia	51.9	76.5	139.6	2014.8
India	35.9	55.0	75.2	1858.7
China	52.8	104.5	139.1	8227.1
South Africa	48.4	55.8	57.7	384.3
Japan	247.5	403.7	478.5	5961.1
Australia	192.9	307.5	428.4	1532.4
South Korea	47.2	80.0	114.4	1129.6
Total				23360

Source: EPB and World Development Indicators, World Bank

Australia, and S. Korea would be foremost in the list of fastest growing RMG markets for Bangladesh, with current GDP totaling over \$23 trillion. Adding up all the low-income countries or lower middle income countries of Africa and Latin America would not create a

market of any significant size. So it would be strategic for Bangladeshi garment and other exporters to target these markets for future growth and consequent employment creation.

One other notable development of recent times is the move to foster regional groupings (or partnerships) of mega-size with the ultimate objective of removing all sorts of barriers to trade and investment. Whether you look East or West, you come up with two mega initiatives in the offing led by USA and its partners in OECD: the Trans Pacific Partnership (TPP) around the Pacific Rim and a potential Trans Atlantic Partnership (TTIP) between USA and EU. Some 80% of our exports are currently destined for these regions which make a market size of over US\$30 trillion. The other potentially formidable initiative for free trade and investment flows is the extension of 10-member ASEAN, into ASEAN+ 6. What is brewing out of the ASEAN trading arrangement is the prospect of an economic community on the style of the European Community: a Regional Comprehensive Economic Partnership (RCEP), which emerges from FTAs between ASEAN and other economies (Australia, China, Japan, India, Japan, Korea) signing up to the commitments for free trade in goods and services besides closing in on a low tariff customs union over time. India has been aggressively signing FTAs with individual countries and regional groups. It is important to reflect where Bangladesh stands vis-à-vis these mega-partnerships in the offing. Although Bangladesh cannot be a member of these regional communities (due to its geographical location), it might not be able to sign FTAs with them either, unless it substantially scales back its high tariffs.

It might be mentioned in passing that these latest moves towards mega partnerships or pacts have something to do with the years of protracted – and often intractable – negotiations that has become the hallmark of multilateralism in trade, as symbolized by WTO. Partly, it could arise from the disappointment of global economic powers from getting critical decisions on freer trade and investment on a fast-track basis in WTO where emerging market economies and developing countries have shown more clout than the size of their economies would warrant. The latest experience with the Doha Development Round might have hastened the process. The Doha Round, which came close to being abandoned on several occasions, was instructive in that it revealed the complexities of consensus-based decision-making in a multilateral organization such as the WTO. Perhaps the principle of “single undertaking” which gave rise to a binding constraint that “nothing is agreed until everything is agreed” often led to an impasse that was almost impossible to come out of. For many, this was frustrating enough. And it might have provided the impetus for rise of the proposed regional partnerships committed to reaching free trade and investment agreements in a short period of time, within a rules framework that would allow decisions to be made faster and easier than what is presently the case in WTO. If the testy last minute bargaining at the 13th WTO Ministerial in Bali between India and the rest WTO on retaining politically sensitive rice subsidies (a political commitment of India’s Congress Party) is any guide, it is no surprise that the salient feature of the Bali package eventually centered on the least contentious of the Doha Development Agenda issues: “trade facilitation”.

As mentioned earlier, emerging market economies (India and China, in particular) are becoming large potential markets for Bangladesh RMG exports in particular which are making slow but steady inroads into these destinations. However, the country with the most immediate prospects is Japan, the third largest economy in the world, with the second largest apparel market of the world after USA, and the third largest importer of knitwear in the world. Japan’s policy of “China plus one” along with its simplification of rules of origin (from three-stage to two-stage processing) has significantly opened doors for Bangladesh RMG exports (see Box 1). RMG exports to Japan have been growing by leaps and bounds in recent years (Table 6). With Japan’s liberal policy allowing preferential market access to LDCs, Japan could indeed become a major market for Bangladesh RMG exports.

Table 6: Bangladesh's RMG Exports to Japan

	RMG Export (Mill USD)	Growth (%)	Knitwear (Mill USD)	Growth (%)	Woven (Mill USD)	Growth (%)
FY 09	74.33		21.99		52.34	
FY 10	173.32	133.2	53.06	141.3	120.26	129.8
FY 11	247.51	42.8	93.83	76.8	153.68	27.8
FY 12	403.65	63.1	163.65	74.4	239.99	56.2
FY 13	499.31	23.7	211.86	29.46	287.45	19.78
FY 14	572.35	14.63	253.42	19.62	318.93	10.95

Source: ASYCUDA, NBR

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 80 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.

Box 1: Japan holds immense promise of geographical export diversification

Effective in 2001, under the 99% initiative, Japan has liberalized imports of industrial products (HS-25 and above) from all LDCs offering duty free and quota free (DFQF) access. This preferential access includes textiles and clothing, but excludes non-manufacturing products. The 99% initiative also includes 8 items of raw hides and skin and leather, 123 items of textiles, 4 silk items, 2 categories for *pearls, precious stones, metal coins*, 1 category of *optical, photo, technical apparatus* for duty free and quota free export.

Japan's apparel market is the second largest in the world, behind only the USA in terms of sales volume and it has become the third largest importer of Knitwear in the world. According to a recent policy called "China Plus One", Japanese RMG buyers intend to relocate about 30% of their orders from China (China is the largest RMG exporter to Japan with US\$25 Billion, around 80% share) to other locations. Possible source countries include Vietnam (15%), Bangladesh (10%), and Cambodia (5%). Bangladesh is the 6th largest supplier of Japan's clothing import with share of around 1.1%. It has good prospects of attracting higher export orders as Chinese garment products become costlier by the day. Export of woven garment products and knitwear items to Japan grew nearly 63% to \$403.65 million in FY12 (EPB). Bangladesh apparel exports are expected to top \$2.5 billion in 3-4 years if the China Plus One policy takes effect.

Given its relatively better endowed knit RMG industry and export capacity to the global market, this holds special significance for Bangladesh. Further, the Japanese government has enacted a law in March 2011 that will bring down three-stage formulation to two-stage applicable to the import of woven and knitwear garments for duty free access to Japan. With zero tariffs and two-stage processing in effect, garment exports could potentially reach US\$10 billion in the next 5-7 years. This also heightens interest of Japanese investors to bring FDI to Bangladesh. Japan's leading retailer, Uniqlo, has become a major investor in RMG production and exports from Bangladesh, followed by Japan's largest sock manufacturer Okamoto, which has expressed interest in setting up factories in Bangladesh. The number of Japanese companies operating in Bangladesh has doubled to 113 since 2007.

However, entitlement to preferential treatment is subject to fulfillment of the following **Rules of Transportation** of Japan, and non-manipulation (direct consignment) conditions:

- Direct freight to Japan, without any transit;
- Goods using third country territory, in the course of shipment, are entitled to preferential treatment only if: (a) they have not undergone any operations other than transshipment and/or temporary storage; (b) transshipment and temporary storage have been done in a bonded area under the supervision of the custom authorities of the transit countries.

However, in the case of non-industrial products – e.g. agricultural products like frozen or processed food – DFQF access is not available and high quality standards and stringent rules of certification (SPS-TBT) apply. Bangladeshi exporters need substantial capacity building and technical assistance in order to meet those requirements.

Japan's Clothing Import by Country (Million USD)

	China	Bangladesh	World	Bangladesh Share (%)	China Share (%)
2009	23625.1	138.7	28135.4	0.5	84
2010	23076.7	212.5	27689.5	0.8	83.3
2011	25077.8	343	31000.1	1.1	80.9
2012	19190.2	403.65	32945.0	1.2	58.2
2013	19273.9	499.31	33631.7	1.5	57.3
2014*	12619.3	572.35	19651.3	2.9	64.2

**Figures for 2014 are till September 2014*
Source: WTO, EPB, HK TDC and Ministry of Finance, Japan

Source: EPB, WTO, BKMEA, The Textile Importers Association of Japan.

IV. INTERNATIONAL EXPERIENCE AND LESSONS LEARNT

It is a matter of historical record that the nature and composition of exports undergo substantial transformation as economies move from low-income status to that of a middle-income or high-income country. Typically, low-income economies tend to have a narrow range of exports with high concentration in a few products. Such export concentration could be mono-product (e.g. petroleum in East Timor, cocoa in Ivory Coast), or multi-product (e.g. jute and jute goods in Bangladesh in the 1970s). As they develop, and export performance improves, diversification of exports also occurs. This product diversification could take various forms as economies progress through different phases of development: (a) from primary to manufactured exports, (b) from labor-intensive to capital-intensive goods, (c) from low skill-intensive to technology-intensive goods, and so on. In each case, the transformation of export baskets is accompanied with a proliferation of products backed by a diversified industrial base.

Although Bangladesh continues to be a low-income country (an LDC), its exports have gone through one transformation phase – from preponderance of primary products to manufactures. But export concentration has arisen afresh with a mono-product concentration in RMG. Therefore, Bangladesh's export policy puts high priority on a sound strategy for diversifying its exports. For this purpose, it is useful to review the experience of some of the economies with superior historical export performance from which to draw some lessons. Over the past three decades, economies in East and South East Asia have been cited for their exemplary export performance including their success in transforming the structure of their exports. In this section, we review some of these experiences. These countries adopted three approaches to export growth and diversification:

- *Export growth and diversification relying on domestic resource-based manufacturing*
- *Export growth and diversification not based on natural resource endowments*
- *Dual approach – a combination of the two strategies – with the latter approach phased in at a later stage of industrialization.*

In the **first group** are the East Asian NIEs of Hong Kong, Taiwan, Singapore, and S. Korea, whose economic success was acclaimed as export-led growth. *What is evident is that export growth of NIEs was not based on processing of domestic resources.* Admittedly, a lot of their success could be attributed to effective government intervention with an eye on ensuring export competitiveness while nurturing domestic industries with tariff and non-tariff support mechanisms.

The Korean experience offers useful lessons for export-led growth. For six decades since the Korean War ended in 1953, the economy grew from \$1.3 billion to just over \$1 trillion by 2010. This rapid growth was arguably driven by exports which grew from \$20 million to \$555 billion in 2011 with trade surpluses for most years since 1980s. During these years, the structure of exports also underwent significant transformation, from agricultural products, before 1970, to labor-intensive manufactures thereafter; then, from mid-1970s, labor-

intensive textile exports gave way to technology and capital intensive goods, such as electronics, and ships. Subsequently, exports became more and more sophisticated in the 1990s, with high-tech goods such as semi-conductors (TVs and mobile phones) and automobiles becoming major exports. Both imports and exports grew very rapidly throughout the period. While its trade-GDP ratio was only 20% in the mid-1960s, it rose to 50-60% from mid-1970s to early 2000s, and then jumped to 90% in 2011. Two problems emerged: (a) multi-product export concentration was on the rise: the share of top 10 products rose from 47% in 1980 to 62% in 2010; and (b) over-reliance on external demand made the Korean economy vulnerable to external shocks. So, while Korea achieved two modes of product diversification: primary to manufactures, and labor-intensive to technology and capital intensive diversification, the transformation was not free from the product concentration problem. The government is now focusing on diversifying its export basket further. As for the second problem of over-reliance on external markets for export demand, in the aftermath of the financial crisis of 2007-09 and subsequent Euro zone problems, focus of Korean policymakers is now shifting towards raising domestic demand. Being a high-income economy with a sizable middle class, stimulating domestic consumption demand could serve as an alternative to export demand when global economic outlook turns bad.

Among the other NIEs, Taiwan's experience is notable. A much smaller economy than S. Korea, with a GDP of \$480 billion, its rapid growth since the 1960s was also driven by exports. From the 1950s through the 1970s, Taiwan was a developing country exporting unskilled-labor-intensive goods and raw material to developed countries while importing capital-intensive goods from them. By the 1990s, it became a relatively developed country, exporting heavy chemical and technology intensive products which made up some 50% of its exports. Moreover, intermediate products, machinery and transport equipment, together made up 84% of its exports by the close of 1990s. Taiwan took full advantage of the Global Value Chains in the PC industry to become one of the leading exporters of notebook PCs. Thus Taiwan's superior export performance over the decades was also characterized by transformation from labor-intensive and low skill-intensive products to technology and capital intensive products. Also, there was export diversification away from consumer goods (whose share fell to 14% by 1998) to intermediate and capital goods.

In the *second group* are the Newly Industrializing Countries (NICs) of South East Asia: Malaysia, Thailand, and Indonesia (Jomo, K.S. and Michael Rock 1998). In the initial stage, the governments of these countries all intervened to diversify their economies. Such diversification included the promotion of new crops (e.g. oil palm) and natural resource exploitation, i.e. diversification of primary production, as well as the promotion of manufacturing. Besides import-substituting and export-oriented manufacturing, primary commodity processing and resource-based manufacturing more broadly have been very important for the industrialization of these countries. Malaysia's palm oil refining, Thailand's agro-processing and Indonesia's plywood manufacturing have figured significantly in their development of internationally competitive industrial capabilities. In the next stage, they went beyond static comparative advantages derived from natural resource endowments to develop new capabilities through learning, productivity growth, externalities and scale

economies. Some firms invested their resource wealth to develop new internationally competitive capacities. *In contrast, China and several ASEAN countries pursued diversification and export growth that was not based on natural resource endowments.* These economies have been successful in first promoting low-skill manufactured exports (e.g. textiles, clothing and simple electronic parts and components), followed by technology intensive electronic and electrical goods, since the second half of the 1980s, and this transformation has continued apace over the last decade.

Thailand stands out as a successful example of export diversification (Bonaglia, F. and Kiichiro Fukasaku, 2003) by adopting a *dual strategy* (a) to upgrade natural resource-based industries (such agricultural and fish products) and (b) to encourage labour-intensive manufactured exports, most notably clothing and electronics. The development of traditional and high-value, export-orientated agriculture stimulated the growth of agro-industry. Thailand established EPZs and licensed bonded warehouses as a means of stimulating manufactured exports and attracting foreign investment. FDI came mostly from neighboring Asian countries (Japan and Asian NIEs).

Malaysia is a different example of a resource-rich country that successfully diversified its exports (José G. Gijón-Spalla, 2010). Malaysia moved away from its two main sources of export—rubber and tin —by promoting other commodities, mostly palm oil, and by moving to higher value-added products like electronics and telecom equipment. The result was a drastic transformation in Malaysian exports, with the share of tin and rubber in total exports falling from more than 60 percent in 1962 to less than 3 percent in 2008. Conversely, during the same period, electronics and telecom components increased from less than 1 percent to nearly 50 percent and became the largest Malaysian exports.

What is remarkable is that the Malaysian model was essentially state-driven and was based on (i) significant public investment in education to create a highly skilled labor force; (ii) close collaboration between the government and the private sector to define policies, develop market know-how, and make policy adjustments; (iii) gradual disengagement of the state from the economy through privatization of state-owned companies to empower domestic private investors; (iv) an open FDI regime to develop nascent industries (e.g. telecommunications and the automotive sector) and the development of a good business climate; (v) excellent infrastructure development (e.g. roads, telecoms, free ports) to support export industries; and (vi) active trade openness policy by signing bilateral, regional (ASEAN), and multilateral (WTO) trade agreements. The authorities created the Multimedia Super Corridor in an effort to make Malaysia a global and regional leader in information and communication technologies (ICT) development and applications, understanding that ICT-related export services could become a new source of growth (Yusof and Bhattasali 2008).

Finally, all East Asian economies along with China benefited from the rise in regional economic integration through the development of cross-country production networks. Economic integration in East Asia has been led by the vertical integration of production chains (global value chains or GVCs) as multinational companies (MNC) sought lower-cost manufacturing facilities beyond national boundaries and capitalize on supportive local policy

initiatives. Economic ties within the region were further strengthened with increasing intra-regional trade and investment.

