BRIEFING PAPER

25 years 1983 2008 CUTS International

16/2008

Trade Liberalisation, Growth and Poverty in Bangladesh

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Bangladesh has liberalised its economy quite considerably. The pace of liberalisation was very rapid particularly in the 1990s. Liberalisation measures have contributed to the reduction of the policy induced anti-export bias to a moderate level. Further liberalisation measures might be desirable but need more careful implementation as most of Bangladesh's trade related quantitative restrictions (QRs) are almost extinct now. Removal of the few existing QRs would not constitute much of an increase in openness. Moreover, the available evidence seems to suggest that the growth performance of Bangladesh has not been significantly influenced by liberalisation measures. The potential growth dividend arising from further tariff cuts also appears to be very small. It is also obvious that in the past liberalisation has failed to energise export response. This Briefing Paper examines the theories related to linkages between trade liberalisation, growth and poverty and assesses impacts of trade liberalisation on Bangladesh economy. The paper is based on a CUTS study findings that imply that liberalisation of the tariff regime alone is likely to be insufficient for promoting export and economic growth in Bangladesh.

Introduction

The impact of trade liberalisation on growth and poverty is a much debated and controversial issue. Theoretically, it has been well argued that trade liberalisation leads to productivity gains through enhanced competition, efficiency, innovation and acquisition of new technology, enlarging the market size (scale economies) and increasing the impact of knowledge spillover. Trade policy works by inducing substitution effects in production and distribution of goods and services through changes in prices. These factors in turn influence the level and composition of exports and imports and thereby allocation of resources. Theoretically, these constitute important components of the effects of trade liberalisation, which together induce growth of output and consequent poverty alleviation.

However, unfortunately the empirical evidence to support these propositions is far from conclusive. The cross-country and country-specific studies have not been able to provide credible and convincing evidence to support the claim that trade liberalisation promotes economic growth and aids poverty alleviation. In the context of Bangladesh, there appears no consensus amongst economists and policy makers on this issue. Bangladeshi economists do not even endorse the views of the World Bank and the International Monetary Fund (IMF) that trade liberalisation pursued by their country have been/is conducive to economic growth and poverty alleviation.

In Bangladesh a beginning was made towards trade liberalisation in 1987 when the 'Structural Adjustment Programme' (SAP) was initiated as a component of 'Structural Adjustment Facility' (SAF) and 'enhanced Structural Adjustment Facility' (ESAF) of the IMF and the World Bank. This adjustment programme put forward a wide range of policy reforms including trade policy, industrial policy, monetary policy, fiscal policy and exchange rate policy, privatisation of state-owned enterprises (SOEs) and promotion of foreign direct investment (FDI).

Ever since its independence in 1971 Bangladesh has followed a highly restrictive trade policy as a part of its import substitution industrialisation policy, using high tariffs, non-tariff barriers (NTBs) and an over-valued exchange rate system to improve its balance of payments position. There was moderate trade liberalisation in the 1980s; however, large-scale trade liberalisation was implemented only in the 1990s. There is a serious debate amongst economists and policy makers in Bangladesh on the pace and depth of policy reforms associated with trade liberalisation in the 1990s. The World Bank and the IMF have claimed that liberalisation has not been as deep or rapid as compared to many other developing countries (World Bank, 1990).

However, economists and private industrial entrepreneurs in Bangladesh do not endorse this view (Mahmud, 1998). In fact, there have been concerns over whether the impact of trade liberalisation has been favourable to the domestic economy. Questions have been raised time and again over whether Bangladesh ought to undertake further drastic trade

With the support of

NORWEGIAN EMBASSY

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liberalisation or adopt a more gradual approach. Against this backdrop this study was conducted to assess the policy of trade liberalisation pursued so far by Bangladesh and examine its impact on growth and poverty in the country using a Computable General Equilibrium (CGE) model for 2005.

Trade Liberalisation, Growth and Poverty Nexus: Review of Theory

The competing theories on trade and economic performance and the empirical studies testing these theories do not provide any conclusive evidence on the effects of trade liberalisation on economic growth and poverty in the context of developing countries. There are four major schools of thought on the relationship between trade and economic growth. They are: (i) theories based on static gains from trade; (ii) the structural pessimist theories; (iii) the new orthodox theories on trade liberalisation; and (iv) new trade and endogenous growth theories.

