Chapter 6

Trade Policies and Strategies for Coping with Post-graduation Adjustment

6.1. Background and Overview

Keeping the economy on track while pursuing the development goals of PP2041 will require the Government to develop a coping strategy of policies to address the challenges that the economy and society will be faced with, once the economy loses the multitude of concessions and support mechanisms from the international community when graduation becomes a reality. In the preceding sections, it has been articulated that "trade preference erosion" – the phasing out (or elimination) of trade-related ISMs – is expected to have the most impact on the economy's growth prospects, jobs, and income. But Bangladesh is not going to wait for that eventuality doing nothing. The Government is fully cognizant of some of the implications and this particular exercise to engage in a rigorous study of "Impact Assessment of LDC Graduation" is testimony to that realization.

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. The Government's Sixth and Seventh Five Year Plans and the Perspective Plan 2010-21 already laid out the blueprint for trade and industrial policies for growth acceleration through outward- orientated trade policy regime. The strategies for outward-orientation of trade policies in order to ensure export-led or trade-led growth will have to be activated in full. However, the reform agenda in this area remains unfinished and more will have to be done as we approach the stage of graduation out of LDC. Policies have to be put in place that ensures export competitiveness on the one hand, and restores the balance of incentives between production for exports and import substitute production for sale in the domestic market on the other. There is little doubt that "Preference erosion" is expected to unleash the strongest forces of competitiveness in the global market.

6.2. A Strategy for the Future

Recognizing that Bangladesh's future industrial prospects will be intricately linked to the projected trends in (a) global and regional trade in a highly competitive environment, (b) the future of globalization, and (c) the evolution of trade policies determined by the transformation of manufacturing and services of the future, during the preparatory period of graduation, it is imperative to develop 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 comfortably across the finishing line of LDC graduation.

To sustain and boost economic dynamism during the run up to LDC graduation, a two-pronged approach is needed which is broadly on track though some shortcomings remain:

a. **Growth acceleration will be driven by export-oriented industrialization:** that is globally competitive and based on the country's dynamic comparative advantage, such that industrialization is employment-intensive with evolving skill-intensity consistent with technological sophistication of the Fourth Industrial Revolution (Industry 4) thus paving the way for greater export diversification and competitiveness. Recognizing that export and protection policies are not mutually exclusive, the objective will be to strike a harmonious balance between the two policies by modernizing and rationalizing export incentives and protective tariffs in addition to completing the unfinished trade reform agenda with emphasis on the trade facilitation component of customs administration modernization.

b. **Recognizing private sector as the driver of growth** and, to this end, creating an investment-friendly environment by transforming the state's role as a facilitator of economic and investment activities, strengthening economic and political governance, including the interaction of the state with the private sector; improving law and order; addressing the critically constraining infrastructure bottlenecks (in power, overland and port transport, and communications); establishing a sound and well-functioning financial sector; and addressing other barriers to productivity growth and international competitiveness.

Seek global markets: We are living in a 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[27]. 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. Properly harnessing these global forces will enable Bangladesh to grow at higher rates in future that were simply not possible before.

Given Bangladesh's enormous challenge for creating roughly 2 million jobs annually, there is no option but to creating bridgeheads in the global market for our exports. Given the small size of its domestic economy, Bangladesh needs to expand its exports of goods and services in order to move to a higher growth path and grow out of poverty. The domestic market, despite its continual expansion, is still no match for the vast global market place of $80 trillion[28] Capturing pieces of that market, beyond EU and North America, into China, India, and the Asia Pacific region to top $100 billion of exports by 2025 will have to be the target to reach.

Enhance productivity: Over the next five years or so Bangladesh must be ready to face unbridled competition in the global marketplace as significant "preference erosion" will have taken place by then. In the new competitive environment, the key challenge for us will be to raise 'productivity' of our firms and industries/sectors within the framework of sound macroeconomic management. Bangladesh has roughly five years to climb appreciably up the ladder of World Bank's Ease of Doing Business (EDB 2019) where it is behind most of the comparators. Economic governance and regulatory environment have to be conducive for business and investment --with well-functioning factor markets, efficiently run infrastructure services, easy market entry/exit, enabling regulatory environment and bureaucracy, access to information, and strong competitive pressures--would allow firms to become more productive, competitive, dynamic, and innovative. Such an environment accentuates competitiveness of exporting firms. It extends beyond comparative advantage (based on cheap labour) and shifts to competing on the basis of competitive advantages.

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[27] *This comes from statements by Michael Spence, Nobel Laureate Economist, in an interview with McKJinsey Global Institute's James Manyika: Interview transcript: Why economies grow rapidly. (April 2014). Spence was also head of the 2006 Commission on Growth and Development.*

[28] *World Bank estimate of World GDP in 2017 reported in World Economic Forum 2018 (Jeff Desjardins: The World's $80 Trillion economy in one chart).*

Strive for diversification and competitiveness: And this is what Bangladesh needs to strive for in the coming years for promoting export diversification and competitiveness. Given that there is a significant backlog of incomplete reforms, there is indeed an urgency to act fast in addressing the priority policy and institutional constraints to improving Bangladesh's competitiveness. First, global markets are undergoing rapid technological transformation and trade integration with mooting competitive pressures. There is no option for Bangladesh but to strengthen its competitiveness and diversify its export in order to improve our export performance to engender faster growth. Second, though Bangladesh has become a global player in RMG it has to be ready to cope with stiffer competition once it loses preferential access to its leading export market – the EU. The RMG industry has indeed matured with some of the world's greenest factories (top 3 eco-friendly and 7 of the top 10 garment factories in the world are in Bangladesh). Nevertheless, the industry must remain on the alert to keep in step with technological innovations taking place that could undermine Bangladesh's competitive edge unless all efforts are made to at least march in step with the industry leaders around the world. Finally, the potential for export diversification needs to be fully exploited. Bangladesh has a mono-product export basket with 83% of her exports made up of RMG. Yet, over the past 10 years, Bangladesh has been exporting non-RMG goods numbering 1000 to 1300 products (at HS6-code level) mostly under $1 million in value (75% of non-RMG exports in FY2018).

The Growth Commission[29] asserted that strategic trade integration in the current state of globalization allows developing economies to grow at much higher rates than before. The way for greater trade integration is through increased trade openness via trade liberalization, accompanied by complementary policies and institutional reforms, which in turn enhances competition and facilitates technological upgrading.