Subsequent research on export diversification (e.g. Girija Nimgaonkar, 2010) identified several of the policies that produced export growth and diversification in these economies:

First, macroeconomic stability was ensured through effective macroeconomic management, while selective export promotion policies facilitated the high export and economic growth.

Second, governments played a significant role in the development process of these economies. The allocation of various preferences and export incentives were based on markets and competition: to qualify for continued support, firms had to show good export performance.

Third, it was the private sector rather than the state-owned enterprises that responded to the various interventions. Foreign investors also played a major role in export success.

Fourth, governments managed to carry out the policies in an orderly fashion without much interference from the interest groups involved and without much corruption.

Fifth, there was heavy investment in infrastructure development. In the early stages of development, the policies focused on the transportation network while the investments in telecommunication and electricity gained importance in the later stage of the process.

Sixth, exporters were given access to inputs and capital goods at world market prices. In most cases, this was achieved through tariff exemptions and duty drawback schemes, although nearly all countries also established special export processing zones or programs for manufacturing sector in order to avoid red tape.

Finally, preferential access was given to the exporters in case of capital and foreign exchange, and credit was provided at lower rate of interest.

V. CONSTRAINTS TO EXPORT DIVERSIFICATION IN BANGLADESH

The search for a successful long-term strategy for export diversification must be based on a solid diagnostics of what ails the export sector. Insights can also be obtained by understanding the factors that have supported the growth of garment exports.

Key Constraints to Export Expansion and Diversification

Considerable research has been done on the constraints to exports performance in Bangladesh. Some are generic to the entire economy or the manufacturing sector, but some factors are specific to the export sector. Some others relate to the challenge of export diversification. These constraints can broadly be grouped under the rubric of

- A. Trade infrastructure, and
- B. Trade policy and incentives

A. Trade Infrastructure

Constraints under trade infrastructure cover factors that affect cost competitiveness, such as technology and labor productivity, enabling environment for trade, the state of trade logistics, ease of doing business, access to finance, and availability of skills. Most of these could be described as supply side constraints behind-the-border, except for those arising from customs clearance procedures.

- **Technology and labor productivity** are obvious factors that influence cost competitiveness. Bangladesh in general is still weak on technology and its average labor productivity is low. These are two areas where Bangladesh needs to work much harder to improve its export competitiveness. Bangladesh can learn valuable lessons from its own experience with RMG exports. In the case of RMG Bangladesh has an edge over its main competitors (China, India, Vietnam, Sri Lanka) in terms of both technology and labor productivity for a wide range of specific product categories that has allowed Bangladesh to penetrate the export market and increase its market share. Bangladesh acquired the technology at the early stages of the evolution of the RMG industry through strategic partnership between Dosh Garments of Bangladesh and Daewoo of Korea (Khondker and Sonobe, 2011). Subsequently, this technology got disseminated widely through the RMG network. Over time, new partnerships with leading fashion houses of the world have allowed a continuous upgrading of designs and quality control that has not only helped Bangladesh to expand RMG exports but also to upgrade its export products.
- 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). The ETI 2012 ranking for Bangladesh is shown in Table 7. 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.

Table 7. The Enabling Trade Index 2014; Bangladesh

	Rank (out of 138 countries)	Score (1-7)
BORDER ADMINISTRATION	123	3.2
Efficiency and Transparency of border administration	123	3.2
INFRASTRUCTURE	119	2.8
Availability and quality of transport infrastructure	120	2.3
Availability and quality of transport services	103	3.6
Availability and use of ICTs	118	2.4
MARKET ACCESS	57	3.8
Domestic Market Access	126	3.4
Foreign Market Access	7	4.2
OPERATING ENVIRONMENT	99	3.7
Physical security	90	4.9

Source: Global Enabling Trade Report 2014, World Economic Forum

A similar picture is indicated by the LPI indicator (Table 8). These are 2010 rankings because an updated picture for Bangladesh for 2012 is not available. However, it is believed that the performance for Bangladesh has weakened significantly in 2012 and the 2010 index is an over-estimate. Even so, compared with exporters in China, Thailand, Malaysia, India and Vietnam, the exporters in Bangladesh had a significant disadvantage in cost competitiveness emerging from weaker trade logistics.

Table 8: Trade Logistics Performance (LPI 2014)

Country	LPI ranking (out of 139 countries)			International shipments	
	LPI score	Customs	Infrastructure		
Germany	1	4.12	4.1	4.32	3.74
Singapore	5	4	4.01	4.28	3.7
Malaysia	25	3.59	3.37	3.56	3.64
China	28	3.53	3.21	3.67	3.5
Thailand	35	3.43	3.21	3.4	3.3
Vietnam	48	3.15	2.81	3.11	3.22
Indonesia	53	3.08	2.87	2.92	2.87
India	54	3.08	2.72	2.88	3.2
Pakistan	72	2.83	2.84	2.67	3.08
Bangladesh	108	2.56	2.09	2.11	2.82

Source: Logistics Performance Index 2014, The World Bank

- **Infrastructure deficiencies.** More generally, transport and power have emerged as serious constraints to manufacturing sector in general. A comparison of infrastructure quality among Asian countries places Bangladesh in the second last position after Nepal (Table 9). The situation is particularly alarming in the power sector. This infrastructure constraint is duly recognized by the Government and priorities have been given in the annual budgets to scaling up infrastructural investment. The problem has been weak implementation, including conflict with donor agencies relating to procurement. Any

export diversification strategy will fail to deliver unless the problems in the power and transport sector are fixed.

Table 9: Comparison of Infrastructure Quality, 2010-11

Country/Region	Country Ranking/1	Overall Infrastructure	Electricity	Roads	Railroads	Port
World	66	4.3	4.5	4.0	3.2	4.3
East Asia(average)	65	4.5	4.6	4.4	3.2	4.5
South Asia (average)	104	3.3	2.5	3.3	3.0	3.8
Bangladesh	130	2.7	1.6	3.0	2.5	3.4
China	72	4.1	5.3	4.3	4.3	4.3
India	91	3.6	3.1	3.3	4.6	3.9

Sources: 2010 World Economic Forum, the Global Competitiveness Report 2011-12

In order for countries to be competitive in the arena of global trade and investments, the availability of quality infrastructure which is a key input, is very crucial. Bangladesh suffers from severe bottlenecks in terms of the quality of infrastructure when compared to other countries. The poor supply of power, gas, transport networks and telecommunications to all enterprises, and the malfunctioning of the country's land and sea ports have been obstacles for exporters.

Port services- The Chittagong port, which handles nearly 85 percent of the country's trade merchandise suffers from labor problems, poor management, and lack of equipment. Its container terminal handles only 100-105 lifts per berth a day, well below the UNCTAD productivity standard of 230 lifts a day. Ship turnaround time is 5-9 days, significantly above the 1 day standard of more efficient ports. In addition, handling charges for a 20-foot container are also quite high compared to those of comparator countries.

Road network - Despite a relatively high density of its road network, poor road conditions and lack of transportation seriously impair private activity, particularly on account of poor construction of roads and bridges; lack of maintenance of roads and waterways; and a lack of integration of different modes of transportation (which makes long-haul transport very difficult). Poor road conditions and lack of transportation are especially constraining for enterprises in far-flung rural areas. Public spending on road maintenance is seen to fall short of what is required. One of the major transport corridors for international trade is the road connecting Dhaka and Chittagong. This road is a combination of two lane and divided four-lane segments but, given the expanding volume of trade, what is needed is an 8 lane highway, albeit presently it is being gradually upgraded to 4 lanes.

Railway system- The container unit train operation between Chittagong and Dhaka has the potential to provide an important benefit to both importers and exporters in the Dhaka area. While there are some operational problems with the yard layout and operation in Chittagong and Kamalupur and with the availability of rolling stock, these

are much less important than the failure to provide sufficient train frequency or to operate in a commercial manner.

Air freight and Airport storage services - The unreliability and unavailability of the air freight services affects the ability of produce growers to make long-term arrangements with foreign buyers that enable both parties to ensure high quality and safe production. The problem is exacerbated by Biman's monopoly control of air cargo facilities. Biman, the national airline, should improve its performance in providing forward-contract air cargo space, and the government should permit other carriers to compete against it. That is, open sky policy for regular air cargo movement needs to be put in place. Insufficient air cargo capacity in BIMAN leads to a quota system with small average quota sizes and a high rejection rates which compels exporters to sell their extra produce in domestic markets at a loss.

- **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. Table 10 shows the Ease of Doing Business rankings for 2012.

Table 10: Ease of Doing Business (2012)

Country	<u>Ease of Doing Business Rank ▲</u>	<u>Starting a Business</u>	<u>Getting Electricity</u>	<u>Registering Property</u>	<u>Getting Credit</u>	<u>Protecting Investors</u>	<u>Trading Across Borders</u>	<u>Enforcing Contracts</u>
Singapore	1	4	5	36	12	2	1	12
Hongkong	2	6	4	60	4	3	2	10
Malaysia	12	54	28	33	1	4	11	33
Thailand	18	85	10	26	70	13	20	23
Sri Lanka	81	33	103	143	70	49	56	133
China	91	151	114	44	70	100	68	19
Vietnam	99	108	155	48	40	169	74	44
Pakistan	107	98	171	126	70	32	85	155
Bangladesh	129	95	185	175	83	25	119	182
India	132	173	105	94	23	49	127	184

Source: The World Bank; Ranking out of 185 countries.

Not surprisingly, Bangladesh performs quite poorly on the whole with a rank of 129. All its competitors face a better business environment. Although India's average ranking is just below Bangladesh, the comparison with the average is not very meaningful. Indeed the dynamic states of Gujarat, Punjab, Andhra Pradesh, Delhi and Mumbai have a fairly

competitive business environment as compared with laggard states like Bihar, Bengal and Uttar Pradesh. It is not surprising these states have attracted most of FDI inflows in India and account for most of India's exports. It is therefore most likely that the ease of doing business in these states is much better than indicated by the average.

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. Considerable more progress is needed in a range of business transactions indicated in Table 4 with a view to making the Bangladeshi investment climate much more attractive for attracting foreign investment and improving export competitiveness.

- **High cost of Finance and limited access for SMEs** Bangladesh ranks low amongst comparators in a measure of access to credit (ranked 83). This deficiency extends to export enterprises as well where market-based interest costs tend to be exorbitantly high. One instrument that has been popular is the revolving fund called Export Development Fund of \$1.5 billion which disburses low-cost loans to export-oriented firms for procurement of imported inputs. The high cost of borrowing represents a significant obstacle to stronger export performance in Bangladesh. The average real lending rate tends to be substantially higher than the real lending rates of such neighbors and competitors as India, Sri Lanka, Malaysia, Thailand, and Vietnam. Weak management, constant political interference, problems of corruption, postal saving schemes and burgeoning volumes of non-performing loans of Nationalized Commercial banks can be held responsible for these high costs. Financing costs alone constitute 13.5 percent of the Fright on Board (f.o.b.) price of an exported set of ceramic tableware, and interest payments make up as much as 2.5 percent of the f.o.b. price of a Bangladesh-made man's t-shirt. Indirectly, bank financing rates impede the growth of produce exports.

However, SMEs in the export sector also face problems of access to working capital and have difficulty in accessing such institutional funds. In general, access to finance particularly working capital finance and investment finance continues to be a prime constraint facing SMEs. Banks in general have considered SME financing as unprofitable. SMEs are also regarded as high risk borrowers because of their low capitalization, insufficient assets and high mortality rates, and consequently banks are not keen to offer them credit at comparable interest rates. In order to address this anti-SME bias in access to finance, Bangladesh Bank has taken initiatives to encourage banks to facilitate SME credit by setting certain minimum targets to be reached failing which they might suffer penalties. This approach has proved effective so far, including for SMEs engaged in exports.

- **Labor productivity and Availability of Skills.** On the labor front, Bangladesh is very favorably endowed with a large supply of under-utilized labor. The flexibility of labor market has helped the RMG sector to mobilize and train workers at low cost (Ahmed, 2012). Despite having an abundance of human resources, Bangladesh lags behind its Asian neighbours and trade rivals in terms of quality of labour and therefore labour productivity. Compared to many other Asian countries, Bangladesh has a rather low level of literacy and years of schooling of the labor force making skill acquisition very difficult. The skills gap and shortages should have provided enough incentives for the private sector to impart training, but there appears to be a market failure in the provision of adequate skills mostly due to high rates of worker turnover along with private inability to pay for training. In absence of a market response to the skill gap, government, manufacturers' associations, NGOs, and private institutions supported by public financing are the main providers of various Technical and Vocational Education and Training (TVET) programmes. However, the TVET stream of education is usually not aligned with the various requirements of the garment as well as other sectors. This leads to a lack of employers' confidence in the TVET system and eventually leading to skill shortages and unemployment amongst TVET graduates. Growing numbers of foreign workers in Bangladesh point to a shortage of supervisory and mid-level management skills. Mid-level and higher-level management employees are usually hired from neighbor countries rather than the own country indicating a lack of semi-skilled and high-skilled workers.

The incidence of enterprise-based on-the-job training is very low in Bangladesh, especially as compared to other countries particularly in East Asia. One study suggests that only 25 percent of Bangladeshi manufacturing establishments provide their employees with in service formal training (Riboud and Tan, 2009). This percentage is very low as compared to East Asian countries such as Malaysia and China where the rates are 50 percent and 75 percent respectively. As noted earlier, the RMG sector is an excellent example of the kind of in-house training that delivers results. In addition to training on the job, the apex RMG institution, the Bangladesh Garments Manufacturers Export Association (BGMEA), has established a fully self-financed training institute.

B. Trade Policy and Export Incentives

Trade policy could be a constraint or support to export growth and diversification depending on how it is formulated and implemented to ensure competitiveness of exports. Together with export incentives it also concerns the attractiveness of investors to go into exports vis-à-vis domestic production. The three main components of these policies relate to exchange rate management; trade policy and fiscal incentives.

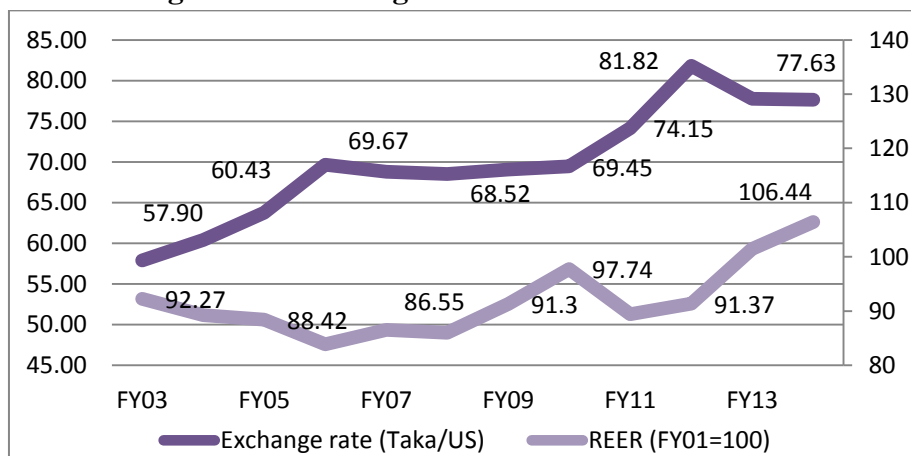
- **Exchange rate management:** Poorly managed exchange rates can be disastrous for economic growth. According to Dani Rodrik, avoiding significant overvaluation (or appreciation) of the currency is one of the most robust imperatives that can be gleaned from the diverse experience with economic growth around the world, and one that appears to be strongly supported by cross-country statistical evidence (Rodrik, 2008).

Overvalued currencies are associated with foreign currency shortages, rent seeking and corruption, unsustainably large current account deficits, balance of payments crisis, and stop-and-go macroeconomic cycles, all of which are damaging to economic growth. Just as overvaluation hurts exports and growth, so undervaluation (depreciation) facilitates it. For most countries, periods of rapid growth are associated with undervaluation. Rodrik cites China as the most fascinating case where economic growth tracks movements in the index of undervaluation. The rapid growth of GDP per capita in China since the 1970s was found to closely parallel the increase in the undervaluation index.

