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Trade and Industry strategy in the 21st Century for sustained rapid growth and job creation

**A Background Study for the Bangladesh Perspective Plan (2021-2041)**



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Table of Contents

[*List of Tables i*](#_Toc496536507)

[*List of Figures ii*](#_Toc496536508)

[*List of Boxes ii*](#_Toc496536509)

[*Abbreviations iii*](#_Toc496536510)

[*Executive Summary iv*](#_Toc496536511)

[Trade and Industry strategy in the 21st Century for sustained rapid growth and job creation 1](#_Toc496536512)

[A. INDUSTRY AND TRADE IN THE 21ST CENTURY 1](#_Toc496536513)

[B. THE FOURTH INDUSTRIAL REVOLUTION AND BEYOND 2](#_Toc496536514)

[C. TRADING IN A NEW WAVE OF GLOBALIZATION 7](#_Toc496536515)

[D. CHALLENGES AND OPPORTUNITIES IN A COMPETITIVE WORLD 12](#_Toc496536516)

[E. LESSONS FROM EXPERIENCE OF HIGH PERFORMING ECONOMIES 14](#_Toc496536517)

[F. BANGLADESH EXPORT PERFORMANCE AND THE TRADE REGIME 21](#_Toc496536518)

[G. EXPORT COMPETITIVENESS AND TRADE POLICIES OF THE FUTURE 36](#_Toc496536519)

[H. COURTING FDI IN EXPORT-ORIENTED MANUFACTURING 47](#_Toc496536520)

[I. STRENGTHENING INSTITUTIONS FOR TRADE AND INDUSTRY 54](#_Toc496536521)

[J. CONCLUSIONS AND THE ROAD TO TRANSFORMATION TO HIC 57](#_Toc496536522)

[REFERENCES 60](#_Toc496536523)

[ANNEX-A 64](#_Toc496536524)

# List of Tables

[Table 1: Effective Exchange Rates for Exports Imports in Korea, 1962-75 16](#_Toc496536525)

[Table 2: Nominal and Effective Protection for Manufacturing 17](#_Toc496536526)

[Table 3: Structure of Imports and Exports FY2016 23](#_Toc496536527)

[Table 4: Bangladesh: 2016 Trade Openness in Asia 24](#_Toc496536528)

[Table 5. The Enabling Trade Index 2016; Bangladesh 27](#_Toc496536529)

[Table 6: Comparison of Infrastructure Quality, 2016-2017 28](#_Toc496536530)

[Table 7: Ease of Doing Business (2016) 29](#_Toc496536531)

[Table 8: Snapshot of Bangladesh Trade Regime FY2017 34](#_Toc496536532)

[Table 9: Evolution of Tariffs and Protection 39](#_Toc496536533)

[Table 10: Exports of Goods and Services expressed as share (%) of GDP 44](#_Toc496536534)

# List of Figures

[Figure 1: Projected economic structure and employment share (%) 3](#_Toc496536535)

[Figure 2: Charting the Course of Industrial Revolutions 3](#_Toc496536536)

[Figure 3: Export performance since 1990 23](#_Toc496536537)

[Figure 4: Rising share of trade in GDP 24](#_Toc496536538)

[Figure 5: Growth of RMG exports exceeds that of Non-RMG exports 25](#_Toc496536539)

[Figure 6: Relative Export Concentration 2015 25](#_Toc496536540)

[Figure 7: Large number of Export Products 26](#_Toc496536541)

[Figure 8: Exchange Rate Movements FY03-FY17 31](#_Toc496536542)

[Figure 9: CD and Para Tariff Trends 40](#_Toc496536543)

[Figure 10: Trends in Output and Input Tariffs: Bangladesh 42](#_Toc496536544)

[Figure 11: Trends in Output and Input Tariffs: High-performing economies 43](#_Toc496536545)

[Figure 12: Trends in Output and Input Tariffs: Vietnam and India 43](#_Toc496536546)

[Figure 13: Futuristic Tariff Profile (FY17-41) 45](#_Toc496536547)

[Figure 14: Global FDI Flows 2005-2016, Billion US$ 51](#_Toc496536548)

[Figure 15: Regional Distribution of FDIs 2016, US$ Billions 51](#_Toc496536549)

[Figure 16: FDI Inflows in East and South Asia 2016, US$ Billion 52](#_Toc496536550)

[Figure 17: Trend of FDIs in Bangladesh 1996-2016 52](#_Toc496536551)

[Figure 18: Sectoral Distribution of FDIs in Bangladesh 53](#_Toc496536552)

# List of Boxes

[Box 1: Robots Replacing Humans in Garments Manufacturing! 5](file:///E:\Projects\Zaidi%20Sattar\21st%20century%20Trade%20and%20Industry%20strategy%2020Sep17_final.docx#_Toc496536553)

[Box 2: Applications of 3D Printing in Industrial Production 6](file:///E:\Projects\Zaidi%20Sattar\21st%20century%20Trade%20and%20Industry%20strategy%2020Sep17_final.docx#_Toc496536554)

# Abbreviations

AdVAT Advance Value Added Tax

AI Artificial Intelligence

AIT Advance Income Tax

ASEAN Association of Southeast Asian Nations

ASYCUDA Automated System for Custom Data

BBS Bangladesh Bureau of Statistics

BGMEA Bangladesh Garments Manufactures and Exporters Association

BKMEA Bangladesh Knitwear Manufactures and Exporters Association

CD Customs Duty

DMCC Dubai Multi-Commodities Centre

DRAM Dynamic Random Access Memory

DWT Deadweight Tonnage

EBA Everything but Arms

ECR Export Concentration Ratio

EERM Effective Exchange Rate for Imports

EERX Effective Exchange Rate for Exports

EPB Export Promotion Bureau

EPZ Export Promotion Zone

ERP Effective Rate of Protection

ETI Enabling Trade Index

EU European Union

FCG Final Consumer Goods

FDI Foreign Direct Investment

FTA Free Trade Agreement

FY Fiscal Year

GDP Gross Domestic Product

GED General Economic Division

GNI Gross National Income

GNP Gross National Product

GSP Generalized System of Preferences

GVC Global Value Chains

HCI Heavy and Chemical Industries

HIC High Income Country

HS Harmonized Commodity Description and Coding System

ICT Information and Communications Technology

ISAC Industrial Sector Adjustment Credit

LC Line of Credit

LDC Least Developed Country

LMIC Lower Middle Income Country

LPI Logistics Performance Index

MFA Multi-Fiber Arrangement

MFN Most Favored Nation

MGI McKinsey Global Institute

MSC Multimedia Super Corridor

NBR National Board of Revenue

NEM New Economic Model

NRP Nominal Rate Protection

OECD Organization of Economic Cooperation and Development

PRI Policy Research Institute

PTA Preferential Trade Area

QR Quantitative Restrictions

RCEP Regional Comprehensive Economic Partnership

RD Regulatory Duty

REER Real Effective Exchange Rate

RMG Ready Made Garment

RTA Regional Trade Agreements

SAFTA South Asian Free Trade Area

SBW Special Bonded Warehouse

SD Supplementary Duty

SEZ Special Economic Zones

SME Small and Medium Enterprises

TNC Trans-National Corporation

TPP Trans Pacific Partnership

TTIP Trans-Atlantic Trade and Investment Partnership

TTRI Trade Restrictiveness Index

UD Utilization Declarations

UMIC Upper Middle Income Country

UNCTAD United Nations Conference on Trade and Development

VAT Value Added Tax

WDI World Development Indicators

WITS World Integrated Trade Solution

WTO World Trade Organization

# Executive Summary

The global business community now recognizes Bangladesh as a nation of dynamic first generation industrial entrepreneurs who can compete with established players in the world market – export performance of readymade garments (RMG) is the classic example. Bangladesh has become a global powerhouse in low-cost manufacturing. But profound changes are taking place in the global economy. A fast-paced technological revolution, the digital age, is under way which will eventually change the way we live, work, and interact with the global community. The future of manufacturing is also digital. These changes are unlike anything humankind has experienced before. Properly harnessing these global forces will enable Bangladesh to grow at higher rates in future that were simply not possible before. And Bangladesh industry must conform to stay competitive.

**Structural Change.** A rapid pace of industrialization centered on export-oriented manufacturing has been responsible for growth acceleration of the Bangladesh economy thus far. The country has gone through structural change since its independence, following the canonical shifts of output and labor, from agriculture to industry, a structural transformation attributable to changing demand patterns: owing to higher income elasticities for manufactures, the share of expenditures in agricultural goods tends to decline. Consequently, industry share in GDP outstrips those of agriculture as national incomes rise. Looking into the future, there is little doubt that industry will remain the key driver of growth at least until Bangladesh becomes an Upper Middle-Income Country (UMIC) by 2030. Thereafter, (or even earlier), the economy will be driven by a combination of futuristic digital and industrial revolution in which, according to expert analyses, services will be making heavy inroads.

**Industry 4.0.** The Fourth Industrial Revolution is upon us -- a phenomenon defined by trends such as the Internet of Things (IoT), robotics, 3D printing, and artificial intelligence (AI), which are changing the way we live and work. The Internet of Things (IoT), with intelligent manufacturing is increasingly becoming the norm in advanced industrial economies. According to global industry experts, the future of manufacturing will be characterized by that of **smart manufacturing**—the application of information and communication technologies (ICTs) to every facet of modern manufacturing processes. The digitalization of manufacturing will transform the manufacturing process as much as it will transform the operations, energy footprint of factories, and the management of manufacturing supply chains. There are concerns however; that it might potentially reduce the relative advantage of low labor-cost exporters like Bangladesh. Therefore, public policy will play a pivotal role in ensuring and sustaining Bangladesh’s global competitive advantage in the future.

**Shifting patterns of Globalization.** In the past 25 years, falling costs of transportation and communication and removal of barriers to trade have been the driving force behind globalization - the closer integration of economies into the global marketplace. According to research by various organizations (World Bank, 2002; Mckinsey Global Institute, 2017), globalization has played a pivotal role in fostering economic growth and poverty reduction. Bangladesh has been among the strongest beneficiaries of this development. Several important features of the current and future trends of globalization have been identified. Global analysts agree that the next 25 years will experience a new wave of accelerated globalization driven by cross-border flow of technology, capital, and knowledge, within a global infrastructure characterized by the greatest trade openness to trade and investment. Also notable is the rising importance of global value chains, where services are actually embodied in manufactured goods.

Over the next 25 years the stage is set for developing and emerging economies like Bangladesh to move center stage in the global economy. Tremendous opportunities will be created along with income inequality, tensions in labor markets, environmental challenges. In charting a long-term perspective of Bangladesh’s transformation to a high-income country, at least three important features of the current and next wave of globalization should be kept in view: (a) boundless growth of trade, (b) greater integration of capital and financial markets, and (c) rapid pace of technological innovation and diffusion. With the help of appropriate policies Bangladesh must ensure that growth is inclusive by addressing the challenges arising from income inequality and potential labor market disruptions.

**Challenges in a Competitive World.** In the unfolding industrial universe of the future, Bangladeshi firms will face the stark reality that competitive advantage founded on low labor cost cannot be guaranteed for all time. Competitive advantage is dynamic and will be evolving. From its current phase of factor-driven competitive advantage Bangladeshi firms will have to move into investment and innovation driven competitive advantage (*a la Porter*). Without such efforts, entrepreneurs need be warned that the current competitive advantage in labor-intensive garment exports could well be lost in future. The state will have to play a significant but facilitating role in ensuring that the competitive advantage of our private firms is sustained over the long-term.

**Lessons from High Performing Economies.** Korea, Taiwan, Malaysia, Thailand, all of these high performing economies that eventually crossed the high-income threshold acquired the following characteristics: macroeconomic stability, high shares of trade in GDP, heavy investment in people (skills development), and strong competition among firms. Bangladesh already has some of these characteristics, and will have to focus on acquiring the rest, especially on investment in people and skill development. All these countries sought to exploit the international market and adopted export-push strategies by the 1980s, or earlier, with active promotion of manufactured exports. This proved to be the most successful combination of fundamentals and policy interventions and hold the most promise for other developing economies. Two strategic policy prescriptions for Bangladesh that emerge from their experience of dynamic export-oriented growth may be divided into fundamentals, or selective interventions. Fundamentals are macroeconomic stability, high investments in human capital, stable and secure financial systems, limited price distortions, and open to foreign technology. Selective interventions include mild financial repression (keeping interest rates low but positive), directed credit, selective industrial promotion, and trade policies that push non-traditional exports.

**Trade openness and Export Competitiveness.** There is strong international evidence that export performance, and its offshoot, progress in export diversification, is in large part the outcome of the trade policy regime governing export production and trade. Though there was wide variation in the extent of incentives, most of the high performing East Asian countries engaged in some form of selective promotion subsidies, preferential financing, tax incentives, subsidized infrastructure, and foreign investment incentives. Because all of them, at some point or the other, had on-going import-substituting policies to support domestic industrialization, export incentives were necessary to effectively offset the anti-export bias of effective protection provided to import-substituting industries. 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 there is still some way to go as Bangladesh’s export basket is not very diversified. One of the features of a competitive dynamic economy is to ensure that domestic prices of tradable are close to international prices which would require protection levels to be modest. Bangladesh has high levels of effective protection to import substitutes which keep domestic prices significantly above international prices with considerably higher profitability of domestic sales compared to exports. A swift rationalization of the protection structure has become an imperative for export diversification.

**Exploiting Global Value Chains.** The fragmentation of production processes across different countries has given rise to global value chains (GVCs) creating opportunities for intra-industry trade globally, especially giving a boost to trade in intermediate goods. But the technical ‘know-how’ needed for the production of an intermediate good in the GVC must be obtained since Bangladeshi entrepreneurs are not exposed to such expertise. That justifies the critical need for foreign direct investment, and policy makers must mitigate any constraints that undermine the prospects of FDI. Not only in the production of intermediate goods, courting FDI will be essential for future technology leapfrogging to capture production and market access in manufacturing products of the coming decades. A clear strategy will have to be laid out for mobilizing foreign direct investment (FDI) through private investments and public–private partnerships. Drawing lessons from the FDI experience of comparators will be critical for this approach as Bangladesh is significantly lagging behind at present.

**Strengthening institutions.** Historical research finds conclusive evidence that inclusiveness of political and economic institutions is critical for sustained prosperity. Bangladesh is on way to building the kind of institutions that yield prosperity for the long-term. The next decade will be crucial for strengthening economic institutions that will help entrepreneurs seize market opportunities emerging in a fast-changing global economy driven by innovation and Schumpeterian forces of creative destruction in the global marketplace.