With LDC graduation looming large, the severest degree of competition will be unleashed over the next 5 to 10 years. Preparation for that stage must be done in earnest now. Given the current state of trade orientation there are two areas in which the country faces serious challenges: (a) making trade policy – internal and external – tilted in favor of exports, and (b) addressing the plethora of behind-the-border obstacles or deficiencies in order to make exports diversified and competitive in the world market based on our comparative advantage. Efforts made towards enhancing international competitiveness and removing anti-export bias will eventually pay off. It is therefore critical that concerted effort is made to improve Bangladesh's competitiveness by addressing both behind-the-border constraints as well as the remaining significant external trade agenda. This chapter focuses on the trade policy challenge, while the next chapter analyses the behind-the-border issues.

6.3. Addressing the Trade Policy Challenge

The trade policy reforms of the 1990s signaled a significant departure from the highly protectionist, inward-oriented import-substitution policies of the past. Trade integration was enhanced along with greater domestic competition, and domestic relative prices were aligned closer to international prices. These reforms were meant to promote efficiency in resource use, lead to productivity growth, spur activities with comparative advantage, encourage technological progress and diffusion and thus generate dynamic gains. The trade policy measures included tariff cuts and rationalization, elimination of quantitative restrictions, adoption of a unified exchange rate system, switching from a fixed to a more flexible exchange rate regime, and current account convertibility.

[29] *The Growth Commission launched in 2006 was an independent body chaired by Nobel Laureate economist Michael Spence that brought together 22 policy-makers, academics, and business leaders to examine various aspects of economic growth and development.*

The expectation was that these reforms would be gradually intensified to make Bangladesh an export powerhouse in the region with the economy would more open and fully integrated with the global market.

Progress has been slow and far between. But with LDC graduation looming large Bangladesh can ill afford to remain complacent. Unless trade policy reforms are taken to the next phase, LDC graduation in 2024-27 could serve as an adverse shock to the economy.

Rationalize protection regime: With Bangladesh's strong labour-cost advantage future potential in trade growth and export diversification is enormous globally. Success in RMG exports where Bangladesh is now a global player has shown the way. Though tectonic shifts are taking place via the Fourth Industrial Revolution (4IR) cementing the forces of innovation, artificial intelligence (AI) and Internet of Things (IoT), with some skill intensity of our labour force there is still 5-10 years of this advantage remaining to be fully exploited. But policy inconsistencies have to be fixed. High protection to domestic industries and recurrent phases of exchange rate over-valuation create significant anti-export bias to divert resources away from non-RMG exports to import-substitution activities. A priority trade policy agenda is to rationalize tariff protection to balance incentives between exports and domestic production/sales of import substitutes.

Despite considerable progress in the past decade, the current trade regime appears biased in favor of import substitute production – anti-export bias. High tariffs and other protective instruments that protect domestic industries create strong disincentives to exports and export activities through several channels, thus causing significant anti-export bias.

❒ Almost all domestic production of manufactured consumer goods is protected by high tariffs and para-tariffs. Duties levied on imports of final goods raise their domestic relative prices, thereby increasing the profitability of import substitutes relative to exports, which have to be exported at world prices. This diverts resources towards production for the domestic market, away from the production of exports. For example, the very high protection (85.6 percent to 113 percent) afforded to the ceramics and plastics industry—tableware, kitchenware; footwear, lamps, and biscuit industry, etc. (Table A6.1 Technical Annex to Chapter 6) which, to some degree, are reflected in much higher domestic prices of these products compared to their export prices. The net result is that domestic sales are far more profitable than exports, so exports are discouraged. Almost all of these products have some exports but export potential, which is much higher, is never realized.

❒ With import demand being curtailed under high protection, import-related (ex ante) demand for foreign exchange is being curtailed, thus perhaps enabling the exchange rate (i.e., a lower domestic currency price for US$) than otherwise. This would mean that export proceeds, expressed in domestic currency, would be lower than what the exporter would receive had the protection levels provided by import duties and other instruments been lower.

❒ Not just tariff levels, tariff escalation is also high. An escalating tariff structure, with lower tariffs on imports of raw materials and intermediates and higher tariffs on more processed products, raises the effective protection for an import substitute above the nominal protection that the same import substitute receives from import duties and other protection.

This means that the value-added (processing margins) involved in production for the domestic market will exceed the value-added that would have existed in the absence of any protection, by proportionately more than the nominal protection of the final product. This further increases the anti-export bias.

❒ Exporters sell in competitive world markets and cannot pass on increases in their costs of production to their buyers. Thus, import duties paid on imported inputs increase their production costs and reduce their profit margins. Similarly, if they buy their inputs from local producers, again there may be cost raising effects due to protection and/or lack of local competition.

- ✔ The duty drawback system (DDS) in place is grossly inefficient and involves delayed collection of rebates and extra payments.
- ✔ The special bonded-warehouse (SBW) scheme used by the RMG sector is far more effective in a high tariffs economy but serves only specific activities that are 100% export-oriented.

Anti-export bias remains high. High tariff protection is the main source of anti-export bias. Export success so far has been limited to readymade garments (RMG) without much traction in other labour-intensive exports. Among other things, there is an inherent conflict between export policy and protection policy, which are not mutually exclusive. This needs to be recognized and actions taken to streamline these policies. High protective duties on imported inputs hurt competitiveness of exports. Table 6.1 shows Bangladesh's low ranking in relation to other developing countries (implying high tariff protection). Tariff protection, which raises profitability of import substitute production, creates an inherent anti-export bias. Tariffs raise the relative profitability of domestic sales compared to exports, thus discouraging production for exports. Thus, there is an inherent bias of incentives skewed in favor of import substitute production rather than exports. This has to change.

Table 6.1: Bangladesh Rank of Average Tariffs in Relation to Other Developing Countries

Countries	All Products (in Asia)	Manufacturing (in World)
Bangladesh	4	19
India	10	74
Pakistan	5	25
Sri Lanka	12	82
Vietnam	16	90
Malaysia	22	102
Thailand	14	84

Note: All products tariff rankings are based on Asian countries (46 countries); Tariff ranking in manufacturing is based on world ranking of tariffs (182 countries); Ranks higher for lower tariffs
Source: ITC database, Indexmundi trade statistics

Bangladesh's trade liberalization efforts since the early 1990s did produce partial success in reducing the anti-export bias of the trade regime. The ratio of (average) effective exchange rate for imports (EERm) to that of exports (EERx) is used as an indicator of the trade regime's anti export bias--the higher the ratio above 1.00, the higher the bias against export activities. As shown in Table 6.2 below, since FY2005 there has been only modest reduction in anti-export bias. While import substitute production gets the benefit of much higher rates of tariff protection (considered indirect subsidies), export production benefits from cash subsidies (5-20%) for selected exports and discounted interest rates out of loans from the Export Development Fund. Beginning with a ratio of 1.35 in FY2004-05 the ratio had trended upwards by FY2012-13 before declining to 1.33. This degree of anti-export bias creates serious disincentives for exports, particularly of non-RMG exports.