Thus 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, which suffer from significant anti-export bias, as will be explained later. The channel through which exchange rate impacts growth is of course through trade. The focus of exchange rate management in Bangladesh has to be on the real exchange rate, which is essentially the nominal exchange rate adjusted for Bangladesh inflation relative to inflation in its major trading partners.

Bangladesh adopted a market-based exchange rate regime with effect from May 2003. Despite fears of a massive nominal depreciation after the float, nothing like that happened in light of prudent fiscal and monetary management that preceded and then accompanied floating of the exchange rate. By adopting a market-based exchange rate management and combining this with a prudent monetary and fiscal policy management over the longer term, Bangladesh avoided an appreciation of its real effective exchange rate (Figure 16). There were slippages in the short term. For example, a look at the trends in the REER shows real appreciation of about 9% between FY03 and FY06. Thereafter, this trend was reversed through real depreciation for the next five years until FY12. Since January 2012, monetary tightening has helped stabilize the nominal exchange rate while moderating inflation, thus keeping the REER from any real appreciation. As a long-term strategy for export diversification, the appropriate exchange rate management would be to avoid rigidity or real appreciation of REER; a moderately depreciating REER would work better to sustain competitiveness of exports, particularly non-RMG exports.

Figure 16: Exchange Rate Movements FY03-14



Source: Bangladesh Bank. Note: Increase indicates depreciation.

- Trade policy:** Though exchange rate management is part and parcel of trade policy, other instruments that affect export incentive include tariffs, quantitative restrictions on imports, subsidies, and so on. 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 (Ahmed and Sattar 2004; World Bank 2004). This complex system of anti-trade and anti-export regime slowly got dismantled, especially since 1990. Today the trade regime is much changed compared to the one prevailing in the 1970s and the anti-export bias of the trade regime is sharply lower than in the past. Yet, as analyzed in detail in next Section, a substantial anti-export bias of the trade policy remains.
- Fiscal policy:** The Government has taken a positive fiscal policy stance in promoting exports. The RMG sector is the highest beneficiary of the various fiscal concessions. In addition to the duty drawback scheme that accords to all exporters, the RMG exporters enjoy the special privilege of paying only a nominal income tax on their earnings. The income tax is fixed at a very low level on total gross earnings of the RMG sector as a withholding tax, which is also the final tax. This is now fixed at 0.6 percent of total export earnings, which is a small tax burden in terms of percent of true profit of the RMG exporters. While the duty drawback is a legitimate scheme to ensure export competitiveness, the income tax treatment of RMG earnings is highly controversial as its relevance to influence export decision is not clear. In addition, the government offers direct cash subsidy to exports of non-traditional items, announced on an annual basis, with the rate varying from 5% on jute goods to 20% on potatoes in the current year (FY2014).

VI. TRADE POLICY AND EXPORT DIVERSIFICATION

There is strong international evidence that export performance, and its offshoot, progress in export diversification, is in part the outcome of the trade policy regime governing export production and trade. Evidence from Bangladesh over the past two decades provides confirmation to the proposition that trade openness has had a positive impact on export performance. But export diversification has stalled in the face of stellar success of RMG exports that only accentuated export concentration. As we saw earlier, a whole host of factors affect export performance, in addition to trade policy. In the case of RMG, many special factors played a positive role that are not available to all exporters in general.

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 Arrangement (MFA) 1974-2005:** The MFA, an external but fortuitous development, 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 free trade regime 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, making 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 as Korean investors, armed with the knowhow of RMG production and trade, came to Bangladesh to take advantage of the quota allocated to Bangladesh. The technology being relatively simple was quickly adapted and transferred to other investors (local) 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.
- **Tax Policy:** The government has taken a very liberal attitude towards taxation of earnings from RMG by having a very low effective tax rate.

After all factors have been considered, evidence shows that Bangladesh leads the world in low cost labor that is largely unskilled or semi-skilled. In essence, low wages appear to effectively compensate for low productivity, so that, in the ultimate analysis, garment exports from Bangladesh become costs competitive. Does this competitive advantage extend to other products as well? Of course, it does, i.e. for most labor-intensive products. Footwear is among the rising star for much the same reason. Shipbuilding (ocean going vessels) is another activity that has recently combined technical soundness with low labor costs to give it competitive advantage, and Bangladesh has emerged as a competitive exporter of ocean-going vessels (under 10,000 DWT) within a short period⁵. At least for the medium-term, low cost labor will continue to be the source of competitiveness of Bangladesh exports in RMG as well as non-RMG products.

The important role of the trade regime 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 and proliferation of new products in the export basket. That bias continues as of fiscal year 2013-14.

⁵ Recently, ships built for Germany and Denmark received strong certification of technical merit from the European buyers.

Table 11 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 11: Snapshot of Bangladesh Trade Regime FY2014

Policy Instrument	Status
Exchange Rate Regime	Unified, Managed Float
Payment convertibility Current account Capital account	Yes, some limits No
Import restrictions Import licensing QRs on imports	No Trade QRs gone WTO compliant QRs remain
Tariff structure Top CD rate Average protective rate Tariff slabs (customs duty) Para-tariffs	25 26.9 3, 5, 12, 25 RD and SD*
Trade openness, trade-GDP ratio (%) 2014	45.8

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 para-tariffs (supplementary and regulatory duties) that have grown in significance and are almost inversely correlated with the reduction in custom duties (Figure 19), thus essentially undercutting any movement in the direction of tariff rationalization. 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 custom duties and para-tariffs tends to distort production incentives through high rates of effective protection to import substitutes. Importantly, the current tariff regime undermines export competitiveness and impedes growth of new exports, thus inhibiting progress in export diversification.

In light of the preceding analysis, Bangladesh's trade policy stance may be summed up thus: whereas a significant degree of trade openness has been realized over the past two decades, through the virtual elimination of all trade-related QRs, tariff rationalization, after the initial intensive phase in the early 1990s, faced considerable setbacks and was not carried through to its conclusive phase. On balance, the tariff structure and its consequent protective effect appears to favor import substituting industrialization rather than exports. Indeed, when effective rates of protection (ERP) to domestic sales are brought into the picture, the anti-export bias of the incentive regime becomes pronounced.

Note that Bangladesh's leading and most successful export sector – RMG – is virtually unaffected by the anti-export bias of the tariff regime. Why? From the very beginning, RMG industries evolved within a sort of “free trade enclave” that essentially neutralized an

otherwise high tariff regime through the institution of Special Bonded Warehouses (SBW) to ensure duty-free imported inputs. Supporting facility of back-to-back LC system provided much needed access to working capital in foreign exchange⁶. Later, once RMG became the leading export, it was given high priority for port clearance and other administrative processes. RMG industry thus developed as a 100% export-oriented sector, not in competition with other manufacturing geared to domestic sales. However, other exports were not as privileged as they had to cope with the high tariff regime while importing required raw materials and intermediate or capital inputs⁷. The dysfunctional duty drawback system was no match to the SBW facility. So when non-RMG manufacturing producers compared relative incentives between exports and domestic sales, they found zero or negative ERP for exports and very high ERP for domestic sales. That meant that whereas processing margins were close to free trade margins for exports, they were significantly higher for sales in the domestic market.

This is how the trade policy regime reveals an anti-export bias for non-RMG exports thus discouraging emergence and expansion of new products in Bangladesh's export basket. As shown earlier, although the number of HS-4 export products over \$1 million rose from 170 in FY05 to 259 in FY12, only a handful of products exceeded \$100 million. Most were under \$10 million and remained so for long periods without much expansion. A significant proportion of domestic producers outside the RMG sector are now in the export business in addition to producing for the domestic market. However, the balance of incentives seems to discourage them from expanding export production or launching new export products. Getting access to export markets and retaining them requires cost and quality competitiveness – two challenging aspects of export success – which might be too much for some producers who find the sheltered domestic market more profitable and far easier to handle. In consequence, product diversification in exports becomes a casualty.

In concluding, it is important to bear in mind that the special instruments – e.g. SBW and back-to-back LC system – directed towards the RMG industry had the effect of creating a free trade channel or enclave within a high tariff regime that applied to the rest of the export or import-substitute industries. The whole purpose of these instruments was to ensure world-priced inputs for the RMG industry so that they can compete at par with others in the world market. Unlike the dispensation of direct or indirect subsidies or duty drawback facility which are meant to offset duties paid on imported inputs, SBW is not a compensating mechanism but an export facilitating measure that eliminates the upfront cost-raising effect of input tariffs that would make exports uncompetitive. The presumed revenue loss on account of the existence of this facility has never been a policy issue (known as tax expenditure) in the wake of the exemplary gains made by the RMG industry in terms of domestic employment creation and export expansion. Exports have zero protection in the destination markets; hence their inputs cannot be subject to positive duties. The administrative complexities of managing the SBW system due to leakages arise from the existence of

⁶Imported inputs such as fabric and accessories were made available on credit linked to export orders, and eventually settled from export proceeds.

⁷ Lately, NBR has been selectively – very hesitatingly -- providing SBW facility to non-RMG exporters.

generally high tariffs elsewhere. As import tariffs generally decline, the incentive for leakage is significantly reduced, as has been the case for RMG, where exporters found the challenge of opening new markets much more rewarding than the quick monies that might be earned from duty-free inputs leaked onto the domestic market. After long debate, the footwear export industry also received the same SBW facility. Electronic management of SBW system can substantially reduce the administrative costs and improve efficiency of the system.

In principle, there is no revenue loss in the SBW system in comparison to its alternative – duty drawback or cash subsidy, both of which are meant to fully compensate for input duties paid and so are revenue neutral. Cost competitiveness in the global marketplace is measured by cents not dollars. When a new exporter crosses a minimum threshold, say \$1 million a year, he should be entitled to receive SBW facility to thrive and expand exports. Having realized that, NBR has been selectively albeit hesitatingly granting SBW facility to non-RMG exporters but evidence suggests that the practice has not taken off. Consequently, non-RMG exports have not reached significant proportions in the export basket.

Protection Policy and Export Diversification

The policy of protecting domestic industries gives rise to incentives against export production. The anti-export bias frequently stems from a tariff structure that provides high nominal and effective protection, an overvalued exchange rate, non-tariff barriers resulting from dysfunctional customs practices, the absence of trade finance, costly infrastructure services, and excessive bureaucratic control of trade procedures. In evaluating Bangladesh's current trade policy stance, it would be useful to reflect on the prevailing viewpoints regarding trade openness amongst academics, policy makers and business circles. After all, what we get in the tariff structure, and the non-tariff measures governing imports, is the outcome of several inter-related developments, such as the approach to supporting domestic industries, external initiatives for market access and promotion of exports, and the strategy for courting FDI. For starters, there are no champion free traders to be found. The most common ground might be found in the position that trade is to be promoted, exports are to be expanded, but imports are to be restricted (a) to protect domestic import substitute industries from stiff import competition, (b) to raise revenues by imposing a wide spectrum of taxes and levies on imports, and (c) to keep the country's balance of payments at manageable levels. This approach to trade could be summed up in the following trade-related policies:

- the trend and structure of tariffs as they impinge on global competitiveness of exports and import substitute production,
- reforms and modernization of customs administration and trade infrastructure,

Tariffs, protection, and trade policy affecting exports. Theoretically speaking, a tariff is an indirect subsidy on import substitutes and a tax on exports. The protection that is afforded through nominal and effective tariffs is also a tax on consumers who bear the ultimate burden of the protection tax by having to pay higher than world prices (tariff-inclusive price) for imported products. So policymakers need to balance the support they extend to producers with the social costs of protection. The community as a whole stands to gain from protection

only when the objective of protection is met: domestic import substitute producers become globally competitive in the shortest possible time so that protection can be removed and domestic prices of import substitutes converge to international prices. The longer this takes, higher are the social costs of protection.

The other adverse implication of tariffs and protection is the anti-export bias they create resulting in dis-protection of exports which, in the first place, have to operate under zero protection in the world market, provided they are fully compensated for duties they have paid on imported inputs prior to exporting. If they do not receive full duty drawback or if they are not given the facility of importing inputs duty-free, export production becomes subject to negative protection – a substantial anti-export bias of policy.

Hence, the trade policy stance that is suitable for globally competitive export production must be characterized by low and uniform tariffs and a seamless export-import regime that facilitates least-cost transactions at the border. Does the Bangladesh tariff regime fulfill this requirement?

Around 1990, an assessment of the World Bank’s Industrial Sector Adjustment Credit (ISAC II) project revealed that roughly 40% of the tariff lines were subject to over 100% tariffs in addition to widespread bans and restrictions on imports. It produced a highly prohibitive import regime that nevertheless failed to result in any breakthrough in import-substitute production or preventing an impending balance of payments crisis. Tariff rationalization and import liberalization became a trade policy imperative.

We have come a long way since those days of prohibitive tariffs and import controls. Table 12 gives a picture of the latest tariff trends in terms of their implications for nominal protection⁸.

Table 12: Tariff Trends FY01-14

Tariffs (%)	FY01	FY 05	FY 10	FY 11	FY 12	FY 13	FY14
Avg. CD (un- weighted)	21.1	16.3	13.7	13.6	13.6	13.9	13.2
Avg. para-tariffs	7.1	10.2	10.2	10.2	12.9	15.1	14.9
Avg. Nominal Protection	28.2	26.5	23.9	23.8	26.5	28.9	28.1
Top CD rate	37.5	25.0	25.0	25.0	25.0	25.0	25.0
Top NPR*	59.0	60.0	79.0	79	88.0	117.0	108.0

(*) excludes tariffs on cars, alcoholic beverages, and cigarettes

Source: NBR & PRI staff estimates

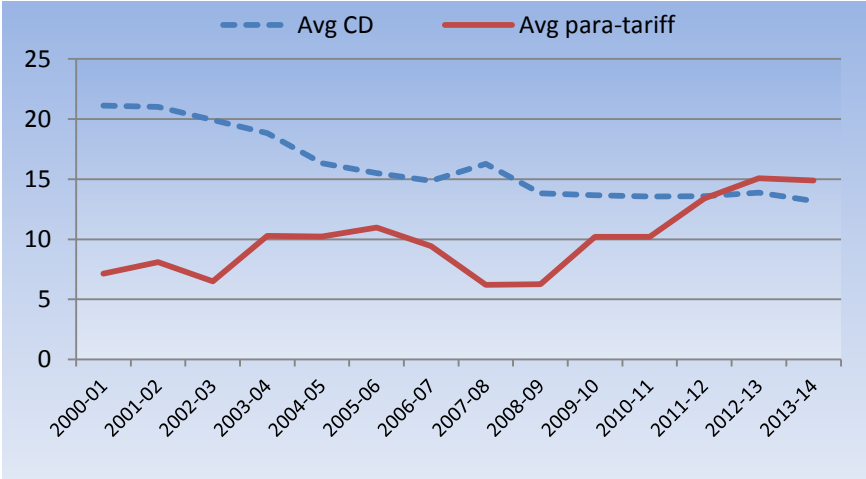
Tariffs and para-tariffs⁹ on imports are now the single most important determinant of trade protection after successive governments in Bangladesh made progressive trade openness the

⁸ Nominal protection rates have to be distinguished from tariff/tax incidence as some trade taxes, such as VAT on imports (which are trade neutral) or Supplementary Duties (SD) do not have a one-to-one impact on protection.

cornerstone of trade policy. Whereas tariffs and quantitative restrictions (QR) 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 CD slabs – 3%, 5%, 10% and 25%, but the imposition of a plethora of import taxes and levies (e.g. SD, RD, VAT, AdvAT, AIT) make the tariff structure rather complex. Although the average customs duty has come down over the past 13 years, the average nominal protection rate (NPR) shows mixed trend. It initially declined between FY01 and FY09 and then started rising again over FY10-FY13. What is notable is (a) the perceptible divergence between the top NPR rate (which moved up since FY01) and the average NPR; (b) the top NPR and top CD rate; and (c) gradual preponderance of para-tariffs (Figure 17). Also notable are the prohibitively high NPRs on consumer goods that are domestically produced (e.g. 108% in FY2013). Such high rates, if effective, constitute *de facto* import bans.

