

# A DECADE OF TRADE LIBERALIZATION: HOW HAS DOMESTIC INDUSTRY FARED IN BANGLADESH?

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## ABSTRACT

By the end of the 1980s, the government of Bangladesh, having negotiated with international financial institutions, plunged into various market-oriented reforms to revitalize the economy. While the reforms had many aspects, this paper focuses on international trade reforms and their effect on the industrial sector. It finds that the reforms have not encouraged the development of an autonomous domestic industrial capability. Among export industries, it is seen that the jute sector has had difficulties because of world market conditions and has not been able to go through sectoral adjustment. Although export growth is largest in the readymade garments sector, it remains dependent on foreign buyers. Leather exporters have also generally suffered from an inability to move to high end products and adopt necessary quality controls. Quality standards pose a marketing problem for seafood producers as well. Furthermore, environmental and labor safety issues persist in all these sectors. These problems are pervasive in import competing sectors such as textiles, chemicals, and metals which have not successfully competed with consumer goods imports. Recent investments in large firms such as power or fertilizer also have not created employment for a labor abundant economy. Small firms have not benefited from the reforms in that cost savings from lower tariffs on imported inputs have rarely been passed on to them. While the reforms have led to some resource shifts in the economy, growth and diversification in the industrial sector has been limited. Marketing, technical, and entrepreneurial skills have yet to be developed to allow such success. These and an ability to negotiate in the larger global economy are critical for the welfare of the country.

## Background

The World Development Report of 1987 classified Bangladesh as a country with a “strongly inward orientation” and as having followed import substitution policies during 1963-85. Bangladesh has also been described as having unacceptably large price distortions or deviations from a vector of international or “shadow” prices (Dodaro, 1991, Hutcheson, 1986, Mallon and Stern, 1991, Warner, 1985, or The World bank, 1992). Only major structural reforms would correct the distortions in the economy and lead to resource shifts to the export sector and improve efficiency in the rest of the economy (Ahammad, 1995 and Khan, 1994). Bangladesh was hardly unique in this respect. This was standard prescription being suggested by international donors to most developing countries. The particularities varied marginally depending on the specific country context (Danaher, 1994).

Bangladesh had an external public debt which amounted to 37% of its GDP in 1985 (World Bank, 1987). Although this was not as insolvent a situation as many countries in Africa for which the ratio exceeded 100%, it nonetheless implied that debt

service was a burden and advice from creditors was to be taken seriously. By the end of the 1980s, the government, having negotiated with international financial institutions, plunged into various market-oriented reforms to revitalize the economy. The long list of reforms which took place during the 1980s and 1990s has been documented by several authors (see Reza, 1996, Hossain, 1996, Rana, 1997, Hossain and Rashid, 1997, Bhattacharya, 1995, Mahmud, 1995, Rahman and Bakht, 1997 among many others.) The reforms include export promotion schemes, exchange rate liberalization, reform and privatization of state owned enterprises, removal of price controls and subsidies, restructuring of the financial sector, and tax reforms. These amounted to the entire gamut of policies suggested to developing countries to smooth the functioning of private enterprise and encourage domestic and foreign investment in the private sector. In addition, import liberalization was undertaken and an abundance of imported goods were made available to both consumers and producers. Foreign aid in the form of both loans and grants were used to finance these imports. These reforms were carried out by the government in partnership with international donor agencies.

The particular reforms that will be considered in this paper are those in the area of international commercial policy, i.e. import and export policies. These include lowering and reducing the dispersion in import tariff rates, reduction of quantitative restrictions on imports, tax exemption on import of capital goods for 100% export-oriented industries, and provision of export incentives in the form of bonded warehouses, duty drawback schemes, back-to-back letters of credit, and export credit guarantee.<sup>1</sup> Other related changes include abolition of the dual exchange rate and the convertibility of the Taka as well as the introduction of a trade-neutral uniform value added tax to replace existing taxes on imports. Financial sector and public enterprise reforms were carried out and a fledgling stock market came into being as did a privatization board which is in charge of privatizing state owned companies. These latter changes also affected the business environment for the private sector so that trade liberalization cannot be considered in isolation without them. Several industrial policies were established in the 1990s to provide an encouraging regulatory environment for foreign investment and to reduce the number of areas limited to the public sector. These measures opened up telecommunications, power generation, and domestic air transport sectors to private investors. The natural gas sector was also opened up to private, particularly to foreign, investment. Two Export Processing Zones (EPZ) were established and facilities for foreign investment in the EPZs were expanded by 1995.

