

CHAPTER 4: TRADE LIBERALIZATION AND EXPORT COMPETITIVENESS

I. Introduction

4.1 Starting in 1991, Bangladesh marked a clear departure from the highly protectionist, inward-looking import substitution policies of the earlier decades, with tangible benefits to GDP growth. Considerable, albeit uneven, progress has since been made on liberalizing the trade and exchange regimes. Trade tariffs have been significantly reduced and rationalized, with the unweighted average customs duty (CD) falling from 100 percent in FY85 and 74 percent in FY92 to 15 percent in FY07, and the top CD rate from 350 percent in FY90 to 25 percent. Trade-related quantitative restrictions (QRs), which covered 21 percent of HS 4-digit tariff lines in FY90, have been eliminated, and import licenses are no longer needed. Foreign exchange liberalization has included unification of exchange rates, removal of most foreign exchange restrictions for current account transactions, and adoption of a floating exchange rate policy.

4.2 Despite good progress, a substantial agenda for deepening trade liberalization and strengthening export competitiveness remains. Although the average CD rate has been steadily reduced by cutting the general maximum rate, a rampant increase in the use of other protective levies (para-tariffs) in the last decade has offset much of that. As a result, the average nominal protection in Bangladesh is the highest in the region and among the highest in the world. Furthermore, trade facilitation procedures are cumbersome and infrastructure bottlenecks to exporting are severe. The resulting anti-export bias has leveled off at around 20 percent since the late 1990s, which works against the emergence of new exports and expansion of the export activities to non-enclave areas. Unsurprisingly, Bangladesh's export orientation, although much higher than in 1990, compares unfavorably with other Asian economies. Moreover, the export base is heavily concentrated in the readymade garment (RMG) sector – which accounts for 75 percent of merchandise exports – where the extent of the anti-export bias is much lower.

4.3 The potential net benefits from further opening up the trade regime are high for – certainly higher than for the larger emerging economies such as China and India. In fact, even these larger economies are now moving decisively down the trade liberalization track to reap its benefits. The impressive growth performance of many successful East Asian economies was shaped in large part by their ability to integrate into the global supply chains at early stages of development. At the heart of their increased integration was lowering of trade barriers and anti-export bias and improving trade facilitation. Gradually, with economic development, strengthened domestic competitiveness, and improved labor skills these economies moved up the quality ladder toward higher-end production chains, achieving unprecedented GDP growth in the process. A broad strategy along those lines holds tremendous potential for Bangladesh.⁶⁴ This chapter presents an overview of the trade policy trends in Bangladesh and makes some policy recommendations that would help strengthen the country's global competitiveness. The trade facilitation aspect of competitiveness is covered in **Chapter 9**.

II. Trends in Trade Policy and the Anti-Export Bias

Overview of Trade Policy Trends Since Early 1990s

4.4 *Considerable, albeit uneven, progress has been made on trade and exchange liberalization since 1991.* Reform measures have included tariff cuts and rationalization, removal of trade-related QRs, adoption of a unified exchange rate system, switching from a fixed to a more flexible exchange rate regime, and current account convertibility. These have been accompanied by complementary measures to

⁶⁴ This combination of trade policy reforms and strengthening domestic competitiveness also appears to be the best policy response to the challenges and risks emanating from the phasing out of the ATC quotas in January 2005.

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liberalize the domestic economy and improve market orientation: contributing to the improved growth since the early 1990s.

4.5 *More substantial progress on trade liberalization measures was made during the first half of the 1990s.* During this period, import tariffs were cut significantly through a ‘tops down’ approach of reducing the maximum CD rate while also reducing the number of tariff slabs. As a result, the (unweighted) average protection rate fell from 73.6 percent in FY92 to 32.4 percent in FY96 and the dispersion of tariffs declined by over 60 percent (Table 4.1). The number of QRs fell significantly in the 1993-95 Import Policy Order (IPO) relative to the 1991-93 IPO (Table 4.2)

