

The SAARC Cumulation : Should We Take it or Leave it?*

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Section I

Introduction

Recently, the SAARC cumulation (SC) system approved by the European Union (EU) has given rise to serious uproar in Bangladesh, particularly among those directly or indirectly related with the Readymade Garments (RMG) and Textile industries. Although the SC is expected to accord immediate benefits to the RMG exports of Bangladesh to the EU countries, it is being argued that the system and its practice is sure to hurt the long term interest of the country as far as the future growth of the textile industries, and consequently of the RMG industry also, is concerned. Therefore, stopping implementation of the SC system will deprive the country of short run economic gains while its enforcement will harm the country in the long run. The study¹ sponsored by the Ministry of Commerce, Government of Bangladesh on the subject suggests for enforcement of the SC on the ground that its implementation will not have any serious odd implication as far as the growth of the backward linkage industry, i.e., textile industry is concerned. Yet another study apprehends exactly these same odds to happen to our Textile industry following implementation of the SC and advocates for renegotiating its terms and condition². In the present study, a middle ground is suggested which will allow our RMG exporters to retain the benefits of the SC without sacrificing the growth of the domestic textile industry. The layout of the study is as follows. The present introductory section, Section I, contains a detailed prognosis of the problem at hand. Section II presents the theoretical basis and empirical

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observations to support the position taken in this study, which is followed by concluding remarks and recommendations in Section III.

Description of the Problem

What is SC? The SC is a proposed tariff and trade arrangement. What is this tariff and trade arrangement? It follows from two other tariff and trade arrangements known as the Multi-fibre Arrangement (MFA) and the Generalized System of Tariff Preferences (GSP). When the General Agreement on Tariff and Trade (GATT) was first concluded in 1947, it was expected that its non-discriminatory trade principle would apply to all types of commodity-trade. However, developed countries by dint of their superior bargaining power were able to keep outside the purview of the GATT most of their trade in Agriculture and Textile where developing countries had a comparative advantage. They tried, and were successful also, to bypass the GATT rules in Textile trade by means of a separate arrangement with the exporting countries and this arrangement came to be known as the Multi-fibre Arrangement or MFA. The MFA provided the developed countries with a tool to protect their domestic textile industry against 'excessive' imports from the developing countries. Meanwhile, the Generalized System of Tariff Preferences (GSP) was instituted as an authorization to the developed nations to grant unilateral non-reciprocal tariff preferences to the developing countries. The EU adopted the GSP scheme and used it together with the MFA to grant differential tariff privileges to the developing countries in respect of trade in textile goods. Because of such differential tariff preferences, Bangladesh as a least developed country enjoys 100% duty-free access to the EU market whereas developing countries like India, Pakistan receive only 15% duty-exemption.

However, such preferential treatment under the GSP scheme hinges on compliance of the exported products with the EU Rules of Origin (RO)³. Previously in order to qualify for GSP benefits, Bangladeshi RMG exports to the EU market were required to undergo *two-stages* and *three stages* of conversions for woven and knit garments respectively⁴. Although the differential tariff privilege accorded to the Bangladeshi exports placed them on a firmer ground in the EU market, the overall GSP utilization rate of Bangladesh declined over the years because Bangladesh did not have strong backward linkage industries⁵ and hence was unable largely to qualify for GSP benefits. In order to have an expanded opportunity for availing GSP benefits, Bangladesh had been asking for flexibility in the RO prescribed by the EU. A short-term derogation in the conversion requirement ('two stages' for knit and 'one stage' for woven garments) was granted in October 1997 and continued up to December 1998 under quota limit.

Later on, the EU RO was revised to *two stages* conversion requirements for both woven and knit RMG and the quota-limit was withdrawn. But even this was not good enough to raise the GSP utilization rate of Bangladesh. So Bangladesh would like to have something more favorable.

Under the EU GSP scheme, partial cumulation is permitted on a regional basis⁶. Regional cumulation allows beneficiary member country of the regional grouping to avail GSP benefits on exports produced from imported raw materials from another member country of the same regional grouping provided the domestic value addition exceeds a certain percentage. The proposed SC is a similar privilege offered by the EU to the members of the SAARC region.

SAARC Cumulation System

So the SC system is a relaxation of the Rules of Origin applicable to the Bangladeshi exports (for that matter, exports of any SAARC member country) in order to obtain GSP facility in the EU markets. More specifically, under the SC system, the RMG exports from Bangladesh will qualify for GSP facility even if they are produced from yarn/fabrics imported from the SAARC countries provided the ratio of domestic value-addition is at least 51 percent.