Table 6.2: Trends in Anti-Export Bias Based on Effective Exchange Rates for Import Substitutes and Exports

Fiscal Year	Imports (billion US$)	Exports (billion US$)	Average Nominal protection (NPR %) Consumer goods	Nominal exchange rate (Tk/US$)	EERm	EERx	Anti-Export Bias EERm/ EERx
2004-05	11.87	8.66	37.35	61.39	84.32	62.53	1.35
2005-06	13.30	10.53	38.80	67.08	93.11	68.06	1.37
2006-07	15.51	12.18	35.77	69.03	93.72	70.16	1.34
2007-08	19.49	14.11	34.19	68.60	92.05	70.02	1.31
2008-09	20.29	14.81	33.31	68.80	91.72	70.54	1.30
2009-10	23.74	16.20	41.20	69.18	97.68	71.39	1.37
2010-11	30.34	22.92	41.29	71.17	100.56	73.29	1.37
2011-12	33.31	24.29	48.36	79.10	117.35	81.47	1.44
2012-13	33.58	27.02	51.40	79.93	121.01	84.16	1.44
2013-14	36.57	30.19	50.67	77.72	117.10	82.76	1.41
2014-15	37.05	31.21	47.76	77.67	114.77	84.81	1.35
2015-16	39.90	34.24	45.95	78.26	114.22	84.55	1.35
2016-17	43.49	34.02	45.23	79.12	114.91	87.85	1.31
2017-18	54.46	36.67	45.98	82.10	119.85	90.22	1.33

Note: Since protection is provided mostly to consumer goods, average NPR for consumer goods is used. Effective exchange rate for import substitutes (adjusted for NPR) is EERm and for exports (adjusted for cash and interest subsidies) EERx.
Source: EPB, BB, and GED estimates

The conclusion: the structure of incentives created by the trade policy still favors the production of import substitutes and constitutes a significant barrier to the emergence of new exports and to the expansion of exports that are not benefiting from enclave arrangements as in RMG sector. Furthermore, these calculations are based on the protection levels made 'available' by NPR rather than effective rates of protection (ERP) which are much higher. Research on effective protection levels for key import substitute industries (Ahmed and Sattar 2012) show much higher average rates (e.g. footwear 273%; agro-processing 287%; plastic and ceramic tableware 215%).

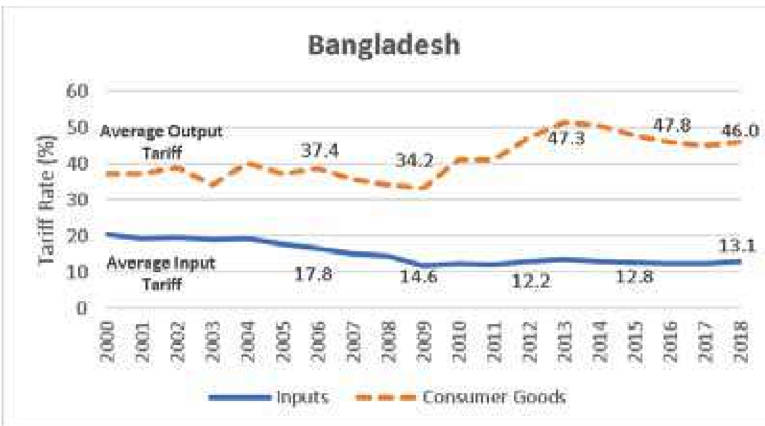
In the circumstances, the two inter-linked policy of rationalizing the protection structure and sufficiently incentivizing exports needs immediate attention. Since protection levels are high any support to export (e.g. subsidies) will have to be high, but such measures will fall afoul of WTO rules following graduation. So, there is no option but to rationalize the level and structure of protection to import substitute industries in order to minimize the level of anti-export bias.