The new element is the emergence and sharp rise of para-tariffs (Figure 17) as a protective instrument of trade policy, which rose to over 50% of average NPR since FY13. Going by

Figure 17: CD and Para Tariff Trends



NPR rather than CD, it becomes evident that the top NPR, which is an indicator of the highest level of nominal protection given to an import-competing product, is not 25%, but as high as 108%, imposed on textile fabrics. This is the top rate appearing on a significant number of tariff lines, though there are occasionally higher NPRs on such items as biscuits and confectionaries (in excess of 100%); excluding the high tariffs on cars, alcoholic beverages, and cigarettes, which are meant to generate revenue or to discourage consumption. Though cross-country comparison of tariffs is made on the basis of CD⁹, it is fair to conclude from available cross-country data that NPR levels are relatively high in Bangladesh thus raising the first wall of anti-export bias. Globally, tariffs have been coming down so that there is a general perception that they do not pose any barrier or market access problems any

⁹ Trade taxes other than custom duties that are akin to tariffs.

¹⁰ Due to lack of comparable cross-country information on trade taxes other than CD.

more and attention is now being diverted to non-tariff measures. Once Bangladesh graduates out of its LDC status or moves across the middle-income threshold, exporters to Bangladesh could soon start drawing attention to the relatively high tariff and para-tariff levels.

According to the World Bank's Trade Restrictiveness Index (TTRI) based on MFN tariffs, Bangladesh ranks 97th among 125 countries. That perception is based entirely on nominal tariffs and does not include para-tariffs. A recent PRI study for the World Bank and WTO (PRI, 2012) found effective rates of protection¹¹ (ERP) for most import substitute products to range from 100% to over 300%. The ERP computations across products and firms now reveal that effective protection rates far exceed NPRs by wide margins because average input tariffs are well below output NPRs, ranging from over 100% for agro-based products like fruit juice, to over 300% for such products as bicycles and plastic bottles. Barring a few products like carbon rods and jute textiles, which are intermediate products, most of manufacturing in Bangladesh is concentrated on consumer goods production, all of which have output NPR rates between 50-100% (200% for biscuits!)¹². More important for global competitiveness of Bangladesh's exports, these high NPR and ERP levels create anti-export bias that has perverse resource allocation implications. More than NPR, it is the effective protection levels that accentuate anti-export bias as they are much more pronounced than NPRs. And there seems no indication that these levels are on the decline; rather, the trend seems to be opposite, implying that effective rates of protection are on the rise. Research and cross-country evidence regarding protection confirm that (a) protection once given has a tendency to perpetuate as producers in protected activities develop a vested interest in maintaining it; (b) industries protected for too long become inefficient and uncompetitive at the global level as they have little incentive to innovate or raise productivity.

If anti-export bias is so prominent in our trade policy orientation, it is pertinent to ask how is it that RMG exports rose to such heights as to make Bangladesh one of the leading RMG exporters of the world. It goes to the sagacity of our policy makers to have devised a "free trade channel" for this 100% export-oriented sector within an otherwise high tariff regime. Aided by the MFA which gave access to world markets, domestic policies designed exclusively for RMG industry, comprising special bonded warehouse and back-to-back LC, were able to soundly neutralize anti-export bias of a high tariff regime. Indeed, these policies constituted the bedrock of success for this labor-intensive industry that symbolized Bangladesh's strength in low-skill intensive manufacturing, the sort of specialization that should spill over to other industries as well.

A close examination of the structure of tariffs reveals that the decline in average NPR was due primarily to the reduction in tariffs on basic raw materials, capital goods and intermediate inputs, while the top CD rate remained flat at 25% since FY05, topped up by generous supplement of levies such as supplementary duty (SD) and regulatory duty (RD) – para-tariffs. The trends in nominal protection rates of import categories reveals that in the recent

¹¹ERP measures the relative change in value added at domestic prices (protective effect on output net of protective effect on inputs) over value added measured in world prices.

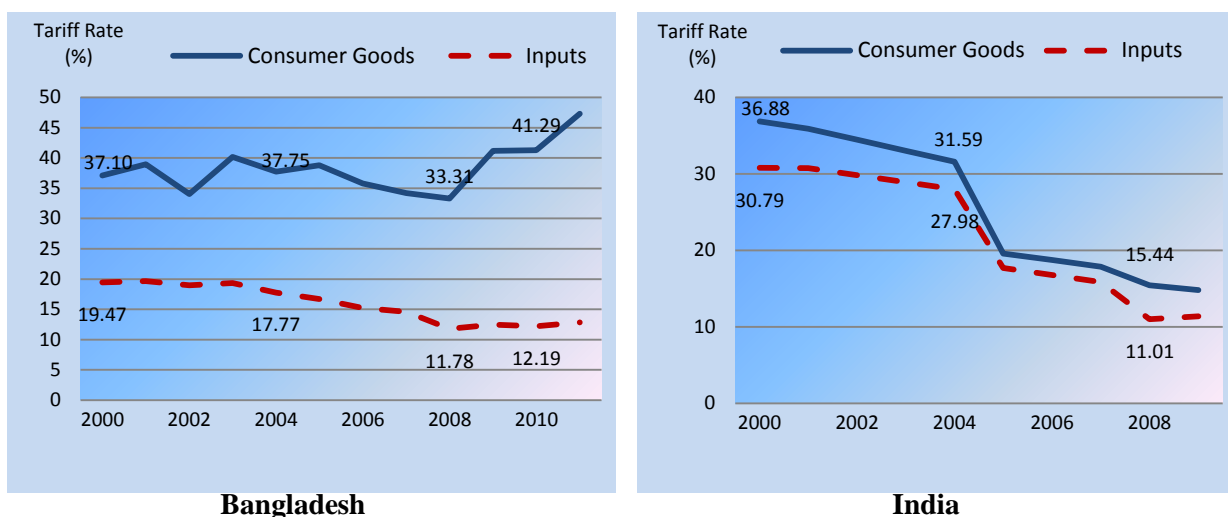
¹² Tariffs on biscuits have been lowered to 100% in FY2014-15 Budget.

past the average NPR for input categories have been declining rapidly while that of final consumer goods remained practically flat if not increased (Figure 2).

The common perception is that reduction in input tariffs while keeping output tariffs high makes domestic production of import substitutes more competitive. But the net outcome of this process is higher effective protection to domestic producers over time yielding windfall profits simply through tariffs and without any improvement in productivity or competitiveness. Moreover, tariffs on final consumer goods (most of which have domestic production) are kept so high that they act as implicit ban on imports resulting in lower revenue yields as well. What is seldom recognized is that this trend of input and output tariffs is unique for Bangladesh.

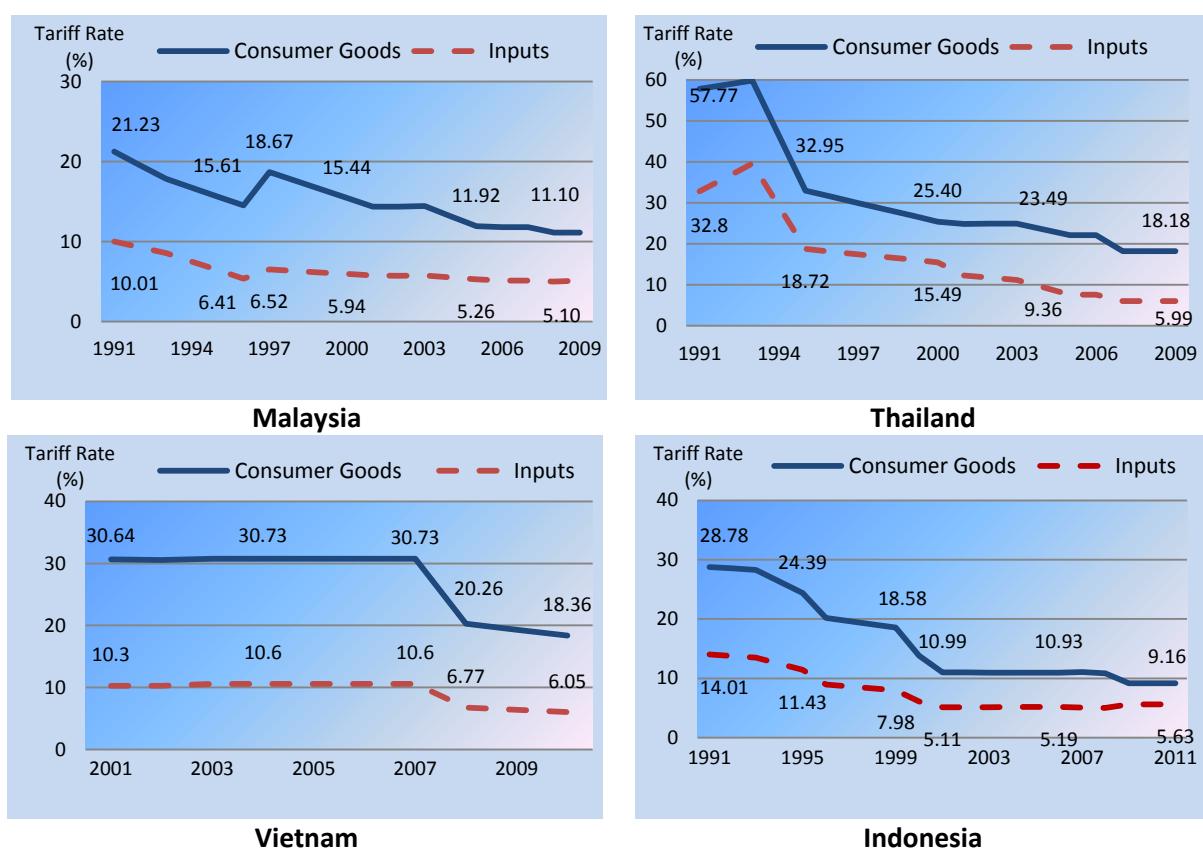
A comparison of the trend in India’s output and input tariffs (Figure 18) shows that both rates trended downwards as tariffs were liberalized thus reducing effective rates of protection or leaving them unchanged over time. This is the approach followed by most developing countries over decades as they liberalize trade.

Figure 18: Trends in Output and Input Tariffs: Bangladesh and India



Box 2 presents trends in output and input tariffs over two decades for a number of comparator countries: Vietnam, Indonesia, Thailand, and Indonesia. Without exception, all countries have pursued a policy of commensurately lowering output tariffs as they lowered input tariffs, just like India. Clearly, this is a long-term strategy of lowering effective

Box 2: Trend in Average Tariffs on Output (Consumer Goods) and Inputs for selected countries



protection to import substitute production with a view to improving efficiency and global competitiveness – as trade theory would suggest. This is also a strategy for elimination of anti-export bias of tariff policy which has yielded good results in that all of the countries in question have been able to transform import substitute industries for export production, or create new export-oriented industries, resulting in substantial increase in export-GDP ratio over time (Table 13).

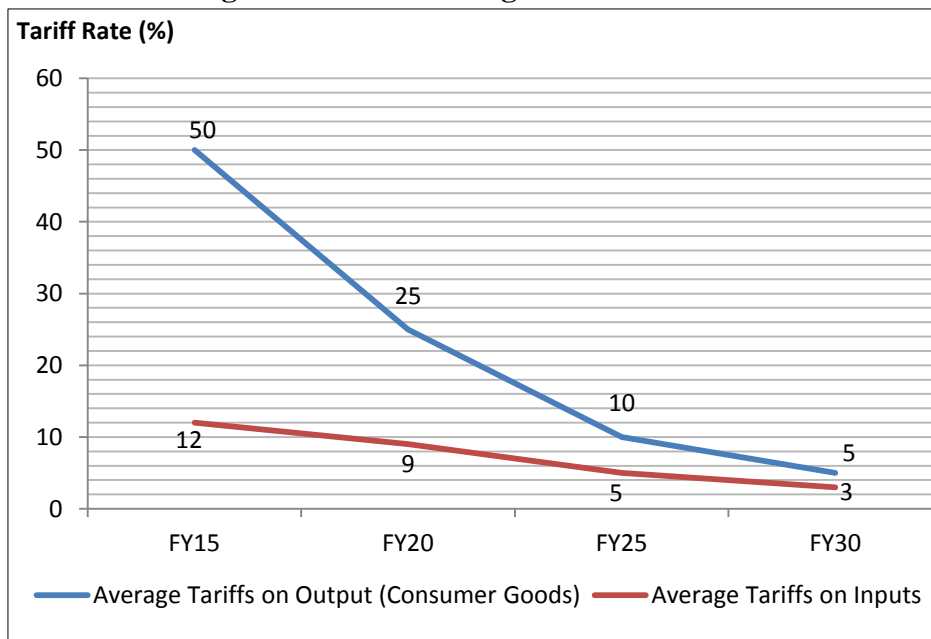
Table 13: Exports of Goods and Services expressed as share (%) of GDP

	Year	
	1970	2012
Bangladesh	8.31	23.12
India	3.72	24.00
Korea	13.63	56.50
Indonesia	13.45	24.26
Malaysia	41.41	87.14
Thailand	14.99	74.98
Vietnam	6.62*	80.03

*Data for the year 1986
Source: World Development Indicators (WDI) database, The World Bank

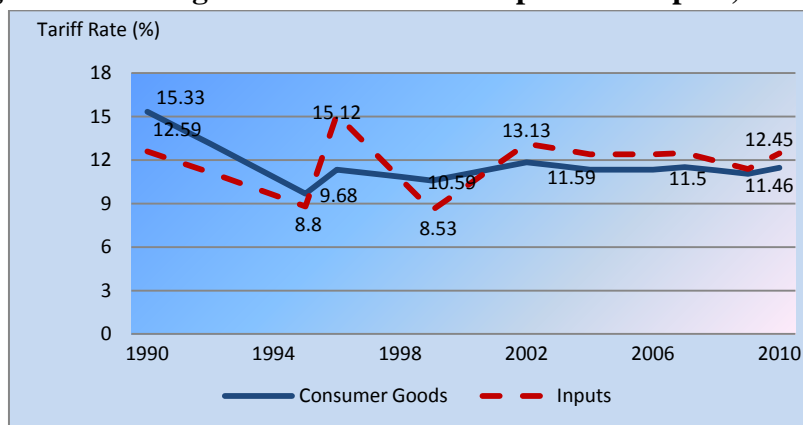
To continue on a path of sustainable export growth with a diversified basket of goods, Bangladesh would have to restructure its tariff regime in order to gradually phase out effective protection levels and anti-export bias. A possible tariff and protection regime of the future is charted in Figure 19. In view of the currently high levels of NPR on final consumer goods, the proposed structure calls for gradual but significant reduction of NPR on these goods while making modest adjustments to input tariffs along the way. Hence, the average NPR of 50% in FY14 will have to be halved by FY20, reduced to 10% by FY25, and to 5% by FY30. Meanwhile, average input NPRs will decline from 12% in FY14 to 3% by FY30. On the face of it, the proposed tariff and protection trend would appear contrary to current trends, but that seems to be the only way to go if Bangladesh is to undergo transformative change in its structure of production where production, jobs and income hinge on the success of exports which, by FY30, could constitute 50-75% of GDP.

