

# Why trade policy is inhibiting export diversification

ZAIDI SATTAR

**E**XPORT diversification must be a formidable challenge: we have been talking about it for over two decades without nearing a solution, with dependency on garment only getting worse by the year. Of the \$36.7 billion exported in fiscal 2017-18, garment alone raked in \$30.6 billion, which is 83 percent of the total.

The time for talking is over. Doing something concrete is now a national imperative.

One needs to take a closer look at our trade policy to figure out that it has been stifling rather than facilitating export diversification.

What trade policy am I talking about? There is enough research evidence around the globe to show that subsidies on exports are not the answer.

In Bangladesh, there are other policies that counter the modest encouragement from subsidies to a selection of exports.

In the particular context of our export diversification challenge, the trade policy at issue is the package of incentives that encourage or discourage exports vis-à-vis domestic sales.

Note that investors and producers have only two markets to choose from: exports and domestic market.

They will be driven to either of these two markets depending on where profitability is the highest or the prospect of sales revenue (and therefore profit volumes) is greater.

Starting in the 1990s garment exports grew at double digits for two decades. In contrast, non-garment exports, of which there were many, seemed to lag behind.

And the result was export concentration.

Garment exports, which were 40 percent in fiscal 1989-90, rose to 76 percent in fiscal 1999-00 and to 83 percent in fiscal 2017-18.

Export concentration in garment makes the economy, jobs and income extremely vulnerable to external shocks arising from changes in global demand for apparel.

But export diversification is one way through which the economy can come out of this bind, the clamour for which has grown louder by the year.

Quite appropriately, export diversification has been the cornerstone of our export policy for several years now. But, progress has not been encouraging so far, suggesting re-examination of the problem in light of recent analytical research.

To come out of the export concentration phenomenon, Bangladesh could pursue several diversification options, with product diversification being one.

It describes a process whereby a range of new products is introduced to the export basket, thereby diluting any export concentration that might have existed.

While fiscal 2017-18's export data reveals that Bangladesh currently exports more than 200 types of apparel, our export basket comprised of upwards of 1,200-1,400 distinct non-garment tradable products that have been exported to nearly 200 countries since 2005.

That looks promising, but 75 percent of these non-garment products are still fetching less than \$1 million, meaning that they started small and are failing to become significant in our export basket. Why?

First, cost competitiveness is essential. The fact that we have been exporting such a vast number of non-garment products shows that we have a fairly wide range of products with good export potential.

The inference is that if we have such a strong competitive advantage in a labour-intensive product like garment, what is stopping us from having it in other labour-intensive products?

Research shows that we do have competitive advantage in numerous products but something is keeping our producers from exploiting that competitive advantage in the world market.

That brings us to the main point of this analysis: competitive advantage is not enough for those export products that also have a domestic market.

Outside the garment sector all



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**Export concentration in garment makes the economy, jobs and income extremely vulnerable to external shocks.**

production has a choice of the domestic or export market. What matters for producers and investors are the prevailing relative incentives for exports versus domestic sales.

Incentive for exports comes from cash subsidies, low cost credit, exchange rate under-valuation and so on.

For Bangladeshi exporters, there is no tariff protection that can prop up prices of Bangladeshi exports. So trade policies must be such as to leave sufficient incentive for producers to opt for export rather than sell in the domestic market.

Unfortunately, that is not how the trade policy is laid out: incentives are heavily skewed in favour of import-substitute production for sale in the domestic market.

Bangladesh has one of the highest protective tariffs (and para-tariffs) in South Asia. Tariff on competing imports of consumer goods that are domestically produced typically ranges from 70 percent (e.g. cosmetics) to 113 percent (e.g. plastic tableware).

These protective tariffs are indirect subsidies on import substitutes; not to mention that at such high rates they often serve as de facto ban on imports.

The net result is that profitability in domestic sales is artificially raised by these protective tariffs, far higher than if these same products were to be exported.

