

# Policy Brief

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## Trade and Industrial Policy Environment in Bangladesh\*

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By now Bangladesh has implemented serious trade policy reforms to make its economy more outward-oriented. Various liberalisation programmes undertaken for this purpose have led to a remarkable simplification of the import regime, decline in quantitative restrictions, diminution and rationalisation of import tariffs, and a freely floating foreign exchange rate regime. An important feature of trade reforms has been the provision for generous export promotional schemes. Trade liberalisation and export support measures have contributed to opening-up of the overall economy and reducing the policy-induced anti-export bias.

With the process of trade liberalisation, Bangladesh's economy has witnessed a robust performance of the export sector. However, the export growth is overwhelmingly dominated by the dynamism in the RMG sector alone. Export response from all other major commodities has been very weak. Therefore, because of a lacklustre performance of non-RMG sectors, the spectacular change in the structure of export basket over the past two decades or so, in which the dominance of jute has been replaced by clothing, has not meant any achievement in terms of export diversification; in fact, currently Bangladesh's export is least diversified in comparison with any other period since independence.

## Evolution of Trade and Industrial Policies in Bangladesh

The number of trade-related banned items has declined from 275 to 5 over the past two decades, while such items on control list have been brought down drastically. A remarkable success has also been achieved in rationalizing and liberalizing tariff restrictions. The highest tariff rate was as high as 350 percent in 1992 in comparison with only 25 percent at present. The number of tariff slabs (including zero) has come down from 24 in the 1980s to only 4. This has greatly simplified the tariff structure, making it more transparent and reducing the administrative burdens of dealing with a complex and high number of tariff slabs.

Reform of the exchange rate regime is central to any trade liberalisation policy. In the past Bangladesh had pursued a policy of 'managed' system of floating when the taka was made pegged to a basket of currencies of the country's major trade partners. Under this system the country had to make regular adjustments through nominal devaluations of the taka to mitigate the problem of overvaluation of the exchange rate. However, the taka was made freely floating in 2003.

Another important element of trade policy reform was the introduction of generous promotional measures for exports. While import and exchange rate liberalisation were intended to correct the domestic incentive structure in the form of reduced protection for import-substituting sectors, export promotion schemes were undertaken to provide exporters with an environment in which the previous bias against export-oriented investment could be

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reduced significantly. Important export incentive schemes that are now available in Bangladesh include, inter alia, subsidised rates of interest on bank loans, duty free import of machinery and intermediate inputs, cash subsidies, duty drawbacks, and exemption from value-added and other taxes.

By any standard Bangladesh's economy is now much more open than before. While the reductions in import tariffs and removal of QRs make the policy intent of the move toward liberalisation obvious, in terms of the outcome of these policy measures the trend in trade-orientation of the economy reveals its increased openness over time. The export-GDP ratio has increased from less than 6 percent of the late-1980s to the current level of 15 percent, while, during the same period, the import-GDP ratio has grown from 12 to 20 percent.

When considered side-by-side, liberalisation programmes give the impression of their being successful in energizing export. However, export growth has been overwhelmingly dominated by the dynamism in the RMG sector alone, international trade in which had been governed by MFA quotas limiting competition and providing a reserved market for the country until the end of 2004. Apart from RMG, export response of all other major commodities has been very weak. The RMG sector also appears to be the main beneficiary of the export incentives while for the non-RMG sectors such schemes have been proved to be less effective. Therefore it is not clear to what extent the policy of liberalisation benefited the export sector.

### **Anti-Export Bias and Trade Policy Options for Bangladesh**

To what extent Bangladesh has been able to reduce anti-export bias in its trade policy regime is an important question. Despite the reforms related to dismantling of quantitative restrictions and diminution of import tariffs, significant policy bias could still exist thereby discouraging the re-allocation of resources in favour of the export-oriented sectors. The analysis undertaken in this volume, however, shows that the current price incentive structure, as measured by average relative effective exchange rates, is only 10-13 percent skewed against the export sector. While further liberalisation of the tariff regime could be another

way of reducing the anti-export bias, the evidence provided calls for undertaking much more careful approach to future liberalisation.

One of the main problems of future liberalisation is the ensuing revenue shortfall. Although revenue losses can arguably be made up by mobilising additional domestic resources, tax administration in a poor country like Bangladesh is not flexible and effective enough for this purpose. Indeed, the increasingly discriminatory use of supplementary duty and other supposed-to-be-trade-neutral taxes largely reflects revenue concerns of the government.

