SECTION 3 – CUSTOMS & BUSINESS PARTNERSHIP

IMPACT OF TRADE OPENNESS IN LABOUR INTENSIVE FULL PACKAGE MANUFACTURING INDUSTRIES AND ITS FRAGMENTED VALUE CHAIN: A THEORETICAL STUDY OF READYMADE GARMENTS SECTOR OF BANGLADESH

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Abstract

This paper adopts a theoretical approach based on certain trade statistics of Bangladesh and existing literature to examine the relationship between trade openness and economic development in the case where fragmented value chain based labour intensive buyer driven manufacturing industry is dominant, taking ready-made garments sector of Bangladesh as an example. Despite there exists no uniform conclusion in the literature that trade openness will always lead to positive development outcome in every context, this paper argues that an open trade economy with comparative advantage in labour supply will always be benefited from the changing nature of global production system that relies more on fragmented value chain. The study finds that in the case of Bangladesh, a shift in policy regime towards an open trade economy from an infant industry protection policy has brought significant positive development outcomes not only for the country's economy but also for the society as a whole as it flourished the development of buyer driven labour intensive readymade garments industry in Bangladesh. Both the static and dynamic gains from trade openness in the country has been substantial in the form of generating employment and export revenue, increasing investments, reducing poverty, raising competitiveness in the global market, promoting female labour force participation in the economy and in many other ways. As such, this paper advocates that further liberalization of trade policies and integrating in the global production value chain should be the prime policy objective of the government in order to establish Bangladesh as a global production hub in the future.

Keywords: trade openness, trade fragmentation, value chain, ready-made garments, full package manufacturing, labour intensive industry, tariff and non-tariff barrier, Bangladesh, development outcome

Introduction

The role of trade in the development process of any country is beyond any doubt nowadays. Particularly trade plays a very important role in the growth process of the developing economies. Despite the evidence of strong correlation between trade openness, export growth rate and growth rate of gross domestic product (GDP) of a country (Thirlwall 2011, p.502), openness to trade and its relationship to development outcome is still considered as a very broad debatable area and whether it will always bring positive development outcomes is yet an issue in the literature which is being questioned by the academicians. Within this broad area, discussion in this paper will be focused on a particular issue—openness to trade in the context of fragmented value chain based labour intensive buyer driven Full Package Manufacturing (FPM) industries in Bangladesh. Within this specific context this paper argues that openness to trade where the labour intensive buyer driven FPM industries are dominant will always lead to positive development outcomes. This is because trade openness will allow to enjoy the comparative advantage of utilizing labour force, create employment, reduce poverty, increase investments, enhance skills and technical knowledge and promote female empowerment all of which coupled together can bring significant positive development outcomes.

Discussions and arguments in this paper will flow in the following manner. First, this paper will very briefly describe the existing literature about "openness to trade" and "development" and then provide specific working definitions for this paper. Second, the fragmented value chain based production and labour intensive buyer driven FPM concept will be outlined and a relationship between these industries and how trade openness impacts these industries will be established. Readymade Garments (RMG) industry will be used as an example to illustrate this concept clearly. Third, it will be discussed that the industrial structure of Bangladesh is mostly labour intensive by analysing some data and therefore it should benefit from liberalized trade policies. Fourth, this paper will show how the labour intensive industries like garments and footwear industries in Bangladesh can enjoy their comparative advantage which can eventually lead to export led growth and more capital accumulation. This part will also explain how this will create more opportunity for new investments, increase technical efficiency, offer employments, reduce poverty and empower female participation in the economy all of which will ultimately push the country towards higher levels of development. The contribution of Bangladesh garments industry will help to understand how this approach can practically contribute to positive development outcomes. In the final section it will be discussed why and how Bangladesh can benefit from open trade policy with the help of some economic indicators and comparison with East Asian countries.