**Trade and Industry strategy in the 21st Century for sustained rapid growth and job creation**

# INDUSTRY AND TRADE IN THE 21ST CENTURY

We are living ina world that is transforming at speeds almost incomprehensible to the average mind. Unlike historical growth rates experienced in the past centuries, it is now possible for developing economies like Bangladesh to grow at 7, 8, 9, or 10 percent annually. This is because of the enabling effect of a rapidly integrating global economy. The global economy provides two things. One is a huge market which is getting more integrated over time. Provided an economy has some competitive edge – and Bangladesh does -- it can basically grow as fast as it can invest and build productive capacity. The second thing— even more important—is that the global economy provides knowledge, technology, know-how. Globalization coupled with instantaneous transmission of digitized information results in acceleration and augmentation of the flow of knowledge, technology, and learning. According to Karl Schwab, the founder and head of World Economic Forum, the digital age will bring change “unlike anything humankind has experienced before.” Properly harnessing these global forces will enable Bangladesh to grow at higher rates in future that were simply not possible before.

The transition from agriculture to manufacturing is still the path to higher productivity and rising living standards for Bangladesh – a structural transformation that is bound to continue and intensify over the next decades. In the future, this transition will come with intense pressures for innovation and securing industrial competitiveness, as manufacturing goods make up 70% of global trade. There is clear consensus that Bangladesh’s future growth and prosperity lies in outward-looking industrialization to create good jobs and income by exploiting our competitive advantage. That will require Bangladesh industrial and trade policies to evolve in tandem with global trends, and developments in industry and trade of the future. In particular, our policymakers will have to recognize that our competitive advantage today based on low-skilled and low cost labor could be threatened by evolving technology and innovation in the 21st century.

Seizing on this global trend and banking on the current state of Bangladesh’s development, the Perspective Plan 2021-41 provides a road map for transforming Bangladesh from a Lower Middle-Income Country (LMIC) to Upper Middle-Income Country (UMIC) by 2030 and then becoming a High-Income Country (HIC) in the 2040s. It is a Plan for one of the speediest transformation of a developing economy in history. The challenge is daunting but the potential exists if the nation could embark on a dynamic path of sound political and economic governance for effectively harnessing its human energies and natural resources.

This chapter lays out the vision for the next 25 years of trade and industrial development in Bangladesh in the context of evolution of global trade and industry over the same period. The fact is that trade and industry across the globe will undergo significant transformation by the 2040s, some of which are modestly predictable while others can only be surmised. Drawing from Bangladesh’s own experience and from ideas articulated by global experts about the shape of things to come, this chapter will first describe a vision of industrial evolution and transformation over the course of the first half of the 21st century, followed by a similar assessment of the evolving global trade scenario.

For much of the next quarter century, the bulk of job creation in Bangladesh will be taking place in a diversified manufacturing sector that is globally competitive, export-oriented, and focused on breaking into emerging markets while expanding its market share in developed economies of the world. Recognizing that Bangladesh’s future industrial prospects will be intricately linked to the projected trends in (a) global and regional trade, (b) the future of globalization, and (c) the evolution of trade policies determined by the transformation of manufacturing and services of the future, this chapter develops an integrated strategy for future growth and job creation for Bangladesh building on the interplay of these three interlinked and strategic forces that can fuel economic growth and propel Bangladesh across the high income threshold in the 2040s.

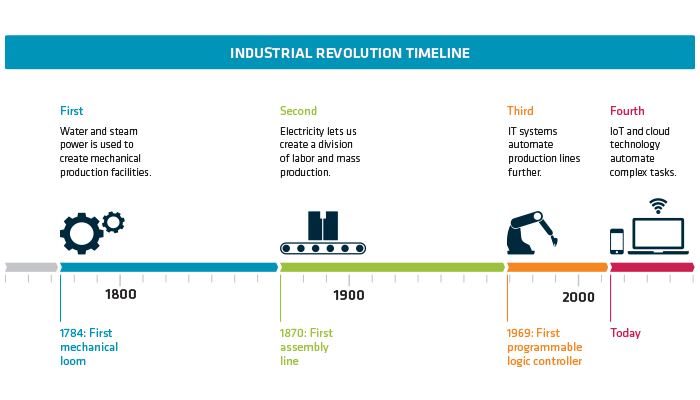
# THE FOURTH INDUSTRIAL REVOLUTION AND BEYOND

Growth acceleration of the Bangladesh economy thus far has been driven by rapid pace of industrialization, primarily based on export-oriented manufacturing. As manufacturing grew faster than agriculture, structural change that has been taking place since independence basically shows industrial GDP replacing agriculture with the result that industry in FY2016 made up 31.5% with manufacturing at 20% of GDP. Looking into the future, it is a foregone conclusion that industry will remain the key driver of growth at least until Bangladesh becomes an Upper Middle-Income Country (UMIC) by 2030. Thereafter, (or even earlier), the economy will be driven by a combination of futuristic digital and industrial revolution, in which services will be transformed into a modern digitized sector (from its current informal state) some of it can only be surmised at the present time. By 2041, like other developed economies, services will become the predominant sector in the economy in terms of output and employment. Projections made by General Economics Division of the Planning Commission with respect to sectoral contribution to GDP and employment for the period 2020-2041 are shown in (Figure.1).

|  |  |
| --- | --- |
| Figure 1: Projected economic structure and employment share (%) | |
|  |  |
| ***Source: GED projections*** | |

The world economy is now in the grip of the Fourth Industrial Revolution. In order to strategize on the approach to trade and industrial growth over the next 25 years, it would be necessary to get a good understanding of what the on-going Fourth Industrial Revolution (Figure.2) is, what it means for Bangladesh, and the kind of opportunities and challenges it presents for Bangladesh’s race to become a UMIC and HIC. The first and second industrial revolution of the 19th and 20th centuries are long over. The Third Industrial Revolution brought computers and the internet. The Fourth is expected to be much broader as machines are becoming smart and connected, contributing to dynamic fusion of technologies in the digital age. The prospect of another industrial revolution – the Fifth -- in the course of the next 25 years cannot be ruled out and must be taken into account in formulating national policies that are flexible and compatible with the changing landscape of trade and industry in the 21st century.

##### **Figure 2: Charting the Course of Industrial Revolutions**



***Source: Extracted from Mjolner Infomatics, Realizing the Fourth Industrial Revolution.***

What will a Perspective Plan be looking for in carving out a strategy for sustainable industrialization consistent with global developments of the next 25 years?

According to an OECD report (OECD, 2016), the Fourth Industrial Revolution (FIR) entails a confluence of technologies ranging from a variety of **digital technologies** (e.g. 3D printing, Internet of Things, advanced robotics) to **new materials** (e.g. bio- or nano-based) to **new processes** (e.g. data driven production, artificial intelligence, synthetic biology). These technologies will be available in the near future (10-15 years, according to OECD, 2016). As these technologies have an impact on the production and the distribution of goods and services, they will have far-reaching consequences for productivity, skills, income distribution, well-being and the environment.

According to global industry experts the future of manufacturing will be defined by **smart manufacturing**—the application of information and communication technologies (ICTs) to every facet of modern manufacturing processes— that is already transforming the global manufacturing economy. According to these experts, the Internet of Things (IoT) has arrived, named **Industry 4.0**, with intelligent manufacturing increasingly becoming the norm in advanced industrial economies. The digitalization of manufacturing will transform how products are designed, fabricated, used, operated, and serviced post-sale, as much as it will transform the operations, processes, and energy footprint of factories and the management of manufacturing supply chains. What is disconcerting is that it will also change the global landscape of manufacturing competition, potentially reducing the relative advantage of low labor-cost exporters like Bangladesh. The countries—and enterprises and industries therein—that lead in embracing smart-manufacturing techniques will gain first-mover advantage over global competitors. Therefore, public policy will play a pivotal role in setting the competitive landscape affecting smart manufacturing leadership, impacting everything from how quickly countries’ enterprises will be able to research, develop, adopt, and diffuse these technologies to how ready their workforces and supply chains will be to leverage them. Bangladesh policymakers cannot ignore these developments.

A sample of the key technological transformations in industry includes:

* **The Internet of Things (IoT)**. This will bring radical change. The term ‘Internet of Things’ (IoT) refers to the connection of devices and objects to the Internet. Thanks to new sensors and actuators, and in combination with big data analysis and cloud computing, the IoT enables autonomous machines and intelligent systems. The IoT can bring improved process efficiencies, customer service, speed of decision-making, consistency of delivery and transparency/predictability of costs (Vodafone, 2015). Beyond production, health services and vehicle efficiency are expected to undergo radical improvements through IoT, bringing major economic and social benefits.
  + - **Robots**, which are set to become more intelligent, autonomous and agile. By being faster, stronger, more precise and consistent than workers, robots have vastly raised productivity on assembly lines in the automotive industry. They are likely to do so again in an expanding range of sectors and processes. Companies like Ford, GM, GE, and Wal-Mart, are taking advantage of automation with robotics to deliver better products at lower prices, bringing jobs back from low labor-cost countries to USA, which has a higher quotient of skilled labor to work in collaboration with robots. BCG Research (2015) predicts that by 2025, adoption of advanced Robots will boost productivity by up to 30 percent in many industries and lower total labor costs by 18 percent or more in countries such as South Korea, China, the U.S., Japan, and Germany.

###### Box 1: Robots Replacing Humans in Garments Manufacturing!

The transformative impact of the Fourth Industrial Revolution is all around. Society is already being redesigned by new technologies that combine the physical, digital and biological worlds. Disruptive technologies such as robotics and artificial intelligence (AI) are already altering workplaces. Bangladeshi companies have started using robotic machines in their factories, replacing hundreds of repetitive tasks and compelling workers to skill up. Emerging technologies will continue to serve consumers with better precision and efficiency. Such disruption calls for a reboot in thinking vis-à-vis future of manufacturing and employment.

Sewbot, robot that can sew together a complete item of clothing, could replace labor in the manufacture of low-cost garments. Sewbot–SoftWear Automation’s clothes-making robot–was developed at Georgia Tech’s Advanced Technology Development Center. In 2012, there was push to develop the concept and form a company to commercialize the technology. By 2015, the company was selling a more basic version of the robot that could make bath mats and towels. The newest version can make T-shirts and partially sew jeans. Other, yet similar, technologies to further develop Sewbot-type machines are in the pipeline across different research centers.

When the Chinese clothing manufacturer Tianyuan Garments Company opens its newest factory, it will be in Arkansas, not China, and instead of workers hunched over sewing machines, the factory will be filled with fully autonomous robots and their human supervisors. Once the system is fully operational, each of the 21 production lines in the factory will be capable of making 1.2 million T-shirts a year, at a total cost of production that can compete in terms of cost with apparel companies that manufacture and ship clothing from the lowest-wage countries in the developing world, such as Bangladesh. The factory will be one of the first to use a technology that could herald immense changes in how the apparel industry works.

Sewing robots will lead to a transition from garment-worker intensive apparel sector to automation of clothes-making. The transition may be messy but as the robots become cheaper and more sophisticated it will most likely replace clothes-making jobs in high volumes. This revolutionary change will threaten jobs in developing countries. In Bangladesh, where there are cheap garment workers, the majority of the country’s exports are clothing. If companies like H&M and Walmart choose to relocate production of some apparel to North America and Europe, workers in Bangladesh and other low-wage countries will most likely lose jobs – an alarming prospect indeed.

***Source:*** *Adapted from Sewbot website (2016), Softwear Automation website (2017), World Economic Forum (2017), Mjølner Informatics (2017), and articles from The Telegraph, Fast Company and Dhaka Tribune.*

* + - **Nanotechnology,** through which new properties are being imparted to materials, making them stronger, lighter, more electrically conductive, more sieve-like, and so on.
    - **3D printing** includes a group of technologies and processes that use a digital file to build a physical three-dimensional object using additive manufacturing. 3D printing makes it as cheap to create single items as it is to produce thousands and thus undermines [economies of scale](https://en.wikipedia.org/wiki/Economies_of_scale) (Wikipedia). 3D printing already permits printing of complex objects (such as an electric battery) that embody multiple structures made from different materials. 3D printing could augment manufacturing productivity, although today the technology is most economical for small quantities of complex customized products. According to The Economist (February 10, 2011 leader) it may have as profound an impact on the world as the coming of the [steam engine in 1750](https://en.wikipedia.org/wiki/History_of_the_steam_engine)—or the [printing press in 1450](https://en.wikipedia.org/wiki/Global_spread_of_the_printing_press), or the [transistor in 1950](https://en.wikipedia.org/wiki/History_of_the_transistor). It is impossible to foresee the long-term impact of 3D printing. But the technology is coming, and it is likely to disrupt every field it touches.
    - **Cloud computing** has been credited with increasing competitiveness through cost reduction, greater flexibility, elasticity and optimal resource utilization. It is raising manufacturing productivity through interlinked supply chain, distribution and services. Cloud computing is accelerating new product development and introduction (NPDI) strategies to attain time-to-market objectives, and enabling, marketing and customer service automation applications.

###### Box 2: Applications of 3D Printing in Industrial Production

**Apparel and footwear.** 3D printing has entered the world of clothing with fashion designers experimenting with 3D-printed bikinis, shoes, and dresses. In commercial production Nike is using 3D printing to prototype and manufacture the 2012 Vapor Laser Talon football shoe for players of American football, and New Balance is 3D manufacturing custom-fit shoes for athletes.

**High fashion.** In the world of high fashion courtiers such as [Karl Lagerfeld](https://en.wikipedia.org/wiki/Karl_Lagerfeld) designing for [Chanel](https://en.wikipedia.org/wiki/Chanel), [Iris van Herpen](https://en.wikipedia.org/wiki/Iris_van_Herpen) and [Noa Raviv](https://en.wikipedia.org/wiki/Noa_Raviv) working with technology from [Stratasys](https://en.wikipedia.org/wiki/Stratasys), have employed and featured 3d printing in their collections.

**Eyewear.** 3D printing has come to the point where companies are printing consumer grade eyewear with on-demand custom fit and styling (although they cannot print the lenses). On-demand customization of glasses is possible with rapid prototyping.

**Industrial Art and Jewelry.** 3D printing is used to manufacture mouldes for making jewelry, and even the jewelry itself. 3D printing is becoming popular in the customizable gifts industry, with products such as personalized models of art and dolls, in many shapes: in metal or plastic, or as consumable art, such as 3D printed chocolate.