Also, the potential effects on growth from further tariff cuts have been found to be quite small. Furthermore, there is clear evidence that the past liberalisation has failed to stimulate export response. Therefore, there are concerns that further tariff liberalisation alone is unlikely to be sufficient for promoting export and economic growth.

Liberalisation programme in Bangladesh has focussed merely on trade related instruments such as tariffs and quantitative restrictions. Not much attention has been given to the reforms of the institutions. However, significant growth-enhancing effects perhaps require reforms in difficult areas like institutions rather than tariff-cuts and removal of quantitative restrictions. This is not to deny the need of future tariff rationalisation programme but to stress the usefulness of more difficult reform measures.

Trade policy and the policy of trade liberalisation must be considered as two separate things. An overall pro-liberalisation policy can be accompanied by policy support for certain specific sectors with high growth and poverty alleviation potentials. However, in the absence of a clear-cut trade policy philosophy and lack of manoeuvrability, Bangladesh has failed to exploit the positive role of trade policy mechanism.

Considering the export sector, it is important to determine if the policy induced anti-export bias is the only problem for expanding exports. When tariff cuts and rationalisation have failed to stimulate export response, particularly of non-RMG sectors, the need for understanding the demand and supply side problems faced by these sectors can hardly be overemphasised. Some of these problems can be

related to policy while others can be structural in nature.

### **Investment Climate in Bangladesh: An Appraisal**

Higher economic growth is preconditioned by mobilising greater amount of resources for investment. It is widely held that Bangladesh has failed to ensure a healthy investment climate, which is also likely to be a constraining factor for the non-traditional export sector's growth. Several surveys and analyses regularly compare cross-country investment climate with other countries, which has drawn a lot of attention of the policymakers and the relevant stakeholders in Bangladesh. However, inter-country ranking that some of these study prepare tend to create a lot of misunderstandings.

It is found that the cross-country surveys are subject to certain limitations, which could affect the ranking of countries on various parameters of investment climate. Policymakers and the relevant stakeholders therefore need to understand the methodologies used in these comparative analyses, their limitations and hence potential consequences of the ensuing outcomes. It has been argued that emphasising on the cross-country ranking is wrong. Rather, the suitability of these ranking exercises in determining inter-country performance in the trends of the associated variables (e.g., inflow of foreign investment, economic growth, etc) should be taken into consideration. Each country has certain unique features in influencing investment climate related parameters, and a comprehensive evaluation of the country situation will call for identifying these factors irrespective of their suggested relative ranking.

This study argues that a great deal of caution should be exercised when reporting the cross-country survey results. Unreliable surveys and studies could affect a country adversely by discouraging potential business enterprises from making investment decisions. The existing situations in low-income countries can be the outcomes of underdevelopment rather than its cause, and the ability of the poorest countries in matching the high-income countries' standards is to be realistically assessed.

On the other hand, rather than only criticising these study findings, however unscientific the methodologies may be, the policymakers in Bangladesh should attempt to make a comprehensive

review of the situation and be critical of the existing practices and determined to make improvements. Policymakers and the relevant stakeholders can learn from success stories of other countries despite the problems of inter-country comparisons. Therefore, rather than focussing on the relative positions of the countries, more attention will have to be given in understanding the cross-country development experiences.

### **Supply-side Constraints in the Export Sectors in Bangladesh**

It is very important for Bangladesh to diversify its export basket by promoting export performances of the non-RMG sectors. In this regard, effective development of a number of thrust sectors could serve this purpose. However, there are several policy-induced and supply-side constraints that have constricted the export responses from these sectors. Some of these factors are sector-specific, whilst others are more general affecting the export industry as a whole. Sector-specific problems can be identified from in-depth sectoral studies, some of which have been identified in this volume. There is a need for further research dealing with each of these sectors in a comprehensive manner. On the other hand, the general factors affecting the export sector across the board can be identified quite easily: lack of investment fund and working capital, high interest rate, shortage of skilled workers, lack of entrepreneurial and managerial skills, poor physical infrastructure, inefficient ports along with high transport costs, weak institutions, poor law and order situation, invisible costs of doing business, etc. are the known supply-side impediments seriously obstructing export activities. Therefore, it is important to address these policy-induced and supply-side constraints for stimulating export responses from these sectors.

One pragmatic way of dealing with the constraints to export response is to consider a well-devised integrated approach. Under this approach, actions required at different levels can be brought together to make intervention schemes or support systems comprehensive. Such intervention schemes should be sector specific as well as economy-wide with a view to ensure effective diversification of the export basket of Bangladesh.



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