In the literature many researchers have described 'trade openness' and tried to measure this in different ways. Pritchett (1996) described the term simply as the intensity of trade of a country's economy. Trade orientation of a country is also significant in measuring openness and its impact on growth (Edwards 1992). A country is said to be outward oriented if it embraces the opportunities to trade with other countries and gain advantage from that whereas an inward oriented country might be unable to take the same advantage due to different factors such as trade barriers, import-export, infrastructure, technologies, scale of economies and market competitiveness. Dowrick & Golley (2004) introduced the concept of 'revealed' openness to trade and 'policy' openness to trade where policy openness refers to policy decisions like tariff and non-tariff barriers and revealed openness refers to the ratio of total foreign trade to Gross Domestic Product (GDP). In line with the concept of policy openness, Stensnes (2006) stated that openness is more accurately defined in terms of government imposed barriers on trade. Another alternative is to measure constructed openness of trade based on some exogenous geographic conditions and variables affecting bilateral trade ratios between any two countries (Frankel & Romer 1999, p.379-81). Sachs & Warner (1995) considered tariff levels, existence of black markets and government interventions in the market while measuring trade openness. But this definition has also faced criticism by Rodriguez & Rodrik (2000).

Drawing on existing literature, it can be said that openness to trade reflects the trade integration process of a country into the world economy where apart from foreign trade-GDP ratio other factors like trade orientation, trade policy, geography, culture, technology and the structure of the economy also plays pivotal role. In this paper the operational definition of an open-to trade country would represent a country which utilises trade as a significant source of GDP growth and which has low tariff structure and low non-tariff and other government imposed barriers.

The concept of development is very broad and is often discussed mainly in the context of economic growth, societal improvement and sustainability. Sen (1999) termed development as the process of expanding people's capabilities where freedom is a vital element of doing that. Earlier, Goulet (1971) encompassed the idea of self-sustenance, self-esteem and freedom in his definition of development. Both of these definitions are very broad and more of social welfare centric and is less related in the context of this paper since the objective is to establish a relationship between trade openness and development which bears more economic sense than the social ones. The working definition of 'development' will be mostly based on Solow-Swan model (Swan 1956, Solow 1956) and Harrod-Domar growth model (Thirlwall 2011, p. 140-45) and will include economic growth, capital accumulation and increased capital, labour and total factor productivity. From the social viewpoint of development, this definition will only capture the gender empowerment issue and economic freedom of women.

It is also the objective of this paper to establish how openness to trade can bring about these positive development outcomes in industries where significant fragmentation of value chain is possible. In order to substantiate this claim it is necessary to analyse what fragmentation is and what impact it has on trade related development. Trade fragmentation is discussed under many different names including vertical specialisation, slicing up the value chain, outsourcing, trade in tasks, offshoring, disintegration of production, multi-stage production and intra-product specialisation (Hummels et al. 2001; Athukorala 2011). All of these labels refer to the same phenomenon—the breaking up of the production process into small parts and the placement of these parts in different locations, usually across borders (Damuri 2012). These different stages are connected in a production network or value chain. A production 'network' is where production is coordinated across a large number of geographically dispersed operations. Value chain refers to the fact that at each stage in a good's production only a small piece of value is added. This is why this approach to production is often referred to as vertical specialisation: different firms involved in the production process specialise in different levels depending on their comparative advantage. Higher levels typically require higher skilled labour and more advanced capital, and correspond to a higher amount of value added than lower stages. When fully integrated these firms form a production network that outputs finished goods.

1. Advantages of production fragmentation for the development of the national economy

Production fragmentation goes hand in hand with modern advances in coordination and information technology, including the internet, remote video conferencing, complete knock down kits and computers (Baldwin 2011). These technologies allow production to be managed across several geographically dispersed factories. With these technologies it is also extremely profitable to disperse production, because by outsourcing certain tasks to other regions or countries, firms can realise gains from cheaper or more specialised labour without any loss of efficiency. For example, creating a car requires several high skilled tasks, such as design and engineering, which are best executed by a developed country with high education standards. But it also involves a myriad of tasks that require lower levels of skill that a highly skilled and therefore expensive labourer would be wasted on. For example, assembling a chassis on a production line is not as difficult as assembling a transmission. These lower value tasks can now be off-shored to different locations to be executed by precisely the right level of labour at optimum cost. This allows firms to make efficiency gains and host countries to profit from their comparative advantages.

Production fragmentation offers many developmental opportunities. In contrast to pre -fragmentation production systems, emerging economies like Bangladesh can now join supply chains rather than having to build them all in house. When early developers like

Japan began their path to advanced economy status it was necessary for them to create entire value chains. Every aspect of a Toyota was produced in Japan, from the tyres to the engine. This was a slow and expensive process. Due to the 'lumpiness' of this kind of industry early developing economies needed to provide infant industries with substantial stimulus, including cheap credit and protection from international competitors, which involved limiting openness to trade. This was costly in the short term, and created market distortions that affected other sectors and were often difficult to manage, especially as they tended to establish vested interests that inhibited reform in the long run (Kharas & Kohli 2011).