**Automotive industry**. In early 2014, Swedish [supercar](https://en.wikipedia.org/wiki/Supercar) manufacturer [Koenigsegg](https://en.wikipedia.org/wiki/Koenigsegg) announced the One: 1, a supercar that utilizes many components that were 3D printed. In the limited run of vehicles Koenigsegg produces, the One: 1 has side-mirror internals, air ducts, titanium exhaust components, and complete turbocharger assemblies that were 3D printed as part of the manufacturing process.

The effect of technological change in industry and other economic activities on employment and earnings inequality has recently drawn increased attention from academics and policymakers. Given current state of technology in Bangladesh manufacturing, the major impact of these technological transformation is likely to be felt in the 2030s decade, with creeping technological evolution in the 2020s. Industrial policies of today will have to take note of these impending developments though one may hope optimistically that Bangladesh’s labor cost advantage will remain unaffected for at least another decade.

Contrary to popular belief, research on firms and industries (Miller and Atkinson, 2013) shows that the employment effects of technological change are generally positive as productivity-enhancing technology causes job losses in some cases and job gains in others. But the number of firms and industries which experience employment growth exceeds the number in which employment contracts. Bangladesh industry is gradually embracing the latest technologies though cost imperatives make labor-intensive production still attractive. It will take several more years for technological change to catch up though leapfrogging innovations that are technology intensive will also happen in the near future, as recent reports from the RMG sector seem to suggest (Islam, R. 2017). These changes (described as automation) have to be closely watched due to the risk of machine-driven labour displacement, which might undermine labour-cost advantages on which Bangladesh has been relying so heavily. Strategies for industrial development that take a longer perspective must factor in these impending transformations in industry in order to be relevant over the long-term.

# TRADING IN A NEW WAVE OF GLOBALIZATION

According to the World Bank (2002), it was globalization that helped poor countries break into the global market for manufactures and services – a successful integration that generally supported poverty reduction in countries like Bangladesh and Vietnam. Pascal Lamy, the former chief of WTO, affirmed that the best thing to come out of globalization was poverty reduction, and the worst thing was inequality (Global Agenda Outlook 2013, WEF). Since global economic integration has supported poverty reduction it should not be reversed.

No doubt, globalization has been a powerful force for economic growth. Research from the McKinsey Global Institute (MGI, 2017) finds that [the movement of goods, services, finance, data, and people across borders adds to GDP and fuels productivity growth](http://www.mckinsey.com/business-functions/digital-mckinsey/our-insights/digital-globalization-the-new-era-of-global-flows). But while globalization accelerates growth, it also amplifies inequality and disruption giving rise to political backlash and spawning protectionism as seen in major markets today. Policy makers are now being challenged to preserve the benefits of globalization while addressing its negative externalities. Because of the growing critique of trade openness in developed countries in recent times, Martin Wolf (CUTS 2014) of the Financial Times described the global trade regime as a “troubled triumph”. But the onward march of globalization demonstrates that it is indeed a triumph that is here to last for many decades – something Bangladesh economy has to accept as given.

The state of globalization and contemporary global trends in the world economy has been aptly described by Arvind Subramaniam and Martin Kessler of the Peterson Institute for International Economics, in Washington DC, who identified several important features (Subramaniam and Kessler, 2013) that will have to be taken on board in formulating any long-term national perspective plan with a futuristic outlook:

1. Hyper-globalization and Universalization: widespread embrace of globalization and greatest openness to trade and investment in world economic history.
2. Mega-traders: rise of China, India, and other emerging market economies.
3. De-materialization of trade: rising importance of services in global trade
4. Proliferation of regional and preferential trade agreements and the current discussion of megaregional ones.

*Future of globalization.* The world has been globalizing for centuries. But the past 25 years has experienced a rapid pace of globalization, at speeds not attained in the past – described as hyper-globalization. There is near consensus among global analysts that the next 25 years will experience a new wave of accelerated globalization driven by cross-border flow of technology, capital, and knowledge, within a global infrastructure characterized by the greatest trade openness to trade and investment.

*Rise of China and India.* The World Bank (Global Economic Prospects, 2007) projects that high-income countries will see their GDP doubled in the next 25 years while GDP in developing countries will more than triple, driven mainly by the impact on the global economy from expansions in China and India. Along the way, there will be many anticipated and unanticipated shocks to the global economic system which global leaders will have to cope with through better and more coordinated global economic governance. China is likely to remain the export powerhouse and mega-trader to contend with. Bangladesh policymakers will have to be conscious of these international developments as the economy will be far more integrated with the global economy than it is today.

*Future of Trade –rise of services.* One notable development is what Subramaniam and Kessler (2013) calls the “dematerialization” of global trade, that is, the rise of trade in services. Only recently have we begun to realize more fully the importance of services to the world economy. The contribution of services to production and trade has been steadily growing. New statistical work by the OECD and WTO shows that when we measure services in terms of their real contribution to trade – that is in terms of value-added rather than gross flows – the share of services in global trade was almost half in 2009, as opposed to less than one-quarter using the old measure. This is due to the rising importance of global value chains where services are actually embodied in manufactured goods showing that trade in services is larger and growing faster in value-added terms than traditional statistics show.

Bangladesh is behind in developing cross-border value chains and trading in intermediate goods. GVCs can be an important avenue for Bangladesh to build productive capacity where local firms could capture a significant share of the trade in value added. But East Asian economies have powered ahead seizing early opportunities, particularly in their trade with China, the leading global assembler. There is still scope for gaining a foothold in regional value chains provided we make significant investment in technology dissemination, skill building and upgrading, and making deep trade facilitation reforms. A structured approach would include embedding GVCs in our industrial development policies, in particular creating an environment conducive to trade and investment and building productive capacities in local firms and skills in the local workforce so that the economy can attract FDI from regional and global sources.

Global analysts foresee a world in which service-led industries are dominant and where businesses with explicit sustainability goals will succeed. This is one area that needs immediate policy attention if Bangladesh is to seize opportunities as barriers to trade in services crumble in future. Another key focus of future export competitiveness of Bangladesh will have to be the development of world class service industries.

*Proliferation of RTAs/PTAs.* In the past 25 years it appears that the era of hyper-globalization has also been accompanied by a proliferation of RTAs/PTAs. Since 1990, the number of PTAs has risen to over 300, and roughly half the exports of the top 30 exporters go to RTA partners. While two mega-PTAs – Trans Pacific Partnership (TPP) and Trans Atlantic Trade and Investment Partnership (TTIP) – have apparently lost momentum for the time being, the mega-regional in Bangladesh’s backyard is the ASEAN+ which is moving up to become an economic community of East Asian countries (Regional Comprehensive Economic Partnership) with the original 10 economies (Indonesia, Malaysia, Singapore, Thailand, The Philippines, Brunei, Cambodia, Vietnam, Laos, Myanmar) joined by another five Pacific economies (China, Japan, Australia, New Zealand, S. Korea) and India. Bangladesh is behind in its regional initiatives being a member of only one FTA, SAFTA, and needs to heighten its proactivity to tie up with other regional groups to access growing markets in proximity of South Asia.

*Future of global trade and Bangladesh.* In the world today, $40 trillion worth of goods – roughly two-thirds of global GDP -- are traded every year across borders along ever shifting import and export routes. 70% of this trade is in manufactured goods whose dominance in trade is likely to continue for long. In the past 25 years, falling costs of transportation and communication and removal of barriers to trade have been the driving force behind the closer integration of developing economies into the global marketplace. Bangladesh has been among the strongest beneficiaries of this development. Over the next 25 years the stage is set for developing and emerging economies like Bangladesh to move center stage in the global economy. Tremendous opportunities will be created along with acute stresses arising from income inequality, tensions in labor markets, environmental challenges. With rapid technological progress touching every aspect of society, global trade in goods and services will accelerate, with greater integration of financial markets, creating opportunities for faster long-term growth.

What is evolving over time is that, thanks to technological breakthroughs, industrial good that were the exclusive preserve of developed countries (e.g. car parts, semiconductors, consumer electronics) is now manufactured and exported by developing countries. These developments create enormous opportunities for Bangladesh to seize, creating jobs and income at home. Importantly, with the help of appropriate policies Bangladesh must ensure that growth is inclusive by addressing the challenges arising from income inequality and potential labor market disruptions.

Thus in charting a long-term perspective of Bangladesh’s transformation to a high-income country, at least three important features of the current and next wave of globalization should be kept in view: (a) boundless growth of trade, (b) greater integration of capital and financial markets, and (c) rapid pace of technological innovation and diffusion. World trade has exploded since the 1960s, growing faster than output, and causing global exports to rise from only $1 trillion to $16.5 trillion in 2015 and is projected to reach $65 trillion by 2050. Despite the brief interlude of discontent with globalism across some OECD countries, trade integration is expected to accelerate, and Bangladesh’s future industrialization lies in seizing the expanding export opportunities in the world economy. Thanks to financial and capital market integration, which will intensify over time, inward FDI flows to developing countries reached $200 billion pre-crisis, fell sharply post-crisis, but is again showing signs of a resurgence, led by inflows into China and India. We will have to make the strongest efforts to create the kind of investment climate that captures a much larger share of global FDI in order to build our infrastructure of the future. Finally, Bangladesh can look forward to further technological breakthroughs and their diffusion accelerating the flows of goods, capital, and knowledge, and we have to position ourselves with adequate investments in education and skill development in order to fully absorb the gains arising from these changes.

*How significant is de-globalization trend?* The preceding describes the evolving global architecture within which Bangladesh trade and industrial policies will have to operate. Some political developments in the advanced industrial countries have raised skepticism against current trends in globalization and trade openness. This is because not all aspects of globalization are positive. Easier access to knowledge and information could also create a world that is more volatile with increased economic uncertainty as the global financial crisis of 2008-09 has shown. Trust in global governance erodes when business and political leaders fail to resolve crisis and improve lives in their own communities. That provides fodder to the voices of economic nationalism fueling forces of protectionism and de-globalization (a la Trump). Disappointing growth rates across the developed world have prompted their political leaders not to sacrifice what they consider national interests for global prosperity. But leading experts on the global economy (Stephen King, 2017) invoke the lessons of history to warn that such pursuit of nationalist agendas could result in a race to the bottom while rejection of globalization and a return to “autarky” will risk economic and political conflict.

The good news is that this sort of parochialism has been countered by leading trade experts as well as the wider political stream in those countries, and the mood has softened. The assessment of global analysts is that the current ambivalence to globalization is an episodic fallout of inward-looking political developments that is already showing signs of decadence. In the broader historical context this could become a passing phase. According to global analysts (Seidel and Chandy, 2016) the coming years will be characterized either by stabilization in the level of globalization, or further growth in the degree of integration but at a more modest pace than in the past. Therefore, scenario changes from the current – hopefully brief -- wave of de-globalization and protectionist sentiments to a new wave of globalization will be surmised by this study for the coming twenty-five years. Bangladesh’s industrial progress therefore will have to be envisioned in a highly integrated world involving seamless flows of goods, services, capital, and even labor.

Under these future scenarios of globalization, trade analysts (Oxford Economics and HSBC research reported in Global Trade Review 2015) have prognosticated on the major trends that will shape the future of trade. A striking conclusion of the report is that service-led industries will become dominant and businesses with explicit sustainability goals will succeed. That is, businesses will have to make sure supply chains are sustainable. The trade of services will be a dominant feature of future trade and the way we deﬁne world trade volumes will need to be changed as a result, such as accounting for trade in value added services. This is because so much of the traded goods have ingrained service components in them. For example, only a percentage of the work that goes into a smartphone is hardware – an industrial product. A significant volume of services is provided with this product in terms of software updates which also need to be accounted for. Similarly, increasing export of healthcare and education services will emerge as significant components of trade volume in the future.

To sum up, Bangladesh will have to contend with five notable trends that will shape the future of trade:

1. **Trade liberalization will continue.** The pace of trade liberalization will continue with the extension of free trade and the continuing harmonization of standards and regulations to reduce barriers to trade, fostering the rise of “mega-regionals”. A more stable political and currency environment is anticipated, making trading easier for companies around the world.
2. **Trade facilitation will reduce cost and increase speed of trade.** Trade will be boosted by improvements in logistics. The cost of shipping will fall, driven by a combination of larger vessels and the expansion of shipping lanes. New airports, with increased energy efficiency and further streamlining of border control processes, will speed up trade and reduce air freight costs too. In addition, continued advances in transport technology and infrastructure will increase capacity, opening up new trade routes.
3. **Global value chains will evolve and consolidate.** Bangladesh will have to make up for opportunities lost in integrating into global and regional value chains by courting FDI and joint ventures to develop and trade in a wide range of intermediate goods and services. This approach provides one more avenue for fostering the elusive export diversification.
4. **Digital innovation in industry and trade and the drive to sustainability.** Digital innovation will continue to provide opportunities for businesses and individuals. New technologies create fresh products and business models that can be adapted for different markets, undermining the importance of location. Increasingly interconnected economies will bring rapid change and transmission of ideas around the world. The supply chain will need to innovate to respond to increasing expectation and demand for greater environmental sustainability.
5. **Mass customization**. Factories of the future will be small and ﬂexible rather than large and rigid, and located close to the end customer. With digitization products can be easily customized and sold in different markets, representing a shift from mass production to mass customization.
6. **Micro-multinationals will emerge and thrive.** With digitization and tightly connected global networks small and medium enterprises (SMEs) have an opportunity to level the competitive playing ﬁeld against larger ﬁrms. New technologies such as 3D printing will enable smaller players to deliver customized products anywhere in the world. That portends a radical shift in economies of scale. This will give Bangladesh SMEs a fighting chance to complete in the global marketplace.

# CHALLENGES AND OPPORTUNITIES IN A COMPETITIVE WORLD

In the previous section we have argued that globalization will be an integral part of the global economic system for the foreseeable future and the only way for economies to survive and thrive in that sort of global trade architecture is to be competitive. While national governments provide the institutions and economic framework in which firms can strive for gaining competitive advantage, it is up to the firms to carve out competitive niches in a variety of products. They do so by deftly harnessing the nation’s factor endowments and its national and physical resources thereby enhancing productivity and reducing costs. Michael Porter (1998), the guru of the Competitive Advantage of Nations, found that nations pass through several phases in achieving and sustaining competitive advantage, the first of which is factor-driven, the stage in which Bangladesh finds itself today. Abundance of low-skilled labor give it the cost advantage in labor-intensive products such as apparel and footwear. To augment this competitive advantage on to other products and sustain it for the long-term, Bangladeshi firms will have to invest and resort to innovation, going beyond the employment of low-cost labor in future.