The foremost theories of *static gains* from trade theories see trade as beneficial for trading countries. Trade benefits both factors of production, viz. labour and capital. Three variants of these theories are dominant in the trade literature; viz. the theory of comparative advantage; the Heckscher-Ohlin-Samuelson theorem and the theory of Vent for Surplus. These theories suggest that gains from trade occur through removal of obstacles to free trade such as tariffs, NTBs etc. These trade gains are static in nature as they are only one time payoffs for trading countries and have no further implications for higher economic growth or investment.

There are several variants of *structuralist* theories on trade, which were developed during 1950s and 1960s. Prominent amongst these are those by Prebisch (1950); Singer (1950), Nurkse (1962), Vernon (1966) and Myrdal (1965). These theories are based on the assumption that the world is divided into two parts: Centre and Periphery. The industrially developed countries constitute the Centre and the developing countries the periphery. The structuralists see trade as a source of impoverishment in periphery countries and a source of enrichment in industrialised countries. Four critical propositions are at the heart of structuralist theories: terms of trade, export instability, pervasive infant industries and maldistribution of gains from trade (Greenway and Miller, 1993). They also believe that free trade inhibits the growth of domestic industries in developing countries (Chenery, 1961; Krueger, 1984).

Developed on the assumption of ‘trade as an engine of growth’, the *new orthodoxy* of trade liberalisation emerged during the late 1970s and early 1980s. Its development was facilitated by several factors including the so called neo-classical counter-revolution in the mid-1970s at both the academic and policy levels, the increasing dissatisfaction with inward looking trade regimes in developing countries, the conditionalities attached to aid and loans under the SAPs of the IMF and the World Bank and the remarkable export growth performance of East Asian economies.

The new orthodoxy theories, which assume that free trade on the basis of comparative advantage is needed for attaining efficiency both at the national and international levels, claim to prescribe simple and universally applicable policy recommendations such as shifting from direct controls to market instruments. The proponents of this theory argue that import substitution (inward looking) policy for industrialisation leads to strict, complicated and often non-transparent government controls which give rise to inefficiency and distorted resource allocation and thus are growth inhibiting in the long run. They believe that any move to the free market economy (through trade liberalisation) is accompanied by a reduction of the ‘activist’ role of the state. Another belief is that the ‘export promotion’ (outward looking) strategy is growth oriented.

The *new trade theories* emphasise issues such as learning, scale, market structure, externalities and institutional influences on trade performance. The proponents of these theories argue that these issues are more relevant to developing countries because these countries suffer from small and imperfect markets (Brander and Spencer, 1985; Krugman, 1986; Rodrik, 1988). In contrast to the new orthodoxy, the new trade theories suggest that because of the important role of scale economies, advantages of learning (experience) and innovation, it seems more likely that labour and capital will earn significantly higher returns in some industries (strategic sectors) than in others.

The endogenous growth theories (Lucas, 1988; Romer, 1990, 1994; Grossman and Helpman, 1991) share many of the views of new trade theories. Both new trade theories and the endogenous growth theories support selective protection as against wholesale free trade. Nonetheless, both point out that in addition to governmental policies for facilitating technology and human development, technological progress requires openness to new ideas, imported capital and intermediate goods, FDI and international markets. It is further argued that institutional arrangements and policy framework are likely to exert a major influence on the growth rate. The above discussion on trade liberalisation and growth clearly demonstrates that there can be no unambiguous conclusion about the role of trade liberalisation in boosting economic growth.

Linkages

Several standard trade theories have suggested links through which a more open trade regime can have positive impacts on poverty alleviation. Based on the Heckscher-Ohlin-Samuelson trade theory the Stolper-Samuelson theorem argues that *an increase in the price of a good will cause an increase in the price of the factor used intensively in that industry and a decrease in the price of the other factor.* Since the developing countries are abundant in labour more trade (read exports) of the commodities using their abundant factor (labour) more intensively would increase returns to that factor (labour). But due to many restrictive assumptions this theorem has negligible relevance in developing countries (Winters, 2000).