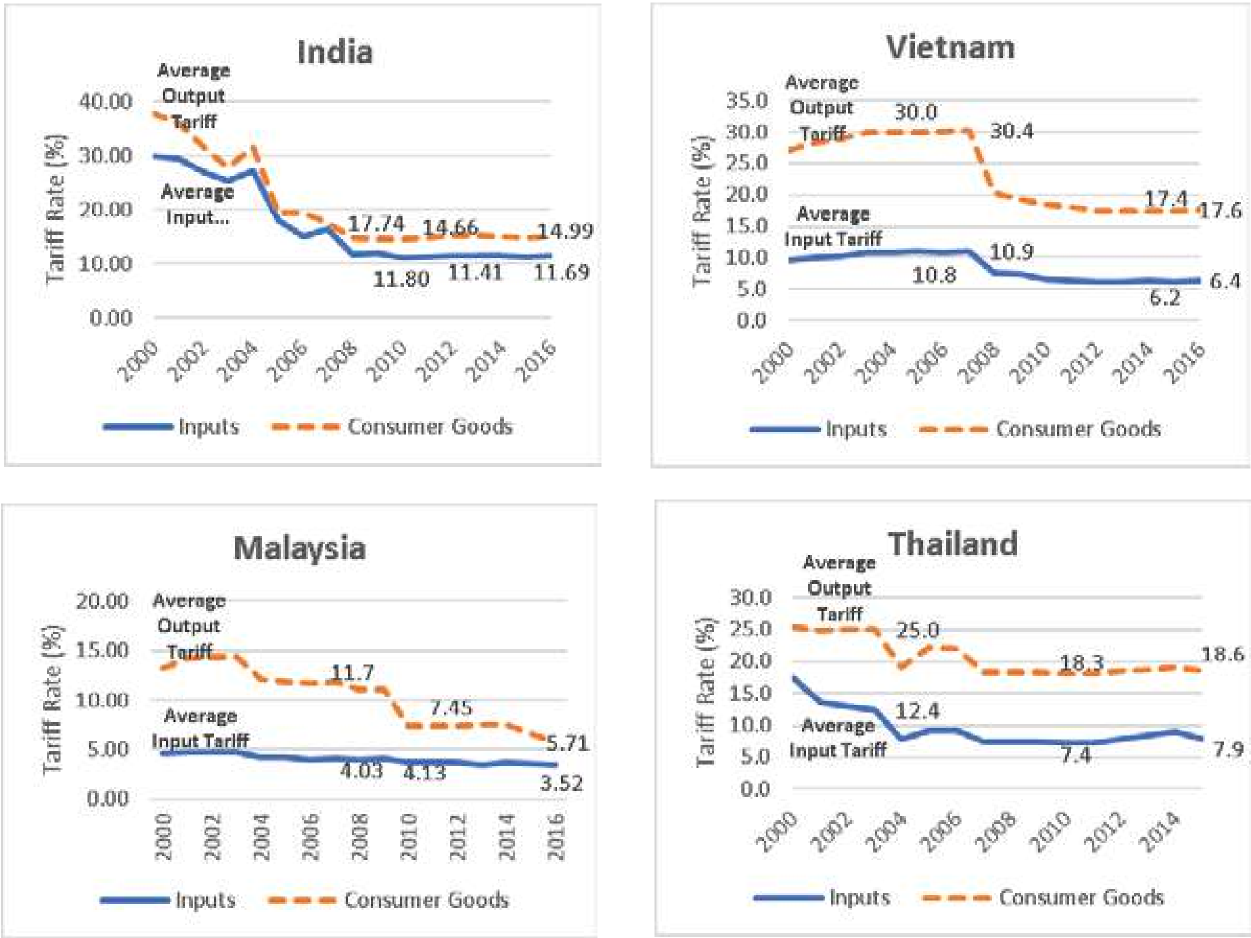
The Imperative of Tariff Modernization

Streamlining trade and tariff policies calls for a five-year program of adjustment culminating in a trade and tariff regime that is reflective of or trending towards a UMIC economy. Needless to say, that the current tariff regime, which is replete with para-tariffs for protection purposes and the near absence of tariff bindings on manufacturing products, will have to change dramatically once the economy loses LDC status. Both external (opening markets by seizing opportunities of bilateral, regional and plurilateral agreements) and domestic content (eliminating anti-export bias by balancing incentives for exports and domestic sales) of trade policy will have to be revamped to fit the demands of a dynamic global market and an export-oriented trading regime.

The current tariff structure is archaic and needs urgent reforms. One required priority action is the further rationalization and modernization of the tariff regime. 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. A close examination of the structure of tariffs reveals that the decline in average nominal protection rate (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 6.1 and Table 6.3). 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 and other comparator countries. Two things to be noted: while the divergence between input and output tariffs (tariff escalation ratio) in comparator countries is low and over time both input and output tariffs trend downwards, the trend in Bangladesh tariffs follow the opposite – output tariffs rise while inputs tariffs decline over time. This is untenable and needs to change for the future. There is no justification for tariff escalation -- defined as ratio of average tariff on output over avg. tariff on inputs – to be the highest in Bangladesh.

Figure 6.1: Trends in Output and Input Tariffs: Bangladesh, India, Vietnam, Malaysia and Thailand





Source: NBR, TRAINS Database, WITS

Table 6.3. Tariff Escalation Ratios of Bangladesh and Selected Countries/Regions

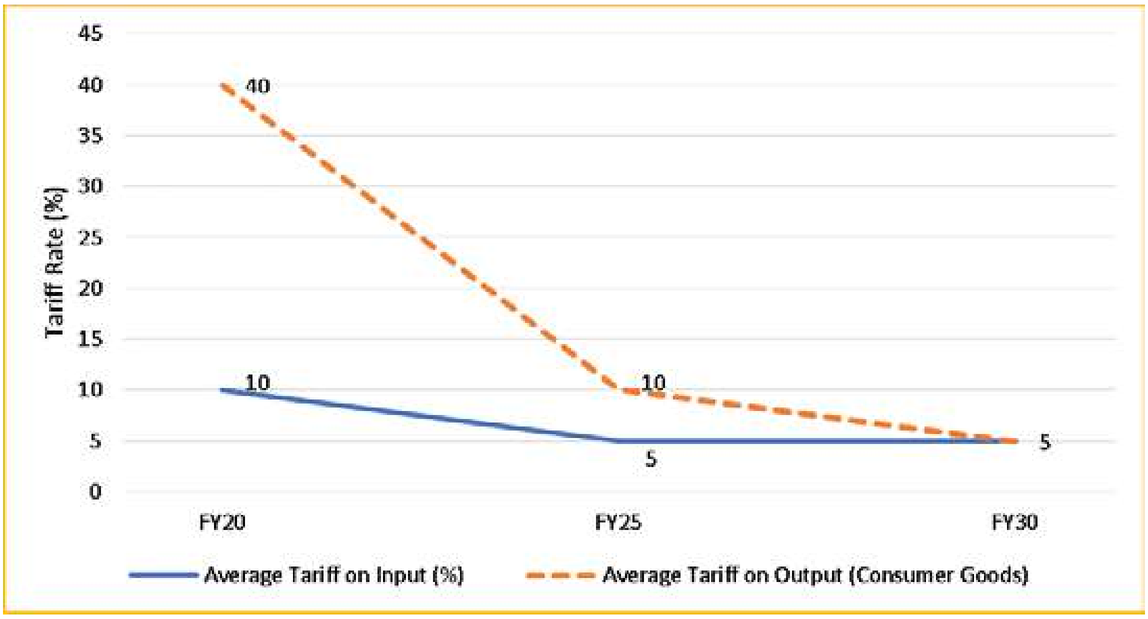
Country/Region	Year	Average Input Tariff	Average Output Tariff	Tariff Escalation Ratio
Bangladesh	**2018**	13.13	45.98	3.50
China	**2016**	8.33	13.41	1.61
India	**2016**	11.69	14.99	1.28
Indonesia	**2013**	5.28	9.20	1.74
South Korea	**2015**	13.24	12.06	0.91
Malaysia	**2014**	3.69	7.53	2.04
Philippines	**2015**	5.01	9.82	1.96
Thailand	**2015**	7.92	18.59	2.35
Vietnam	**2016**	6.41	17.59	2.74
Turkey	**2016**	7.69	10.58	1.38
South Asia	**2016**	10.66	16.00	1.50
ASEAN	**2016**	3.65	7.27	1.99

Source: NBR; WITS Database, World Bank

The common perception is that the 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. It breeds further inefficiencies in the protected industries. This simply cannot be a long-term protection strategy for an economy seeking a productive and competitive industrial sector during the run up to graduation in 2024-27. Bangladesh continues to have the highest tariffs among its comparators, it's output and input tariff trends show no improvement in tariff escalation ratio which is also the highest.