**Table 4.1: Average Protection Rate in Bangladesh
(MFN Rates, including concessional rates in %) ^{/1}**

	1991/92	1995/96	2003/04	2004/5	2005/06	2006/07
<u>Unweighted average Customs Duty (CD) – MFN rates only</u>	70.6	28.7	18.8	16.3	15.5	14.9
Industrial products ^a	69.7	28.4	18.0	15.6	14.7	14.0
Agricultural products ^b	76.6	30.1	22.6	19.6	19.4	19.1
<u>Unweighted total protection rate – MFN rates only ^{/c}</u>	73.6	32.0	29.1	26.5	26.5	24.3
Industrial products	73.2	31.9	26.8	25.4	25.3	22.4
Agricultural products	76.6	32.4	39.8	32.1	32.4	31.3
<u>Standard deviation of total protection (based on MFN tariff lines)</u>	41.9	15.9	25.9	25.5	27.1	22.6
<u>Tariff lines subject to protective SD and VAT</u>						
Supplementary Duty	49	13	691	1066	1031	1043
VAT	426	373	727	582	600	601
<u>Unweighted avg. CD – MFN rates, adjusted for tariff exemptions/concessions</u>	57.6	22.6	15.6	13.5	12.4	11.8
Industrial products	55.9	21.5	14.6	12.6	11.4	10.8
Agricultural products	73.5	29.4	22.2	19.3	18.9	18.7
<u>Unweighted total protection rate – MFN rates, adjusted for tariff exemptions/concessions</u>	60.2	25.1	23.7	21.4	20.7	18.9
Industrial products	58.7	24.0	21.2	19.9	19.1	17.3
Agricultural products	73.6	31.6	38.9	31.4	31.6	30.5
<u>Percentage and the number of tariff lines with international tariff peaks (total protection rate >15%)</u>	93.3 (6233)	86.1 (5810)	72.5 (4983)	70.1 (4699)	70.8 (4746)	69.4 (4649)
/ 1: Averages reported here are based on 8-digit 6877 tariff lines and the MFN tariffs, and do not reflect ‘preferential’ tariffs.						
/ a: Harmonized System (HS) Chapters 25-97;						
/ b: HS Chapters 01-24.						
/ c: ‘Total protection’ incorporates, in addition to customs duty, the protective effective of the para-tariffs.						

Source: *Trade Policies in South Asia: An Overview*, World Bank, 2004; *Bangladesh’s Import Policies*, World Bank, 2005.

4.6 *The trade liberalization drive slowed down considerably during the FY97-99 period, with even some instances of reversal.* The average rate of nominal protection rose slightly over the period and the number of HS 4-digit items subject to QRs increased from 111 in the 1993-95 IPO to 122 in the 1997-02 IPO. Resistance by domestic protectionist lobbies, the heavy reliance on customs revenues, and concerns about the slow progress in addressing domestic business environment weaknesses played a key role in the slow down. Many openly worried that Bangladesh was perhaps opening up too much, too fast. These fears turned out to be unfounded, however.⁶⁵ Bangladesh had started the trade policy reforms from prohibitively high protection levels to begin with, and a significant portion of the initial tariff cuts essentially amounted to eliminating ‘water-in-the-tariff’ (i.e., tariff redundancy) in the case of final products. More importantly, trade liberalization was accompanied by sustained strong performance of the export sector and the economy in general. The BOP was also not overwhelmed by a surge in imports

⁶⁵ This point is forcefully made by *Bangladesh: Trade Liberalization: Its Pace and Impact*, World Bank, 1999.

during periods of import liberalization, as many had predicted: in fact, export growth outpaced import growth during these periods.

4.7 **Trade liberalization was partially revived during FY00-FY02, and picked up pace in FY03.** The average CD was cut from 26.6 percent in FY99 to 21 percent in FY02, and further to 14.9 percent in FY07. The decline in average nominal protection was more modest, however, because of increased use of other protective import levies, or para-tariffs (see below) – nominal protection fell from 32.4 percent in FY99 to 24.3 percent in FY07. In the meanwhile, the number of QRs has been lowered to 15 (Table 4.2), of which only three are protection-related (poultry, eggs, and salt), and on these GoB has obtained waivers from WTO until 2009. More significantly, the long-standing import bans on many textile products have also been removed, strengthening the competitiveness of the critical garment manufacturing sector.

TABLE 4.2: EVOLUTION OF IMPORT RESTRICTIONS 1991-2006

	IPO 1991-93	IPO 1993-95	IPO 1995-97	Section 1.02 <u>IPO</u> <u>1997-02</u>	Section 1.03 Section 1.04 <u>IPO</u> <u>2003-</u> <u>06 (july06)</u>
Number of items in the control list at the HS 4-digit level	193 (15.6%)	111 (9.0%)	120 (9.7%)	122 (9.8%)	48 (1.4%)
Number of trade-related items in the control list at the HS 4-digit level	79 (6.4%)	19 (1.5%)	27 (2.2%)	28 (2.2%)	3 (0.3%)

Source: WTO Trade Policy Review, Bangladesh 2000; IPOs various years.

4.8 **A pattern of increasing reliance on para-tariffs for protection has emerged over the last decade, to the detriment of trade openness.** Since the mid-1990s, the Government has increasingly relied on the para-tariffs for protection as well as revenue purposes, partially offsetting cuts in CDs.⁶⁶ Four types of para-tariffs have been put to use: Infrastructure Development Surcharge, Regulatory Duty, Value Added Tax (VAT), and Supplementary Duty (SD).⁶⁷ The Regulatory Duty, introduced in FY01, was later removed in FY05. The para-tariffs now cover about 20 percent of tariff lines and account for just under 40 percent of total nominal protection provided by the statutory import duties, as opposed to 10 percent in FY96.⁶⁸ These developments have led to an increase in the dispersion of total tariff protection, from 15.9 percent in FY96 to 22.6 percent in FY07. Moreover, introducing protection through the back door – i.e., through increased use of para-tariffs – increases the scope for lobbying pressures by protectionist groups and for corruption.