As the 21st century rolls into the third decade and onwards, tremendous opportunities will open up for Bangladesh entrepreneurs in a competitive global market to trade in goods as well as services. But opportunities will be associated with enormous challenges stemming from fierce competition in global markets with rapidly changing demand structures, over time and space. The speed of Bangladesh’s industrialization with job creation will depend on how well the economy is integrated with the global economy, with well-heeled policies to capture external markets while removing distorted incentives in domestic markets.

A nation’s industrial and export success over time will be defined by the ability of its firms to acquire and sustain competitive advantage. But there is nothing guaranteed about competitive advantage. The past and future of competitive advantage could be a lot different. Internationalization of competitive advantage has already taken place. As trade barriers have come down, it has also become difficult to shelter uncompetitive firms. Gone are the days when it could be said that countries with low cost labor will have all the advantage in labor-intensive products and nations with plenty of capital will specialize in capital-intensive products. Technology and innovation has cut into the roots of this thinking. China’s labor cost advantage was not enough to catapult it into the global stage as the export powerhouse. The application of technology and innovation was just as important for its firms to gain sustained competitive advantage in many diverse technology-intensive products. Having recognized that innovation requires sustained investment in research, physical capital, and human resources, the Chinese government is now making sufficient resources available for its firms to invest more in these areas (R&D) to gain and sustain the competitive edge.

There are stark lessons for Bangladesh. Competitive advantage founded on low labor cost cannot be guaranteed for all time. The new theory of competitive advantage starts with the premise that competitive advantage is dynamic and evolving. It was Joseph Schumpeter who recognized decades ago that there was no “equilibrium” in competition (McCraw, 2012). In the international competition of tomorrow, competitive advantage cannot be a static idea but a dynamic one. Bangladeshi firms in RMG or other export industries must recognize the fact that competitive advantage grows and is sustained through relentless improvement, innovation, and change. From its current phase of factor-driven competitive advantage Bangladeshi firms will have to move into investment and innovation driven competitive advantage (a la Porter). Without such efforts, the current competitive advantage in labor-intensive garment exports could well be lost in future. History and cross-country evidence shows that there are few competitive advantages that cannot be copied. Take the case of S. Korea which trumped Japan in the production of TV and electronic products in a matter of years. So did Brazil over Italy in leather shoes, and China-Vietnam is about to do so in non-leather sports shoes. Which means that Bangladesh’s current leadership in garment exports can only by augmented and sustained over the long-term only through relentless innovation, and improvement in management of labor, skills, technology, and capital, extending its competitive advantage to many more products. The state will have to play a significant but facilitating role in ensuring that the competitive advantage of our private firms is sustained over the long-term.

To address future challenges and ensure competitiveness, a harmonious public-private endeavor has to develop in Bangladesh in the following priority tasks:

* Easing **infrastructure constraints**
* Enhancing the **quality of the workforce**
* Investing in **R&D** to promote innovation at every stage of production
* Improving the **business climate** and reducing the **costs of doing business**.
* Mobilizing the large amounts of **financing needed for physical and social infrastructure**, including through private investments and public–private partnerships
* Ensuring **environmental sustainability and climate resilience**

What is clear is that in the coming decades, as Bangladesh graduates out of its LDC status into a Middle Income Country (MIC), under international rules of the game (WTO compliant), it would be difficult to shelter uncompetitive firms or industries because in keeping step with global competitors Bangladesh will have moved towards greater trade openness making exports and domestic sales equally profitable. To create employment for some two million entrants to the job market, jobs in large and SME enterprises will have to be linked as much to the economy’s external sector as to its domestic market, recognizing that factories of the future will be small and ﬂexible rather than large and rigid, and located close to the end customer.

# LESSONS FROM EXPERIENCE OF HIGH PERFORMING ECONOMIES

There are only a few instances of low-income developing economies of the 1960s reaching middle-income status and going on to become developed economies. These countries are in East Asia: South Korea, Taiwan, Hong Kong and Singapore. Apart from Hong Kong (now part of China) and Singapore which are city states, there are important lessons to be drawn from the development strategies pursued by Korea and Taiwan, the two countries that successfully avoided the “middle income trap” to reach high-income status. Other developing economies in East Asia that also became high-performers in the 1970s and 1980s include Malaysia, Thailand, and Indonesia. None of them however reached high-income status and continue to be upper middle income developing economies, though Malaysia is closest to reaching high-income threshold. China, which recorded double-digit GDP growth for two decades at a stretch and is on course to become a high-income country by 2030, has not been included in this group because of the distinct nature of its government and economic system, something Bangladesh cannot and perhaps will not emulate. Elsewhere, Brazil and South Africa have stagnated for long with per capita income under $12,000, falling into a “middle income trap”, according to some analysts (Kharas and Kohli, 2011).

Currently, Bangladesh economy, having reached Lower Middle-Income Country (LMIC) status, stands at the cusp of moving out of the LDC group. UMIC beckons in 2030, and the present Government is embarking on a strategy of reaching high-income status by 2041. Export-push, among other domestic policies, is very much on the cards. Bangladesh faces the dual challenge of export expansion and diversification of its largely mono-product export basket. 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. And all this will have to be done in a global market of speedy transformation and evolution of trade and industry. Some lessons could be drawn from some of the successful economies in South East and East Asia (e.g. S. Korea, Taiwan, Malaysia, Thailand, and India-China). But care must be taken not to cling to any format but devise and adapt our own best policy scenario in a rapidly transforming world because, by most accounts, the next 25 years are expected to be nothing like the previous 25.

In what follows, the development experience of Korea, Taiwan, Malaysia, and Thailand, are reviewed with particular focus on their industrial and trade strategies as they moved from low-income to high-income status (Korea and Taiwan); approaching high-income status, as is the case with Malaysia; or caught in the grip of “middle-income trap” as is the case of Thailand. ANNEX-A presents summary of key indicators of development transformation in these four economies.

**KOREA**

Korea has transformed itself from a stagnant agrarian society into one of the most dynamic industrial economies of the world within four decades. Korea’s industrialization began in a war-ravaged economy in the 1950s with a completely decimated industrial sector. An import substitution policy emerged to restore some basic industries like sugar refining, milling and spinning, plus glass, cement, and fertilizers. But by the close of the 1950s the government was quick to realize the futility of such policies in a country with a small domestic market. In the 1960s industrialization strategy switched to aggressive export promotion and import liberalization with a selective import protection scheme for the domestic market. It came from the recognition that Korea did not have a sufficiently large population to contemplate a strategy other than export-led development. Thus the 1960s industrialization strategy involved importation of raw materials and intermediate goods, adding value through processing, followed by exports. The trade regime was generally biased in favor of exports but essentially neutral with regard to composition of exports. Tariff exemptions on equipment and raw materials imported for export production were also introduced along with financial and other inducements.

But the government did intervene to affect the factor intensity of exports, encouraging investment in industries such as shipbuilding, electronics, machinery, petrochemicals, anticipating that Korea will soon have comparative advantage in these industries. Most important, private entrepreneurs took the hint and began investing in just these strategic industries identified by the government. To accelerate investment, capital goods imports received preferential treatment while intermediate goods imports were encouraged to raise the capacity utilization rate. Export-oriented strategy solidified as Korean officials saw the benefits of export-push – improved balance of payments and accumulation of foreign exchange reserves. Export-GNP ratio which was only 6% in 1960 moved up to 40% in 1980.

With a mix of exchange rate and other support policies one strategic approach followed was to turn the effective exchange rate for exports (EERX) more favorable than that for imports (or import substitutes, EERM). L. Westphal (1978) computed the ratio of EERX/EERM and found them to be greater than unity for the entire period 1962-1975 (Table.1). That means the trade regime was not neutral but tilted in favor of export production.

#### Table 1: Effective Exchange Rates for Exports Imports in Korea, 1962-75

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Years | 1962 | 1965 | 1970 | 1971 | 1974 | 1975 |
| Ratio of EERX/EERM | 1.03 | 1.04 | 1.18 | 1.22 | 1.17 | 1.12 |

One deviation was the drive for promoting heavy and chemical industries (HCI) during the 1970s. Six industries were identified as strategic: steel, petrochemicals, nonferrous metals, shipbuilding, electronics, and machinery. They received support in the form of tax incentives, detailed engineering, subsidized public services, and preferential financing. The outcome of these policy interventions was not all positive; rather bottlenecks emerged, the baking system became loaded with non-performing debt, while labor-intensive industries were starved of credit. Realizing their mistake, the government switched course (World Bank, 1993). Nevertheless, some manufacturing giants, like Samsung and Hyundai, were able to take advantage of the interventions soon becoming global names in cars and electronics. Since the 1980s, Korea emphasized financial and import liberalization, continuing the export-push with focus on technology-intensive production. With a strategic focus on changing the factor-intensity of exports over time towards technology-intensive production, Korea succeeded in moving ahead with export-oriented industrialization that also encouraged innovation and technological progress. Consequently, it has also established world prominence in such technology areas as semi-conductors, LCD, telecommunication equipment, automobiles, shipbuilding, and so on. Indeed, it has emerged from nowhere as one of the key international players in the global economy.

Korea’s high growth and rapid transformation continued during the 1980s and 1990s. With income per capita having reached developed country levels, Korea joined the OECD in 1996. It is now the 13th largest economy in the world with a per capita income (2016) around $35,000. It has also established world prominence in such technology areas as semi-conductors, LCD, telecommunication equipment, automobiles, shipbuilding, and so on. Indeed, from low-income beginnings in the 1950s, it has emerged as one of the key international players in the global economy.

The principal lesson from the Korean industrialization experience is that export-push worked even under domestic interventions that supported import-substituting or strategic industries. During the entire export-push period Korea continued with providing moderate level of effective protection to selected import-substituting industries (Table.2), with high protection to heavy, chemical, and apparel manufacturing. While average nominal tariffs on consumer goods declined (12.7% in 1988), effective rates were higher but still averaged under 40%, lower than other developing countries during those years (Jung-Ho, 1993).

#### Table 2: Nominal and Effective Protection for Manufacturing

|  |  |  |  |
| --- | --- | --- | --- |
| Protection | 1978 | 1982 | 1988 |
| Nominal Rate (NRP) | 19.7 | 17.2 | 12.7 |
| Effective Rate (ERP) | 24.4 | 31.5 | NA |

***Source: Yu Jung-Ho (1993***)

The critical thing was that any anti-export bias of interventions were offset by support that gave exports a more favorable exchange rate with greater profitability. While there was considerable protection of goods sold in the domestic market at various times, the overriding strategy that the Korean government engineered was the application of a variety of instruments, especially export targets and rebates, to ensure that exporters faced international prices for their tradable inputs. Korean growth was essentially driven by a superior export performance.

**TAIWAN**

With a population of 23.5 million, and GDP of $529 billion, Taiwan is the 24th largest economy in the world, and 5th largest in Asia. It is classified as a high-income country by the World Bank with $22,500 income per capita. Taiwan transformed itself from a predominantly agrarian economy in the 1950s to highly industrialized economy by the end of the 20th century. Over time, the factor intensity of its exports has undergone radical change, from labor-intensive manufactures in the 1960s and 1970s to predominantly capital- and technology-intensive products since the 1980s. The economy of Taiwan is now an indispensable partner in the Global [Value Chains](https://en.wikipedia.org/wiki/Value_Chain) of [Electronics Industry](https://en.wikipedia.org/wiki/Electronics_Industry) (World Bank, 2010). [Electronic products and components](https://en.wikipedia.org/wiki/Electronic_components) and personal computers are areas of international strength of Taiwan's Information Technology industry. The electronics sector is now Taiwan's most important industrial export sector and is the largest recipient of United States investment.

Being a small economy, Taiwan’s leaders realized at the outset that trade would have to be its lifeline. Indeed, foreign trade has been the engine of Taiwan's rapid growth during the past 70 years. Taiwan's economy remains export-oriented, depends on an open world trade regime, and remains vulnerable to downturns in the world economy. The total value of trade increased over fivefold in the 1960s, nearly tenfold in the 1970s, and doubled again in the 1980s. The 1990s saw a more modest, slightly less than twofold, growth. Throughout Taiwan’s history, export growth has been the cornerstone of its development policy. In the early 1980s. Taiwan embarked on a development programme designed to shift the economy away from reliance on labour-intensive industries towards the development of technology-intensive products and industries, with appropriate state interventions. While continuing to pursue ongoing trade liberalization, the government simultaneously adopted a sectoral policy of identifying and promoting “strategic industries” in order to further industrial development and restructure industry. Industrial goods now make up 98% of its exports. As for trade policy, except for the initial post-war period, Taiwan generally pursued a policy of an open and liberalized trade regime with emphasis on export-oriented industrialization.

A review of Taiwan’s process of economic development reveals that it has adopted several different economic strategies. In the 1950s, an import-substitution policy was followed to reconstruct the economy and establish an industrial base after the Second World War. High tariffs and import restrictions helped develop some labor-intensive industries like textiles, apparel, wood, and leather products. However, the costs of import substitution soon appeared in growing trade deficits and declining growth. In the 1960s, an export-promotion policy was put forward to stimulate exports and to speed up economic growth. Tariffs and import controls were gradually reduced, especially for inputs to export. At that time, labor-intensive industries were comparatively advantageous and became the key industries that gained the support of the government.

After the oil crises of the 1970s, capital intensive and technology-intensive industries became the new key industries. In the 1980s, as wages rose Taiwan began losing its competitive advantage in labor-intensive products and exports lost ground. So, in order to promote industrial development and improve the country’s industrial structure, the concept of “strategic industries” (mechanical products, information, and electronics sectors) was adopted (Kuo, 2015). The focus now shifted to high-technology industries: information, biotechnology, electro-optics, machinery and precision instruments. The shift to high-technology also necessitated close coordination of industrial, financial, science and technology, and human resource policies. The country soon passed the stage where its companies merely imported high-tech components. A large number of high-tech firms emerged producing increasingly sophisticated and higher-value added industrial products. That trend has continued into the 21st century with 98% of its exports being manufactured goods with high degree of sophistication. Taiwan is the world's largest supplier of contract computer chip manufacturing ([foundry services](https://en.wikipedia.org/wiki/Semiconductor_fabrication_plant)) and is a leading [LCD panel](https://en.wikipedia.org/wiki/Liquid_crystal_display) manufacturer, DRAM computer memory, networking equipment, and consumer electronics designer and manufacturer. All said and done, Taiwan is poised to reap the benefits of any forthcoming industrial revolution in the future.