Conflict of Interest

The relaxation of the Rules of Origin for Bangladeshi exports to the EU markets is, however, likely to affect the domestic industries asymmetrically. The RMG industry will be the direct beneficiary of this change in the Rules of Origin. In other words, the SC system will allow the RMG exporters to procure their raw materials (yarn/fabric) from the SAARC countries at a relatively cheaper price (than the domestic price of the similar products) and yet those RMG produced from imported fabric/yarn will qualify for GSP facility offered by the EU countries to the Bangladeshi exports. This means a direct saving by the RMG exporters in terms of cost of production. Consequently, the profit margin of the RMG exporters will rise and this will directly benefit those involved with the RMG industries.

On the other hand, the implementation of the SC system is likely to have negative effects on the domestic industries producing yarn/fabrics. Since the demand for these products by the RMG industry is likely to be diverted to the foreign sources (SAARC countries), the growth of the textile industry at home is likely to be adversely affected. Consequently, the textile industry in Bangladesh will experience a decline in the sales revenue following implementation of the SC system.

The preceding paragraphs, however, only describe the possible short run gains and losses of the specific industries. National losses from the implementation of the SC system are going to be even larger in the short run as well as in the long run. In the short run, the loss in terms of output and employment in the textile industry is likely to outweigh the savings made by the RMG industry from the cheaper imports of raw materials. In the long run, not only will the growth of the textile industry at home be adversely affected, the savings made by the RMG industry in the short run may also be far exceeded by the expensive imports of raw materials from the same sources⁷.

BGMEA versus BTMA

So the battle line has been drawn. On the one side is the BGMEA—the association of the garments exporters of Bangladesh and on the other side is the BTMA—the association of the textile mill owners of the Bangladesh. The BGMEA maintains that because of the local supply constraint, about 90%⁸ of the raw materials for RMG is to be imported. Under the current *two stages* conversion requirement prescribed by the EU RO, the bulk of Bangladeshi RMG exports do not qualify for GSP benefits. If the SC is allowed, Bangladesh's RMG exports will get an additional boost in the EU market regarding its competitive position.

On the other hand, the BTMA holds the view that under private initiative and government patronage, the backward linkage industry of RMG i.e. textile industry of Bangladesh has made significant progress in the recent years. Such progress has been made possible by the protection received by this industry from the Government in the past. Agreeing to SC will be tantamount to surrendering the competitive advantage presently Bangladeshi textile industry enjoys vis-a-vis its counterpart in the SAARC countries. Once the SC goes into operation, the local producers of fabric will lose their competitive advantage over their SAARC counterparts since the Bangladesh RMG exporters will be able to source their input (fabric) from the SAARC countries and still qualify for GSP benefit.

Reconciling the Conflicting Interests

Obviously, going for SC will jeopardize the interest of the textile manufacturers and not going for it will force the RMG exporters to forego the opportunity offered by foreigners (EU countries). So reconciling the mutually conflicting interests of the two important manufacturing sectors of our country will be the sole endeavor of the present study.

Section II

The Impact of SAARC Cumulation

Several studies on the subject of SAARC cumulation (SC) previously tried to analyze the impact of SC on the textile and apparel industry of Bangladesh. Two of the studies¹, mentioned before, focused mainly on the possible production and trade displacement in Bangladesh following implementation of the SC. Both studies endeavor to demonstrate that the enforcement of the SC will not cause any serious and significant deviation from the present trends of production and trade flows in the textile and apparel industry. On the basis of such findings, the study by the Ministry of Commerce rather meekly suggested that the SC could be implemented since it would not spell any misfortune for Bangladesh. The other study, however, quite contrarily observed that the idea of the SC had been ill-conceived/ill-advised. So the study suggested for re-negotiation of the terms and conditions of the SC, since it would not bring, in its present form, any improvement in the textile and apparel industry. In the present study, we will focus on both the external and internal displacement of production and trade in the textile and apparel industry following implementation of the SC.

Analysis of the Present Production and Trade Structure of the Textile and Apparel Industry

An examination of the production and trade structure of the Textile and Apparel Industry of Bangladesh shows that the RMG exports recorded a compound growth rate of 14.8% between 1991-92 and 2001-02 (Table II.1). The import of fabric through back-to-back L/C grew at the (compound) rate of 9.9% during the same period. The lower growth rate of import of fabric compared to that of the growth of export of RMG indicates that import-substitution occurred in the fabric production in the last decade²

On the other hand, if we look at the imports of cotton and yarn, we can see that both grew at rates roughly equal to or exceeding the growth of RMG exports. The imports of cotton recorded a growth rate of 17.3% and that of yarn recorded a growth rate of 13.2% between 1991-92 and 2000-01. This implies that in the case of yarn, not much import substitution occurred. This is further confirmed by the very little growth rate, if any, of yarn production in the country during the same period.