4.9 **Especially worrisome is the recent widespread use of SDs, which have become a key instrument of trade protection.** SDs now cover 1,043 tariff lines, up from 356 tariff lines in FY03. The increased reliance on their use was most visible in the FY05 budget. Then, in a far-reaching move, the Government reduced the maximum CD rate from 30 percent to 25 percent, moved from a four to a three non-zero tariff slab system, and eliminated the Regulatory Duty. But it also further increased the number of tariff lines

⁶⁶ For a detailed discussion on the protective application of the para-tariffs, see: *Trade Policies in South Asia: An Overview*, Chapter 3; and *Bangladesh's Import Policies*, World Bank, 2005.

⁶⁷ In principle, both the SDs and VAT are supposed to be protection-neutral taxes. In practice, however, the SDs are levied mostly on only imported products, and when applied on domestic goods, the rates are generally lower. Furthermore, because the SDs are applied on the landed value plus CD, it has a cascading effect, with protection rates rising further with higher CD rates. Similarly, VAT has been used to provide extra protection to certain import competing industries (e.g., imports of textiles are subject to the general VAT rate of 15 percent, but domestically produced textiles are subject to a special lower VAT rate of 2.5 percent).

⁶⁸ This was despite the elimination of the *License Fee* in FY03, an across-the-board import tax of 2.5% of the assessable value, and also the removal of the Regulatory Duty (of varying rates) in FY05.

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subject to SDs, from 691 in FY04 to 1,066 (**Table 4.1**), offsetting much of the impact of the other liberalization measures.

4.10 *There is significant tariff escalation in the import duty structure, with the CD rates rising according to the stages of processing.* This means that the effective rates of protection for import substituting final products are considerably higher than the nominal tariff protection on these products. This escalation is magnified by the imposition of the SDs whose duty-base includes landed costs plus CD. For example, given the general maximum tariff rate of 25 percent in FY05, with an SD rate of 25 percent, total nominal protection for tableware products reached 84 percent.⁶⁹ The calculations for major commodity categories presented in **Table 4.3** show tariff escalation as well as the cascading impacts of para-tariffs since FY92. Moreover, because of a plethora of end-user specific CD concessions, tariff policies have discriminated against the domestic production of certain products that were not favored, such as intermediate material and components.⁷⁰

Table 4.3: Bangladesh: Tariff Escalation and Cascading Impacts of Para-Tariffs on Total Nominal Protection

FY	Description	Unweighted Average Rates (based on MFN tariffs only, %)					
		CD	CD+DS+RD +LF /*	P-SD /*	P-VAT /*	Total Nominal Protection	Protection from para-tariffs (%)
06-07	Basic raw materials	9.3	12.8	0.9	0.0	13.7	31.7
06-07	Intermediate inputs	12.3	16.1	1.1	-0.1	17.2	28.2
06-07	Capital goods	9.2	13.1	1.7	0.1	14.9	38.7
06-07	Final consumer goods	20.2	24.1	8.5	3.3	35.8	43.6
06-07	Overall	14.9	18.7	4.3	1.3	24.3	38.8
03-04	Basic raw materials	12.1	15.9	0.2	0.2	16.2	25.6
03-04	Intermediate inputs	16.9	20.8	1.4	0.3	22.5	25.0
03-04	Capital goods	12.0	15.9	3.1	0.2	19.2	37.8
03-04	Final consumer goods	24.0	30.5	6.3	3.3	40.2	40.3
03-04	Overall	18.8	23.8	3.7	1.6	29.1	35.4
95-96	Basic raw materials	14.9	17.4	-0.1	0.1	17.4	14.4
95-96	Intermediate inputs	26.3	28.8	0.0	0.9	29.6	11.3
95-96	Capital goods	20.6	23.1	-0.2	0.2	23.0	10.5
95-96	Final consumer goods	35.9	38.4	-0.3	1.4	39.4	9.1
95-96	Overall	28.7	31.2	-0.2	0.9	31.9	10.1
91-92	Basic raw materials	38.1	40.6	-1.1	0.3	39.8	4.3
91-92	Intermediate inputs	62.2	64.7	-0.9	1.3	65.1	4.5
91-92	Capital goods	62.3	64.8	-0.4	0.2	64.6	3.6
91-92	Final consumer goods	87.6	90.1	-2.1	3.2	91.1	3.9
91-92	Overall	70.6	73.1	-1.3	1.8	73.6	4.0

/* CD: Customs Duty; DS: (Infrastructure) Development Surcharge; LF: License Fee; RD: Regulatory Duty; SD: Supplementary Duty; VAT: Value-Added Tax. P-SD: Protective component of SD; P-VAT: Protective component of VAT.
Source: Staff calculations.