In the new global production system development is different. Instead of creating entire production chains, countries can now plug into existing supply chains at the value level that is most appropriate for them, specialising in one small aspect of production based on their comparative advantage. This specialisation allows for economies of scale as nations can invest all their resources into one area. Because this process involves interaction with multinationals looking to offshore, there is also a degree of technology transfer from developed to developing nations as international firms train local workers to create the components they need for operations higher up in the value chain (Baldwin 2013). Multinationals also bring with them foreign capital, developing industry without direct cost to the host nation (OECD 2002). Combined, these factors mean that countries can industrialise rapidly in the new system if they are able to effectively join a supply chain. This industrialisation drives capital accumulation, and profits accruing from new industrial activities can be reinvested in education and infrastructure to move incrementally up the value chain (Ando et al 2006, pg. 9).

It is also worth elaborating on the role of government in fostering gains from trade in the context of fragmentation, as it is one of the most fundamental controversies in trade for development theory. As noted earlier, many developmental success stories, notably the Asian Tiger economies, made extensive use of infant industry protection involving closed-to -trade policies as part of their development models which has led a good number of researchers arguing against openness to trade as a pathway to development. However, these approaches need to be re-thought in the context of supply chain fragmentation, which makes infant industry protection difficult and not as profitable in development terms as joining a value chain. Fragmentation allows international firms to capture dramatic cost savings, which makes their finished products (RMG for example) much cheaper than those produced by single country production chains where labour is expensive.

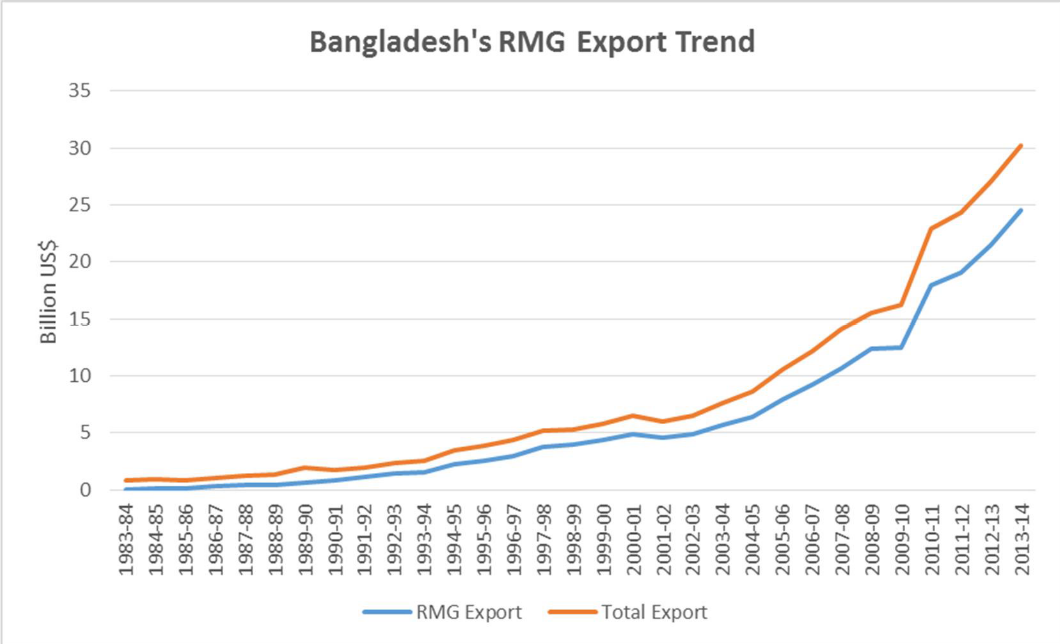
In the context of current global value chains, the buyer driven value chain can be described where the physical production process of a commodity or industrial good is outsourced in geographically dispersed different exporting countries by the world's leading giant retailers, marketers or branded manufacturers. These types of industries are mostly labour intensive. Commonly this type of buyer driven industries such as garments, footwear, toys and consumer electronics has led the industrialization process so far in the developing countries where labour is comparatively cheaper. The FPM is an extended version of subcontracting the production process by a buyer to a supplier where the supplier produces finished products according to the design given by the buyer and where the product will be finally sold under the buyer's brand name (Gereffi & Memedovic 2003). In this case, the supplier is responsible for coordinating material purchase and production, working closely with firms in selecting materials, designing, completing production, and sometimes even delivering to the buyer's final customer. This is considered a better version of subcontracting than assembly because it is much more domestically integrated and offer higher value addition throughout the production chain since the buyer-seller linkage between foreign merchants and local manufacturers allows and encourages a greater degree of local learning and innovation all the way through the value chain (Gereffi 1999).