The reforms have been hailed as generating employment, growth, and development in Bangladesh. They are seen as being important in sustaining growth in the future (The World Bank, 1999 or Muhith, 1999). The following section considers the effect that the reforms have had on output, investment, and employment in the domestic industrial sector and finds that the current policy has not encouraged an autonomous domestic industrial capability.

### **Changes in Industrial Structure**

An examination of the industrial structure shows that most of this sector consists of small enterprises engaged in activities such as handloom production, rice and saw milling, metal goods production, and light engineering (Rahman and Bakht, 1997). According to the Bangladesh Bureau of Statistics, over 53% of value addition occurs in small and cottage industries. Among medium and large

industries, the important sectors are textiles (including jute textiles), fertilizer, petroleum refining, and pharmaceuticals. Many of these are state owned enterprises and were established several decades ago. It is well known that many of these public enterprises produced import competing goods under protection and that the removal of such protection has contributed to financial losses and subsequent privatization (GATT, 1992, or The World Bank, 1995). However, the issue of privatization of such loss making state owned enterprises is not directly addressed in this paper.

How have these different industries fared under the changes in the last decade? There is no single study that summarizes this topic and any generalization must be patched together from several sources. We will examine some important sectors to see how trade policy changes have been relevant to each. This is by no means a complete assessment. Yet, the major sectors are considered and, therefore, reflect most industrial activity in the country.

#### **a) Export sectors**

*i) Jute Manufactures:* This is the traditional source of export earnings as well as one of the most important sectors in terms of employment. However, competition from other countries, consumption substitution with synthetic products, and public sector management of many of the mills have all led to financial problems in this sector. With advice and help from donor agencies, half of the public sector jute mills were privatized in 1982 (Bhaskar and Khan, 1995). The government still has equity in over three-quarters of the sector. After privatization, more manual labor was hired but output fell steadily. Much of the decline in output since the 1980s was because of falling world demand. Although jute manufactures still account for three-fourths of total jute exports, the proportion of raw jute and jute manufactures in total exports has fallen from 68.4% in 1980 to 11% in 1995 (Rahman, 1997). The appreciation of the Taka against Asian competitors in the world market also had adverse effects on output. More recently, the allowance of zero duty on machinery imports has helped jute industries to re-orient themselves to some degree. The government has participated in a sectoral adjustment scheme with the World Bank to close down a third of the public mills, downsize two large mills, and privatize the remaining mills, but labor union and political opposition has led to the cancellation of this program (The World Bank, 1999).

*ii) Ready Made Garments (RMG) :* This sector is the mainstay of export and manufacturing activity in Bangladesh today in terms of employment, output, investment, and foreign exchange earnings. The most important source of growth in garments was due to access to the US and EU markets. These markets account for over 80% of ready made garment exports from Bangladesh. These export destinations were available as a result of quotas given to the country's producers through the Multi-Fibre Agreement. These quotas are to be phased out by 2005. At present, almost two-thirds of total exports from Bangladesh consist of knit and woven fabric ready made garments (Rahman, 1997). However, value added accounts for only 25-40% of gross product and is limited to cutting and sewing. The sector remains dependent on foreign buyers and price per unit received in the world market is lower than that for competitors in neighboring countries.

Labor productivity in this sector with its largely female workforce has been high compared to productivity wage ratios in traditional sectors. This sector is the main user of export promotion schemes such as bonded warehouses and back-to-back letters of credit. Firms in this sector are mostly medium in size. Because of tax holidays given to new entrants in this industry, extant firms expand by establishing new enterprises rather than increasing plant size or having multi-plant establishments under the existing company name. The government has attempted to encourage greater value addition by introducing a cash compensation scheme that provides a 25% cash subsidy to domestic suppliers of raw materials to the garment sector. This has led to some investment in composite knit mills, many investors being RMG producers themselves.

Despite the export promotion schemes made available by the government, there are several problems endemic to this sector. These include a concentration on low end products, lack of quality control, and little negotiating ability with regard to price. There is a lack of technical expertise in the sector and businesses are unable to service complex export orders because of an inability to organize production or acquire and operate machines in the requisite manner. There is little indigenous innovation in the sector and the enterprises struggle simply to respond to buying agents. Technological changes in RMG are also driven by these agents as they are often the ones to introduce and sell machinery to garment producers. Domestic entrepreneurs are rarely able, on their own, to market

products that they have developed. Because their destinations are dynamic markets in industrialized countries, direct market access is impossible with existing marketing knowledge and capacity. Without changes in such capability, prospects for this sector may be bleak. Of interest is the increase in secondary economic activity that has occurred as a result of the growth in the exports of RMG. Several firms which make textiles, dye or print gray cloth or accessories such as buttons or zippers have come up in recent years. Although these businesses are also very import intensive in production, only a decade ago these were non-existent and most products made by these firms were imported.