⁶⁹ For more examples of product specific tariff escalation by stages of processing, see: *Trade Policies in South Asia: An Overview*, page 64, Table 3.17.

⁷⁰ These calculations are based on the protection levels made 'available' by import duties. In practice, statutory tariffs may not reflect the actual price differences between domestic and international prices due to illegal border trade and smuggling through official channels. However, it is important to stress that such informal trade is induced, in part, by high protection rates, and it is the structure of protection shaped and made available by the statutory duties that is going to affect medium- and longer-term production decisions.

Anti-Export Bias Remains High

4.11 Anti-export bias, measured here as the ratio of (average) *effective exchange rate* for imports (EERm) to that of exports (EERx), is often used as an indicator of the trade regime's anti-export bias.⁷¹ The higher is the ratio above 1.0, the higher the bias against export activities,⁷² and the more damaging it is for export competitiveness. **Box 4.1** discusses the various channels through which trade protection impacts the anti-export bias.

Box 4.1: Trade Protection: Its Impact on Anti-Export Bias and Export Competitiveness

4.2 Enhancing Bangladesh's export competitiveness depends crucially on reducing the anti-export bias of the trade regime, which, in turn, is shaped by the level of trade protection. The tariff structure impacts the anti-export bias through several channels:

- Duties levied on imports of final goods raise their domestic relative prices, thereby increasing the profitability of import substitutes relative to exports. This diverts resources towards inefficient production for the domestic market, away from the production of exports. For example, the very high protection (nearly 100 percent) afforded to the ceramics industry e.g., tableware – reflected in much higher domestic prices of ceramics products relative to their export prices – appears to be discouraging production for exports.
- An escalating tariff structure 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.
- With import demand being curtailed under high protection, import-related (ex-ante) demand for foreign exchange is also curtailed, enabling the country to maintain a lower exchange rate (i.e., a lower domestic currency price for foreign currency) than otherwise. This then translates into lower domestic currency proceeds for export.
- Exporters sell in competitive world markets and cannot pass on higher production costs to buyers. Thus, import duties paid on imported inputs increase their production costs and cuts into their profit margins and make them less competitive globally.
- Even if there is a duty/tax rebate system, these are generally very inefficient and slow, and even the delayed collection of rebates have associated costs (e.g., bribes). Enclave arrangements, such as the bonded-warehouse scheme used by the RMG sector and export processing zones (EPZ), provide speedy duty-free access to imported inputs, but they serve only specific/limited activities and, as such, they are not substitute for extended periods for broader and deeper trade liberalization.

4.12 *Reflecting the patterns of trade liberalization, the anti-export bias fell significantly in the first half of the 1990s, and has leveled off at a relatively high rate since the late 1990s (Table 4.4).* This holds for both the average import effective exchange rate based on the MFN rates only (column 9) as well as with the import EERs that also reflect end-user tariff concessions/exemptions (column 10). The lack progress in the latter period was on account of declining amount of direct cash support and other forms of explicit subsidies (such as provision of subsidized credit) for exporters, which offset the reductions in average nominal protection. The increased use of the para-tariffs has also contributed to the high levels of

⁷¹ EERs for imports refer to nominal exchange rates adjusted for (protective) import levies and any scarcity premium that exchange controls may generate. The EERm here indicates the domestic currency cost of one US\$ worth of imports. For exports, EERx represents the exchange rate after adjusting for existing export promotion schemes (direct export cash subsidies, subsidized export credits etc.). Thus, EERx represents domestic currency equivalent of proceeds from exports worth one US\$.

⁷² A ratio of 1.0 would imply a trade policy that is neutral towards exporting and import substituting production.

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anti-export bias by holding back the reduction in nominal protection. With the extent of average bias remaining at about 20 percent, 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 export areas and to the expansion of exports that are not benefiting from enclave arrangements cited below.