Table II.1: Production and Trade Structure of the RMG and Textile Sectors of Bangladesh

Year	Production of Cotton (Thousand Tons)	Production of Yarn (Million Kgs.)	Domestic Fabric for RMG (Million Meters)	Import of Cotton (Million Dollar)	Import of Yarn (Million Dollar)	Import of Fabric (B/B L/C) (Million Dollar)	Demand for Fabric for RMG (Million Meters)	Export of RMG (Million Dollar)
1991-92	14	60.50	—	71	92	741.11		1182.57
1992-93	16	60.60	—	82	127	874.39		1445.03
1993-94	26	51.50	45	72	168	1033.39	830	1555.78
1994-95	13	49.10	104	135	200	1522.73	1150	2228.35
1995-96	13	49.90	169	185	296	1432.72	1322	2547.11
1996-97	14	50.16	231	195	395	1265.55	1486	3001.24
1997-98	14	52.88	317	207	327	1529.28	1802	3783.63
1998-99	14	54.80	356	233	283	1389.05	1860	4020.10
1999-00	14	58.54		277	300	1580.91	2049	4352.39
2000-01	—	60.82	—	360	322	—	—	4860.56

Source: Bangladesh Bank, *Economic Trends*, May 2002, Col. 1; *Bangladesh Economic Survey*, different issues, Col.2; MOT and BTMA, Cols.3,7; Bangladesh Bank, *Import Payments* 2000- 01, Cols. 4,5,6; EPB, Col.8.

Production and Trade Structure of the Textile and Apparel Industry without SAARC Cumulation

Although according to BBS data, the domestic production level of yarn remained static between 1991-92 and 2000-2001, with a decline of output in the first half of the decade (i.e. first half of 90's) and later rising to the previous level, the EPB and the Ministry of Textile (MOT) reported a growth rate of 14.23% between 1993-94 and 1999-2000 (Table II.2). Anyhow, following the figure reported by the EPB and the MOT, we projected the growth of domestic yarn production for the period 2000-2001 to 2003-2004. For the same period, we projected the growth of demand for fabrics for the production of RMG. In doing so, we used the input (fabric) requirement reported by the EPB and the MOT for the year 1999-2000. Further, we used the assumption that input requirement would grow at the same rate of the growth of output i.e. the growth of the RMG exports. By subtracting the domestic production of yarn from the total demand for yarn, we arrived at the figures for imported yarn for RMG. For estimating the domestic supply of fabric for RMG, we computed the ratio of the same to the total demand for fabric by the RMG

Table II.2 : Domestic Supply of Yarn and Fabric for RMG and Cash Subsidy

Year	Production of Yarn (Million Kgs.)	Domestic Fabric for RMG (Million Meters)	Share of Fabric (B/B L/C) in total Export (percent)	Domestic Fabric as % of total fabric used in RMG Export (percent)	Cash Subsidy (Million Dollar)
1991-92	—	—	63.01	—	0.64
1992-93	—	—	60.51	—	0.58
1993-94	63.20	45	66.42	5.06	1.94
1994-95	96.50	104	68.33	9.91	7.21
1995-96	113.00	169	56.25	13.04	10.77
1996-97	116.80	231	55.04	15.85	18.38
1997-98	139.70	317	49.90	17.93	49.68
1998-99	146.70	356	42.99	18.97	95.87
1999-00	167.57	—	—	—	—

Source: BTMA, MOT, EPB, Bangladesh Bank.

sector for the period from 1993-94 to 1998-99 and then projected those ratios for the years up to 2004, by extrapolation using simple time-trend values. This in turn enabled us to compute the domestic supply of fabric for RMG for the period between 2000-01 and 2003-04 (Table II.3). The estimation of domestic supply of fabrics together with the total demand of fabrics for RMG allowed us to arrive at the figures for imported fabric for RMG-production during the same period. The values for the import of cotton and export of RMG have been projected on the

Table II.3 : Projection of Production and Trade Structure of the RMG and Textile sector of Bangladesh (2000-01—2003-04)

Year	Production of Cotton (Thousand Tons)	Production of Yarn (Million Kgs)	Production of Fabric for RMG (Million Meters)	Requirement of Fabric for RMG (Million Meters)	Requirement of Yarn for RMG (Million Kgs)	Import of Fabric for RMG (Million Meters)	Import of Yarn for RMG (Million Kgs)	Export of RMG (Million Dollar)
2000-01	14	191.42	576.54	2352.25	507.41	1775.71	315.99	4860.56*
2001-02	14	218.66	736.67	2700.39	582.50	1963.72	363.84	4583.80*
2002-03	14	249.77	931.56	3100.04	668.72	2168.48	418.95	5262.20
2003-04	14	285.32	1168.02	3558.85	767.68	2390.83	482.36	6041.00

Note: * actual values.

basis of respective growth rates obtained, by fitting exponential trend line to the time-series data for the period between 1991-92 and 1999-2000. For the cotton production, the last available figure from the BBS has been quoted for the period from 2000-2001 to 2003-2004 as no growth was observed in the preceding period.