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. In the process, tariff escalation rates would be gradually minimized as the tariff structure trends towards low and uniform rates. A possible tariff and protection regime for the next decade is charted in Figure 6.2. 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 46% in FY2019 will have to be reduced to 40% by FY20, to 10% by FY25, and to 5% by FY30[30] . Meanwhile, average input NPRs will decline from 14% in FY19, to 5% by FY25, and stay at 5% by FY30. Thereafter, the tariff regime will be one with low uniform tariffs of about 5% without distinction between input and 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 FY25 and beyond, could constitute 50-75% of GDP.

Figure 6.2: Forward Looking Tariff Profile (FY19-30)



Source: GED Projections

[30] *Note that roughly half of the NPR comes from para-tariffs like SD/RD, which will have to be phased out by 2024 anyway, revenue loss notwithstanding.*

The potential adverse revenue implications of tariff rationalization must be addressed. Currently 30% of NBR tax revenue comes from trade taxes (including VAT on imports) compared to 60% in 1990. The strategic shift from reliance on trade taxes to domestic taxes has been occurring – as it should – but this needs to be accelerated as trade taxes are the most distorting form of taxation. The strategic option is to gradually reduce average tariff protection on consumer goods by reducing the top customs duty ratee of 25% (stuck at that level for 15 years) and cutting back on para-tariffs. At 46%, the average NPR (protection) on consumer goods is already too high with tariff escalation the highest among comparators. Because tariff elasticities are highest for consumer goods imports revenue losses from tariff reduction is expected to be modest. Bangladesh experience with tariff reduction in the early 1990s showed no loss of revenue, as average NPR came down from 90% in 1992 to 45% in 1995. In the present context, even if there is some loss in revenue this could be made up by expanding the income tax base and by major reforms in VAT that is being implemented. The government has launched the new VAT law starting in July 2019 that gives hope of a spurt in revenues in the coming years. Attention must also shift to reforming income taxes and rejuvenating and modernizing the entire tax system to make it business friendly and more productive.

6.4. Exchange Rate Management for Exports and Growth

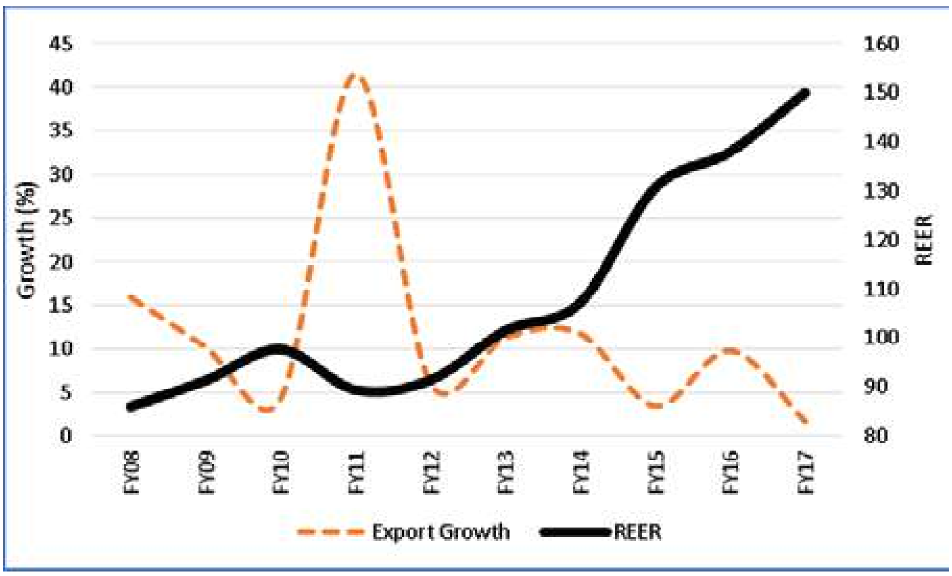
A proper management of the exchange rate should be a critical part of trade policy geared to a superior export performance and high economic growth. Historical and cross-country evidence shows that dynamic and rapidly growing economies have also proactively and effectively managed their exchange rates to ensure that they do not become over-valued. Rather, these countries made sure that their exchange rates were sufficiently under-valued to make their exports more competitive in the world market. The most recent example is China which practiced a deliberate policy of under-valuing its exchange rate for over 30 years. The other example is S. Korea which did the same during its rapid growth phase starting in the 1960s.

Leading economists like Bela Balassa (1982), John Williamson (2003), and Dani Rodrik (2003) have stressed the importance of maintaining a competitive exchange rate as a strategic policy for development. Smart exchange rate management will be required to cope with cut-throat competition following graduation. The record so far has been mixed. Rather than pursue a policy of under-valued exchange rate for export promotion, the tendency has been to err on the side of over-valuation which will not be good for a solid export performance. Prudent management of exchange rate and ensuring exchange rate stability are critical for BOP sustainability and macroeconomic stability. Bangladesh Bank has been following a flexible market-based exchange rate policy since the adoption of the floating exchange rate regime in 2003. This policy has generally served the economy very well by allowing the rate to be determined in the interbank foreign exchange market with occasional interventions from Bangladesh Bank to minimize the exchange market volatility – i.e. managed float regime. A key objective of exchange rate management would be to maintain export competitiveness by preventing any appreciation of the real effective exchange rate.

Criticality of exchange rate management: Poorly managed exchange rates can be disastrous for economic growth. Research evidence shows that 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. China is 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.

Bangladesh experienced double digit export growth for nearly 20 years. During this entire period, though not overly proactive, exchange rate management was prudent with the exchange rate hovering around a relatively narrow band with the help of mini devaluations until the Taka was floated in 2003. The real effective exchange rate (REER[31]) remained fairly stable and moderately depreciated to keep exports competitive. Trade economists consider the REER to be the more relevant indicator as it reflects overall exchange rate competitiveness by taking into account the movements in the nominal exchange rates and inflation in relation to the country's major trading partners. Trade economists have been strong in their advice that countries should avoid over-valuation of their REER as it has deleterious effects on exports. In the past few years, the Bangladesh real exchange rate has taken a turn for the worse, thus hurting exports. Between FY2012 and FY2017, the REER appreciated by nearly 45% serving as a significant damper on exports (Fig.6.3). As expected, exports remained sluggish throughout this period. In FY2018, the situation has improved somewhat not so much due to the modest nominal depreciation of the Taka but rather for the appreciation of the US dollar and other external developments.

Figure 6.3: Export Growth and REER FY08-FY17



Source: EPB and Bangladesh Bank

[31] Simply put, REER is the nominal exchange rate adjusted for inflation differences between Bangladesh and its major trading partners.