Table 4.4: Estimates of Anti-Export Bias Based on Effective Exchange Rates for Imports and Exports

Fiscal Year	Imports (in billion tk)	Average total protection rate (%) ^{/a}	Average total protect. rate (%) ^{/b}	Nominal Exchange rate (Tk/US\$)	EERm	EERm1 ^{/b}	EERx	Anti-Export Bias	
								EERm/EERx	EERm1/EERx
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
1991-92	134.5	73.6	60.1	38.15	66.24	60.94	38.53	1.72	1.58
1992-93	159.3	60.5	49.6	39.14	62.83	58.45	39.76	1.58	1.47
1993-94	167.7	45.9	38.1	40.00	58.36	55.14	40.50	1.44	1.36
1994-95	234.6	37.5	28.5	40.20	55.29	51.64	40.52	1.36	1.27
1995-96	283.0	31.9	25.1	40.84	53.89	51.04	41.24	1.31	1.24
1996-97	305.4	31.6	24.8	42.70	56.20	53.27	43.17	1.30	1.23
1997-98	341.8	33.1	26.2	45.46	60.53	57.37	46.06	1.31	1.25
1998-99	384.8	32.4	25.6	48.06	63.64	60.34	49.10	1.30	1.23
1999-00	421.3	29.4	22.7	50.31	65.09	61.72	51.82	1.26	1.19
2000-01	503.7	28.5	23.4	53.96	69.36	66.56	55.50	1.25	1.20
2001-02	490.5	29.4	24.0	57.43	74.33	71.24	59.19	1.26	1.20
2002-03	559.2	26.4	21.6	57.90	73.20	70.42	59.68	1.23	1.18
2003-04	642.6	29.1	23.7	58.94	76.10	72.88	60.74	1.25	1.20
2004-05	809.0	26.5	21.4	61.39	77.66	74.51	62.81	1.24	1.19
2005-06	892.2	26.5	20.7	67.08	84.84	80.95	68.01	1.25	1.19

/a: Average (unweighted) total protection based on MFN rates only, and the corresponding EERm is given in column 6.
/b: Average (unweighted) total protection based on MFN rates adjusted for end-user concessions and exemptions—the corresponding EERm is given in column 7. The latter also reflects duty-free access to imported inputs provided to 100 percent RMG exporters.

4.13 *Bangladesh has managed to insulate certain activities— most notably the RMG sector – from the anti-export bias, through the bonded-warehouse and Export Processing Zones (EPZs).* Furthermore, exporters without access to the duty-free bonded warehouse system or EPZs (because they are not 100 percent exporters) and required to pay import duties or domestic taxes on imported inputs, can benefit from the existing duty drawback system managed by the Duty Exemption and Drawback Office (DEDO). While such enclave type arrangements provide cheaper access to certain types of exporters, they do not offer shelter from the broader disincentives caused by high protection listed in **Box 4.1**.

4.14 *Moreover, the DEDO suffers from weak governance and inefficiencies.* Exporters experience significant delays in payments of tariff/tax rebates, despite various attempts to strengthen the DEDO through staff training, new technical staff, and strengthened reimbursement procedures. This is partly due to the complexity of the existing import duty regime and a very lengthy duty drawback process involving the determination of input-output coefficients and the submission of 18 documents by direct exporters (even more documents are required in the case of indirect exporters). *It takes a minimum of six months for drawbacks to be paid; 50 percent of applications are not disposed of in two years.*

4.15 Securing both the continued success of the RMG sector and export diversification will require sustained efforts to reduce the anti-export bias through further trade reforms, along with measures to address the key behind-the-border investment environment bottlenecks discussed elsewhere in this report.

Bangladesh Lags the Rest of the World on Trade Openness

4.16 *While trade liberalization occurred in fits and starts in Bangladesh, stronger and more decisive commitment to trade liberalization was seen in majority of the rest of the world.* As a result, Bangladesh lags behind on most measures of trade openness (Table 4.5). Even after the reduction in nominal protection in the FY07 budget, Bangladesh has the highest level of trade protection in the region, which itself is the most trade restrictive region in the world. Other South Asian countries, particularly India and Pakistan, have cut their protection levels far more aggressively in recent years, while Sri Lanka started its trade liberalization in the late 1970s and has continued to maintain much lower protection levels (except for the agricultural products). In fact, in 2004, only 4 countries in the world had higher average nominal protection than Bangladesh, and it is unlikely Bangladesh's rank has improved since. Trade liberalization did lead to an increase in Bangladesh's trade-to-GDP ratio – from 20 percent in 1990 to 38 percent in 2005. However, since trade liberalization was a common phenomenon across the globe over the period, Bangladesh's global rank on the measure did not change by much. Among the 140 countries for which comparable data are available for 1990 and 2004, Bangladesh ranked 135th in 1990 and slipped to 137th by 2004 in terms of the trade to GDP ratio.⁷³

Table 4.5: Average MFN tariffs in South Asia and other select developing countries