Figure 19: A Tariff Regime of the Future



There is yet another twist in the story for the long-term. We have mentioned that the fastest growing segment in international trade is the trade in intermediate goods; and East Asian countries, like Korea, have had great success in exploiting global value chains by linking up with China, the super assembler of the world. To spur the production and export of intermediate goods, requires a different tariff profile where relative incentives to intermediate goods production is no worse, if not better than final goods production (Figure 20). This apparent

Figure 20: Average Tariff Trend for Outputs and Inputs, S. Korea



Source: WITS Database, World Bank

paradox is evident in the Korean approach. Whereas prior to 1994, average input tariffs trended downward and was lower than output tariffs, as usual, we see a reversal of that trend since 1995 when average input tariffs were higher than output tariffs – a clear preference for higher incentives to primarily the intermediate goods sector. It seems Korea has adjusted to the notion of keeping trade policy orientation neutral between inputs and outputs (mostly final consumer goods), which is done by moving towards uniform tariffs, with a slight tilt in favor of intermediate goods (during 2000-2010, average input tariffs are about 1% points higher than average output tariffs). At any rate, where exports are concerned, Korea has an efficient system of free trade channels for export commodities.

VII. EXPLOITING EMERGING TRADE PATTERNS FOR EXPORT DIVERSIFICATION

There are emerging opportunities for changing direction of Bangladesh trade stemming from the evolving pattern of global trade. According to a WTO-UNCTAD report (WTO 2011), trade in intermediate goods was the most dynamic sector of international trade in the past two decades, accounting for more than 50% of non-fuel world merchandise trade. This is a new trend that has evolved in the character of export-led growth. With the ‘unbundling’ of production across countries fostered by widespread trade liberalization, advances in ICT, and lower transportation costs, entrepreneurs often find it more economical now to ‘unpack’ their factories and locate various production stages far from each other, to other countries in accordance with these countries’ respective comparative advantages. Such fragmentation of the whole manufacturing process triggers increased vertical intra-industry trade as assembly operations typically migrate to lower-wage economies, while more developed economies specialize in the production of higher-value added components. This inevitably fosters a boom in trade in intermediate goods, which has over the years become a major driver of export growth particularly in East Asia and other emerging economies of Asia.

The fragmentation of production processes across different countries has given rise to global value chains (GVCs) creating opportunities for intra-industry trade globally as well as between contiguous economies within a region. East Asian countries have seized early

opportunities from this development by linking up with China – the world’s assembling powerhouse. As much as 75% of East Asia’s trade is in intermediate goods, some of which involve high value-added components of sophisticated electronic products like mobile phones, computers, LED TVs, etc. An IMF study found the share of intermediate goods in trade flows into emerging Asia has increased to 65 percent, while the share in similar trade flows among more developed economies is about 40 percent (Gruenwald and Hori, 2008). Studies by Commonwealth-UNCTAD (2014) reveal that these trading opportunities have bypassed or are bypassing LDCs and low-income economies, depriving them of the benefits of the fastest growing component of global trade by keeping them out of some of the most profitable intra-industry production networks.

This conclusion is largely though not completely applicable in the Bangladesh context simply because Bangladesh was an early participant in the GVCs through its leading export sector – readymade garments. Bangladesh started as a pure ‘assembler’ in a low value added GVC activity – cutting and making of readymade garments (RMG). Thanks to the initial infusion of FDI, bringing technology, management techniques, marketing access and information, both forward and backward linkages were established. Today, Bangladesh has become a leading exporter of RMG in the world.

There are important lessons from this experience regarding the prospects, challenges, and opportunities for Bangladesh stemming from GVCs in other product or service sectors.

- First, it was a foreign investor – in this instance, Daewoo of Korea – which facilitated Bangladesh’s entry into the GVC by teaming up with a Bangladeshi company – Desh Garments. Daewoo brought technology, management, and knowledge of market access under the umbrella of MFA. With Daewoo’s advice, Bangladesh trade policy was radically adjusted for RMG export production, by introducing a system of duty-free imported inputs within a high-tariff regime (special bonded warehouse), in addition to providing for supply of imported inputs on credit (back-to-back LC system). The total package created a free-trade channel for RMG export production that produced wonders for this one sector. Unfortunately, the lesson from this experience was not passed on to other sectors. Hence, there was no replication of RMG experience – at least, not yet.
- Second, it was a fact that the choice of the GVC component was based on Bangladesh’s comparative advantage in low-skill intensive manufacturing production. Then, it must be the case that Bangladesh also had comparative advantage in many other low-skill intensive manufacturing production – which could be in final consumer goods or intermediate goods. Yet, there was no progress in the emergence of intermediate goods in Bangladesh’s export basket. 98% of Bangladesh’s exports today are final consumer goods – an import-substitute sector that remains highly protected from import competition for years on end, with no sign of protection being phased out. Protection to these final consumer goods has been given at the expense of protection for intermediate goods, as tariffs on the latter have been scaled back over time. Indeed, the protection structure creates not just an anti-intermediate goods bias

but also an anti-export bias that constrains the emergence of non-RMG products in the export basket, thus stifling export diversification prospects. So, intermediate goods production or exports has not been on Bangladesh's radar in the past. The new trends in global trade reveal existence of tremendous opportunities for export of intermediate goods within GVCs. This calls for a radical change in the current incentive regime that favors production of final consumer goods over intermediate goods.

What must Bangladesh do to exploit GVCs to break into new markets and export new products? What are the entry barriers? As mentioned earlier, to exploit GVCs, entrepreneurs may exploit two specific options: (1) produce intermediate goods; or (2) emerge as an 'assembling' hub. With regards to the first, Bangladesh entrepreneurs need to identify components that involve labor intensive or low skill intensive processes while searching to establish strategic partnerships with established transnational who will assemble the final product in another location. With regard to the second option Bangladesh may ponder emulating China's successes at GVCs by emerging as an 'assembling' hub. In this case it is instructive to look at the economic rise of China associated with the emergence of a distinctive structure for the Asian-US production system, commonly understood as the 'tri-polar trade through China' model. In this structure: (i) East Asian countries, except China, produce sophisticated parts and components and export them to China; (ii) China assembles them into final products; and (iii) these are further exported to the US market for consumption.

There are several issues worth discussing. To start with, if local entrepreneurs are willing to engage in the production of an intermediate good, then it is probable that they will face issues that are associated with efforts dedicated to 'learning how to imitate'. In short, the technical 'know-how' needed for the production of an intermediate good in the GVC must be obtained if the local entrepreneurs are not exposed to such expertise. In this context, a prudent strategy for local entrepreneurs is to opt for a collaborative production structure that builds long-run commitments between local and foreign actors, so that the technical 'know-how' needed by the local actors is obtained by inviting FDI.

On the other hand, if local entrepreneurs are willing to devote resources to assembling activities, then they should choose a product where there is a high local demand in addition to high export demand (e.g. auto parts in Bangladesh, automobiles in India). The security of sales in the domestic market will attract FDI from the foreign firm, and a collaborative production structure will diffuse the initial technical know-how needed for the assembling of the final good (or intermediate good). Thus the choice of the product for which assembling activities is undertaken is partially determined by the characteristics of the local market, especially the level of effective demand it carries for the product.

Thus it becomes apparent that a prudent option for a local entrepreneur is to seek collaboration with foreign firms for the production of intermediate goods, and also to emerge as a key 'assembling' player within the industry. This, however, will mean that foreign direct investment is needed, and policy makers must mitigate any constraints that undermine the

prospects of FDI. Apart from the critical need for a stable political environment, issues that need priority attention are:

- Efficient Containerization
- Efficient Land Ports
- Information and Communication Technology
- Export Processing Zones or Special Economic Zones

Other issues that also merit attention are: corporate tax regime with appropriate incentives, import liberalization, strong intellectual property rights, rule of law, and a developed financial system, including modernization of Foreign Exchange Regulation Act (FERA) 1947.

Furthermore, in order to promote integration into GVC (and attract FDI with this objective), the following steps would be essential:

- A liberalized investment policy regime, which offers scope for international firms to have unlimited stake in the local firm.
- Joint ventures with established actors within the GVC will allow the diffusion of technology, which ultimately boost the export potential of the local firm.
- Local firms must have the capacity to innovate and acquire a basic level of technological standard, so that such types of cooperation are possible.
- Availability of appropriately skilled labor at a competitive price, which motivates established foreign actors to participate in joint ventures with local players.

Can GVCs work for LDCs? The Global Value Chain can provide a means for Least Developed Countries (LDCs) to mitigate their development disadvantages arising from their small domestic markets, insufficient capital, and lack of experience in meeting international standards. Through participating in the international production networks of MNEs, LDCs can benefit in terms of gaining access to the world market, employment creation, and technology transfer. Developing and diversifying GVC opportunities for LDCs depends on their current trade and production patterns and resulting participation in GVCs. UNCTAD's GVC participation rate refers to the extent to which a country's exports incorporate inputs with foreign value added, and the extent to which its exports contribute value added to other countries' export. The data for Asia-Pacific LDCs reveal that that these countries are participating only at the end stage of the process in international production networks, where activities are mainly concentrated in unskilled labor-intensive assembly of intermediate imports into final goods for either domestic consumption or exports. This is evident in the data in the large gap between the value of intermediate imports and exports for the Asia-Pacific LDCs.

Assessing the composition of exports of LDCs, two types of GVC portfolios have emerged based on levels of development and supply-side capacity. These are: (a) resource endowment driven value chains and; (b) light manufacturing value chains. As an example, Bangladesh with 36 percent GVC participation rate and endowed with low cost labor as a result of its demographic dividend, has been an attractive location to establish the low-skill segment of the apparel and footwear GVCs. Aside from country-specific factors, the ability of LDCs to improve connectivity to the region alone with trade and investment policies and regional cooperation play a crucial role in determining their participation in GVCs. Common disadvantages faced by LDCs in connecting to value chains identified in a OECD-WTO (2013) firm study states inadequate infrastructure as the foremost issue, followed by access to trade and finance and compliance with sanitary and phytosanitary (SPS) measures or technical standards. Trade facilitation measures have been mentioned as the most crucial area where support would be effective in bringing suppliers in LDCs into their supply chains. Other issues included labor force training and improving public-private dialogue with national authorities.

Though Thailand is not an LDC, the experience of Thailand in GVC integration is instructive. Thai multinationals emerged out of the very sectors in which they previously engaged as low-cost suppliers and production base of globally integrated value chains including both buyer and producer-driven chains. In a study of the global structure of manufactured intermediate goods trade, Thailand ranks 18th among the top 50 countries, with a trade structure that shows its integration into the GVCs of several industries (Sturgeon and Memedovic, 2011). Exporting to global buyers has been a crucial part of Thailand's historical development along with value-chain control as a more recent strategic driver inciting emerging MNEs to expand abroad. Thai MNEs are most active in industries whose value chains have been extensively globalized, particularly agribusiness & food, electronics, and textiles. These sectors are conventional representatives of both the producer-driven (i.e. electronics) and buyer-driven chains (i.e. agribusiness, food and textiles). Developing Asian economies, particularly Southeast Asia and China, are the most important destinations for Thai multinationals, together accounting for 71.2 per cent of the total amount of overseas FDI (OFDI). Two of Thailand's most globally integrated industries have been electronics and food. Within the GVC of these industries, Thailand has long played a major role as producer and supplier. The globalization of these two sectors takes place through both production as well as trade of intermediate products. Firms from these two sectors rank among the most active of Thai overseas investors being at the forefront of global economic integration in production and trade.

Lessons from countries successfully integrating into GVCs suggest four necessary conditions: (a) liberalization of trade and investment in goods and services through multilateral and regional trade agreement; (b) efficiency in trade facilitation; (c) international and regional cooperation and; competitiveness and supply-side development. High trade and transport costs faced by LDCs can be mitigated through improving transparency and simplification of trade procedures, improving the domestic business environment, and harmonizing laws and standards for cross-border paperless trade. Finally building supply-side capacity is essential

for LDCs to improve their competitiveness and chances for linking to GVCs. This can be achieved through substantial investment for infrastructure development, reforms in educational and skill development systems, and provisions of financial and technical assistance to SMEs

Finally, it is now increasingly recognized that regional economic integration through improved logistics, trade facilitation and connectivity results in larger markets, with trade expanding and benefiting from scale and agglomeration economies. In small economies and less developed countries, such integration has been shown to induce the consolidation of the regional portions of GVCs. Findings from a number of joint Commonwealth Secretariat-UNCTAD studies (COMSEC, UNCTAD 2011) illustrate the scope to develop regional supply chains (RSC) in light manufacturing and processing activities that are able to promote employment generation and structural transformation in many LDCs. The rise of several large developing economies as a major source of trade and economic activities has also contributed to the escalating prospect of value-addition through RSCs, providing opportunities for other smaller and poorer developing countries to engage with these regional growth centres more productively (Brunner, 2013). In addition, with limited entrepreneurial and exporting capacity, firms in developing countries tend to know their regional market relatively well. One of the further benefits of RSCs would be the regional harmonisation of trade related infrastructure and policy initiatives, including safety and other standards, which could all be cohesively raised through stronger regional cooperation.

The Commonwealth-UNCTAD assessment of the textile and clothing (T&C) sector in South Asia identifies many disaggregated items for individual countries where potential regional production linkages can be established. They have identified the substantial untapped potential for expanding the RSC in the T&C Sector within South Asia, enabling all countries within the region to benefit from concentrating specialization and the sourcing of products required for specialization within the region itself. Nevertheless, South Asian countries continue to have formidable trade barriers amongst themselves, covering all aspects of intra-regional flows including goods, services and capital movements. Member countries are often observed to impose more stringent barriers on intra-regional trade flows compared to their imports from the rest of the world partners. A substantial portion of regional trade is also more likely to be channeled through land-ports partly because of the existence of many landlocked countries in both the regions. However, poor and inaccessible land routes coupled with other trade-related barriers restrict regional trade.

The scope for establishing and expanding export-led regional production networks is given that India and Pakistan each have a strong textile base and are sources of important raw materials while Bangladesh and Sri Lanka are mainly apparel manufacturers. While a large range of policy steps are required, several key initiatives will be needed to address intra-regional barriers to trade, improving trade facilitation measures, strengthening trade-related infrastructure and policy support to develop trade capacity, developing more effective regional trade policy mechanisms to promote RSCs.

VIII. ROLE OF FOREIGN DIRECT INVESTMENT (FDI) IN EXPORT DIVERSIFICATION

Potential Role of FDI in Promoting Exports

Export diversification is often constrained by limited domestic capital, technology and market knowledge. An important research question is can these constraints be eased by attracting foreign firms? It is not surprising that the role of foreign direct investment (FDI) in promoting exports has attracted considerable attention in recent times. FDI with their better technological and managerial skills and knowledge about international marketing conditions, are expected to improve the productivity as well as export performance of host country firms by creating certain positive externalities known as 'spillovers'. Spillovers can take place when FDI improves the productive efficiencies of domestic firms, making their products efficient in price and quality in the international market and thus improving their export performance. Such spillovers may occur either to domestic firms in the same industry group of foreign firms through competition, known as 'horizontal spillovers', or to firms in the upstream supply chain through buyer-supplier linkages, known as 'backward spillovers'. FDI can help to channel capital and technology into industries that have the potential to compete internationally, and the global linkages of multi-national corporations can facilitate their access to foreign markets. In addition to exports that are generated directly by foreign affiliates, FDI can also promote exports of domestic firms through the teaching of proper marketing strategies, methods, procedures, and channels of distribution.

In an important research Helpman, Melitz and Yeaple (2004) show that only the more productive firms choose to serve the overseas markets and the most productive among this group will further choose to serve the foreign market through FDI. This is supportive of the above rationale that FDI will likely provide superior technology, higher productivity and better knowledge to the host countries, which in turn will improve domestic efficiency and productivity thereby enabling export competitiveness.