There is plenty of research evidence (Johnson, Ostry, and Subramanian 2007, Easterly 2005) to show that foreign exchange shortages, unsustainably large current account deficits, and balance-of-payments crises, are associated with overvalued exchange rates, with deleterious impact on economic growth. Other research confirm that greater degree of undervaluation engenders economic growth, but it is mostly pertinent for developing economies (Bhalla 2007, Gala 2007). For example, the high growth in China for three decades was accompanied by considerable undervaluation (from 100 percent overvaluation to 50 percent undervaluation). A cheaper yuan made Chinese exports less expensive, boosting the overseas sales that have been among the main drivers of growth during the nation's remarkable economic progress over the last three decades. To compensate for institutional weaknesses or market imperfections, Bangladesh could undertake a depreciated real exchange rate approach to keep exports buoyant. Undervaluation could then even be a substitute for industrial policy.

A depreciated exchange rate paves the way for a surge in growth as domestic goods become cheaper in foreign countries which in turn increases the demand for these goods. It also makes foreign goods more expensive for local consumers, which drives them towards purchasing more domestically produced goods. Many prominent economists believe that undervaluation promotes growth because it motivates firms to invest in high productivity tradable industries, which increases overall productivity rates (Rodrik 2008). Others believe that undervaluation of exchange rates lowers labour costs, which boosts investment and thereby causes growth (Levy- Yeyati, Sturzenegger, and Gluzmann 2013). Undervaluing currency also enables countries to enjoy positive trade balances which often alleviate risks of capital flight and financial crises (Acemoglu et al. 2003, Reinhart and Rogoff 2009). Moreover, it also makes entries into new markets profitable for both domestic and foreign investors. An undervalued currency potentially boosts foreign direct investment as domestic assets become cheaper for the foreign investors. Increases in foreign investment brings forth surges in growth as more employment opportunities open up, better technology is adopted and labour productivity improves. Unemployment also goes down during undervaluation because the persistence of lower wages relative to foreign imports encourage firms to hire more workers. In addition to stimulating exports and employment intensively under a regime of 'good currency management', there's more exploration of new products and markets, more diversification opportunities emerge, and more restructuring of trade away from traditional export sectors to modern services occur (Freund, Pierola 2008).

A strong resistance to exchange depreciation stems from the potential price effect. But the adverse price effect can be countered by an approach called "compensated depreciation" that includes a compensatory reduction in tariffs. For example, a 10% depreciation would affect prices of imports and import substitute products upward by 10%, which leads to the fear of fueling inflation via currency depreciation. That is where the compensation principle kicks in. If tariffs are then reduced by 10% across-the-board, the price effect of the currency depreciation would be neutralised. The net result is a 10% uniform (i.e. nondiscriminatory) incentive to all exports but without increasing the prices of imports. Effective protection and revenues will remain unchanged. To be fair, any depreciation does raise the Taka cost of servicing foreign debt. But Bangladesh's debt servicing capacity (at 3.5% of foreign exchange earnings) leaves room for bearing the extra cost which will raise public expenditures marginally with only a ripple effect on the fiscal deficit.

The policy dilemma: Export margins are typically thin[32]. Global competition continually squeezes profits by driving down prices for export products, including readymade garments. Trade theory tells us that as a small open economy Bangladesh is a price taker (i.e. with little power of price determination at the world level). With all the negotiating skills that our exporters can muster, they can only make marginal gains. Recent investment in remediation work in the RMG factories have imposed additional burden on our primary export sector. Exporters would therefore love to see the nominal exchange rate depreciate significantly (i.e. yielding more Taka per dollar of exports) to compensate for difficulties on the price front. While selected non-traditional exports have been identified for cash subsidies ranging from 5% to 20%, that is still not the answer for all the 1300+ non-RMG export items that cannot all be covered with subsidies. Moreover, when compared with the subsidy given to import substitutes through tariff protection (e.g. plastic and ceramic tableware receive nominal protection of 125%+) the incentives are biased against exports. But Bangladesh Bank has avoided letting the exchange rate slide for the fear of fueling inflation. The interbank Taka-dollar exchange rate has moved only modestly over the past 5-6 years within a narrow band of 2-3%. Clearly this is not enough when the REER has appreciated 45% between FY2012 and FY2017. Is there a way out?

The preceding analysis reveals accumulating research evidence that if exchange rates become excessively overvalued, a nominal depreciation has to be made accompanied with either fiscal or monetary adjustments as needed. In the Bangladesh context we find that (a) external inflation rates are beyond our control, and (b) domestic inflation is unlikely to be brought down to 2-3% anytime soon. The confluence of these two factors will cause the real exchange rate to appreciate unless accompanied by corrective nominal depreciation of the Taka, by about 3% annually.

Finally, the exchange rate is not immune to our policy of protection either. High protection by restricting import demand also has the effect of curtailing demand for foreign exchange. In a floating exchange rate system (managed float in the case of Bangladesh) this would enable the country to maintain a lower exchange rate (i.e. a lower Taka price of foreign exchange) than otherwise would be the case. This would mean that export proceeds, expressed in Taka, would be lower than what the exporter would receive had the protection levels provided by tariffs and para-tariffs been lower. Thus, an overvalued exchange rate creates pressure for the persistence of protection (by cheapening competitive imports) making return to more liberal trade policies even more difficult without exchange rate adjustment. Undervaluation would then relieve that pressure and make protection reforms easier.

Given the balance of payments outlook, characterized by moderate external current account deficits/surpluses and surpluses in the overall balance, there should not be any major instability in the exchange market even with moderate degree of Taka depreciation to keep REER from appreciating. The strategy will be to maintain or augment the current comfortable reserve position of Bangladesh Bank which should help fending off any speculative pressure in the exchange market. The comfortable external position will also allow Bangladesh Bank to consider easing some of the current and capital accounts restrictions in a phased manner. Such a phased liberalization of the capital account, in a stable macroeconomic and strong external environment, would help boost investor confidence in the economy and promote inflow of FDI.

[32] *Typical profit margins for our exports are 5-7% or less.*

6.5. Trade Policy Stance Going Forward

For effective export promotion, in addition to the export policies, a set of other complementary policies and programs are critically required. Stabilities of the macroeconomic environment, effectiveness of the export promoting and supporting institutions, and smooth functioning of the financial markets are necessities. Furthermore, the quality of governance should be improved through promoting transparency and accountability, and by reducing the extent of corruption. The government should also take effective role in technology diffusion and in providing appropriate physical infrastructural facilities. These issues are laid out in more detail in the next chapter.