All products (134 countries)				Agriculture (134 countries)			
	Average tariff (%)	Rank	Year		Average tariff (%)	Rank	Year
Morocco	33.4	1	2002	Morocco	53.6	1	2002
Tunisia	30.2	3	2002	Turkey	51.6	2	2001
Bangladesh	26.5	5	2004-05	Tunisia	44.7	4	2002
Iran	23.9	7	2002	Korea	43.5	5	2002
Nigeria	23.4	8	2002	India	40.1	7	2004-05
India	22.2	10	2004-05	Iran	35.7	9	2002
Pakistan	18.5	19	2002-03	Bangladesh	32.1	10	2004-05
Egypt	18.4	20	2002	Sri Lanka	28.1	12	2003-04
Nepal	18.0	22	2003-04	Mexico	25.7	14	2002
Mexico	16.2	30	2002	Nigeria	23.0	25	2002
Vietnam	15.0	32	2001	Pakistan	22.6	26	2002-03
Ghana	14.7	34	2000	Ghana	20.2	37	2000
Thailand	14.7	35	2002	Vietnam	19.7	40	2001
Sri Lanka	13.4	42	2003-04	Nepal	19.6	42	2003-04
Turkey	12.6	47	2001	Egypt	18.2	46	2002
Korea	12.6	48	2002	China	17.9	50	2002
Brazil	12.3	51	2002	Thailand	16.2	56	2002
China	12.3	52	2002	Colombia	15.9	59	2003
Argentina	11.8	62	2001	Argentina	12.3	85	2001
Colombia	11.7	63	2003	Brazil	11.7	90	2002
Malaysia	8.8	86	2002	Philippines	10.5	101	2003
Indonesia	7.2	99	2002	S. Africa	10.2	104	2001
Chile	7.0	101	2002	Indonesia	8.4	115	2002
S. Africa	6.4	106	2001	Chile	7.0	119	2002
Philippines	5.1	120	2003	Malaysia	3.0	129	2002
Median	11.2			Median	15.1		
Mean	11.7			Mean	16.7		

4.17 Source: World Bank (2004): *Trade Policies in South Asia: An Overview*, page 35.

III. Trade Liberalization in Bangladesh: Impact and Remaining Challenges

Growth has Benefited from Trade Liberalization

4.18 *The intended objectives of Bangladesh's trade policy reforms initiated in the early 1990s were to foster trade integration, enhance domestic competition, and align domestic relative prices with*

⁷³ Source: World Development Indicators, World Bank.

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international prices. The expectation was that these developments would promote efficiency in resource use and encourage technological progress and diffusion and thus generate dynamic gains and higher productivity growth. This reasoning drew on the widespread agreement that in the long-run economies with liberal trade policies and greater openness show stronger economic growth and overall development performance, based on supporting evidence from numerous cross-country studies and country case studies.⁷⁴ *Has trade liberalization in Bangladesh brought with it the intended consequences of growth and efficiency gains?*

4.19 ***Trade liberalization and the resulting increase in export orientation in Bangladesh since the early 1990s has certainly coincided with and very likely contributed to faster GDP growth.*** This is supported by evidence at the micro and macro levels. **Chapter 1** of this report shows that export orientation and productivity across manufacturing firms in Bangladesh are positively correlated. A similar conclusion was reached by a previous World Bank study.⁷⁵ At the macro level, too, growth performance, especially of manufacturing sector and exports, has improved considerably since 1991, benefiting from the trade reforms.⁷⁶

4.20 ***A large part of the growth response of exports came from the RMG sector, which, in addition to preferential access to developed country markets, benefited from far deeper trade liberalization than did the rest of the economy.*** The Government moved early to avail of the opportunities presented by the ‘reserved’ import markets under the Multi Fiber Arrangement (MFA) and more recently under the Agreement on Textiles and Clothing (ATC) until its complete removal in January 2005 and by the Generalized System of Preferences (GSP) and ‘Everything But Arms’ programs in the European Union markets. It expanded the use of ‘special bonded warehouses’ to facilitate quick duty-free access to imported inputs for the 100 percent exporters, offered back-to-back letters of credit, and established EPZs to bypass some of the business environment weaknesses besetting the rest of the economy. Authorities also substantially lowered tariffs on imports of raw materials and capital equipment for most finished products. *Several other industries, that had the potential to show a similar growth response, were held back by the slow pace of trade liberalization.*

4.21 ***The positive experience of the RMG sector is testament to the benefits of reducing protection levels while improving business environment and trade facilitation.*** It reflects the capacity of the Bangladeshi private sector to respond to the new opportunities and the significant positive externalities created through the learning-by-doing process, as evidenced by the emergence of a new generation of entrepreneurs in Bangladesh.