The Empirical Evidence

There is now considerable body of evidence from countries in Europe, East Asia, South Asia and Africa that FDI supports the growth of exports. Kutan and Vuksic (2007) estimate the potential effects of FDI inflows on exports in 12 Central and Eastern European (CEE) economies for the period between 1996 and 2004. They separate the effects of FDI into supply capacity-increasing effects and FDI-specific effects. The supply capacity-increasing effects arise when FDI inflows increase the host country's production capacity, which, in turn, increase export supply potential. The FDI-specific effects arise because the multinational company may have superior knowledge and technology, better information firms. The empirical results indicate that, for all countries in the sample, FDI increased domestic supply-capacity and hence exports. However, FDI-specific effects on exports are observed only in the new member states of the European Union. In another research Bucevska (2008) looks at impact of FDI on the export performance of three EU candidates: Croatia, Macedonia and Turkey. The results of the estimated models show that in the period

1997-2007 FDI has had a positive and significant impact on the export performance of the three countries.

In East Asia the experience of China that has witnessed both a massive growth in exports and FDI is of particular interest. The volume of literature available on China on this subject is vast. So the paper provides the findings of a few of those to illustrate the positive role of FDI in exports. Zhang (2005) attempts to investigate the role of FDI in promoting manufacturing exports in China. The empirical evidence from the study suggests that FDI indeed has had a positive impact on China's export performance. The research finds that the export-promoting effect of FDI is much greater than that of domestic capital and its effect is larger in labor-intensive industries, as one might anticipate.

In another research Zhang and Song (2000) approach the subject from a spatial dimension. Examining the spatial patterns of exports and FDI, the study found that both of them concentrated in the coastal areas. Over 85% of China's exports came from the coastal areas and more than 85% of inward FDI went to these areas. Calculating a correlation coefficient using a simple regression model, this paper found a strong link between exports and FDI. Using panel data at the provincial level in the period of 1986 to 1997, the paper found that 1% change in the level of FDI in previous year is associated with 0.29% increase in exports in the next year. It also found that the results on the variable of inward FDI are the most statistically significant. The findings support the widely held belief that increased levels of FDI positively affect provincial manufacturing export performance.

Johnson (2007) investigates the flows of FDI and trade in eight high-performing East Asian economies with a focus on the relationship between FDI and host country exports. The concerned countries are: China, Hongkong, Indonesia, Malaysia, Korea, Singapore, Taiwan and Thailand. The development and importance of FDI and trade for the region is described. The empirical part of the paper examines the relationship between FDI and host country exports, using data for the period 1980 to 2003. Time series regressions for individual economies as well as panel data estimation indicate that FDI inflows have a significant and positive effect on host country exports, suggesting that export-platform FDI may be important for the East Asian economies. Granger causality tests find indications of FDI inflows causing exports, providing further evidence that the export-platform FDI strategy applies for the East Asian economies.

Vietnam in recent years has experienced a substantial inflow of FDI. Xuan and Xing (2008) look at the implications of FDI for export performance in Vietnam. The study examines the implementation statuses of a total of 5,919 foreign direct investment (FDI) projects approved by the Vietnamese Ministry of Planning and Investment since 1988, and compiled a database of actually disbursed FDI in Vietnam. The database covers FDI flows into Vietnam from 23 countries from 1990 to 2004. The research analyzes the impact of FDI on the exports of Vietnam with gravity equations. The empirical results demonstrate that FDI is one of the major factors driving the rapid export growth of Vietnam. It has significantly facilitated the expansion of Vietnam's exports to FDI source countries. In particular, the empirical analysis

shows that a 1 percent increase in FDI inflows is expected to lead to a 0.13 percent increase in Vietnam's exports to these countries.

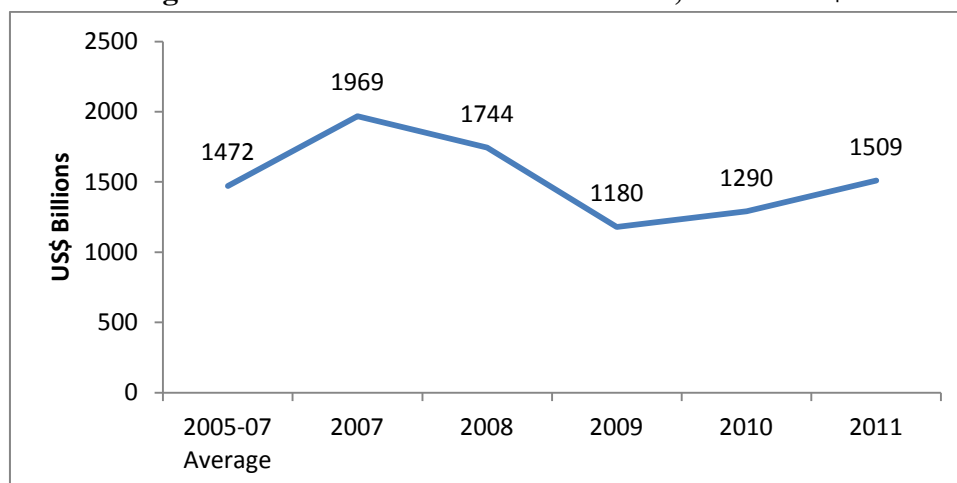
Within South Asia India has experienced significant FDI inflows in recent years. Before the 1980s India was a heavily regulated and a virtually closed economy. Reforms since the mid-1980s have transformed India into an increasingly globalized economy. Responding to the liberalization of trade and investment policies, FDI inflows have grown rapidly in India since the mid 1990s. Prasanna (2010) investigates quantitatively the question of how FDIs have impacted on India's export performance. The research finds that the impact of FDI inflows on export performance is significantly positive. The study also suggests that the policy regarding domestic efforts to enhance manufacturing exports needs reassessment in line with the FDI policy framework in order to reap maximum and long-term benefits. The role of FDI in Africa is often shrouded in controversy. It is therefore important to ask how FDIs have helped the export sector in African countries. In an important research Ahmed, Cheng and Messinis (2008) research this question. The study investigates the short-run and long-run causality relationships between exports and growth, exports and FDI, and between growth and FDI, and growth and imports in 5 Sub-Saharan African countries. The empirical work uses the autoregressive distributed lag (ARDL) approach in the examination of a Granger type test of causality with an error correction. The findings are further examined through the Pedroni estimation procedure, which also allows for heterogeneity across individual countries in the mean and time effects. The estimation results show that bi-directional Granger causality exists between FDI and exports in Ghana, Kenya and Nigeria. For the other two countries, the Granger causality runs from FDI to exports in South Africa and from exports to FDI in Zambia. Moreover, the estimation results suggest a causal linkage from FDI to growth (income). A positive causal relation from exports and FDI to income is observed for all five African countries studied, as indicated by the estimated cointegrating vectors (only in the case of Kenya the research finds a negative impact of FDI). Finally, the statistical significance of F-statistics for joint significance of autoregressive terms and/or the error term implies a strong bi-directional causality between export and GDP growth in all five Sub-Saharan African countries. Overall, the results presented provide evidence of an indirect causal chain where exports, by relieving foreign exchange constraints, promote imports which facilitate income growth. While taking into account other relevant macroeconomic variables (e.g. imports, external shocks and liberalization reforms) we have used both VAR/VECM specifications to ensure that causality inferences drawn are robust.

The review of international experience is quite telling. There is a strong body of evidence from a range of countries that FDI have played a positive role in supporting exports in the host countries. The experience of China is particularly illustrative of the potential. The rapid growth of China's manufacturing exports with a wide range of diversified production and successful penetration in the global markets, especially in those of USA and Europe, suggests that a strategy of mobilizing FDIs to deepen China's manufacturing base and diversified export base has paid off handsomely. Since China is a net exporter of capital it is not so much the money but the technology, know-how and skills associated with FDI that have been instrumental. The lesson for Bangladesh and other developing countries is quite clear.

Bangladesh Experience with FDI

The recent trend in global FDI flows is shown in Figure 21. The global financial crisis of 2008-09 had a deleterious effect on the flow of global FDI but there is clear evidence of a recovery since 2010. Although still below the peak levels in 2007, global FDI flows were a healthy \$1.5 trillion in 2011.

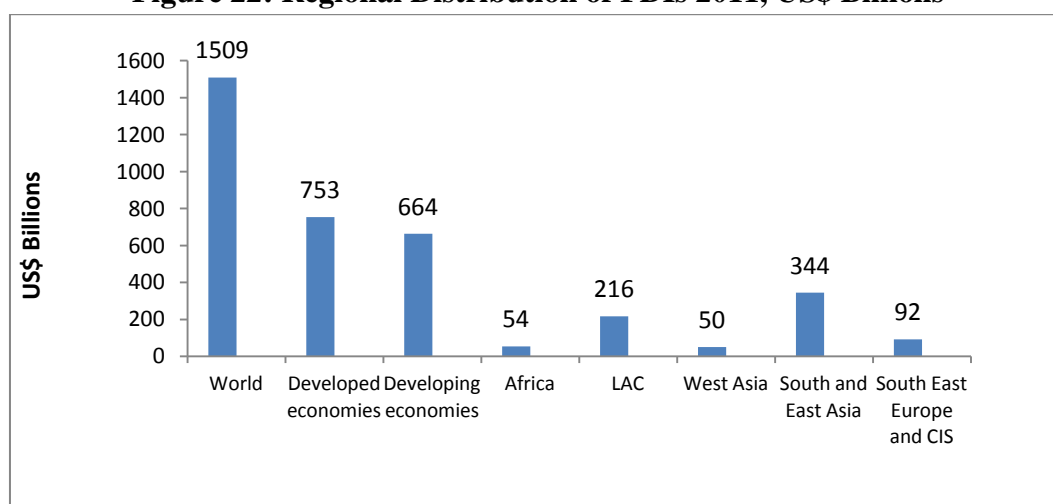
Figure 21: Global FDI Flows 2005-2011, Billion US\$



Source: UNCTAD, 2012

The distribution of these flows by regions is shown in Figure 22. Developing countries accounted for some 44 percent of the total global FDI flows. Within the developing world, the South and East Asia Region got 50 percent of the FDI inflows to the developing countries.

Figure 22: Regional Distribution of FDI 2011, US\$ Billions

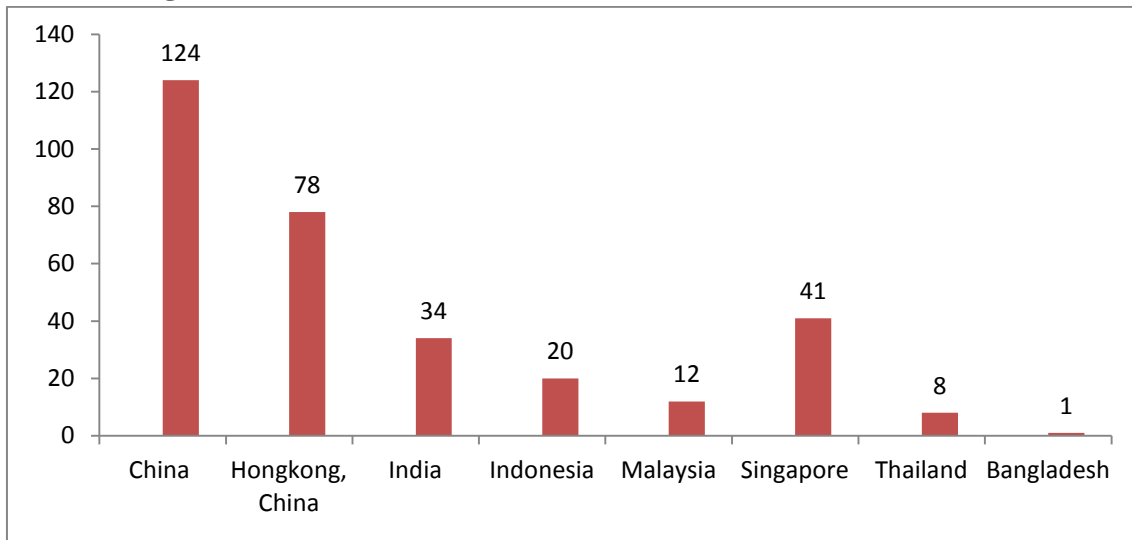


Source: UNCTAD, 2012

Indeed, FDI inflows in the East and South Asia competed very effectively with the European Union and the USA, accounting for 23 percent of the global FDI in 2011 as compared with 27 percent in EU and 14 percent in USA. Within East and South Asia, China and Hongkong accounted for a whopping 59 percent of the total inflows.

Bangladesh is a minor player in FDI. As of 2011, it approached about 1 billion dollar, which is less than 0.03 percent of total inflows in South and East Asia as compared with \$34 billion in India (Figure 23). Clearly, this is a missed opportunity for Bangladesh. In order to understand the constraints to FDI, it will be instructive to look at the lessons of the experience with FDI so far.

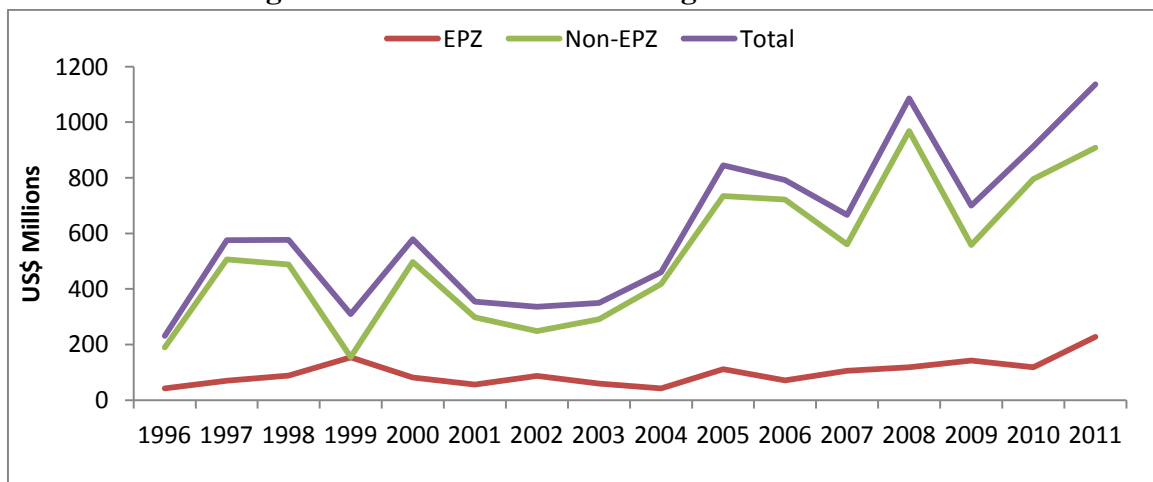
Figure 23: FDI Inflows in East and South Asia 2011, US\$ Billion



Source: UNCTAD 2012

Figure 24 shows the trend of FDI in Bangladesh between 1996 and 2011. In the early 1990s there was hardly much inflow of FDI into Bangladesh. Even in 1996 total FDI inflow was a mere \$232 million. The performance remained lack luster until 2004, fluctuating in the \$400-500 million range. FDI inflows increased after this but showed considerable fluctuations. The FDI inflows are now around the \$ 1.0 billion mark. Much of the FDIs were outside the export-promotion zone (EPZs), which is an interesting result and raises questions about the efficacy of EPZs for FDI. This is also in sharp contrast with the experience in China where much of the FDIs went into the free trade zones.