*iii) leather products:* A few large firms have moved into finished leather goods of high quality. The remaining firms continue to produce finished leather. Price fluctuations have been difficult for such producers as they have sometimes found that the price of finished leather in the world market was lower than the prices they were paying for rawhide. Quality problems also persist in this sector and any formal research and development is non-existent. Because export credit had been widely available, many firms had borrowed to set up what seemed to be a profitable venture with little start up knowledge. When the government stopped giving export subsidies to the production of wet blue leather, these firms began to lose money. Most businesses in this sector are not healthy. The only exception is a few larger firms which have exported leather shoes the production of which increased substantially in 1997. One issue is the poor environmental standards in the industry that has not been addressed by the government.

*iv) seafood:* Frozen seafood, particularly shrimp, is another upcoming export which comprised 11% of total exports in 1999. The seafood industry suffered a major setback in 1997 because several shipments of frozen shrimp sent to the EU were identified with a virus. The EU is the major destination for frozen shrimp exports and over \$14 million worth of export revenue was lost. Only six firms had obtained permission to export after the ban and of the 100 or so firms that had come up, most had closed. The Department of Fisheries in the Bangladesh government has not implemented a quality control program that is rigorous enough to counteract the situation. Market entry into the United States has been difficult because of quality standards. Also, there is severe price competition from India and Thailand. The provision of duty free imports of

machinery helped several firms expand to higher value added products such as cooked shrimp. But there is little product diversification as yet. Environmental problems associated with salinity in arable land continue to persist. More intensification of shrimp cultivation may check this trend if growth in this sector is to continue.

## **b) Import competing industries**

*i) cotton textiles:* Few if any of the cotton textile mills supply fabric to the ready made garments sector, despite the availability of the cash compensation scheme. Instead, most production is for domestic consumption. Handloom producers predominate in this sector. During the 1980s, over 27 large public firms were privatized in the textile sector. These and other larger firms face stiff competition from Indian, Chinese and other foreign imports. The government encouraged this sector in the 1980s by providing generous credit which led to the entry of a substantial number of firms, but most are bankrupt and prospects for the remaining firms are dim. An increase in the world price of raw cotton, as well as the recent devaluation of competitors' currencies have also adversely affected this sector.

*ii) chemicals:* The chemicals subsector includes pharmaceuticals, petroleum refining, and fertilizer. Value added in this sector is generated by mostly large, capital intensive industries with little contribution to employment. The availability of gas has made investment in such enterprises attractive. KAFCO, the Karnaphuly Fertilizer Plant, is one of the largest foreign investment in Bangladesh in recent years. Consumer items in this sector face stiff competition from Indian products which continue to capture increased market share. These products enjoy a price advantage and established reputation due to economies of scale in production and marketing.

Recently, many pharmaceutical firms have come up as a result of reduced tariffs on chemicals and non-tariff barriers employed in the import of medicine. These are very import intensive in their production. Larger pharmaceutical firms enjoy scale economies and control most of the domestic market. Some of the larger firms have allegedly exported medicine in recent years.

*iii) steel and engineering:* Production in the steel sector was primarily in the hands of public firms until the 1980s. Steel rolling enjoyed a large amount of protection as did the production of machine tools and

other engineering products. When such protection was removed, the public sector firms went under and were either shut down or privatized. There is little machine tools production any more but steel rolling is still carried out by many medium sized private firms. Scrap from shipbreaking is an important input into this sector. A lack of quality controls and standards is a serious problem in this sector.

Other import competing sectors such as vegetable oil, paper, insecticides, and machinery have reduced both output and employment owing to the pressure brought on by import liberalization.

## **c) Small firms**

Although the 1986 Industrial Policy declared small enterprises as being eligible for a variety of incentives such as tax holiday, exemption from capital gains, long term capital gains, and the setting up of an export processing zone, the reality as regards the policy regime has been, if anything, unfavorable. Small industries have typically located outside industrial areas, not having access to commercial prices for power or gas. They are usually denied loans unless proprietors can guarantee these with their own real estate. They are exempted from paying VAT. Yet there is frequent complaint of harassment from the VAT office. They mostly use local inputs for their products and to the extent that the price of non-tradables increase with trade liberalization, they are not beneficiaries of this process. In various cases such as rubber sandals, soap, or metal products, they often do not benefit from lower tariffs on raw materials because large importers do not pass on price discounts to these small users. For the most part, liberalization policies seem to have benefited larger enterprises. Many items such as spare parts for trucks, bicycle parts, or various types of metal products that used to be produced by small enterprises now come mostly from India or even China rather than being produced locally. A sole exception to this has been the export of Grameen check that has used backward linkages involving small rural weavers.