The export-led growth philosophy underscores the need for setting up an incentive structure that overcomes the problem of serious policy-induced anti-export bias. The notion of anti-export bias is related to the trade policy measures that act to favor the import-substituting sector and discriminate against the export activities. The principal route to this 'bias' or discrimination is accomplished by altering relative prices of exports and domestic sales. While for exporters it is not possible to influence the world price, import tariffs and quantitative restrictions allow the producers to raise the domestic price of their commodities above the world price. The resultant profitability (and thus relatively high price of import substitutes to export goods) under the shield of protective measures encourages reallocation of resources from the production of exportable to that of import substitutes. Also, policy-induced domestic production may result in increased demand for non-tradable diverting further resources into this sector at the cost of exportable. True, the domestic market is expanding rapidly with a fast-growing middle class strengthening domestic demand. Growth strategies that rely exclusively on domestic demand eventually reach their limits. The home market is usually too small to sustain growth for long, and it does not give an economy the same freedom to specialize in whatever it is best at producing. Over time, future trade policy must move towards neutrality between domestic and export markets, with a slight tilt for exports. The open world economy offers developing countries like Bangladesh deep elastic markets for their exports.

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 labour-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. Replicating these policies for non-RMG exports is the way to go as long as high tariff protection prevails.

Going forward, apart from the move towards uniformity of the tariff structure, other aspects of efficiency and transparency will have to 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. Our trade regime must be so formulated as to enable a modern high-tech industrial sector of the future to function with seamless movement of goods and services across borders or via online with least transaction costs.

Institutions. Policy frameworks need institutions to become effective. In other words, it is institutions through which strategies are ultimately implemented. Besides, trade or export policies usually encompass a number of institutions or departments and coordination of their tasks has important implications for all eligible exporting firms' benefiting from incentives. Therefore, strategies need to be outlined in details and the roles and responsibilities of relevant institutions and departments should be articulated.

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. 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.

New directions in trade policy. Some new thinking and new directions in trade policy orientation, with significant departures from past approaches have become the national imperative for successful export-push policies for industrialization in the post-LDC period. These are:

(a) *New approach to protection policy.* High protection for a long period creates inefficiency and undermines competitiveness over the long-term. Consider reviewing protection policy, scale down the level of protection, and institute a mechanism of time-bound protection for import-substitutes.

(b) *Tariff rationalization.* Bangladesh tariffs, nominal and effective protection levels are among the highest in the world. In addition, tariff escalation, and the spread between NPR on output and inputs is too high. Recognizing that a high tariff regime undermines export competitiveness, it is time to seriously start scaling back NPR on domestically produced final consumer goods. NBR must adopt a strategy of lowering average NPRs by 3-5 percentage points every year until 2025, largely by reducing NPR on import-substitute consumer goods.

(c) *Access to world-price (duty-free) inputs must be ensured to all exports.* The spectacular success of RMG industry has not been replicated. A major reason for this is the existence of anti-export bias in non-RMG export production. To replicate RMG success in other labor-intensive production, the facility of duty-free imported inputs must be provided even to firms that export part of their total production. The policy for providing duty-free inputs for export production is not a privilege (or support) but a requirement for all export production in order to be on a level playing field with global competitors who have access to world-priced inputs. Export success calls for a policy environment with no anti-export bias.

(d) *Intermediate goods sector needs a boost.* 98% of Bangladesh's exports are final consumer products with little or no intermediate goods. As high protection is provided to mostly consumer goods, trade and domestic policies have an anti-intermediate goods bias. This needs to change as trade in intermediate goods is the fastest component of global trade. Bangladesh needs to exploit the opportunities created by cross-border production networks to produce and export intermediate goods that could be assembled elsewhere.

(e) *Access to long-term and short-term financing* 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.

(f) *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 catch up with the latest advancement in global manufacturing.

(g) *Government support to open external markets.* As trade preferences get phased out over the 5-10 years in developed markets, government assistance and support through embassies become even more critical for successful market penetration in the largest global markets, such as EU, North America, Japan, and emerging economies.

(h) *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.

(i) *Trade Agreements with Regional Communities.* Barring the USA, the vast majority of WTO member countries would like to see a reformed and more effective multilateral trading system. Bangladesh, which has benefited from the multilateral regime as an LDC, may use the special dispensation for LDCs for the remaining years (until 2024) but will have to prepare for the stiffer competition our firms will face in the global market, once the preferential access provision evaporates following graduation. Furthermore, it must seek market access under various bilateral and regional trade and investment agreements. Markets in Asia are growing faster than any other region of the world and ADB projects that by 2050 50% of global GDP will be in Asia. Two regional trading arrangements that hold tremendous potential for trade and investment are RCEP (ASEAN+) and CPTPP which together will constitute the bulk of Asian market of the future. Bangladesh would be well advised to reach trading arrangements with these groupings. But that could be an uphill task give the current high tariff regime in Bangladesh and the enormous resistance from domestic import substitution industries to any reduction of protective tariffs. The political economy challenge is considerable but a breakthrough is essential in this area.

Trade-related capacity building: To pursue the new directions in trade policy that would be adequate enough to address the emerging challenges of a post-LDC world, Bangladesh must close the huge gap that exists in trade-related capacities in the key ministries and agencies responsible for formulating and carrying out strategic trade policies and mainstreaming them as essential components of growth and poverty reduction national policies.

As an LDC, Bangladesh has mostly enjoyed preferences that are unilaterally granted by trade partners. This might have discouraged more proactive market exploration initiatives through bilateral and regional trade deals that would have required exchange of trade concessions based on reciprocity. The need for actively looking for export opportunities has recently been catapulted into prominence as graduation from the LDC group looms large on the horizon. There is a broad-based consensus that the accomplishment of LDC graduation must be complemented by continued export success along with diversification, at least by product and destination.

However, in spite of these challenges on the horizon, Bangladesh Government has serious capacity constraints in preparing and developing negotiation strategies and undertaking actual negotiations. As noted in Chapter 4, the multilateral trade system (e.g. WTO) is under threat, with rising economic nationalism and protectionism worldwide, there are uncertainties surrounding the WTO-sponsored trade opening. That makes it absolutely critical that Bangladesh prepare for bilaterally or regionally negotiated trade deals to address some of the challenges arising from its upcoming LDC graduation.

While there are a sufficient number of officials in place to perform policy analysis and prepare inputs for trade negotiations, the actual technical competence of the Ministry is variable and weak in some areas. A quick assessment of "urgently needed" areas of trade-related capacities in the MOC lists expertise in such areas as assessment of trade prospects, analysis of trade data, training on WTO agreements, costs and benefits of regional or bilateral preferential trade agreements, costs of protection, policies to ensure export competitiveness and promote diversification, and so on. There is also pent up demand from other related ministries/agencies involved in trade negotiations for support and training in order to develop their capacities in specific statistical and econometric tools, analysis of the trade data and trade policy of other countries, training on WTO agreements, and training on trade negotiations. What is required are customised training programmes to develop some immediate technical capacities and assistance for commissioned research/technical studies for dealing with some of the urgent priorities, as outlined above. Furthermore, in a post-LDC Bangladesh, there is need for strong recognition of the importance of mainstreaming trade and trade policies in the overall development strategies for the economy in the medium- to long-term.