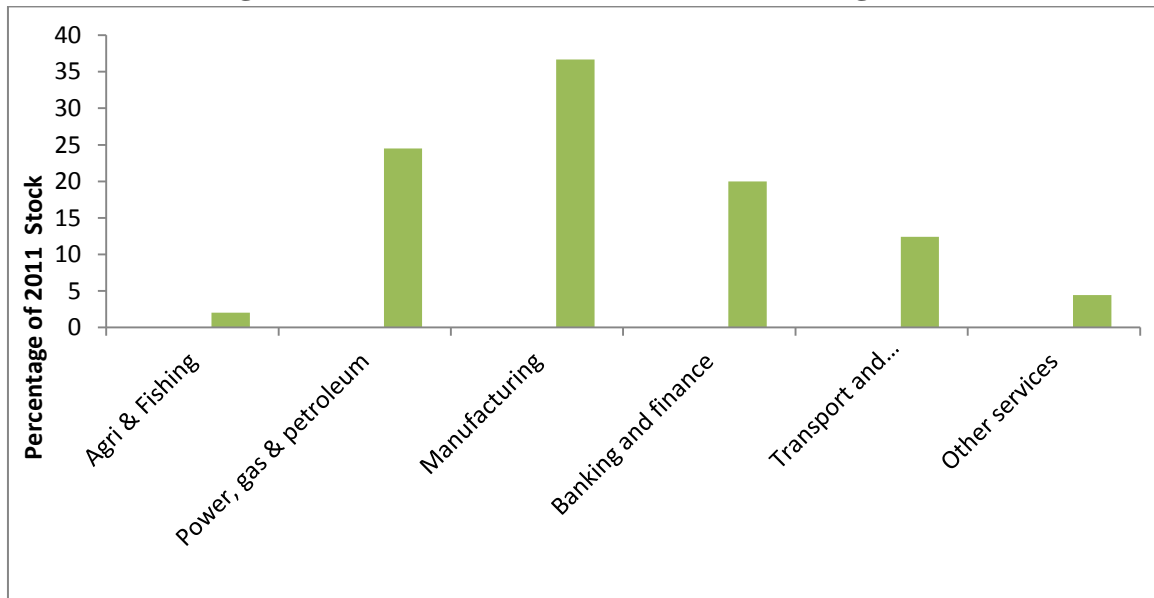
Figure 24: Trend of FDI in Bangladesh 1996-2011



Source: Bangladesh Bank

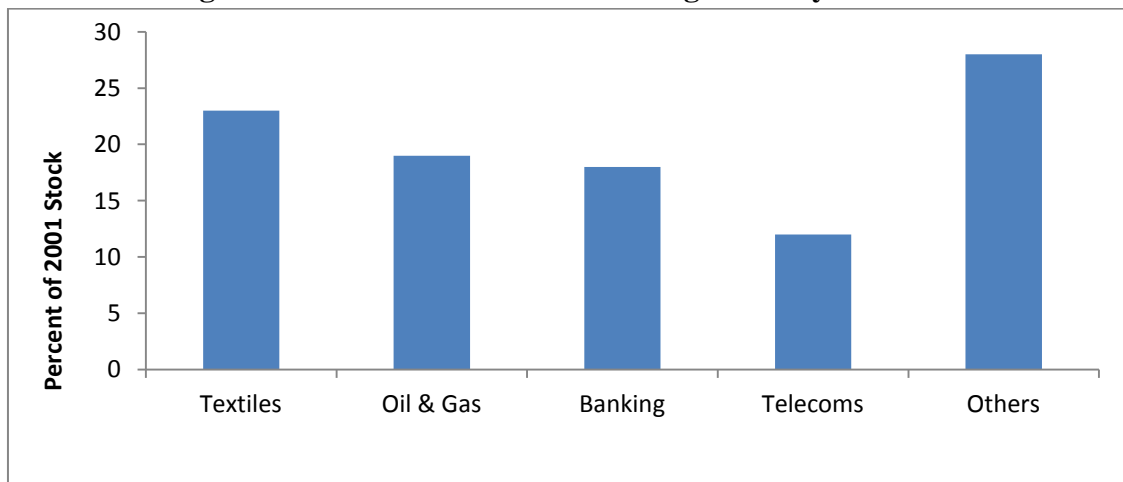
The sectoral composition throws additional insight on the nature and pattern on FDIs in Bangladesh (Figure 25). Much of the FDI concentrated in three major areas: manufacturing (37 percent), energy (25 percent) and banking (20 percent). More recently, with the deregulation of the telecommunications industry a substantial amount of FDI has flown into the sector since 2003. At a more disaggregated level, textiles, petroleum and gas, banking and telecommunications sector have attracted the bulk of FDI inflows into Bangladesh (Figure 26).

Figure 25: Sectoral Distribution of FDIs in Bangladesh



Source: Bangladesh Bank

Figure 26: Distribution of FDI in Bangladesh by Activities



Source: Bangladesh Bank

The concentration of FDI in four core activities is not accidental and tells an important story of policy reforms and FDI inflows. In the early years much of the FDI concentrated in textiles and oil and gas. The textile industry was undergoing the well-known RMG revolution based on the deregulation of the RMG sector through trade and policies and supportive fiscal and banking incentives. RMG entrepreneurs took advantage of this positive

environment and invited foreign firms to enter into joint ventures. These FDI brought in new technology, financing and market access. Regarding oil and gas, the government invited foreign firms for oil and gas exploration offering them attractive terms. The deregulation in the banking sector has similarly attracted significant FDI inflows, especially since 2005. Finally, the deregulation of the telecommunications sector has attracted significant FDI since 2004. Even this limited evidence from Bangladesh is supportive of the global experience that FDI flows into countries and activities where business environment is deregulated and production incentives are attractive.

FDI experience in Bangladesh is too limited in scope to allow for a meaningful quantitative evaluation of the role in exports. However, some indicative observations can be made of the potential based on this experience.

First, the FDI inflows did play a major role in spurring the RMG sector. The partnership between Desh Garments and the Daweoo enterprise of Korea is illustrative of this role. This partnership in the early stages of the evolution of the RMG sector allowed Bangladesh to acquire important technology and quality assurance skills that proved invaluable in the later stages when this knowledge got heavily diffused throughout the garment industry. Bangladesh RMG is similarly benefitting from partnership with name-brand firms in reaching out the upscale RMG market in USA and Europe.

Secondly, FDI inflow in the energy sector is helping address a major energy constraint in Bangladesh. The true potential of the role of FDI in easing this constraint is not being exploited by Bangladesh owing to a range of policy and institutional constraints. But there is little doubt that GDP growth and export diversification will benefit tremendously from additional FDI in energy and transport sector.

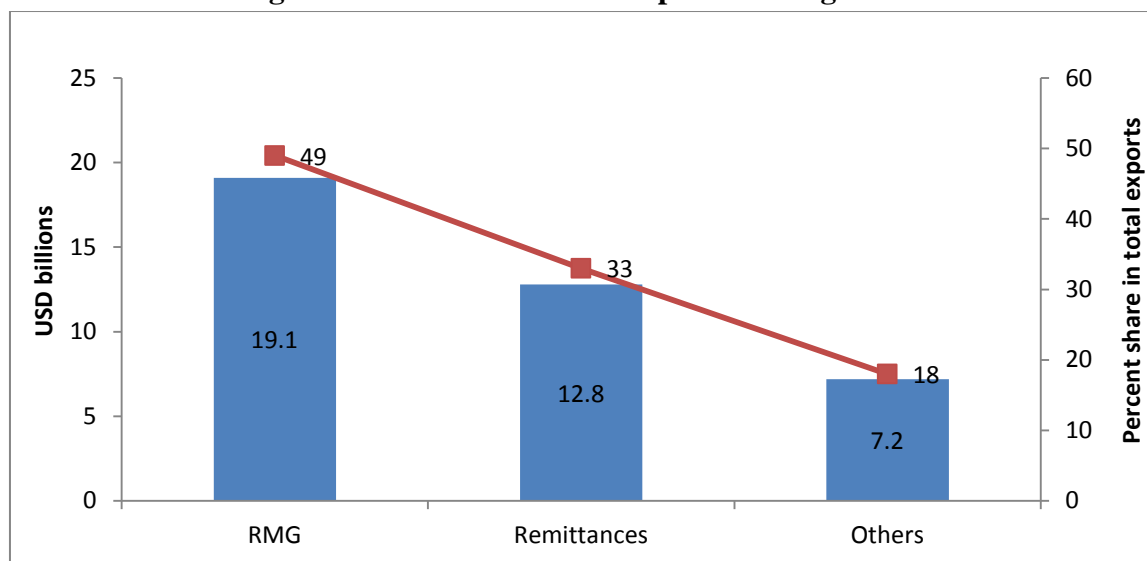
Finally, FDI flows in banking and telecoms are helping modernize these sectors and upgrade service quantity and quality. Both are critical inputs into the export supply chain. In particular, the potential for service exports in the ITC sector depends on strong FDI partnerships in both sectors.

IX. DIVERSIFYING INTO SERVICES EXPORTS

So far we focused on exports of goods only. A part of the diversification strategy needs to focus on services exports as well. When the coverage is broadened to include exports of services as well, the concentration story and associated risks get even more worrisome. Bangladesh is heavily dependent on two sources of export earnings: RMG and remittance from guest workers abroad. Between the two they account for 82 percent of all export earnings (Figure 27). If anything the concentration has increased over time. Given the downside risks associated with the near-exclusive dependence on these sources of export earnings and limited access to foreign capital markets it is important that Bangladesh

develops a long-term strategy to diversify its sources of foreign earnings. A diversified base will also allow for much more scope for expanding exports through domestic policies.

Figure 27: Sources of Total Export Earnings FY12

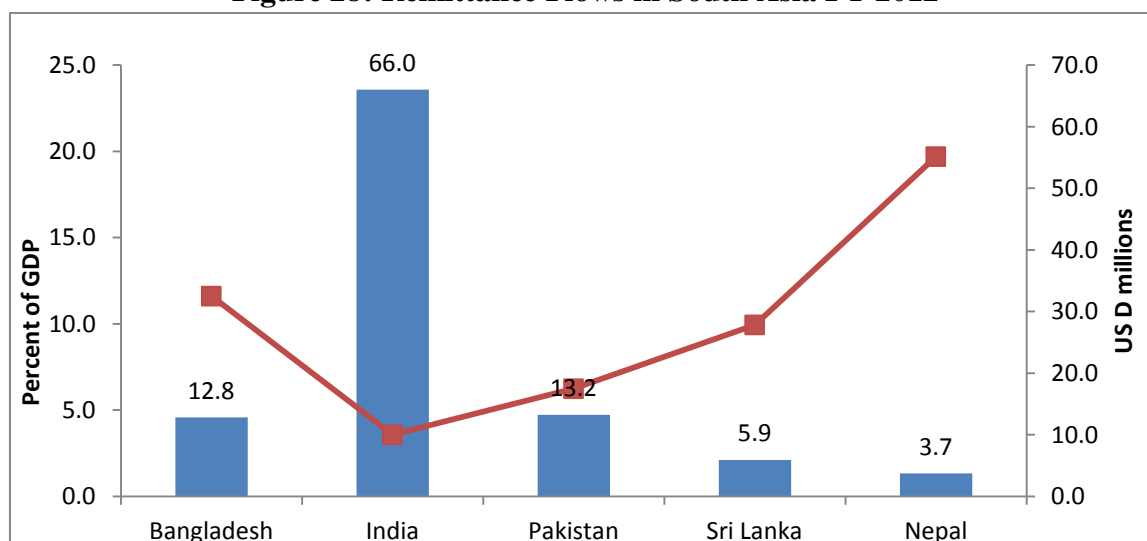


Source: Bangladesh Bank.

The Remittance Boom in Bangladesh

Bangladesh has already emerged as a leading South Asian player in the export of factor services (labor) to a wide range of countries, especially in the Middle East (Figure 28). In absolute dollar amount India leads the race with \$66 billion inflow in FY2012, followed by Pakistan (\$13.2 billion) and

Figure 28: Remittance Flows in South Asia FY 2012



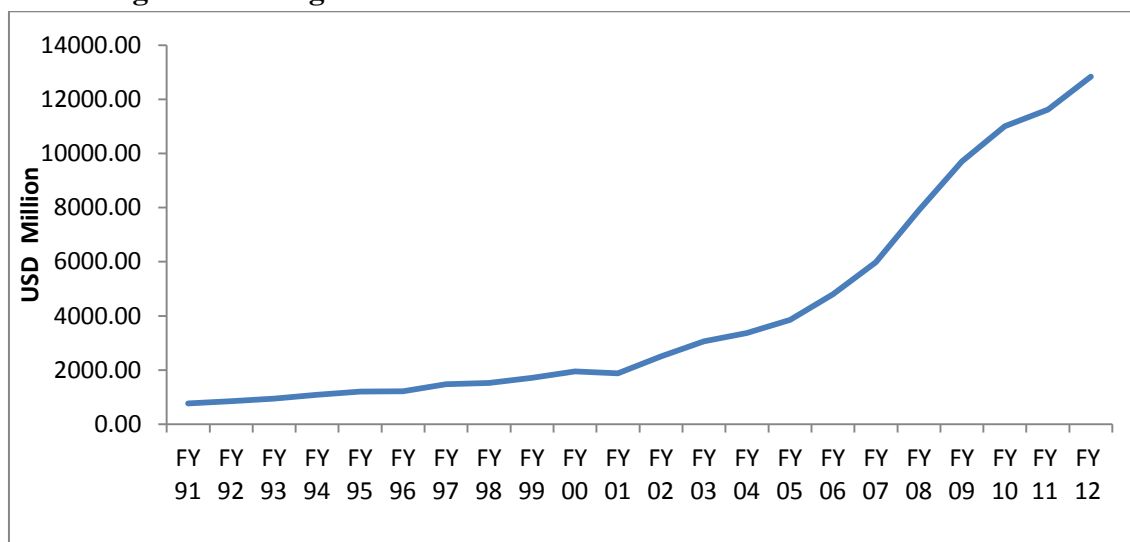
Source: World Bank online database and Bangladesh Bank

Bangladesh (\$12.8 billion). However, given the varying size of these economies, the share of GDP is a more meaningful indicator of the relative importance in terms of impact on the

respective economies. Measured by this indicator, Nepal leads the way with a whopping 20 percent of GDP followed by Bangladesh at 12.6 percent of GDP.

While much of the impetus to the surge of remittance in Bangladesh has come from the private sector, government policies have generally played a supportive role, especially through a range of enabling policies to support outward migration of workers, banking support for mobilizing remittances, fiscal incentives (tax free remittance inflows) and a favorable exchange rate. These have paid off handsomely. Remittance inflows grew slowly in the 1990s but then gained momentum in the 2000s. In FY2012 official remittances reached an all time high of US\$ 12.8 billion (Figure 29). This is now the second highest source of export earnings after RMG. The prospects for remittances remain bright as evidenced by further growth of remittances in FY13. For example, monthly remittances in October 2012 reached an all time monthly high of \$1.4 billion. This is a remarkable achievement and has been a life saver for Bangladesh in terms of both supporting the balance of payments, but more fundamentally in terms of providing a massive safety net for a large segment of the population.

Figure 29: Bangladesh Trend in Remittance Inflows FY1991-FY2012



Source: Bangladesh Bank

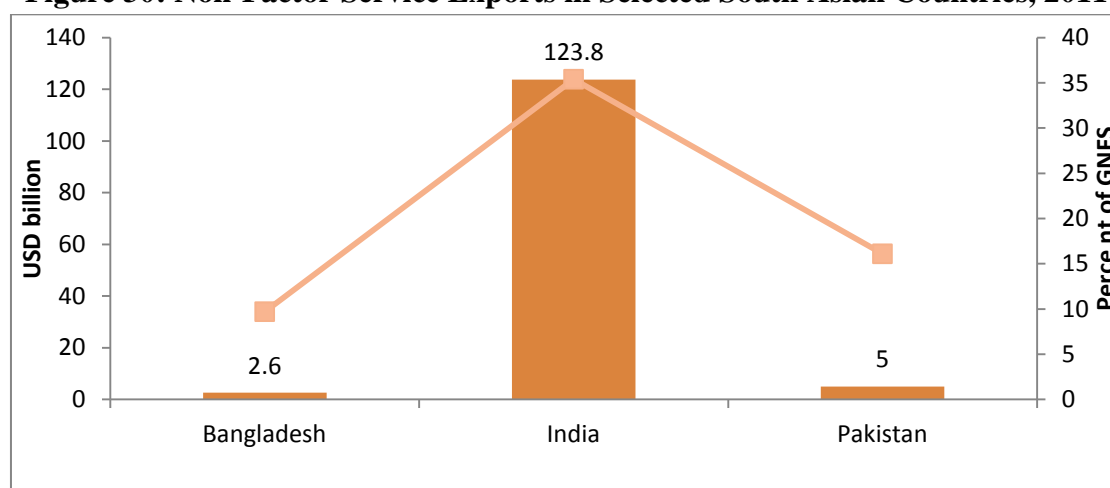
Downside Risks to Excessive Reliance on Remittances

Although there is much reason to celebrate, there is also a need for Bangladesh to take a pause and strategize to guard against downside risks and to take advantage of a healthy exports market for non-factor services. The downside risk emerges from the two important characteristics of the Bangladeshi guest workers abroad. First, this source of income is highly susceptible to internal political developments in host countries. And second, much of the workers are very low skilled with not much market beyond the Middle East including in the home country. Bangladesh has experienced these risks a number of times based on Kuwait War, the recent turmoil in the Middle East and hostile environment in a number of host countries. While, these have not culminated in a collective downturn, it will be imprudent to put all eggs into the remittance market, as in the case of RMG.