Although the garments and clothing industry is generally perceived as a labour intensive low wage industry, it can be a very innovative and dynamic sector as well. The dynamism and characteristics of the garments sector is mainly driven by the market demands of the major retailers, buyers and established fashion brands of the world. The high quality fashion market is usually characterized by modern technology, sophisticated designs, creativity and higher pay for the employees whereas the low value market segment which mainly focuses on mass production (eg. items like jerseys, t-shirts, uniforms) is fundamentally characterized by relatively low wage and less creativity. The production and the supply chain process involves distinct activities from sourcing raw materials, designing, testing , cutting, sewing, dyeing, finishing, marketing and finally supplying which proves that the industry is vertically fragmented in different value addition segments (Jones et al. 2005).As a result, the manufacturers often contracts out the discrete activities of the production process in favourable locations which they decide mainly on the variables namely cost, quality, reliability and lead time. In order to get the final products the raw materials and the intermediate products might require several cross boundary transfers. Here, the degree of openness can be the deciding factor for the entrepreneurs to choose the location as they will always prefer to have low tariff and non-tariff barriers and a conducive environment for trade. This implies a flow of significant foreign investments without any major cost to the host nation. Only some infrastructural issues like setting up Export Processing Zones, developing port facilities and improving the transportation system would be required. But the return can be manyfold. The industrialization process would drive capital accumulation in the form of profits which can be further reinvested in education and infrastructure to create a domino effect of welfare gain (OECD 2002). In addition, developing countries like Bangladesh can enjoy the dynamic gains of trade to a greater extent from this sector due to its use of modern technology (e.g. sophisticated pattern making and design software) which requires relatively low investments compared to many other manufacturing industries that would have the same impact on the economic growth (Nord?s 2004). Furthermore, this fragmented industry creates a high demand in the market for related goods and services. For example, demand for packaging materials such as cartons, poly bags and accessories such as labels, zippers and so on will rise and at the same time demand for services like banking, insurance, transportation etc. also increases.This drives the growth of the backward and forward linkage industries and thus create a vent for surplus in the economy.

2. Impact of trade openness in labour intensive RMG industries of Bangladesh

Up to this point working definitions for ‘openness to trade’ and ‘development’ and a theoretical explanation of the characteristics of buyer driven manufacturing industry has been illustrated. The next analytical steps will focus on the main argument of this paper and discuss how openness to trade will promote development in Bangladesh.

As the part of structural adjustment program, Bangladesh liberalised its trade policy gradually since 1990 by reforming the export, import and exchange rate policies. The country has significantly reduced both import and export tariffs and other non-tariff barriers, introduced duty drawback and tax rebate for exported goods, allowed duty free access of capital machineries, and adopted flexible exchange rate policies (Hossain & Alauddin 2005). As a result, the country has experienced a significant growth in the industrial sector especially in the labour intensive apparel manufacturing industries as compared to the pre-liberalization period. This industry alone now contributes 70 per cent of the total manufacturing industry contribution in the GDP and accounts for more than 80 per cent of total export earnings of the country (Bangladesh Bank 2015).With the continuous efforts from the RMG entrepreneurs backed by government policies and supportive roles RMG sector has become the highest source of foreign exchange earnings for Bangladesh. From 3.89% in 1983-84, it has been growing impressively to 81.13% of total export earnings in 2013-14. According to WTO (World Trade Organization) international trade statistics 2011 Bangladesh ranks as fourth largest clothing exporter in the world with a 3% share of the global market. Although the first RMG export from Bangladesh took place in 1978 it has started booming during the mid ‘80s. Since 1983-84 RMG export has been maintaining a sustained growth for the last three decades. During 1986-87 total RMG export value was US$ 298.67 million (27.74% of total export value) which has now become US$ 24491.88 million (81.13% of total export value) in 2013-14 (RMG export trend shown in Figure 1) (BGMEA 2014).