**MALAYSIA**

Malaysia’s economy has evolved from a low-income, agriculture-based economy with gross national income (GNI) per capita of US$240 in 1962 to an upper middle-income manufacturing and services driven economy with US$9,850 GNI per capita in 2016. With the current high-income threshold of US$12,475 set by the World Bank Malaysia is on track to become a high-income nation by 2020.

Malaysia’s early transformation is attributed to strategic vision, bold policy decisions and ability to mobilize support from both public and private sectors. Malaysia’s industrial transformation can be divided into three phases. In the first phase, 1957-1970, the country’s mainstays were rubber and tin production, as well as entrepot trade centers in Penang and Malacca. While the government protected import-substituting industries, protection was moderate, averaging only 7 percent, compared to a range of 25 to 90 percent for countries in the same level of income. This policy provided the initial spurt to manufacturing growth in the economy.

The second phase, from 1971 till 1990, saw growth centered on the rise of construction and manufacturing, with focus on equitable distribution. Export-oriented manufacturing gained momentum and foreign direct investment was promoted. Privatization took off and together with the development of the Multimedia Super Corridor (MSC) in 1990s were considered instrumental in achieving rapid industrialization. In trade policy, the government began more active promotion of natural resource exports, particularly rubber, timber, palm oil, and light manufactured exports, particularly textiles, footwear, and garments. Export processing zones, free trade zones, and licensed manufacturing warehouses that permitted duty-free import of materials to be assembled were crucial for the successful combination of import substitution and export promotion. Anti-export bias of policy was reduced as effective protection to industry declined from 31 per cent in 1979 to 17 per cent in 1987.

In the third phase, from 1991 till 2007, Vision 2020 was introduced, setting the goal for Malaysia to be a self-sufficient industrialized nation by 2020. Malaysia sought out new growth areas and pushed towards higher-value added and knowledge-based industries amid erosion in its comparative advantage in labor costs and labor-intensive manufacturing. Malaysia aggressively courted FDI to promote export-oriented industrialization.

The fourth phase, from 2008 till the present, sees the country’s transformation into a high-income nation being challenged by the global crisis (2008-09), leading to the New Economic Model (NEM), unveiled in 2010. The NEM was designed to address concerns that the country was stuck in a middle-income trap with sub-par growth potential and lack of private sector dynamism. Consequently, focus has shifted to seizing opportunities presented by the fourth industrial revolution (Industry 4.0) to promote high-technology industries and minimize dependency on manpower. Priorities include automation, digitalization, robotic development and big data. The country is nearing high-income status, inclusiveness with equitable distribution of wealth, combined with financial and environmental sustainability.

**THAILAND**

In the 1970s and 1980s, Thailand economy averaged 7-8 per cent annual growth to be included among the high-performing economies of East Asia by the World Bank (World Bank, 1993). But, following the Asian financial crisis of 1997, the economy lost its growth momentum and analysts[[1]](#footnote-1) contend that not only has its medium- to long-term average growth declined by 2 percentage points, Thailand is now in the grip of a “middle-income trap” that could last for two decades, unless it embarks on a restructuring program that focuses either on manufacturing or services, not both.

Like Malaysia, Thailand’s economy initially (1955-70) relied heavily on resource-based exports comprising primary and agricultural products, dominated by rice. It maintained industrial protection, modest by comparator standards, for specific industries. Effective protection for consumer goods manufactures were in the range of 25-30 per cent while machinery and intermediate inputs garnered 15-20 per cent. Import substitution strategies deepened somewhat during 1971-85 with tariffs on consumer goods raised to 30-55 per cent while those on capital and intermediate goods were reduced, thus raising effective protection levels in manufacturing (found to be 77% in 1981, 66% in 1985, according to Brimble, 1993). Textiles, pharmaceuticals, and automobile assembly were particularly favored, but domestic content requirement were established. Early in the 1980s, however, Thailand changed course, moving away from an import substitution stance as trade policy shifted explicitly in the direction of export promotion. Export taxes were eliminated and the exchange rate was devalued, eventually moving to a managed float. For much of the 1980s export-push incentives were specifically designed to offset remaining distortions from Thailand’s import substitution era. Export processing zones, duty-free imports, and tax rebates came into play.

Until the Asian financial crisis of 1997, the Thai economy recorded average growth rates of 7.5 per cent per annum since 1982. That growth rate slipped to only 3.5 per cent in 2005-15, signaling the possibility of a middle-income trap, with a per capita GNI around $6000 in 2015. Thailand faces the immediate challenge of avoiding the middle-income trap by identifying strategies to introduce new processes and find new markets to maintain export growth. Ramping up domestic demand is also important—an expanding middle class can use its increasing purchasing power to buy high-quality, innovative products and help drive growth.

**LESSONS**

*What lessons can Bangladesh draw from the transformative experience of the four East Asian economies reviewed*?

The review of experience of these East Asian economies reveals some notable commonalities:

1. all countries began as low-income economies in the 1950s, relying on resource-based exports of primary and agricultural products;
2. in the early and middle phases of their development, all economies embraced import substitution industrialization with effective protection levels moderately lower than other developing economies;
3. all instituted outward-looking export-push strategies for manufactures, some more aggressively than others, without completely abandoning import-substitution policies;
4. Korea countered anti-export bias of protection policies more effectively to achieve industrial modernization with high growth rates; Taiwan adopted a more liberal trade stance, moving away from labor-intensive manufacturing to technology-intensive industries, with rich dividends; Malaysia achieved moderate success in its export-push with emphasis on technology-intensive products; Thailand economy however slowed down after the Asian financial crisis compared to the boom of 1975-96 period.
5. All countries sought to exploit the international market and adopted export-push strategies by the 1980s, or earlier, with active promotion of manufactured exports. Export push strategies have been by far the most successful combination of fundamentals and policy interventions and hold the most promise for other developing economies.
6. As strategies for industrialization, the policy of promotion of specific industries (picking winners) generally did not work (Page and Petri, 1993) and therefore holds little promise for developing countries. Directed credit worked sometimes but carries high risk. It was export-push strategy that proved by far the most successful intervention and holds the most promise for developing economies.

To sum up, all of these high performing economies that eventually crossed the high-income threshold (or approached HIC, like Malaysia, except Thailand, which got caught in the middle-income trap) acquired the following characteristics: macroeconomic stability, high shares of trade in GDP, heavy investment in people (skills development), and strong competition among firms. These features are the outcome of many diverse instruments and public interventions, leading to accumulation, efficient allocation, and rapid technological catch-up. With all the import-substitute protection that was imparted in these economies, research shows that their domestic prices were closer to international prices compared to other developing economies, suggesting that protection in these countries was more moderate. Two strategic policy prescriptions that emerge from their experience of dynamic export-oriented growth may be divided into **fundamental**s, or **selective interventions**. Fundamentals are macroeconomic stability, high investments in human capital, stable and secure financial systems, limited price distortions, and open to foreign technology. Selective interventions include mild financial repression (keeping interest rates low but positive), directed credit, selective industrial promotion, and trade policies that push non-traditional exports. Several leading economists (Westphal, 1978; Brimble, 1993; Kuo, 1983) have carefully studied the experience with regard to selective industrial promotion, such as HCI (heavy and chemical industries) in Korea, “strategic industries” in Taiwan, and the verdict is not clear that such selective promotion actually worked. That puts a damper on the Bangladesh approach of picking winners in the promotion of “thrust sectors” calling for a reassessment of this approach.

# BANGLADESH EXPORT PERFORMANCE AND THE TRADE REGIME

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, 1970’s, and 1980s, Malaysia, Thailand, and Singapore during 1970-90, China since 1980, and eventually India since 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. The challenge of creating good jobs for the two million labor that is added to the workforce every year can only met by sustained expansion of exports in the global marketplace, something the limited domestic market can hardly match.

Moreover, to reach high-income status by 2041, the economy will have to record average growth of 8% in 2020s, and 9.5% in the 2030s. Historically, we have seen that that kind of high growth has been driven by superior export performance in the East Asian economies, whose development experience has been reviewed in the previous section. Besides, robust empirical evidence has been provided by many researchers on the positive relationship between export and growth (Sachs and Warner, 1995; Srinivasan and Bhagwati, 1999). Export activity has also proved to be productivity enhancing and stimulates growth by transferring resources from lower productivity activities to the higher-productivity goods identified by the entrepreneurial cost-discovery process in export markets (Hausmann and Rodrik, 2003). Surveying the evidence in East Asia and other developing countries, economists conclude that rapid and sustained GDP growth is closely associated with a fast pace of export growth (Brenton and Newfarmer, 2007).

Trade openness will be another critical factor in facilitating export success in an integrated world economy. 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. As developing and emerging economies strive to reach the level of developed and high-income countries, the sanguinary role of trade in their progress becomes all the more integral. Trade openness therefore is another lever of development that will have to be fully integrated with Bangladesh’s growth process. That is to say, over the next 25 years, Bangladesh’s progress to middle-income and high-income status will have to be largely driven by a high performing export sector that is competitive in a highly globalized world.

With the labor cost advantage that Bangladesh enjoys, at least for another decade 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.

Earlier, it has been clarified in Section D what the implications are of a changing landscape of competitive advantage. With the kind of rapid transformation taking place in global manufacturing today (and projected for the future), Bangladesh can ill afford to cling to the current factor-intensity (labor-intensive) of its exports. Like Korea, Taiwan, and Malaysia, it can be surmised that by 2030, if not earlier, Bangladesh will have to move towards technology-intensive exports and requisite investment in developing appropriate skills and logistics to ensure the future competitive advantage of Bangladeshi firms will have to begin now. The Perspective Plan (2021-41) could provide the road map for making that happen.

Leveraging the growing 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 2030, and high-income status by 2041. Bangladesh’s export performance so far presents signs of strength as well as weakness in its export basket. Although the total number of distinct export products (HS-6 code) in FY2016 reached 1575, the vast number of them (about 900) recorded export volumes of under $1 million. Export concentration (RMG share at 82% of $34.5 billion in FY2017) has emerged as a formidable challenge to address and overcome. Furthermore, the structure of exports show concentration of final consumer goods without much diversity from intermediate and capital goods (Table 3).

#### Table 3: Structure of Imports and Exports FY2016

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Product Categories** | **Imports** | | **Exports** | |
| **$billion** | **Share (%)** | **$billion** | **Share (%)** |
| **Basic raw materials** | 5.98 | 13.10 | 0.32 | 0.96 |
| **Intermediate goods** | 16.37 | 35.86 | 1.37 | 4.06 |
| **Capital goods** | 9.00 | 19.71 | 0.10 | 0.29 |
| **Final Consumer Goods** | 14.30 | 31.33 | 31.82 | 94.68 |
| **Total** | 45.66 |  | 33.60 |  |

***Source: NBR ASYCUDA database and PRI staff estimates***

***Export performance.*** There is growing consensus in economic literature that countries achieving structural change in exports through increased export diversification also grew rapidly and inclusively. To chart out an export strategy for the future it would be good to review Bangladesh’s recent and past export performance. Bangladesh exports gathered pace since the early 1990s, as a direct outcome of trade liberalization. Compared to the decades of the 1970s and 1980s, export performance was exemplary, averaging double digit growth rates annually for nearly 25 years since 1990. Between 2000 and 2010, exports tripled (from $5 billion to $15 billion). In FY2017, total exports of US$34.8 billion was nearly seven times exports of FY2000 (Figure.3). Over 95% of exports comprised manufactures making Bangladesh unique among LDCs in its export composition.

##### **Figure 3: Export performance since 1990**

***Source: EPB***

Progress in trade openness since the early 1990s clearly had a positive impact on a superior export performance. The share of trade in GDP has been rising since 1990 when it was only at 19%. As Figure.4 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. But 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, but close to the average of South Asia (Table 4).

##### Figure 4: Rising share of trade in GDP

***Source: EPB; Bangladesh Bank; BBS***

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Table 4: Bangladesh: 2016 Trade Openness in Asia | | | | |
| **(Trade-GDP ratio)** | | | | |
|  |  | **Exports** | **Imports** | **Total** |
| **Bangladesh\*** |  | 14.1 | 17.6 | 31.7 |
|  |  |  |  |  |
| **South Asia** |  | 11.5 | 16.9 | 28.4 |
| **Southeast Asia\*\*** |  | 44.7 | 42.2 | 86.9 |
| **Emerging Asia\*\*\*** |  | 20.2 | 17.1 | 37.3 |
| **Low Income countries** |  | 12.7 | 27.8 | 40.5 |
| \*The data for Bangladesh is for the FY2016-17 | | | | |
| \*\*Timor-Leste has been excluded due to unavailability of data | | | | |
| \*\*\*This group consists of China, India, Indonesia, Malaysia, Thailand and Vietnam | | | | |
| ***Source: WTO, WDI database of World Bank*** | | | | |

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. By 2015, Bangladesh became the second largest single-country exporter of RMG in the world, after China. But the fact that RMG exports have been growing at an average annual rate faster than that of non-RMG exports (Figure 5), leads to a rising share of RMG in the export basket, resulting in further concentration of exports (Fig.6X). Export diversification thus becomes a challenge that must be addressed, (a) because over-reliance on a single export commodity makes the economy vulnerable to external shocks, and (b) a diverse export basket is a sine qua non of stable export revenue and its growth.

##### Figure 5: Growth of RMG exports exceeds that of Non-RMG exports

***Source: EPB***

##### Figure 6: Relative Export Concentration 2015

***Source: WITS database, World Bank***

Figure 6 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 ECR (15)[[2]](#footnote-2). Bangladesh has the highest export concentration of 0.82, nearly twice the concentration level of Thailand. What is surprising is that Vietnam, a strong competitor of Bangladesh in the RMG sector, has a fairly diversified export basket, similar to that of India.. 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 India has a well-diversified export basket as its 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 7: Large number of Export Products

***Source: ASYCUDA database, NBR***

***The challenge of export expansion and diversification.*** How has Bangladesh faired in the quest for achieving a superior export performance with a diversified export basket that contains more of non-RMG products? 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. Figure. 7 shows that Bangladesh exports a large number of products in small quantities (1200 HS-6 products <=$1 million in FY16) without these exports growing into major export items in a diversified export basket. Considerable research has been done on the constraints to exports performance in Bangladesh. These constraints can broadly be grouped under the rubric of

1. **Challenges with trade infrastructure, and**
2. **Challenges related to trade policy and the incentive regime**
3. **Challenges with 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 administration and port efficiency.