Winters (2000) has argued that trade liberalisation affects poverty through three institutions: price, enterprise and government. Trade liberalisation affects prices of goods and services consumed and produced by the poor. Falling prices benefit consumers and rising prices benefit producers. Where prices change, reduction in poverty is dependent, among others, on the ability of the household members to adjust their consumption and production in an appropriate direction in response to the price change.

The enterprises (producers) are affected by trade liberalisation through changes in prices of their products, which may alter their production pattern. Rising prices encourage production and falling prices do the reverse. Where production increases, this may lead to an increase in wages or levels of employment. The extent of poverty reduction thus depends on the level of initial wages and magnitude of increase relative to the poverty line. When trade taxation is an important source of revenue, reduced public resources as a result of trade policy reform is most likely to affect households dependent on the provision of public services.

Empirical Evidence on Trade, Growth and Poverty Nexus

The empirical evidence on trade, growth and poverty are inconclusive. The cross-country econometric models (Dollar, 1992; Sachs and Warner, 1995; Dollar and Kraay, 2001) do not provide any conclusive evidence in favour of the proposition that countries with higher levels of trade liberalisation are more successful in reducing poverty. Therefore attempts are made to focus on individual country experiences. Edwards (1998) has shown that unilateral trade liberalisation in Chile over the 1974-2000 period has contributed to gross domestic product (GDP) growth by increasing it at about 7 percent per annum and has cut poverty by more than half between 1987 and 1998; however, Chile suffered from adjustment costs in terms of loss in employment in protected sectors.

Bhagwati-Srinivasan (2001) have shown that economic liberalisation in India has almost doubled the pace of GDP growth from around 3 percent during 1950-1980 to around 6 percent between 1980 and 2000. As the trade-GDP ratio grew from 10 percent in 1980 to 25 percent in 2000 poverty declined substantially from 45 to 26 percent. Winters (2000) has offered two contrasting case studies in this context. In the case of Zimbabwe, trade liberalisation in the cotton market benefited the poor farmers through increased market opportunities, higher prices and the availability of extension and input services. As a result, agricultural employment rose considerably (by 40 percent from 1988 to 1997), with an increased production of both traditional and non-traditional agricultural products. Winters provides a completely opposite picture of liberalisation in his study of the maize market in Zambia which resulted in the disappearance of markets for poor farmers.

Winters (2000) also studied the effect of trade liberalisation on labour markets in India. He concluded that in the formal manufacturing sector, there is acceleration in the rate of growth of employment and deceleration in the rate of growth of real wages (though not a decline). However, in the informal manufacturing sector, there is a significant decline in employment. He argues that because of the fact that formal wages are well above the poverty line, the increase in formal sector employment is likely to have a greater effect on poverty reduction in India.

Trade Liberalisation in Bangladesh: an Overview

Bangladesh pursued an import substitution industrialisation strategy from 1971 to the early 1990s, which included extremely high tariffs, a variety of QRs, foreign exchange rationing and an overvalued exchange rate. However, in the face of failure of such inward looking strategies to deliver the desired outcomes along with rising internal and external imbalances, trade policy reforms were introduced in the early 1980s. Since then trade liberalisation has become an integral part of Bangladesh's trade policy.

During the 1980s, moderate import liberalisation took place. In 1984, a significant change was made in the import policy regime with the abolition of the import licensing system and imports being permitted against letters of credit. The list of banned and restricted items was curtailed gradually over the years from 478 items in 1985-86 to 239 in 1990-91 and further to 63 items in 2003-06. The import policy for 2006-09 reiterates the government's commitment to continued liberalisation of the import regime in Bangladesh.

From the late 1980s, the tariff regime has become increasingly liberalised. Between 1991-92 and 2004-05 the un-weighed average tariff rate fell from 70 percent to 13.5 percent, although most of this was through a reduction in the maximum rate (350 percent in 1991-92 to 25 percent in 2004-05). The number of tariff bands fell from 24 in the 1980s to 18 in the early 1990s and only 4 at present. The percentage of duty free tariff lines has more than doubled between 1992-93 and 1999-00 (from 3.4 percent to 8.4 percent). All these measures have greatly simplified the tariff regime and helped streamline customs administration procedures (see Table 1).