Important Challenges Remain Because of the Uneven Nature of Trade Liberalization

4.22 ***The impressive success of the RMG sector is yet to be replicated in other industries, and Bangladesh’s export base remains narrow.*** As noted, in large part this is because trade liberalization has been much slower in reaching the non-RMG sectors. If anything, Bangladesh’s RMG experience demonstrates that relying on enclave-type arrangements to facilitate export growth in a specific economic activity, while postponing broader and deeper trade liberalization, can even backfire in some ways by creating significant concentration of the export base. Today, knitwear and woven-based RMG exports

⁷⁴ Dollar and Kraay (2002) and (2004), Michaely, Papageorgiou, and Choksi (1991), Winters, McCulloch, and McKay (2004). There are also studies reflecting skepticism over the findings of cross-country studies on the grounds of inappropriate measurement of ‘trade policy-induced openness’, weaknesses in the methodologies used, and failure to establish the direction of causality: Rodriguez and Rodrik (2000). However, the latter is in turn criticized for ignoring the findings of the country case studies: Srinivisan and Bhagwati (1999).

⁷⁵ The *Bangladesh- Trade Liberalization: Its Pace and Impacts*, World Bank, 1999, Report No. 19591-BD.

⁷⁶ Ahmed and Sattar (2003) make the case that the improved growth performance since the early 1990s was in significant part due to the trade reforms.

account for 75 percent of Bangladesh's merchandise exports and directly employ 1.8 million workers (90 percent being women), and indirectly another 0.8 million workers in the accessory industries. In this post ATC era, with the abolishment of the quota system, such heavy economic concentration presents significant vulnerabilities that need to be recognized.

4.23 *In order to diversify its trade base and improve export competitiveness in general, Bangladesh needs to develop and implement a well-thought-out sequence of trade liberalization measures.* The country has to accept the reality of increasing global economic integration that is likely to persist, intensifying competitive pressures among nations. Beyond that, global competition for Bangladesh's main export, RMGs, itself has stiffened with the phase-out of the textiles and clothing export quotas. Low wages notwithstanding, competitiveness of Bangladeshi exporters continues to be undercut by low productivity, higher input costs, perceptions of poor product quality, inefficiencies in trade facilitation and long lead times, and weaknesses in the domestic business environment; areas where many of Bangladesh's main competitors for RMG exports (e.g., China, India, Sri Lanka, Vietnam) are generally doing better. In order to maintain its position as a leading RMG exporter and also to diversify its export base, Bangladesh would need to strengthen its export competitiveness by addressing each of these critical areas of concern.

IV. Towards Growth-Supporting Trade Policy Strategy

4.24 *Over the last two decades, Bangladesh has followed a unilateral approach as the principal avenue to liberalize its trade policy, while remaining active in the ongoing WTO multilateral trade negotiations, particularly as a leader in the Least Developed Country (LDC) coalition under the Doha Development Round.* However, in the area of 'offers' in agricultural and non-agricultural trade, Bangladesh has opted for a strategy of keeping the coverage of its 'tariff bindings' very low (at 13 percent of all tariff lines so far). Furthermore, the bound rates have also been kept significantly above the applied rates for both agricultural as well as for manufactured products.⁷⁷ In any case, given Bangladesh's prohibitively high protection rates in the early 1990s, trade liberalization through unilateral actions (of course, in a manner that is consistent with the multilateral system of the GATT principles) and not waiting for the multilateral trade negotiations as a key instrument of Bangladesh's own tariff rationalization efforts seems to have been the right strategy.

4.25 *Bangladesh and the other South Asian countries have also been actively involved in the negotiations of various regional 'preferential trade agreements' (PTAs) and in discussions of potential bilateral free trade agreements (FTAs).* Quite apart from general opening up through unilateral trade liberalization particularly since the early 1990s, South Asian countries view increased cooperation and trade among themselves as a key objective. This was reflected in the signing by the member nations of the South Asian Association of Regional Cooperation (SAARC) – Bangladesh, Bhutan, India, The Maldives, Nepal, Pakistan, and Sri Lanka – of the South Asian Preferential Trade Area (SAPTA) Agreement in 1993, which became operational in December 1995. The actual exchange of preferences has been quite limited, partly due to the hostilities between India and Pakistan, and the impact of this initiative on Bangladesh trade liberalization and trade openness has been minimal.

4.26 *More recently, the worldwide proliferation of PTAs has led to a change in thinking in the region, especially in India but also in other South Asian countries, which have all begun to negotiate a series of PTAs of their own.* As in other regions, these efforts particularly intensified in the aftermath of the failed September 2003 Cancun Ministerial meet. The South Asian Free Trade Area (SAFTA) Agreement was signed in January 2004, with the ultimate objective of turning South Asia into a full-

⁷⁷ For details, see: *Trade Policies in South Asia: An Overview*, World Bank, 2004, Report No. 29949. In FY04, the simple average of bound tariff rates was 188 percent – 197 percent for agricultural products and 50 percent for manufactured products.

fledged FTA with the internal liberalization beginning in January 2006. This agreement has come in the wake of a bilateral FTA agreement between India and Sri Lanka in 1998 that became operational on March 1, 2000. At the same, there is an ongoing discussion between India and Bangladesh on a possible bilateral FTA. Outside the region, Bangladesh is discussing details of an FTA with Malaysia.⁷⁸