* **Technology and labor productivity** are obvious factors that influence cost competitiveness today, and the foreseeable future. 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 for the long-term. 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 Desh 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. A similar approach is needed in other export sectors like Footwear and Leather goods, and electronics, by courting FDI and joint ventures with an eye on the future. The challenge of technology adoption and upgradation with a vision for the distant future is very real. And it is a steep climb for Bangladesh given its current state of technology in manufacturing and the forthcoming transformations vis-à-vis Industry 4.0 and beyond.
* 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(--TBU) ranking for Bangladesh is shown in Table.5. 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 5. The Enabling Trade Index 2016; Bangladesh

|  |  |  |
| --- | --- | --- |
|  | Rank (out of 136 countries) | Score (1-7) |
| ENABLING TRADE INDEX | **123** | **3.5** |
| BORDER ADMINISTRATION | **130** | **3.0** |
| Efficiency and Transparency of border administration | 130 | 3.0 |
| INFRASTRUCTURE | **108** | **3.1** |
| Availability and quality of transport infrastructure | 109 | 2.7 |
| Availability and quality of transport services | 100 | 3.5 |
| Availability and use of ICTs | 112 | 3.1 |
| MARKET ACCESS | **84** | **4.4** |
| Domestic Market Access | 127 | 3.4 |
| Foreign Market Access | 12 | 5.3 |
| OPERATING ENVIRONMENT | **128** | **3.5** |
| Physical security | 119 | 3.8 |

***Source: Global Enabling Trade Report 2016, World Economic Forum***

**Infrastructure deficiencies.** A comparison of infrastructure quality among Asian countries ranks Bangladesh poorly (Table.6). 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. Only sustained investments in infrastructure (estimated at $10 billion a year) over the next two decades can bring Bangladesh up to par with its comparators.

#### Table 6: Comparison of Infrastructure Quality, 2016-2017

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Country/Region | Country Ranking/1 | Overall Infrastructure | Electricity | Roads | Railroads | Port |
| Southeast Asia(average) | 51 | 68 | 67 | 64 | 54 | 72 |
| South Asia (average) | 89 | 87 | 96 | 80 | 48 | 92 |
| Bangladesh | 106 | 120 | 110 | 113 | 72 | 89 |
| China | 28 | 43 | 58 | 39 | 14 | 43 |
| India | 39 | 51 | 88 | 51 | 23 | 48 |

***Source: The Global Competitiveness Report 2016-2017, World Economic Forum***

**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. Port modernization, upgradation, and establishment of deep sea ports will have to be in Bangladesh’s long-term agenda.

**Road network** - 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 needs to be converted into an 8 lane highway along with all the trappings of modern traffic management.

**Railway system**- The container unit train operation between Chittagong and Dhaka has the potential to provide an important benefit to both importers and exporters. 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. Investment in modernization and establishment of speed train network have to be on cards.

**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. An 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 imposes constraints on expansion of exports by air.

* **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.7 shows the Ease of Doing Business rankings for 2012.

#### Table 7: Ease of Doing Business (2016)

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | [**Ease of Doing Business Rank ▲**](http://www.doingbusiness.org/Rankings?sortcolumn=2&sortorder=desc&regionID=0&incomeID=0&tercile=&ajax=1) | **Starting a business** | **Registering Property** | **Getting Credit** | **Trading across borders** | **Enforcing contracts** |
| **Bangladesh** | 176 | 122 | 185 | 157 | 173 | 189 |
| **Singapore** | 2 | 6 | 19 | 20 | 41 | 2 |
| **Hong Kong** | 4 | 3 | 61 | 20 | 42 | 21 |
| **South Korea** | 5 | 11 | 39 | 44 | 32 | 1 |
| **China** | 78 | 127 | 42 | 62 | 96 | 5 |
| **Malaysia** | 23 | 112 | 40 | 20 | 60 | 42 |
| **India** | 130 | 155 | 138 | 44 | 143 | 172 |
| **Thailand** | 46 | 78 | 68 | 82 | 56 | 51 |
| **Indonesia** | 91 | 151 | 118 | 62 | 108 | 166 |
| **Vietnam** | 82 | 121 | 59 | 32 | 93 | 69 |
| **Pakistan** | 144 | 141 | 169 | 82 | 172 | 157 |

***Source: Doing Business Report 2017, World Bank***

Not surprisingly, Bangladesh performs quite poorly on the whole with a rank of 129. All its competitors face a better business environment. 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.7 with a view to making the Bangladeshi investment climate much more attractive for attracting foreign investment and improving export competitiveness.

* **Addressing Low Labor productivity and Skills Gap.** 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 neighbors and trade rivals in terms of quality of labour and therefore labour productivity. 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 in an excellent example of the kind of in-house training that delivers results. This practice needs to be replicated on a wider scale across the manufacturing sector.

**II. Challenges related to trade policy and the incentive regime**

The experience of the high-performing East Asian economies clearly demonstrates the criticality of export-oriented trade policy for a superior export performance. 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 (Rodrik, 2008), 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. 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 effective exchange rate (REER), 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. 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 for the most part. As a long-term strategy for export expansion, 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.8shows that there has been a slippage in this policy as the REER has been appreciating since FY12 making exports less competitive. This situation needs to be reversed as export performance during FY12-17 has suffered in consequence.

##### Figure 8: Exchange Rate Movements FY03-FY17

***Source: Bangladesh Bank; Note: Rise in REER index indicates appreciation***

* **Trade policy stance:** 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 much lower but still a significant problem for exports.
* **Fiscal incentives:** Like mostdeveloping countries seeking to expand exports, the Government has taken a positive fiscal stance in promoting exports. The RMG sector is the highest beneficiary of the various fiscal concessions. In addition to the duty drawback scheme accorded 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 on exports, which is also the final tax. This is now fixed at 0.6 percent (FY2018) of total export earnings, which is a small tax burden in terms of percentage 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 yarn to 20% on halal meat and potatoes in the current year (FY2018).

***Trade regime and exports.*** There is strong international evidence that export performance, and its offshoot, progress in export diversification, is in large 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 missing for other exporters.

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 Desh 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 incentive:** The government has taken a very liberal attitude towards taxation of earnings from RMG by having a very low effective tax rate on income from RMG exports.

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 period[[3]](#footnote-3). 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. However, policymakers and private entrepreneurs will have to look out for (and ready to adopt) the technological advances occurring in the global marketplace in the coming decades in order to ensure sustained competitive advantage in exports.

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 2017-18. This section will conclude with an articulation of the basic parameters of our future trade policy in strengthening competitive advantage in a transforming global marketplace.

Table.8 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 (5), and a moderate trade-GDP ratio.

#### Table 8: Snapshot of Bangladesh Trade Regime FY2017

| **Policy Instrument** | **Bangladesh** | **S. Korea** |
| --- | --- | --- |
| Exchange Rate Regime | Unified, Managed Float | Unified, Managed Float |
| Payment convertibility  Current account  Capital account | Yes, some limits  No | Yes, largely unlimited  Yes, some limits |
| Import restrictions  Import licensing  QRs on imports | No  Trade QRs gone  WTO compliant QRs remain | No  Only WTO compliant ones |
| Tariff structure  Top CD rate  Average protective rate  Tariff slabs (customs duty)  Para-tariffs | 25  26.9  3, 5, 12, 25  RD and SD\* | 8.0  8.0  Many  No |
| Trade openness, trade-GDP ratio (%) | 31.7 | 63.8 |

***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.9), 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 exchange[[4]](#footnote-4). 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 inputs[[5]](#footnote-5). 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 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 but the vast array of small exporters have not. Electronic and digitized management of SBW system can substantially reduce the administrative costs and improve efficiency of the system when accorded to all exporters.

Cost competitiveness in the global marketplace is measured by cents not dollars. Unless exporters are fully compensated for duties paid on imported inputs they lose competitiveness. It is a basic principle of export competitiveness that all exporters must be ensured world-priced inputs. Recognizing this, NBR has been selectively albeit hesitatingly granting SBW facility to non-RMG exporters but evidence suggests that the practice has not taken off, at least for the vast numbers of small exporters. This is clearly one reason why non-RMG exports have not reached significant proportions in the export basket.

# EXPORT COMPETITIVENESS AND TRADE POLICIES OF THE FUTURE

Ensuring export competitiveness in the global marketplace must be a key export strategy for all times. High performing economies of East Asia have always had this principle uppermost in their policies when striving for export-push in the 1970s and 1980s. Though there was wide variation in the extent of incentives, all of them engaged in some form of selective promotion subsidies, preferential financing, tax incentives, subsidized infrastructure, and foreign investment incentives. Because all of them, at some point or the other, had on-going import-substituting policies to support domestic industrialization, export incentives were necessary to effectively offset the anti-export bias of effective protection provided to import-substituting industries. The record shows that these policies worked and export-push policies produced exemplary export performance for several decades.

Two points relevant for the Bangladesh context must be noted: (a) effective protection levels were moderate in those days (manufacturing protection were under 60% in Korea and Thailand, under 40% in Malaysia and Taiwan, and declined over time), and (b) the higher the import-substitution protection levels greater the competence of bureaucracy required to offset the anti-export bias of such policies.

Because of the wide divergence between input and output tariffs (high tariff escalation) ERPs were found to range from 100% for beverages to 400% for biscuits and plastics (PRI, 2012) with rates averaging upwards of 250% for all manufactured. This is the state when effective protection on exports are close to zero. Such a major incentive bias in favor of protection for domestic sales requires exemplary competence in a bureaucracy to offset the anti-export bias even if that were intended. Bangladesh clearly does not have that kind of administrative acumen in its crop of bureaucracy. Which implies that whatever export-push policies that might be designed will have a steep climb to effectiveness in boosting exports and their diversification.

The prevailing tariff structure does not resemble that of a UMIC or HIC. A major challenge for policymakers in Bangladesh for the next decade and beyond will be to reorient trade and tariff policy that will be consistent with a dynamic export-oriented economy. end the growing divergence between input and output tariffs and put it in reverse gear so that the trends in input-output tariffs are in line with what we find in the UMIC and HIC economies.

Trade policy analysis of the preceding sections and the historical evidence from high-performing economies establish several key features of successful export-push policies for industrialization in an economy with significant level of effective protection, as is the case in Bangladesh:

1. *Protection must be time-bound*. Protection, even if justified on strategic grounds of dynamic comparative advantage, must be made time-bound, with prior announcement for scaling down protection over time. Protection in LMIC and UMIC economies are modest at best, and in HIC, only for selected agricultural commodities (e.g. rice in Japan and Korea are subject to 300%+ duties).
2. *Access to world-price inputs must be ensured*. While import substitution policies prevail, support schemes have to be put in place to ensure that all exporters have access to world-priced inputs so that they compete in the international market on a level playing field; high protection to import substitutes prevent graduation of such industries from becoming export-oriented.
3. *Access to long-term and short-term financin*g must be made available to both large and small exporters in a country where large numbers of small exporters are unable to scale up their export activities due to various constraints.
4. *Foreign direct investment (FDI).* Partnership with good international investors that can support technology transfer, create market access abroad and jobs at home, can be the ultimate boost for exports. Most important for the next decade, FDI can help bridge the technology gap and make Bangladesh manufacturing play catch up with the latest advancement in global manufacturing.
5. *Government support to open external markets.* For developing countries like Bangladesh preferential access is granted under various schemes (e.g. EBA in EU, GSP in others) in developed markets, but government assistance and support through embassies are prerequisites for successful market penetration in the largest global markets, such as EU, North America, Japan, and emerging economies.
6. *Policy flexibility helps*. Not all good policies produce their intended outcome. Experience of successful export economies shows how flexibility in policy implementation averts crisis. When a policy does not yield results there should be scope for changing directions.

**Protection Policy, Exports and Export Diversification**

The most common position with regard to trade policy in Bangladesh may be summarized thus: 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 results in a structure of tariffs that impinge heavily on global competitiveness of exports and import substitute production, necessitating significant reforms and modernization of all constituents of trade policy, customs administration, and trade infrastructure, in order for Bangladesh to be dynamically competitive into the next decades of its development. It is an empirical fact that while tariffs around the world has come down significantly over the past 25 years, tariffs in Bangladesh remain stubbornly high relative to its comparators. Trade theory and empirical evidence suggests this is not conducive to a dynamic export performance. So there is much to be done.

***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. 9 gives a picture of the evolution of tariffs in terms of their implications for nominal protection[[6]](#footnote-6).

#### Table 9: Evolution of Tariffs and Protection

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Tariffs (%) | FY92 | FY01 | FY 05 | FY 10 | FY17 |
| Avg. CD (un- weighted) | 70.6 | 21.1 | 16.3 | 13.7 | 13.3 |
| Avg. para-tariffs | 2.7 | 7.1 | 10.2 | 10.2 | 12.4 |
| Avg. Nominal Protection | 73.3 | 28.2 | 26.5 | 23.9 | 25.6 |
| Top CD rate | 350.0 | 37.5 | 25.0 | 25.0 | 25.0 |
| Top NPR\* | 362.5 | 59.0 | 60.0 | 79.0 | 85.6 |

***Source: NBR & PRI staff estimates***

Tariffs and para-tariffs[[7]](#footnote-7)on imports are now the single most important determinant of trade protection after successive governments in Bangladesh made progressive trade openness the 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 six non-zero CD slabs – 1%, 2%, 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 25 years, the average nominal protection rate (NPR) shows mixed trend. It initially declined rapidly between FY92 and FY01 but 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. Such high rates, if effective, constitute *de facto* import bans.

The new element is the emergence and sharp rise of para-tariffs (Figure.9) as a protective instrument of trade policy, which rose to about 50% of average NPR since FY13. Going by

##### Figure 9: 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 86% imposed on footwear and 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 CD[[8]](#footnote-8), 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 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 protection[[9]](#footnote-9) (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 47-86% (100% for biscuits!). 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 past the average NPR for input categories have been declining rapidly while that of final consumer goods remained practically flat if not increased. The wedge between output and input tariffs has become unusually large, unlike that in any other country (Figure.10). What is seldom recognized is that this trend of input and output tariffs is unique for Bangladesh and deviates far from the pattern followed by the high-performing economies in East Asia.

##### Figure 10: Trends in Output and Input Tariffs: Bangladesh

**Bangladesh**

***Source: NBR; WITS Database, World Bank***

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. This simply cannot be a long-term protection strategy for an economy seeking a productive and competitive industrial sector of the future.