Source: BGMEA (2014)

Figure 1. Bangladesh’s RMG export trend, 1983-84 to 2013-14

From 1986-87 to 2013-14 in an average condition Bangladesh’s RMG export growth is about 300%. This astonishing trend suggests that Bangladesh’s RMG sector has gone through a substantial structural development during the past three decades. It would be very interesting to explore the underlying factors that actually propel this remarkable achievement in the RMG export of Bangladesh.

The Heckscher-Ohlin theorem suggests that a poor country with labour abundance can enjoy welfare gains by producing labour intensive goods where they have the comparative advantage (Thirlwall 2011). Low-cost labour force is one of the key factors of rapid development in this sector, especially the female work force. About 80% of the total manpower engaged in Bangladesh’s RMG industry are women (BGMEA 2014). They actually foster RMG export growth, their sincerity, dedication, industriousness and traditionally inherited skill have made Bangladesh’s garments product unique in the world in terms of quality and competitiveness. During 1984-85 total employment in this sector was 0.12 million which has increased sharply to 4.0 million in the year 2012-13. While at the same time period total number of garments factories increased from 384 to 5876 (BGMEA 2014). Although at the beginning Bangladesh’s garments industry started growing in an unplanned manner, the scenario has changed a lot. It has now been experiencing a more organised and planned development which made some significant progress in the sector.

On top of this, the dynamic gains from trade consists of the stimulus to competition, the acquisition of new knowledge, new ideas and the dissemination of technical knowledge, the possibility of accompanying capital flows through Foreign Direct Investment (FDI) all of which ultimately increases the labour productivity, capital and total factor productivity (Thirlwall 2011, p.508-14).This theory applies in reality as this paper shows how openness to trade can bring positive development outcomes considering the example of the Bangladesh RMG industry. Countries seeking gains from trade should be open to the trade networks available. It actually implies that key policies should allow open trade through the elimination of tariffs and behind the border barriers such as excessive bureaucratic red-tape and hidden charges like registration fees (Wignaraja 2013 & Anas 2012). Yi (1999) shows that tariffs dramatically inhibit vertical specialisation and their elimination should thus be the first policy of economies seeking to profit from value chains. Since value chain trade involves unfinished goods crossing borders multiple times with only small amounts of value added, there is every possibility that tariffs and other behind and beyond the borders trade barriers wipe out these small gains and thus make countries unattractive destinations for outsourcing.

In addition to tariff reduction, developing economies would do well to create an economic environment attractive in general to offshoring activities. Basri & Patunru (2011) point to three principle areas in this effort. First, infrastructure provision is crucial. Ports, roads and electricity are all important to the profitability of trade based ventures, and must be developed by governments seeking gains from trade. Second, effective policies for macro -economic stability, particularly with regards to exchange rate controls, are valuable. Finally, good labour market management that balances equity with the smooth allocation of labour to growing sectors is necessary.

In the case of Bangladesh, reduction of tariff in the post liberalization period has led to the growth of export oriented labour intensive industries, mainly garments industry in Bangladesh which has pulled the labour force from less productive agricultural and informal sectors. This reallocation eventually helped to increase the nominal income of the marginal people of the rural and urban society and led to poverty reduction (Nahar & Siriwardana 2009). The garments sector alone now directly employs four million people and another one million people are working in the accessories and waste recycle industry (Bangladesh Bureau of Statistics 2012). Since this sector can employ unskilled or semiskilled people a significant number of workers, especially women have been employed in this sector and this trend is continuing (Raihan 2008).