Profit margins in export are razor thin. It is only the massive sales volume and augmented revenues that would attract producers to export markets. In this circumstance, what would producers choose: export or sell in the domestic market? You guess.

Furthermore, an important requirement for exporters in a high tariff economy is the facility of duty-free imported inputs -- a critical trade policy component.

In fiscal 2017-18, all of the 3,700 garment exporters had the duty-free import option of Special Bonded Warehouse (SBW). Of the 3,000 exporters of non-garment products,

not even 500 were given that facility.

Without duty-free import of inputs, exporters cannot be competitive in the world market.

Duty drawback -- which is an obsolete and dysfunctional scheme -- is no substitute for the SBW system. As a result, non-garment exports are stifled and export diversification is going nowhere.

The focus of current export policies seems to be to pick winners, i.e. select "thrust" sectors and promote them with all sorts of incentives in the hope that they will flourish like garment in future.

If we recall, this is not how garment emerged as the leading export item of Bangladesh.

With the advent of Multi-Fibre Arrangement (MFA) in 1974, the right policies were formulated to give garment production a free trade channel, i.e. by providing duty-free inputs through bonded warehouse and back-to-back letters of credit system.

International experience suggests that in a high tariff regime export success cannot come through subsidies provided to "thrust" sectors.

It could, however, come through providing garment-like competitive environment to existing and potential exports.

While there is no magic recipe to promoting diversification, a broad array of policies might help, including:

- Facilitating duty-free imported inputs for exports. Zero duty makes the imported inputs the same as the global prices, which is needed for exports to be competitive in world markets;

- Making the incentive structure for exports the same as for import-substitute production for domestic sales, or slightly tilted in favour of exports;

- Lowering the costs of trade-related services (improved trade and transport logistics, and, of course, energy infrastructure) is critical for ensuring export competitiveness;

- Checking appreciation of the real effective exchange such that the exchange rate ensures export competitiveness;

- Introducing proactive policies, such as helping exporters to: upgrade existing products, break into geographic markets and launch and consolidate new line of business abroad.

Though progress in product diversification so far has been muted, Bangladesh has made good strides in geographical diversification as the share of exports to top 5 destinations has fallen significantly over the past decade.

The strategy of geographical diversification is expected to yield good dividends as markets open up in Japan, China, India, Canada, Brazil and Russia.

To conclude, there is no magic recipe for diversifying exports. But the trade policy needs to be tilted more in favour of exports rather than import-substitute production.

The writer is the chairman of the Policy Research Institute of Bangladesh.

## Assets worth 800b pounds to shift from UK to EU due to Brexit



REUTERS/FILE

**A view of the City of London. Britain is due to leave the EU bloc in March.**

REUTERS, London

**A**SSETS worth nearly 800 billion pounds are being moved from Britain to new financial hubs in the European Union ahead of Brexit, consultancy EY said on Monday.

Britain, which is due to leave the bloc in March, has yet to approve a deal to avoid an abrupt severing of ties with the EU. Although the British parliament is due to vote on a proposed settlement next week, it is unclear if it will be approved.

"The closer we get to 29 March without a deal, the more assets will be transferred and headcount hired locally or relocated," Omar Ali, UK financial services leader at EY, said.

EY has been tracking the Brexit plans of 222 financial firms since Britain voted in June 2016 to leave the EU. In its latest update to the end of November 2018, it said that 80 firms are considering or have confirmed relocating assets and staff. The latest estimate from EY says that

800 billion pounds in assets would move, a fraction of Britain's 8 trillion pound banking sector.

Frankfurt Main Finance, which promotes the German financial centre, has said it expects 750 to 800 billion euros of assets to transfer there alone, largely during this quarter.

Around 2,000 new European roles have been created by financial services companies in response to Brexit, with Dublin, Luxembourg, Frankfurt and Paris the most popular locations, EY said.

Forecasts of hundreds of thousands of UK financial jobs moving to the EU have not materialised, and the Bank of England expects about 4,000 jobs to have moved by March 29.