As a consequence of the liberalised import regime Bangladesh experienced a surge in its imports. In 1984-85 the total imports stood at US$2.64tn, which rose to US$5.83tn in 1995-96 and further to US$13.14tn in 2004-05. The surge in imports is illustrated by a rise in the import penetration ratio over time from 12 percent in the early 1990s to over 20 percent in recent periods. The Government of Bangladesh switched over to export promotion from import substitution policies from 1985 onwards by initiating a number of promotional schemes to increase exports. Extensive export-promotion measures and favourable market access in the EU and US has enabled Bangladesh exports to rise remarkably in the last 20 years. In 1984-85 total exports stood at US$934mn, which rose to US$3.47bn in 1994-95, and further to US$8.65bn in 2004-05. Exports in 2006-07 are expected to cross US$12tn. With the considerable and rapid rise in export earnings, the export-GDP ratio also rose significantly from around 7 percent in the mid-1980s to more than 15 percent in 2003-04.

Table 1: Tariff Structure in Bangladesh

Fiscal Year	Number of Trariff Bands	Maximum Rate (%)	Unweighted Tariff Rate (%)
1991-92	18	350.0	70.0
1992-93	15	300.0	47.4
1993-94	12	300.0	36.0
1994-95	6	60.0	25.9
1995-96	7	50.0	22.3
1996-97	7	45.0	21.5
1997-98	7	42.5	20.7
1998-99	7	40.0	20.3
1999-00	5	37.5	19.5
2000-01	5	37.5	18.6
2001-02	5	37.5	17.1
2002-03	5	32.5	16.5
2003-04	5	30.0	15.6
2004-05	4	25.0	13.5

Source: Bangladesh Economic Review (2004)

Reform of the exchange rate regime is central to any trade liberalisation policy. Bangladesh maintained an ‘overvalued’ and fixed exchange rate system to facilitate the inward-looking development strategy in 1970s. In 1980, the fixed exchange rate regime was replaced by a ‘managed’ system of floating exchange rate and initially pegged to a basket of currencies of the country’s major trade partners; after sometime the intervention currency was changed from British Pound to US Dollar. Since 2003 Bangladesh is operating on a free floating exchange rate. A review of these measures suggests that the policy environment in Bangladesh has undergone significant changes over the last two decades. Trade and other macro and sectoral policies have been evolved with the aim of developing a more open, market oriented and private sector oriented economy.

Impact of Trade Liberalisation in Bangladesh

It has been argued by economists that due to unavailability/ inadequacy of relevant time series data, almost all studies of the Bangladeshi economy that evaluate the impact of trade liberalisation on growth, poverty and inequality do not provide any systematic relationships between these variables (Begum and Shamsuddin, 1998; Razzaque et.al., 2003a; Ahmed and Sattar, 2004. The studies of Razzaque et.al. (2003b) and Raihan (2007), though overcoming some of the methodological problems of earlier studies, have also found no significant effect of trade liberalisation on the export-growth relationship. Furthermore, Raihan’s (2007) study of the manufacturing sector of Bangladesh for the period 1977-98 period found no evidence of any statistically significant positive ‘trade liberalisation-growth nexus’.

All these studies using historical data fail to depict a conclusive relationship between trade liberalisation and growth in the context of the Bangladesh economy. Some simulation exercises based on applied general equilibrium models such as those of Khondoker and Raihan (2004), Annabi et al. (2006) have not shown any significant growth dividend from further trade liberalisation of tariffs in Bangladesh. The relationship between trade liberalisation and employment has been a contentious issue. It is difficult to establish a direct linkage between trade liberalisation and employment as there are many channels through which trade liberalisation can influence the labour market, directly or indirectly.