In the post liberalization period total exports continuously grew and export-GDP ratio changed in Bangladesh mainly due to the contribution of the labour intensive RMG industry. This factor coupled with wage earners remittance has enabled the country to improve its balance of payment term through earning foreign exchange (Hossain & Alauddin 2005). Openness to trade will expose the export oriented labour intensive industries like RMG industry to a greater degree of local and international competition which will act as a driving force towards improving technical efficiency and thereby increase the total factor productivity (Hossain & Karunaratne 2004). Moreover, trade openness in the form of tariff reductions or no tariff will encourage the local entrepreneurs to import the capital machineries embodying latest technology to increase the efficiency level. There are always incentives for firms to increase and improve their productivity in order to remain in the market which is a function of investment. This eventually leads to lower cost and higher profit (Boubakri et al. 2005). This partly explains the average high profitability in the knitwear industry of Bangladesh. It also explains why even after losing the quota advantage from the phasing out of Multi Fibre Arrangement (MFA), contrary to the speculation that RMG export will decline, Bangladesh has remained competitive in the global market and performed extremely well after 2005, as evidenced by increased exports to United States and European Union (Ahmed 2009). During the early days, duty-free access to the world market has been a proliferating feature of Bangladesh's RMG export. As a developing nation member of WTO Bangladesh has been enjoying this privilege to the world's major export destinations like EU, Switzerland, Canada, Australia, Japan etc. But the Multi-Fibre Arrangement (MFA) under which Bangladesh was enjoying RMG export quota had expired on January 2005. It has been predicted that Bangladesh would be a major loser country after this significant change but surprisingly enough she has been maintaining her phenomenal RMG export growth with slight fluctuation since then. Moreover, Bangladesh has done remarkably well to continue a steady growth of RMG export during the global financial crisis.

Since the operational definition of 'development' in this paper encompasses the gender impact, now it will be explained how trade openness has contributed in this regard in Bangladesh. Fontana (2003) suggested that the employment effects of trade have been most favourable to women in countries that specialize in the production of labour intensive goods. Trade liberalisation has led to the expansion in garments, textiles and footwear industries in Bangladesh which has kind of feminised the labour market in these industries. Despite severe criticism that these industries are exploiting the workers; especially women in terms of low wage; there is no denying the fact that it has provided them platform to establish self-esteem and identity which is one of the greatest positive turnabout in the male dominant society of Bangladesh (Kabeer & Mahmud 2004). Study has found that a female garment worker is more likely to have access to better housing facility, higher propensity of income, and lower exposure to major health hazards compared to the women of similar socio economic background who do not work in the garment sector (Hewett & Amin 2000). It has boosted the confidence in the women to act as an independent economic agent and made their contribution to the economy very much visible. This historical societal transformation has helped Bangladesh to take a big leap further towards development.

So far this paper has led the theoretical discussion about how greater openness to trade in the context of value chain based labour intensive industry can lead to positive development outcome. We see this in Bangladesh post liberalisation period. During the open trade regime from 1990 till present, due to domestic resource mobilization mainly in the labour intensive industrial sector and increased trade volume; investment as percentage of GDP increased from 18.40 per cent to 28.69 per cent, trade to GDP ratio rose from 18 per cent to 47 per cent, national savings as percentage of GDP went up from 18.79 per cent to 30.54 per cent and government tax revenue increased by 12 times despite the reduction in tariff structure (Bangladesh Bank 2015). The success of East Asian economies in leading the global buyer driven value chain industries so far and their gradual transition from assembly manufacturing to FPM is a perfect case study which can help us to understand why and how trade openness would always lead to a positive development outcome in the context of Bangladesh (Gereffi 1999). At present, the export oriented labour intensive manufacturing sector in Bangladesh contributes to the low value mass production sector with more concentration in assembly production. But in course of time, with the challenge of increasing wage rate Bangladeshi manufacturers will also have to shift their choice of manufacturing from assembly orientation to full package production to sustain their growth in the face of growing competition due to globalization.

Summary and concluding remarks

Thus, from the analysis above it can be concluded that, if other things remain constant, openness to trade in the context of labour intensive buyer driven industrialization of Bangladesh, will always lead to positive development outcomes. The concept of value chain based fragmented production system in these industries has brought significant changes in trade related activities. A country like Bangladesh with open to trade economy can be a global production hub and substantially benefit from trade by gradually moving towards the upper segment of the value chain. Both the theoretical analysis and the statistics has shown how openness to trade has led to development in the form of capital accumulation and investment, employment generation, poverty reduction, women empowerment and increasing GDP. Therefore, further liberalization of trade policies backed by good institutional framework will foster resource mobilization in the more productive sectors enabling smooth structural transformation which ultimately will lead the country towards further economic growth and development.

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