Diversifying Services Exports to Non-Factor Services

Experience from India has shown how it has taken advantage of a favorable global environment for non-factor services exports and increased its global market share with a range of non-factor services exports (Figure 30). India's exports of non-factor services soared to a massive \$ 124 billion in FY2011, accounting for more than 35 percent of total exports of goods and non-factor services. Pakistan has also done relatively well with non-factor services accounting for some 16 percent of its export earnings from goods and non-factor services. In Bangladesh, non-factor services are a very modest source of export earnings -- less than 3 billion dollars – which is below 10 percent of exports of goods and non-factor services.

Figure 30: Non-Factor Service Exports in Selected South Asian Countries, 2011



Source: World Bank online database

The success of India's drive for non-factor service exports has been researched extensively. Two of the recent research include (Matto 2011) and (Ghani, 2012). Although information technology (IT) services are dominant, India exports a range of non-factor services including transport (shipping, airlines); health services; education services; and tourism. Factors that have enabled India to secure such rapid expansion of non-factor services include a very supportive government policy in terms of deregulation; a skilled manpower; investment in scientific education, research and development; strong private sector role in the delivery of health and education services on a commercial basis.

Although detailed data on the composition of non-factor services exports for Bangladesh is not available, the limited evidence suggests that much of these services are concentrated in the area of shipping related to Bangladeshi exports. More recently, some earnings are coming from banking services linked to the mobilization of remittances and from export of IT services on a limited scale.

The potential for Bangladesh to penetrate the services exports market is large. With its huge and young labor force Bangladesh can be an important player in the global services exports beyond the guest worker initiative. The potential for exports is particularly good in IT, education and tourism. This will require a special mindset for policy makers to think global rather than inward looking. In the first place there is a huge deregulation agenda, especially

in the area of foreign currency regulation. The exchange regime has to be substantially liberalized to allow exports of tourism, education and IT that are highly sensitive to timeliness of response and transaction costs. Second, substantial investments are needed in education and tourism infrastructure. Much of this will come from the private sector but the government's regulatory policies in the areas of foreign currency transactions, licensing, accreditation, import of trained foreign experts, visas, and foreign investments have to be vastly simplified and digitalized. The government made good progress in deregulating the telecommunications sector, but more recently considerable problems have been reported by foreign investors in the matter of license renewal, taxes and fees. These disputes tend to have a major negative impact on foreign investors in a highly competitive global market and ought to be carefully managed.

X. THE INSTITUTIONS FOR EXPORT DIVERSIFICATION

Trade Promotion Organizations (TPO)

TPOs emerged in many countries as 'focal point' institutions to assist exporters in penetrating foreign markets. Their inceptions have come about from the creation of the International Trade Centre (ITC) in the mid-1960s. Since then they have served as organs that provide commercial intelligence, market research, services to foreign buyers, group promotions, and advice on shipping, transport, and packaging. Though formally not recognized as a TPO, Bangladesh's Export Promotion Bureau (EPB) acts as one.

There are seven elements which determine whether TPOs are effective:

1. First, TPOs can only function if the overall incentive framework is favorable for exports. TPOs operate in an environment characterized by a strong anti-export bias stemming from an overvalued exchange rate, a tariff structure that provides high nominal and effective protection, non-tariff barriers resulting from dysfunctional customs practices and poorly designed quality control mechanism, the absence of trade finance, costly infrastructure services, and excessive bureaucratic control of trade procedures. Special mechanism to provide export support (e.g. EPZ, duty drawbacks, etc.) cannot substitute for a truly export friendly incentive system.
2. Second, TPOs must be autonomous in their operations to be able to influence policy, mobilize the resources and services needed to support an export drive and deliver these services when and where required. These would require top-level political support maintaining close formal and informal links with public and private sectors allowing TPOs to conduct their work without the time delay of attaining clearances. However in reality, TPOs operate under the trade ministry which implies that as public agencies they are handicapped in influencing exporters of arguing against public policies that hurts them.
3. Third, TPOs should follow a demand-driven strategy with the private sector playing a dominant role in defining, implementing and monitoring their plan. Even though the

government sets the ground rules of the export 'game', in the end it is the private sector that does the exporting. For this matter trust plays an important role as diagnosis and 'ownership' of the export promotion problem and its solution is in the hands of the exporter community. This would require TPO boards to have a majority of recognized exporters headed by well-respected business leader of acknowledged integrity. Since country circumstances differ, in reality in most developing countries very few TPO heads have significant export experience.

4. Fourth, export promotion means promotion of competitiveness which is at the heart of how business is conducted and this required a balance between offshore and onshore objectives. Competitiveness encompasses pricing, quality standards; the ability to interface with new business modes that emphasizes timeliness of delivery, outsourcing, business-to-business relations; availability of supportive infrastructure services, and quality of domestic inputs. The traditional TPOs focus on offshore activities including information gathering, market research, trade representation, and fairs which leaves out much of the onshore agendas. TPOs have to balance their objectives towards being attentive to supply conditions addressing firm-specific bottlenecks faced by potential exporters through well targeted enterprise support. Support policies and services can be provided by both private and public agent on equal terms with the initiate and strategies emerging from the TPOs.
5. Fifth, quality staffing is crucial for the success of a TPO. In order to able to attract experienced and quality personnel, TPOs must match salaries paid by the private sector. In most cases TPO staff operate under civil service rules that make discipline and accountability difficult and all too often imply unattractive pay and low motivation. This bring bureaucracy into the TPO operation structure implying that staff often do not have the requisite commercial experience to interact efficiently and credibly with the private sector. A partial mitigation to this problem can be achieved by allowing TPOs the autonomy to set their recruitment and salary standards to attract experts in the field.
6. Sixth, adequate funding is necessary to ensure long-term sustainability of the TPOs. This can be derived from domestic revenues or through external means of donor funding. In case of the latter there are positive spillovers in the form of best practice knowledge which should be temporary and followed by sufficient domestic resources. Revenue generation through charging fees for services rendered act as a rationing mechanism and ensure that the services provided are valued by the recipients. Nonetheless, fee-based services may also lead to under-provision of public goods (externalities) that such services may generate namely improvement of the country's image abroad, overall quality enhancement of industry, strengthening of the foreign exchange reserve position, and so on. The funding problems of some TPOs have come about because of dwindling budget allocations, requirements to transfer fees raised to the treasury, and piecemeal and badly structured donor financing.
7. Finally, the effectiveness and efficiency of TPO activities must be periodically evaluated so that policymakers can learn from experience, refine strategies, and avoid self-perpetuating activities. It should be kept mind, the process of evaluating these services is not an exact science. TPO activities may be felt with some delay and

export activities are affected by many variables, only some of which are under the control of the TPO.

Export Processing Zone (EPZs)

EPZs are enclaves within which governments attempt to provide a policy environment and associated infrastructure that are conducive to investors seeking to produce for export. EPZs are generally used to achieve three goals: promotion of investment and employment in export-oriented production; increased foreign exchange earnings from non-traditional exports; and encouragement of foreign direct investment (FDI) in countries where legal, administrative (red tape, corruption), and infrastructure-related weaknesses impede investment in exportables. An added objective is the transfer of technology and know-how from the EPZs to the rest of the economy. EPZs allow the public and private sectors to cooperate in creating the preconditions for efficient export production in a small geographic region. Effective EPZs combine clear private property rights and investment regulations, no restrictions on foreign exchange, tariff-free imports for export production, and moderate levels of taxation, streamlined administrative procedures, and private sector management. The success of EPZs is highly dependent on a hospitable host country economic environment with sound macroeconomic and exchange rate policies. Experience suggests that investors place importance on economic and political stability along with labor skill compatibility and productivity when deciding to invest. The quality of infrastructure is a major determinant of success of EPZs. Public provision of basic infrastructure outside the zone has positive spillovers while development and management of EPZ should be privately handled. This requires simultaneous removal of bottlenecks in infrastructure, the custom service and labor regulations. The creation of a pro-business environment along with the provision of infrastructure and services, international marketing and investor relations all at the same time requires a reform process with the presence of four critical factors: vision, consensus, concerted action, and continuity.

Trade Finance and Subsidies

Export finance is one of the primary constraints inhibiting exports in many low-income developing countries. Inadequacies may result from the overall weakness of the financial sector mainly in facing difficulties in assessing the creditworthiness of traders. Small firms bear the brunt in obtaining access to trade credit similar to the difficulties they face in accessing other parts of the financial sector. Two public sector mechanism used to promote access to finance (especially for smaller firms) are foreign currency revolving funds and pre-shipment export finance guarantee scheme. The revolving funds provide finance for imported inputs based on the exporter presenting the letter of credit which allows the exporter's bank to access the fund's foreign exchange to pay for the imports. The guarantee schemes cover exporters' manufacturing nonperformance risks and are generally targeted at smaller firms and new entrants into the export area that have difficulty in satisfying bank's collateral requirements. These trade finance mechanisms have been designed to comply with WTO rules to ensure they are not in violation of falling under the category of subsidies which are conditional on export. Government subsidies in support of economic activities include direct

payments or grants, tax concessions, soft loans and government guarantee and equity participation. These may be firm-or industry specific with sector specific support having economy wide objectives.

WTO rules concern specific subsidies as economy-wide subsidies are presumed not to distort the allocation of domestic resources with regards to tradable. The WTO Agreement on Subsidies and Countervailing Measures (SCM Agreement) asserts that subsidies must not be conditional on export performance or the use of domestic inputs, limited to an enterprise, industry, or enterprises within a designated geographical region. Three categories of subsidies have been identified in the agreement: prohibited, actionable, and non-actionable. The former are subsidies contingent on export performance and the use of domestic over imported goods. Actionable subsidies are those that are permitted but may cause adverse effects to the interest of WTO members, give rise to consultation, invocation of dispute settlement procedures or the imposition of countervailing duties by the affected importing country. Lastly, non-actionable subsidies are in place to provide research support, to aid disadvantaged regions, and to facilitate the adaptation of plants to new environmental regulations. These rules attempt to strike a balance between the need to agree on a minimum standard regarding those subsidies which distort trade and the need to ensure that measures used by importing countries to offset the effects of foreign subsidy programs are not abused. It should be noted that, least developed countries (LDCs) and certain other countries with a GNP per capita below US \$1000 are exempted from the prohibition on export subsidies; however, this must be eliminated within eight years upon reaching the US \$1000 threshold.

Special Economic Zones (SEZ)

Bangladesh can implement Special Economic Zones (SEZs) as a way of catalyzing the desired private sector investment to cross over the 7% rate of GDP growth. SEZs have normally the following attributes: (a) geographically delimited area; (b) single management; (c) eligibility of benefits based upon physical location within the zone; and (d) Separate customs area and streamlined procedures. Through SEZs, governments aim to develop and diversify exports while maintaining protective barriers (political economy issue), to create jobs, and to pilot new policies and approaches (for example, in customs, legal, labor, and public- private partnership aspects). The other big advantage is opportunity to streamline regulatory processes and providing efficient one-stop service as well as ensuring compliance with all regulatory requirements like labor, environment, building code, work place safety etc. It is also intended to realize agglomeration benefits from concentrating industries in one geographical area. These benefits include efficiencies in government supervision of enterprises, provision of off-site infrastructure, improved environmental controls. It is the Special Economic Zones (SEZs) that has helped many countries (China, East and South East Asia for example) in overcoming similar business environment and investment climate related constraints. SEZs were established by China to serve as “demonstration areas” for policy reforms and to encourage foreign investment. Bangladesh is deficient in both business environment and infrastructure and SEZs could be a way out over the short to medium term

attracting FDI while sourcing from the domestic supply chain, and boosting exports through integration into Global Supply Chains (GVCs).

For TPOs and other institutions to be effective players in export promotion, there is a critical need to improve the regulatory framework and processes at and behind the border, covering a wide range of efficiency improvements:

- ***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 priority clearance mechanism that is equipped with state of the art hardware and software.
- ***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 IT softwares is absolutely critical to achieve the various forms of export diversification that have been discussed in this report.
- ***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. Also critical is the need to make for a really friendly investment climate that will foster FDI into GVCs linking Bangladesh with transnational companies elsewhere.
- ***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.
- ***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.
- ***Regulatory environment.*** Export success begins with setting up and conducting a business in an atmosphere of certainty. It is not helpful to exports that Bangladesh continues to fall behind its comparators in terms of governance and ease of doing business indicators. Repeated surveys have shown that businesses find the regulatory

environment both oppressive and non-transparent, while administration is riddled with corruption. Export diversification requires moving into new markets with new products and unless this is facilitated with a friendly regulatory environment and ease with which to start and run a business, that objective might remain a distant dream.

- **Research and development.** Bangladesh ranks poorly amongst its comparators when it comes to spending on R&D in the manufacturing sector – with a miniscule share of GDP going into R&D. This is one area where public-private collaboration is essential in building institutions that can encourage market oriented research to create new marketable products or improve existing products in order to move up the value chain, both of which will advance export diversification.

XI. STRATEGY AND POLICY FOR EXPORT DIVERSIFICATION

Overall, for policy makers seeking good practice and guidance for diversification of their exports, the policy package should be multifaceted and comprehensive (covering constraints at the borders, behind the borders (supply side), and beyond the borders (market access issues). Hence, a multi-faceted approach is essential for a successful export development strategy.

- **Addressing constraints at the borders** implies a focus on tariff and non-tariff barriers to imports and exports, as well as better customs facilitation; against a background of appropriate macroeconomic framework (including low inflation, realistic exchange rate, low fiscal and external deficits), anti-export bias policies, and measures to mitigate adverse social consequences of reforms needed to align domestic to international prices.
- **Addressing constraints behind the borders** implies addressing supply side constraints (Infrastructure, trade-related Institutions, policy constraints, including adequate business regulatory framework, and investment policy regime), competitiveness constraints (standards, packaging, quality, and delivery in time), and needed support incentives (fiscal incentives and credit incentives) for export diversification, **including emphasis on R&D for developing improved products or moving up the value chain.**
- **Addressing constraints beyond the borders** implies addressing market access barriers to export growth. By and large, expanding exports to respond to increased regional and global market demands requires increased production (supply) of goods and services in many sectors (agriculture, industry, services). This in turn, requires not only adequate infrastructure (telephone, services, electricity, water), but also adequate trade related institutions, good policies, and the ability to deliver quality products in needed quantity and in a timely manner.

A country's export performance and its diversification are closely related to the kind of trade policy that governs domestic production and international trade. Evidence is strong that a

highly restrictive trade regime cannot produce a superior export performance whose prerequisite is a high degree of trade openness. Bangladesh trade policy which was earlier characterized by inward-looking import-substituting industrialization changed course in the 1990s towards outward-looking export-oriented development by launching a program of trade liberalization and greater trade openness. The fruits of that change in policy are quite evident in the superior export performance since then. It has become a national imperative to maintain those positive trends under the Seventh Five Year Plan 2016-2020.

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