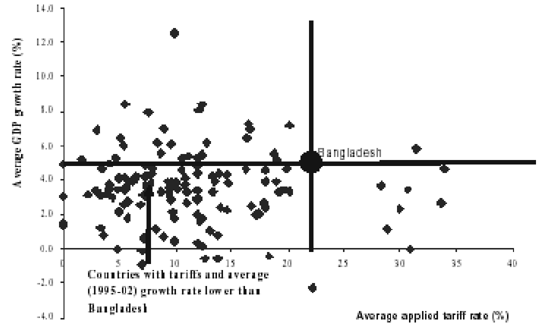
The Heckscher-Ohlin (H-O) trade theory suggests that trade liberalisation increases demand for the commodity which uses the abundant factor intensively. Thus trade increases the demand for abundant factor and hence creates employment opportunities in labour surplus economies. However, empirical studies are inconclusive about such a relationship between trade and employment. According to Papageorgiou et al. (1990), the study for the World Bank conducted in developing countries found that 8 out of 9 countries studied had higher employment in the manufacturing sector during the liberalisation period and a year later. But Ernest (1990) finds that the impact of trade liberalisation in Argentina and Brazil was disappointing; however, in case of Mexico, there was growth in productivity and employment in manufacturing sector during the second half of the liberalised 1990s. Fu and Balasubramanyam (2005) found a positive and significant impact of exports on employment in China, while Rama (1994) found a negative effect of trade liberalisation on employment in Uruguay in the late 1970s and early 1980s.

One of the objectives of the CUTS study was to investigate the impact of trade liberalisation on sectoral employment. As trade openness is difficult to measure the author has used the sectoral export-output ratio and sectoral import-output ratio as an imperfect proxy of trade liberalisation. The author has provided an *ex-ante* analysis of the impact of different trade liberalisation scenarios on the allocation of labour across different sectors using a computable general equilibrium (CGE) model for Bangladesh. Based on this methodology the author has come to the conclusion that any further trade liberalisation in Bangladesh will favour in general the expansion of export oriented sectors at the cost of import-competing sectors.

The CUTS report suggests that the existing level of anti-export bias may not be very serious. Bangladesh has an option to carry out further liberalisation measures to reduce the existing policy bias. However, the main question policy makers now need to deal with is regarding the extent to which further liberalisation will stimulate export response, particularly from the non-Ready Made Garment (RMG) sectors and from the entire economy as a whole.

Making recommendations about the need for further liberalisation on the basis of a simple and casual inter-country comparison between trade barriers and growth performance can be problematic as inferences drawn are sensitive to the choice of countries used. For example, Figure below illustrates the average GDP growth and applied tariffs for a total of 135 countries though there are only 25 countries with lower tariffs but higher GDP growth than Bangladesh. With reference to these countries, Bangladesh could be advised to reduce tariffs. But, given that there are 102 countries with tariffs and growth rates lower than those of Bangladesh, such a suggestion is unlikely to make much sense.

Figure 1: Economic Growth and Average Tariff Rates: Bangladesh and Others



Note: (1) GDP growth rates are annual averages for 1995-2002, data for which come from the World Bank World Development Indicators CD-ROM 2004.
(2) Average applied tariff rates are from WTO (2003). They correspond to average tariff for all goods (both agriculture and non-agricultural goods).

Conclusion

Bangladesh has liberalised its economy quite considerably. The pace of liberalisation has been very rapid particularly in the 1990s. Liberalisation measures have contributed to the reduction of the policy induced anti-export bias to a moderate level. Further liberalisation measures might be desirable but need more careful implementation as most of Bangladesh's trade related QRs are almost extinct now. Removal of the few existing QRs would not constitute much of an increase in openness.

Moreover, the available evidence seems to suggest that the growth performance of Bangladesh has not been significantly influenced by liberalisation measures. The potential growth dividend arising from further tariff cuts also appears to be very small. It is also obvious that in the past liberalisation has failed to energise export response. These findings would imply that liberalisation of the tariff regime alone is likely to be insufficient for promoting export and economic growth.

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This briefing paper is based on a research report entitled 'Trade Liberalisation, Growth and Poverty in Bangladesh' (2008), under the project entitled, "Mainstreaming International Trade into National Development Strategy: A Pilot Project in Bangladesh and India", funded by the Royal Norwegian Embassy, New Delhi.