"Whilst roles will no doubt move from the UK, many firms are only moving those employees deemed essential and are hiring locally given the expense of relocation," Ali said.

Moves so far would be only the "tip of the iceberg" if there is a no-deal Brexit, EY said.

## China studying new reforms to help small business

REUTERS, Shanghai

Chinese policymakers are studying new ways to give small firms access to cheaper credit and support private sector businesses that face refinancing challenges, the official China Daily said on Monday.

The paper said financial institutions are now being mobilised to provide more support to private companies, and will be allowed to use a wider range of financial tools such as bonds and bank lending.

China is trying to avert a sharp economic slowdown, brought about by slowing domestic demand and tough US tariffs on its exports. On Friday, the central bank cut reserve rate requirements for a fifth time in a year, which is expected to free up \$116 billion in cash for new bank lending.

Chinese Premier Li Keqiang also said on Friday that China would work to cut taxes and fees to try to boost the economy in what he described as a programme of "countercyclical adjustments".

Chinese regions are already drawing up new plans to support private businesses, with the southwestern municipality of Chongqing and the northeast province of Liaoning both announcing new measures, including relief funds, to promote private enterprise development.

## Tesla breaks ground at Shanghai Gigafactory to launch China push

REUTERS, Shanghai/Beijing

Tesla Inc broke ground on Monday for its Shanghai Gigafactory where it plans to begin making its Model 3 electric vehicles (EV) by year-end, a first step in localizing production in the world's largest auto market.

At a ceremony at the site of the plant on the outskirts of Shanghai, Chief Executive Elon Musk joined the city's mayor and other local government officials to formally begin construction of a factory that Tesla has said will cost around \$2 billion.

"We think with the resources here we can build the Shanghai Gigafactory in record time and we're looking forward to hopefully having some initial production of the Model 3 towards the end of this year and achieving volume production next year," Musk said at the event.

The so-called Gigafactory is China's first wholly foreign-owned car plant, a reflection of China's broader shift to open up its car market, even amid a trade war with the United States which has seen a rise in tariffs on cars imported from the US.

## RBI says it is open to liquidity needs



REUTERS/FILE

**Shaktikanta Das, governor of the Reserve Bank of India, gestures as he attends a news conference in Mumbai.**

REUTERS, New Delhi

**T**HE Reserve Bank of India (RBI) is open to infusing "need-based" liquidity into the financial system, Governor Shaktikanta Das said on Monday ahead of a meeting with the shadow banking sector, which has been hit hard by a funding crunch.

Government officials have pressed the RBI over the past few months to ease lending and capital rules for banks and provide more liquidity to shadow banks.

They have also urged the RBI to step up lending support for small businesses and allow the government to use more of the central bank's surplus reserves to boost the economy.

Das said the RBI constantly monitors liquidity conditions and would take steps to address any deficit in the banking system. But he said it was also keen to prevent the creation of excess liquidity.

"The Reserve Bank would not like a situation where liquidity becomes kind of loose money," he told reporters in New Delhi. "Any infusion of liquidity will have to be very carefully considered and has to

be need-based."

He said the central bank would meet representatives of non-banking financial institutions (NBFCs) in Mumbai on Tuesday.

Defaults by big NBFC Infrastructure Leasing & Financial Services (IL&FS) on some of its debt obligations late last year triggered declines in stock and debt markets, and led to concerns about broader risks in the financial sector.

"There has been a lot of discussion and a lot of views have been expressed about the issue of liquidity faced by the NBFCs," Das said. "So in tomorrow's meeting we will utilize the opportunity to get a perspective from the NBFCs."

He also said the RBI was considering governance reforms for state-owned banks, which dominate the banking sector with over two-thirds of its assets.

"Governance reforms are an important component of the revival of public sector banks," he said. "There is definitely improvement noticed in the reduction of the non-performing asset levels of the banks as a whole and the public sectors in particular."