## **Limits and Resistance to the Reforms**

While the reforms have led to some resource shifts in the economy, growth and diversification in the industrial sector has been limited. The size of the domestic market is not large enough to absorb a substantial increase in industrial output. Exports, on the other hand have been constrained by a lack of

access to foreign markets and are limited to low value added products. The reliance on ready made garments as the major source of foreign exchange earnings without a commensurate ability to rely on these as a stable source or such earnings leaves Bangladesh vulnerable to the mercy of the same countries which influence international donor agency policies. In the export processing zones some of the firms which have come up in electronics or plastics are small and rely little on domestic inputs or human capital. The lack of a large entrepreneurial base and skilled labor force has been a problem as has been an absence of familiarity with international technology and marketing standards. In addition, infrastructural bottlenecks and lack of credit have not encouraged investment.

Resistance to the reforms came from labor unions in the public sector and a variety of civil society groups in 1991. The resistance was one of the factors that caused the Ershad government to fall that year. When the BNP government came to power and continued the liberalization, it also lost to the opposition led by the Awami League which received support from labor unions and anti-reform groups (Maclean, et.al., 1997). Despite some resistance from interest groups such as selected producer groups or unions, there is general consensus in the public and media that Bangladesh is too small to be insulated and must integrate with the global economy. However, the nature of this integration is said to be passive, superficial, and with little linkage to the bulk of people and economic activity in the country. Also, the policies undertaken for such integration reallocated resources away from public expenditure for the provision of health, education, and other services. There was a general perception that the earlier emphasis on poverty alleviation had shifted to a more strict focus on market determined economic efficiency. A simultaneous rise in democratic and popular movements has led to a search for alternative approaches to poverty alleviation and the provision of basic needs. This is seen in the expansion of non-governmental organizations (NGOs), both local and international, which have concentrated on empowerment, health, education, and micro-enterprises. Such provision of social services and participation can lead to a greater success of market based policies in the long run.

## **Conclusion**

Upon liberalizing the trade regime, both imports and exports have increased. The evidence is somewhat mixed, with some sources suggesting that imports have not grown as much as exports and the mix of producer and consumer goods have not altered (Reza, 1996, and Rahman, 1997) while others suggest that consumer goods now occupy a larger share of imports (World Bank, 1998). In agriculture, some gains have been made from liberalizing the trade in pumps and engines and reducing their costs, although the use of these is not widespread in a countryside that remains largely impoverished. Resource shifts have occurred in the industrial sector but it is unclear that these will allow sustained increases in output and employment. Growth has been limited largely to the RMG sector, the future of which is uncertain. Diversification of exports is much needed, but quality control and marketing knowledge is sadly absent among most domestic firms. The industrial sector is not at a stage where a smooth reallocation of resources can lead to international competitiveness. Marketing, technical, and entrepreneurial skills have yet to be developed to arrive to such a state. Also, import liberalization in all sectors of the economy has led to an inflow of goods that has devastated fledgling and small enterprises. Production in the EPZ uses and imparts little labor skills. Most producers face a shortage of managerial and technical professionals that are a necessary ingredient for a thriving export sector. The export sector needs well-developed domestic industrial capability in order to mature and respond to international conditions. Without increased social provision of health, education, and infrastructure which is much needed to encourage domestic industrial capability, there is little scope of a strategy for development which is self determined and not dependent on international charity. While banking reforms continue and foreign investment in telecommunications, power, natural gas, and the financial sector increases with support from the international institutions, these are rarely in accord with a local determination of policies and local capability. They do not rely on local capability but remain passive to international capital. Bangladesh is among the least-developed countries which are negotiating market access in the World Trade Organization. It is hoped that these initiatives will include a bound of zero tariff rates for all exports from least-developed countries including textiles as well as changes in rules of origin, simplifying them and making allowances for the interests of the least-developed countries. Being a meaningful part of such negotiations is only one of the tools needed for self-

confidence and empowerment in a rapidly changing world economy.

<sup>1</sup> There were quantitative restrictions on about 315 four digit tariff heading items. These covered about a fourth of all import categories. Restrictions were reduced to 112 in 1993 and then to about 30 by 1997. There was also a use of “tariff values” to assess the value of tariff liabilities. These were removed in 1994.

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