4.27 ***The potential costs of PTAs/FTAs need to be carefully evaluated.*** Given that South Asia is the most protected regions of the world, Bangladesh faces considerable risks of adverse ‘trade diversion’ effects from regional PTA/FTA agreements. This is because such (multilateral and bilateral) preferential trading arrangements may lead to shifting of the source of imports away from least cost/most efficient third countries to higher cost members countries. In addition, a loss of customs revenues could also result.⁷⁹ It is therefore critical that Bangladesh continues to reduce the high protection levels with unilateral trade policy reforms by reducing the average level and dispersion of import tariffs, with a particular effort to dismantle the existing para-tariffs. This strategy will also enable Bangladesh to better manage its ‘regional integration’ objectives by helping to minimize the adverse ‘trade diversion’ effects.

4.28 Specific recommendations are listed below, first with respect to the unilateral trade liberalization strategy, and then on the key elements of a strategy toward potential FTAs, assuming that the Government is determined to remain a member of the SAFTA and finalize the ongoing bilateral discussions with a view to signing FTA agreements.

4.29 ***Recommendations for the future unilateral trade liberalization program:***

- ***Establish a low and uniform tariff rate in not so distant future*** – the key ultimate objective of the future trade reforms. And these interim reform steps will need to include further simplification of the import tax regime, and reduction in the dispersion and average level of nominal (and thus effective) protection, preferably through a pre-announced medium- and long-term schedule of tariff reductions (as done recently by India).
- ***Unify all para-tariffs and merge these with the CD***, with the result of having one tariff rate for each tariff line (in one-to-two years);
- Following the practice of the last decade, a ‘tops down’ tariff reduction approach could be maintained. ***Accordingly, gradually reduce the maximum tariff rate (after the merging of all para-tariffs with CDs) to 20 percent over the next two-three years, followed by a new maximum tariff rate of 15 percent by, say, 2010.*** This would, of course, also require parallel progress in expanding the base of VAT and direct taxes, elimination of the numerous tax exemptions, and further strengthening of tax and customs administration;
- ***Eliminate all end-user tariff exemptions/concessional tariffs;***
- ***Discontinue protective use of VAT*** by ensuring that it is levied both on domestic production and imports of the same products (in one year);
- ***Eliminate all the remaining quantitative restrictions/bans that are for protective purposes, such as those applying on imports of poultry, cartons, and salt.*** Replace them with appropriate tariffs (in one year);
- To maximize benefits from the EU’s GSP/EBA preference programs extended to the LDCs, ***resist objections raised by the textile sector to the use of ‘regional cumulation’ allowed by the EU***

⁷⁸ For further details and analysis, see: Baysan, Panagariya, and Pitigala (2004); *Trade Policies in South Asia: An Overview*, Chapter 5, (Volume II), World Bank, 2005; *Global Economic Prospects: Trade, Regionalism, and Development*, World Bank, 2000.

⁷⁹ For details, see: Baysan, Panagariya, and Pitigala (2004).

towards meeting the latter's 'rules of origin' conditions. This will help Bangladesh's RMG exports in the EU markets; and

- ***Lobby strongly in the USA for duty-free entry for its RMG exports,*** since such a preference has already been extended to the LDCs in Africa under the Africa Growth and Opportunity Act.
- Since many export items do not benefit from the duty-free access to imported inputs through the bonded warehouse and EPZ schemes, it is critical to ***ensure a well functioning duty drawback system*** such that rebates are paid quickly. To this end, the full implementation of the new duty drawback and bonded warehouse scheme is needed immediately.

4.30 ***Recommendations for the regional track to trade liberalization through free trade area (FTA) agreements:***⁸⁰

- First, continue with unilateral trade liberalization to minimize the likely adverse trade diversion effects, the key elements of which are listed above.
- Both for the SAFTA and for any bilateral FTA that might be signed:
 - minimize sectoral and/or product exception from such FTA agreements;
 - have clear rules against tariff-rate quotas;
 - have 'rules of origin' that are liberal, simple, transparent, and uniform for all products;
 - extend such agreements to services trade and investment;
- It would be desirable if countries in the region use the instrumentality of SAARC to promote economic cooperation in areas other than trade, de-linking those with cooperation on trade under SAFTA. Using the SAFTA instrumentality to promote trade and other agendas could face the risk of each being held hostage to the progress in the other. Specific areas of regional economic cooperation where the SAARC forum could be used include: infrastructure; trade facilitation; and harmonization of technical and sanitary and phytosanitary (SPS) standards in line with the standards of the major export markets.

⁸⁰ For an analysis of economic arguments on the topic, see Baysan, Panagariya, and Pitigala (2004).