For trade policy making and trade negotiations, the Ministry of Commerce (MoC) is the lead line ministry for preparing technical inputs, commissioning and overseeing studies/inputs to be prepared by external resource persons, consulting the private sector, and developing negotiating strategies. Two departments that work directly with MoC on these issues are Bangladesh Tariff Commission and Export Promotion Bureau. In addition, the Bangladesh Institute of Foreign Trade, which was established under a public-private partnership (PPP) initiative, also provides assistance to MoC. The National Board of Revenue (NBR) under the Ministry of Finance, which is in charge of Customs and tariff policy formulation, is also a major participant in trade negotiations, having an important stake in orchestrating tariff concessions on a reciprocal basis. The Ministry of Foreign Affairs (MoFA) actively works with the MOC in conducting bilateral, regional and multilateral negotiations. These will be the primary stakeholders of any capacity building programme. However, all the relevant ministries and departments, and private sector bodies/institutions will constitute primary stakeholders with the Ministry of Commerce playing the role of coordinator. Private sector and civil society organisations may also be involved in the capacity building programme, given their roles in trade negotiations and policymaking.

The FTA option: Government sources have acknowledged Bangladesh's receiving requests for bilateral trade negotiations from several countries including China, India, Malaysia, and Thailand. What should be the strategic trade policy orientation when it comes to negotiating and signing bilateral and regional FTAs during the run up to LDC graduation and beyond? Post-LDC Bangladesh may have to negotiate a trading arrangement with the EU along with the possibility of another one with the post-Brexit United Kingdom to ensure favourable access to these important markets. Beyond that, Bangladesh may seek more bilateral or regional FTAs if the projected trade creation (or trade growth) contributes positively to growth and employment creation.

First, it is important to acknowledge that Bangladesh is a significant beneficiary of the multilateral trading system (WTO) and its special and differential dispensation for LDCs and developing countries. It would be in the best interests of Bangladesh to continue to be a strong participant under this global system of compliance of trade rules even after graduation.

In the meanwhile, since the multilateral system does permit the contracting of preferential trading arrangements, such as a Free Trade Agreement (FTA), departing from the guiding principle of non-discrimination defined in Article I of GATT, Article II of GATS, and elsewhere. FTAs may be signed under Article XXIV of the GATT, which allows for the formation of trade blocs, permitting WTO members of a trade bloc to discriminate against nonmembers, as long as the agreement results in trade liberalization among the signatories extends what is available under the WTO. FTAs in recent times are seldom limited to just trade in goods, as they encompass services as well as investment.

Of late, the multilateral trade regime and its offshoot, globalization, has come under serious strain from the rise in economic nationalism and protectionism. Consequently, a growing number of nations, both developed and developing, have been seeking to sign FTAs on a regional or bilateral basis. Bangladesh, with only one regional FTA (SAFTA) and no bilateral FTA in its armor, has fallen behind in this game of trade openness beyond the WTO. Basically, an FTA has the potential of creating access to larger markets for Bangladesh exports. But they have advantages and disadvantages.

On the plus side, an FTA can force local industries to improve competitively and rely less on government subsidies. These can open new markets, increase GDP, and invite new investments. They also allow companies to discover new technologies and better ways of doing things. FTAs could trigger a beneficial process of "competitive liberalisation", as nations vie to open their markets to each other. On the downside, FTAs could bring disruptive competition, destruction of traditional livelihoods, with adverse implications for employment.

Whereas Bangladesh's preferential access into major global markets under WTO system relies on unilateral provision, a fundamental tenet of FTA is "reciprocity". Concessions in the liberalization process have to be offered, though there is scope for negotiations for staggered adjustments of tariffs or other trade barriers. Where Bangladesh is involved in a North-South (i.e. developed and developing country) arrangement, tariff reductions on its part could have a longer timeline. Gains from an FTA is expected to be greater when such FTA opens larger markets (e.g. North-South FTA, such as between Bangladesh and OECD members). But there are potentially large market creation effects to be had from engaging with regional associations (South-South) like the BIMSTEC, ASEAN or its surrogate, the Regional Comprehensive Economic Partnership (RCEP) that adds six more FTA partners.

However, it is worth keeping a few things in mind while considering FTAs:

- Deeper, broader, rapid liberalization under an FTA produces a bigger effect. Firms are less likely to incur additional administrative costs if the tariff advantage provided by the FTA is small.
- The FTA impact will be greater if the impediments to trade removed by the FTA are large relative to those that remain untouched.
- The most fundamental factor is the capacity of our economy to increase supply of products for which the FTA has boosted demand.
- They reinforce the point that any contribution of an FTA to Bangladesh's economic development is likely to be influenced heavily by the broader policy stance of its government, the flexibility of the economy and the extent to which supply can respond to any new demand that has been created.

- We could target FTA with countries that have already shown interest, such as Malaysia, China, India (post-LDC, as SAFTA already gives market access), Thailand. Emerging market economies would also be good candidates, quite apart from OECD member countries. The point to note is that gains from any FTA will be minimal if the market size of the partner country is small.
- Most importantly, the first item in an FTA relates to trade openness in terms of tariffs. With its sky high tariff regime relative to its comparators, that is where Bangladesh will face a major hurdle in getting prospective FTA suitors to come calling. Mutually reciprocating tariff reductions are usually critical items in any FTA negotiation. But when tariffs are very high, as is the case for Bangladesh, the leverage from offering tariff reductions is all but lost. Thus rationalizing Bangladesh's tariff structure then becomes a national imperative if the country seeks FTAs with any country or region in the future. FTA negotiations could be highly complex and take long periods of time.

To conclude, it is time to mainstream trade and trade policy. For trade reform to unleash its catalytic potential during the run up to LDC graduation it should be designed as part and parcel of Bangladesh's 8th and 9th Five Year Plans and the Perspective Plan 2041, where its role will be given due cognizance and the necessary facilitating infrastructure adequately provided to make trade policy perform. In practical terms, this means incorporating trade issues into every stage of the development planning cycle. This must be underpinned by strong inter-ministerial coordination and consultative processes with a wide range of stakeholders, including consumer groups.