Figure.11 presents trends in output and input tariffs over two decades for the four high-performing economies of East Asia. Without exception, all countries have pursued a policy of commensurately lowering output tariffs as they lowered input tariffs. Not even other developing countries which liberalized trade over decades showed such proclivity for tariff dispersion (Figure.12 for Vietnam, India). Besides, the divergence between input and output tariffs were nowhere near the exorbitant levels seen in Bangladesh. Clearly, this is a long-term strategy of lowering effective 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.10)).

##### Figure 11: Trends in Output and Input Tariffs: High-performing economies

|  |  |
| --- | --- |
|  | |
|  |  |
| **Malaysia** | **Thailand** |
|  |  |
| **South Korea** | **Taiwan (China)** |

***Source: WITS Database, World Bank***

##### Figure 12: Trends in Output and Input Tariffs: Vietnam and India

**India**

**Vietnam**

|  |  |  |
| --- | --- | --- |
| Table 10: Exports of Goods and Services expressed as share (%) of GDP | | |
| **Country** | **Year** | |
| **1970** | **2016** |
| **Bangladesh** | 8.31 | 15.23\* |
| **Korea** | 13.63 | 42.24 |
| **Taiwan** | 13.5 | 70.0 |
| **Malaysia** | 41.41 | 67.24 |
| **Thailand** | 14.99 | 68.93 |
| **Vietnam** | 6.62\*\* | 93.62 |
|  |  |  |
| \*The data for Bangladesh is for the FY17  \*\*Data for the year 1986 | | |
|  | | |

***Source: World Development Indicators (WDI) database, The World Bank; Bangladesh Bank; BBS***

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. This configuration of tariffs was adopted by S. Korea.

Though somewhat higher than other OECD countries, the structure of tariffs in S. Korea approximate developed country features. Since 1990, average input tariffs trended downward and was lower than output tariffs, as usual, but a reversal of that trend is observed since 1995 when average input tariffs were higher than output tariffs – a clear preference for higher incentives to primarily the intermediate goods sector, to take advantage of global value chains and develop 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 maintained an efficient system of free trade channels for export commodities.

To continue on a path of sustainable export growth with a diversified basket of goods, Bangladesh faces an immediate challenge 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.13. In view of the currently high levels of NPR on final consumer goods (FCG), 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 FCG NPR of 45% in FY17 will have to be reduced to 25% by FY20, to 10% by FY25, and to 5% by FY30. Meanwhile, average input NPRs will decline from 13% in FY17, to 10% by FY20, and down to 5% by FY30. Thereafter, the tariff regime will be one with low uniform tariffs of about 5% without distinction between input or output. 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 and beyond, could constitute 60-75% of GDP.

##### Figure 13: Futuristic Tariff Profile (FY17-41)

Apart from the uniformity of the tariff structure, other aspects of efficiency and transparency will be added to customs administration which, by 2025, will no longer have a major role in revenue collection because domestic taxes (income tax and VAT) will become the principal revenue instruments. Trade facilitation will be the underlying principle of its existence. Still, protection of specific products through the application of tariff peaks (a high tariff rate) might emerge from time and time and exceptions to the uniform tariff rule would then have to be made as temporary measures. Such a tariff structure will impart minimal distortion to domestic production and trade. From 2030 onwards, a modern high-tech industrial sector should be able to function with seamless movement of goods and services across borders or via online with least transaction costs.

Exploiting Global Value Chains. Pascal Lamy, the former head of the World Trade Organization (WTO), described global trade of today as less about products and services and more about trade along value chains which span not just across countries but also continents. This evolving pattern of global trade creates opportunities for changing the structure and direction of Bangladesh trade over the next decade. 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 ‘unpackage’ their factories and locate various production stages far from each other, to other countries in accordance with these countries’ respective comparative advantages.

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. 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 – a clear example of the export-promoting and job creation potential of GVC.

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. 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.

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 since Bangladeshi 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.

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. Not only in the production of intermediate goods, courting FDI will be essential for future technology leapfrogging to capture production and market access in manufacturing products of the coming decades.

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.
* The government has an important role to play in kick-starting GVCs in non-RMG export sectors. Various support policies (e.g. low-cost credit, tax waivers, generous transfer pricing rules) can be devised that can bypass current WTO ‘rules of the game’, as WTO regulations have yet to catch up with the rapid growth of trade in value added (GVC).

The critical role of foreign direct investment (FDI) in Bangladesh’s future strategy for trade and industrial development, as well as in fostering GVC exports, will be analyzed in the next section.

# COURTING FDI IN EXPORT-ORIENTED MANUFACTURING

As a rapidly developing economy, Bangladesh will need to mobilize large amounts of financing needed for physical and trade infrastructure. Quite apart from concessional aid coming from multi-lateral agencies, a clear strategy will have to be laid out for mobilizing foreign direct investment (FDI) through private investments and public–private partnerships. One key strategy for export expansion and diversification will entail mobilizing FDI for export-oriented industries by competitively offering attractive physical and fiscal concessions to notable multinationals – micro or large. Drawing lessons from the FDI experience of comparators will be critical for this approach as Bangladesh is significantly lagging behind at present.

**Potential Role of FDI in Promoting Export-oriented Industrialization**

Export expansion and 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 export-oriented industrialization has attracted considerable attention in recent times. FDIs 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 multinational 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.

One final note on the criticality of FDI in supply chain trade (SCT) must be made. It has been argued that Bangladesh needs to get on the bandwagon of GVCs as a means to export-oriented industrialization. Cross-border FDI flows have been the lifeline for the growth of GVC (or SCT) trade that helps sustain the growing production networks across borders. Therefore, courting FDI in the future to capture and expand supply chains will have to be an essential strategy for Bangladesh’s export-oriented industrialization.

**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. The focus here is on the experience of East Asia and South Asia.

In East Asia the experience of China is instructive as it has witnessed both a massive growth in exports and of FDI contemporaneously suggesting 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 approaching the subject from a spatial dimension Zhang found similar results. Examining the spatial patterns of exports and FDI, he found that FDI concentrated in the coastal areas and so did exports from them. Using panel data at the provincial level in the period of 1986 to 1997, the study found that 1% change in the level of FDI in previous year is associated with 0.29% increase in exports in the next year. The findings support the widely held belief that increased levels of FDI positively affect provincial manufacturing export performance.

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.

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 empirical evidence indicates 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.

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 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 preceding review provides strong research evidence of the critical role played by FDI as a catalyst for export-oriented industrialization which was the lynchpin of high growth in the East Asian economies. FDI inflows could play a similar role in Bangladesh’s transformation into a high-performing industrial economy with robust exports in the next decades.

*FDI fuels GVC exports.* In Asia, FDI has played a particularly catalytic role in stimulating trade in intermediate goods over the past 25 years or so. From 2001 to 2016, Asia’s share of global FDI increased from 12 percent to 28 percent; much of it had to do with the complementarity of trade and investment in the context of ‘Factory Asia’ and Asia’s growing participation in cross-border global value chains (GVCs). GVCs are typically coordinated by Trans-National Corporations (TNCs), with cross-border trade of inputs and outputs taking place within their networks of affiliates, contractual partners and arm’s-length suppliers. According to UNCTAD (2013) TNC-coordinated GVCs account for some 80 per cent of global trade. As a result of the role of TNCs in global trade, FDI is found to be closely linked with a countries’ GVC participation. The correlation between FDI stock in countries and their GVC participation rates is strongly positive, and increasingly so over time, especially in the poorest countries, indicating that FDI may be an important avenue for developing countries to gain access to GVCs and grow their participation. Climbing the GVC development ladder implies not only increasing GVC participation and increasing domestic value added in exports. It also means moving into activities that can provide more development value added and increasing participation in more sophisticated GVCs, from resource-based activities, to low-, medium- and high-tech activities, to knowledge-based activities such as design, innovation, R&D, marketing and branding – as the experience of East Asian economies show.

Currently, Bangladesh faces the dual challenge of mobilizing more FDI and into the GVC operation. That is, its best chance of getting on the GVC bandwagon lies in aggressively courting FDI from multinationals that are seeking low-cost locations for producing parts and components or for final assembly within the framework of cross-border production integration. FDI thus becomes critical for Bangladesh to not only develop a wider base of intermediate goods industry but also to diversify exports into intermediate goods by vertically integrating with cross-border production entities. It needs to translate its RMG experience with GVC on to other sectors like Footwear and Leather goods, electronics, light engineering, and other sectors with an aggressive strategy of FDI-driven GVC over the course of the next decade. That would constitute a new form of export-oriented industrialization for Bangladesh on way to becoming a UMIC.

**Bangladesh Experience with FDI**

The recent trend in global FDI flows is shown in Figure.14. 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 $1.7 trillion in 2016.

##### Figure 14: Global FDI Flows 2005-2016, Billion US$

***Source: UNCTAD, 2016***

The distribution of these flows by regions as shown in Figure.15demonstrate that developing countries are increasingly mobilizing FDI, accounting for some 40 percent of the total global FDI flows. Within the developing world, the South and East Asia Region got 67 percent of the FDI inflows to the developing countries with China marshalling a whopping 53 percent of that.

##### Figure 15: Regional Distribution of FDIs 2016, US$ Billions

***Source: UNCTAD, 2016***

Bangladesh is a minor player in FDI. As of 2016, it approached about 2 billion dollar, which is less than 0.04 percent of total inflows in South and East Asia as compared with $44 billion in India (Figure.16). 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 FDIs so far.

##### Figure 16: FDI Inflows in East and South Asia 2016, US$ Billion

***Source: UNCTAD 2016***

Figure.17shows the trend of FDI in Bangladesh between 1996 and 2016. The FDI inflows have now crossed the $2.0 billion mark. Much of the FDIs were outside the export-promotion zone (EPZs), simply because EPZ were limited in size relative to demand. This is also in sharp contrast with the experience in China where much of the FDIs went into the free trade zones. The Government’s current plan to set up 100 special economic zones (SEZ) will be addressing the binding constraint of land with functioning infrastructure to attract FDI.

##### Figure 17: Trend of FDIs in Bangladesh 1996-2016

***Source: Bangladesh Bank***

The sectoral composition throws additional insight on the nature and pattern on FDIs in Bangladesh (Figure.18). Much of the FDI concentrated in three major areas: energy (33%), manufacturing (26%), banking (15%), and communications (10%). More recently, with the deregulation of the telecommunications industry a substantial amount of FDI has flown into the sector since 2004.

##### Figure 18: Sectoral Distribution of FDIs in Bangladesh

***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 policies and supportive fiscal and banking incentives. RMG entrepreneurs took advantage of this positive environment and invited foreign firms to enter into joint ventures. EPZ also attracted FDI into this sector. These FDI brought in new technology, financing and market access. Regarding power, oil and gas, the government invited foreign firms for private power generation, 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 the most 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 all exports, except RMG. Even in RMG and textiles, though it is the major destination for manufacturing FDI, much of the inflow has been limited to EPZ, as there was local resistance to FDI outside EPZ[[10]](#footnote-10). This situation is now changing as the government has put pressure on the BGMEA/BKMEA to issue utilization declarations (UDs) to foreign RMG firms as well. 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 to the upscale RMG market in USA and Europe.

Second, 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.

Third, 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.

Fourth, with GDP having crossed $250 billion, Bangladesh has attracted FDI into a rapidly growing hospitality industry which has attracted the top global Hotel chains like Westin, Radisson, Holiday Inn, Sheraton, Pan Pacific, to set up and manage high class hotels in the country. Hospitality infrastructure plays a vital role in facilitating exports and international trade.

Finally, taking the cue from the initial GVC experience in RMG, Bangladesh needs to launch a concerted effort to hop on to the GVC bandwagon by nurturing incumbent FDI and courting TNCs that are looking for low-cost production centers to expand their supply chains in the South and East Asia region. For the next decade and beyond, this particular feature of FDI promises to boost Bangladesh’s trade and exports by diversifying into many potential export products that are many (some 900 export products were recorded under $1 million in 2016) but still small players in the country’s export basket.

# STRENGTHENING INSTITUTIONS FOR TRADE AND INDUSTRY

From a careful review of economic history, we find confirmation of the fact that rapid growth that transforms developing economies into developed economies in the course of a generation requires a combination of two things: sound economic policies and good institutions to implement them. Research has shown that differences in institutions related to trade and industrial activity explain a good deal of why export and industrial performance differs across countries. There is much to be done in reforming several of the institutions in Bangladesh that deal with trade and industry, particularly in the area of promoting exports and its diversification.

*Sound policies.* The World Development Report 1991 argued that sustained rapid growth results from the positive interaction of four critical aspects of economic policy: macroeconomic stability, human capital formation, openness to international trade, and a policy environment that encourages private investment and competition. That argument is valid today, and will remain so for the foreseeable future.

Macroeconomic stability with sustainable internal and external balance is a fundamental prerequisite of rapid growth. On this score Bangladesh does well for having maintained low and sustainable fiscal deficits, prudent management of public expenditures, modest inflation rates, and low level of public debt, both domestic and foreign. On the external front, exchange rate management has ensured exchange rate stability, a competitive exchange rate for the most part, and helped accumulation of foreign exchange reserves to comfortable levels, without any episode of external debt overhang or debt rescheduling.

Economic policies have to be market-friendly with the state playing a facilitating role. In letting markets function private agents will be facing a competitive environment in which to invest and allocate resources efficiently and productively. Bangladesh meets this criteria in modest terms. Having recognized the pivotal role of markets in development, Bangladesh followed a gradualist approach of moving toward market-friendly growth strategy with a carefully delimited government activism leaving much of activities in the hands of the private sector. While the industrial sector is no longer subject to investment restrictions for the private sector, there still remains a sizable quantum of state-ownership of enterprises in jute and cotton textiles, and some other products. Loss-making state-owned industries and a bunch of state-owned banks are the Achille’s heels of the Bangladesh economy as they continue to gouge significant public resources periodically (through subsides and cash infusion) to stay afloat.

Trade openness and greater integration with the world economy has given exports a boost for many developing economies that were able to break into the global market for manufactures. With regard to trade openness, Bangladesh has made huge progress since 1990 but the agenda of trade reforms remains unfinished. There is still some way to go as we have not been able to transfer the success of RMG sector to other export products. One of the features of a competitive dynamic economy is to ensure that domestic prices of tradable are close to international prices. That would require protection levels to be modest as in the case of the East Asian economies during their import substitution phase. This is where Bangladesh has work cut out as high levels of effective protection to import substitutes keep domestic prices significantly above international prices with considerably higher profitability of domestic sales compared to exports. A swift rationalization of the protection structure has become an imperative for export diversification, i.e. expansion of non-RMG exports.

Export-oriented development in the future must take note that the future of global trade is digital. The mega-trends of digitization and more efficient systems are all in play around the globe. According to Dubai Multi-Commodities Centre (DMCC, 2015), on-going digital revolution by stimulating digital commerce in global trade is expected to create 350 million more businesses that will export goods and services adding as much as $29 trillion to the world economy over the next decade. Bangladesh will have to be ready with its own digital strategy for the future in order to create opportunities for the vast numbers of small businesses (SMEs) that could gain access to world markets and take advantage of this revolution. Digital Bangladesh will have to shift some of its focus to digital trade creation opportunities with supportive regulation, access to funding, securing talent, and forging system efficiency.

Institutions. Economic historians who have studied prosperity and decline of nations have concluded that inclusiveness of political and economic institutions is critical for sustained prosperity (Acemoglu and Robinson, 2012). With a return to democratic politics in the 1990s, opening up of markets, deregulation and privatization of industrial enterprises, trade and exchange liberalization, Bangladesh is on way to building the kind of institutions that yield prosperity for the long-term. The next decade will be crucial for strengthening economic institutions that will help entrepreneurs seize market opportunities emerging in a fast-changing global economy driven by innovation and creative destruction. Though it appears that Bangladesh is on the right track with its growth trajectory on an upward trend, it should not give rise to complacency, as history shows that prosperity over time follows a non-linear process. In order to attain and sustain high economic growth what is needed is building and nurturing inclusive economic institutions that are effective in enforcing property rights, creating a level playing field for small and large entrepreneurs, SMEs and big business, and encouraging investment in innovation, adoption of new technologies and developing skills for the future.

Transforming the Bangladesh economy into a high-income economy over the next 25 years will require strengthening of institutions that promote sound economic fundamentals, enhance functioning of markets for efficient resource allocation, and foster competitive discipline. Intervention in markets would have to be kept to a minimum. The record of high-performing economies show that promotion of specific industries did not yield results as industrial development tended to be market-conforming and exports performed better when driven by factor-intensity based comparative advantage. That means we need to revisit the approach to “thrust sectors” providing instead a conducive policy environment for all investors and let those with the best potential succeed. The likely scenario in our digital future is that information asymmetry will fade to equalize market opportunities for all players.

What about institutions that determine policies for import substitute protection and export promotion? For one, there is no alternative but to phase out the current high level of effective protection as early as possible. Tariff protection -- if ever needed in the future -- as an economic policy can only be justified on a time-bound basis. Research on Bangladesh tariff structure and protection (PRI, 2012) reveals a high degree of tariff escalation resulting in a high magnitude of protection. A transparent and efficient tariff policy of the future can only conform to a scheme of low and uniform tariffs. This is also because escalated tariff structure with high import substitute protection creates significant anti-export bias of incentives. Moreover, bureaucratic institutions (customs and tax administration) that govern such protection schemes need to be highly efficient and incorruptible to effectively implement neutralizing schemes (e.g. bonded warehouses, duty-free imports). Likewise, export promotion policies like cash subsidies, favorable exchange rate, directed and concessional credit schemes, etc. also need to be results-oriented (e.g. yardstick of export targets) and time-bound. The best option for exports in the future would be to move towards a free trade regime with support for skill development and technological deepening.

As Bangladesh graduates out of its LDC status, it will need to be cognizant of some WTO rules that it had hitherto ignored – particularly, those relating to levels of protective tariffs and para-tariffs. Other multilateral disciplines will also come into play, such as rules governing intellectual property, subsidies, standards, and trade-related investment, which are going to be the same for developing and developed economies. Moreover, if Bangladesh were to seek membership of regional trading blocs, like RCEP, it would have to submit to their disciplines which are also likely to be stringent. Broadly speaking, economic institutions in Bangladesh will have to start getting ready to face and conform to a more competitive and rules-based global trading environment in the future. Nevertheless, trade facilitation with improved customs infrastructure and administration will remain effective mechanisms to promote exports while being consistent with multilateral rules.

# CONCLUSIONS AND THE ROAD TO TRANSFORMATION TO HIC

The present study has argued that the future of the world economy, trade and industry, is going to be digital. Bangladesh will have to be transformed into a digital economy with industry and services rapidly adopting the technological advances taking place around the globe. That calls for heavy investment in education and skill development as the economy moves into UMIC status. There is no scope for missing the bus. It has been made clear in this study that falling behind in making this investment in human capital will rob the country of its potential attainment of HIC status by 2041.

Development economists have often referred to Bangladesh as a model of development. Gone are the skeptics who had dubbed Bangladesh a “basket case”. With all the technological breakthroughs and churning that will take place over the next 25 years, Bangladesh could indeed pull another surprise and join the ranks of HIC in the 2040s propelled by high growth in the 2020s and 2030s.

High growth is possible. According to Nobel Laureate Michael Spence, from ancient to modern times, the global flow of goods and services has never been static. It is now possible for countries to grow at 7,8,9, and 10 percent annually because of the enabling effect of the global economy. That is, economies can grow as fast as they can invest, provided they have some competitive edge. Bangladesh has proven its competitive edge in labor-intensive products, which will remain the basis of its global competitive advantage for the next decade before knowledge and skill-intensive growth takes over. Bangladesh will thus have to start now for achieving that transformation in competitive advantage.

These are some of the transformations that will be taking place as the economy moves up the income ladder:

* ***Structural change***: the share of industry in GDP, at 33% in 2020, is expected to reach 40% in 2030, then decline to 33% by 2041; services at 54% of GDP in 2020 will be rising to become the dominant part of the economy reaching 62% of GDP by 2041. Agriculture, like in most developed economies, will shrink to only 5% of GDP by 2041 (Fig.1).
* ***Fourth Industrial Revolution***: Bangladesh will need to play catch up and adopt the technological transformations of Industry 4.0 (IoT, 3D printing, etc.) in order to remain a global player in RMG and other potential exports.
* ***New Wave of Globalization***: just as globalization created opportunities for Bangladesh to break into world markets for manufactures, it must remain fully prepared to embrace the new wave of globalization, seize emerging opportunities, and take on future challenges. That remains the only option for Bangladesh to become a highly industrialized economy of the future.
* ***Future challenge of competitiveness***: In the unfolding industrial universe of the future, Bangladeshi firms will face the stark reality that competitive advantage founded on low labor cost cannot be guaranteed for all time. Competitive advantage is dynamic and will be evolving. From its current phase of factor-driven competitive advantage Bangladeshi firms will have to move into investment and innovation driven competitive advantage (*a la Porter*). Without such efforts, entrepreneurs need be warned that the current competitive advantage in labor-intensive garment exports could well be lost in future.
* ***Lessons from East Asian economies*** (Korea, Taiwan, Malaysia, Thailand): all of these high performing economies that eventually crossed the high-income threshold acquired the following characteristics: macroeconomic stability, high shares of trade in GDP, heavy investment in people (skills development), and strong competition among firms. Bangladesh already has some of these characteristics, and will have to focus on acquiring the rest, especially on investment in people and skill development.
* ***Trade openness and reliance on external markets***: The experience of the high-performing East Asian economies clearly demonstrates the criticality of export-oriented trade policy for a superior export performance. Ensuring export competitiveness in the global marketplace must be a key export strategy for all times and access to world-price inputs must be ensured. The speed of Bangladesh’s industrialization with job creation will depend on how well the economy is integrated with the global economy, with well-heeled policies to capture external markets while removing distorted incentives in domestic markets.
* ***Exploiting Global Value Chains and courting FDI***: The fragmentation of production processes across different countries has given rise to global value chains (GVCs) creating opportunities for intra-industry trade globally, especially giving a boost to trade in intermediate goods. But the technical ‘know-how’ needed for the production of an intermediate good in the GVC must be obtained since Bangladeshi entrepreneurs are not exposed to such expertise. That justifies the critical need for foreign direct investment, and policy makers must mitigate any constraints that undermine the prospects of FDI. Not only in the production of intermediate goods, courting FDI will be essential for future technology leapfrogging to capture production and market access in manufacturing products of the coming decades.
* ***Strengthening institutions for trade and industry***: Historical research finds conclusive evidence that inclusiveness of political and economic institutions is critical for sustained prosperity. Bangladesh is on way to building the kind of institutions that yield prosperity for the long-term. The next decade will be crucial for strengthening economic institutions that will help entrepreneurs seize market opportunities emerging in a fast-changing global economy driven by innovation and creative destruction (*a la Schumpeter, 1942*)[[11]](#footnote-11).

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# ANNEX-A

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Table-A1: Republic Of Korea: Key Growth Drivers During Transition From Lower Middle Income(LMYC) to Upper Middle Income(UMYC) and Beyond** | | | | |
| Economic Indicator | **1970s** | **1980s** | **1990s** | **2000s** |
| **Real Sector Block** |  |  |  |  |
| Real GDP growth (%) | 10.5 | 8.8 | 7 | 4.7 |
| Per Capita GDP Growth (%) | 8.3 | -3.2 | 8.7 | 8.0 |
| **Economic Transition** | **1971** | **1980** | **1990** | **2000** |
| Agriculture share of GDP (%) | 29.5 | 15.9 | 8.4 | 4.4 |
| Industry Share of GDP (%) | 25.2 | 35.4 | 39.6 | 38.1 |
| Service Share of GDP (%) | 45.5 | 48.7 | 51.9 | 57.5 |
| Investment rate (%) | 25.5 | 34.6 | 39.6 | 32.9 |
| ICOR | 2.4 | 21.5 | 2.8 |  |
| Saving rate (%) | 15.9 | 25.4 | 39.2 | 34.3 |
| GNI Per Capita | 1979 | 3663 | 8451 | 14989 |
| **Table-A2: Taiwan: Key Growth Drivers During Transition From Lower Middle Income(LMYC) to Upper Middle Income(UMYC) and Beyond** | | | | |
| Economic Indicator | **1970s** | **1980s** | **1990s** | **2000s** |
| **Real Sector Block** |  |  |  |  |
| Real GDP growth (%) | 10.8 | 8.5 | 6.9 | 2.6 |
| Per Capita GDP Growth (%) | 3.3 | 4.8 | 6 | 6.4 |
| **Economic Transition** | **1971** | **1980** | **1990** | **2000** |
| Agriculture share of GDP (%) | 15.3 | 7.5 | 4 | 2.1 |
| Industry Share of GDP (%) |  |  | 38 | 32.4 |
| Service Share of GDP (%) |  |  | 58 | 65.5 |
| Investment rate (%) |  | 28.4 | 24.8 | 26 |
| ICOR |  |  |  |  |
| Saving rate (%) |  |  |  | 32 |
| GNI Per Capita | 451 | 2386 | 8431 | 15142 |
| **Table-A3: Malaysia: Key Growth Drivers During Transition From Lower Middle Income(LMYC) to Upper Middle Income(UMYC) and Beyond** | | | | |
| Economic Indicator | **1970s** | **1980s** | **1990s** | **2000s** |
| **Real Sector Block** |  |  |  |  |
| Real GDP growth (%) | 7.9 | 5.9 | 7.2 | 4.8 |
| Per Capita GDP Growth (%) | 3.3 | 4.8 | 6.0 | 6.4 |
| **Economic Transition** | **1971** | **1980** | **1990** | **2000** |
| Agriculture share of GDP (%) | 28.4 | 23.0 | 15.2 | 8.6 |
| Industry Share of GDP (%) | 30.5 | 41.8 | 42.2 | 48.3 |
| Service Share of GDP (%) | 41.1 | 35.2 | 42.6 | 43.1 |
| Investment rate (%) | 21.5 | 27.9 | 32.6 | 26.8 |
| ICOR |  |  |  | 3.5 |
| Saving rate (%) |  | 26.8 | 30.4 | 35.9 |
| GNI Per Capita | 2006 | 3199 | 4359 | 6470 |
| **Table-A4: Thailand: Key Growth Drivers During Transition From Lower Middle Income(LMYC) to Upper Middle Income(UMYC) and Beyond** | | | | |
| Economic Indicator | **1970s** | **1980s** | **1990s** | **2000s** |
| **Real Sector Block** |  |  |  |  |
| Real GDP growth (%) | 7.1 | 7.3 | 5.2 | 4.3 |
| Per Capita GDP Growth (%) | 1.9 | 3.0 | 9.6 | 3.4 |
| **Economic Transition** | **1971** | **1980** | **1990** | **2000** |
| Agriculture share of GDP (%) | 23.9 | 23.2 | 12.5 | 8.5 |
| Industry Share of GDP (%) | 27.1 | 28.7 | 37.2 | 36.8 |
| Service Share of GDP (%) | 49 | 48.1 | 50.3 | 54.7 |
| Investment rate (%) | 24.2 | 29.1 | 41.4 | 22.3 |
| ICOR |  |  |  | 5.9 |
| Saving rate (%) |  | 22.7 | 32.8 | 29.2 |
| GNI Per Capita | 946 | 1392 | 2472 | 3390 |

***Source: World Bank’s World Development Indicators***

1. Nonarit Bisonyabut of Thailand Development Research Institute, as quoted in The Nation, October 11, 2014. [↑](#footnote-ref-1)
2. Top 15 exports as percentage of total exports. [↑](#footnote-ref-2)
3. Recently, ships built for Germany and Denmark received strong certification of technical merit from the European buyers. [↑](#footnote-ref-3)
4. Imported inputs such as fabric and accessories were made available on credit linked to export orders, and eventually settled from export proceeds. [↑](#footnote-ref-4)
5. Lately, NBR has been selectively – very hesitatingly -- providing SBW facility to non-RMG exporters. Still, vast numbers of small non-RMG exporters are essentially deprived of world-priced inputs. [↑](#footnote-ref-5)
6. 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. [↑](#footnote-ref-6)
7. Trade taxes other than custom duties that are akin to tariffs. [↑](#footnote-ref-7)
8. Due to lack of comparable cross-country information on trade taxes other than CD. [↑](#footnote-ref-8)
9. ERP 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. [↑](#footnote-ref-9)
10. As Utilization Declarations (UDs) for RMG exports were issued by the two associations, BGMEA and BKMEA, exporting firms has to be members in order to get the UDs and foreign investors faced entry barriers to these exclusive local clubs. Lately, Export Promotion Bureau (EPB) has decided to issue UDs to foreign firms, if they are unable to obtain them from the associations. [↑](#footnote-ref-10)
11. The expression "**creative destruction**" was popularized by and is most associated with Joseph **Schumpeter**, particularly in his book Capitalism, Socialism and Democracy, first published in 1942. [↑](#footnote-ref-11)