The exercise reveals that in the year 2004, the terminal year of MFA, the domestic yarn supplied to our RMG will increase to about 37% of total demand for RMG production. In the same way, the domestic supply of fabrics for RMG production will increase to about 33% of total demand for fabrics by the RMG sector. However the growth of the domestic supply of both yarn and fabrics is somewhat 'phony'. As mentioned before, the BBS has reported an almost static production of yarn between 1991-92 and 2000-01 while BTMA and also EPB claim that yarn production increased by about 14% during the same period. In the case of fabric also, the same story goes. According to the BBS data, while fabric production actually declined between 1991-92 and 1999-2000, the supply of fabric for RMG production recorded a rapid increase according to the BTMA and the MOT. One explanation for this observed contradiction in the production of yarn and fabric may be that while total production declined or remained static, some of the existing production of yarn and fabric were diverted towards the RMG sector by the 'lure' of generous cash-incentive given by the Bangladesh Government under the cash compensation scheme. This is reconfirmed by the strong negative correlation between the growth of cash subsidy and the decline of imports of fabrics and accessories through back-to-back L/C (the Pearsonian coefficient of correlation being -0.98). The strong negative correlation between the growth of cash subsidy and the decline in the imports of fabrics, yarns and other accessories under back-to-back L/C while indicates the replacement of imports by domestic supply, it also suggests the dependence of the latter on the former at the same time. And if this dependence is strong enough (there are also reasons to believe so), the proposed reduction in the rate of cash subsidy from 25% to 15% is likely to have a negative impact on the replacement of imports by domestic supply in the case of yarn and fabrics in the future. In such a situation, the shares of domestic supply of yarn and fabrics are going to be even smaller than those projected for the year 2004.

Analysis of the Production and Trade Structure of the Textile and Apparel Industry *with SAARC Cumulation*

Simple micro economics tells us that the rational producers will try to maximize their profit. In order to do this they may want to raise the price of their product or minimize the costs of inputs or both. Since our RMG exporters sell in a competitive international market, so they are the 'price-taker', that is, for our

RMG exports, price is given. So the other alternative left for our RMG producers is to try to source inputs in such way that the costs will be minimum. Presently, these producers receive subsidy from our Government if they use domestic inputs (fabrics). It is needless to mention that this subsidy defray a part of the cost of production of our RMG producers. Again, if the inputs are sourced locally, our RMG products qualify for tariff-exemption in the EU market under the GSP scheme. This is also equivalent to a reduction in the cost of production³. On the other hand, if our RMG producers procure their inputs from abroad, neither they receive any cash subsidy from our Government nor do their products qualify for GSP benefits in the EU market. Naturally, the RMG producers will prefer domestic inputs (fabrics) to imported inputs provided there is no quality or supply constraint.

If P denotes the price of Bangladeshi RMG product in the EU market, C_B denotes the costs of input (fabrics) procured domestically in Bangladesh, C_I denotes the costs of imported inputs, T denotes the tariff exemption received under the GSP scheme and S denotes the subsidy given by the Bangladesh Government to RMG exports produced from domestic inputs, the profit function of the Bangladeshi RMG exporters to the EU market may be given as follows:

$$\begin{aligned} \Pi_D &= P - (C_B - T - S) \text{ or} \\ &= P - C_B + T + S \quad \dots\dots\dots(1) \end{aligned}$$

On the other hand, if our RMG exporters use imported input, their profit function will stand as -

$$\Pi_I = P - C_I \quad \dots\dots\dots (2)$$

Now our RMG exporters, as rational profit-maximizer, will prefer domestic inputs as long as

$$(P - C_B + T + S) > (P - C_I) \quad \dots\dots\dots(3)$$

The condition (3) can be rewritten as

$$(C_B - C_I) < (T + S) \quad \dots\dots\dots (4)$$

Condition (4) implies that our RMG producers will prefer Bangladeshi input (fabrics) to the imported inputs as long as the costs difference between domestic inputs and imported inputs is less than the sum of tariff exemption (in the EU market) and cash subsidy given by the Bangladesh Government. When the costs difference is just equal to the sum of tariff exemption and cash subsidy, the RMG producers will be indifferent between domestic inputs and imported inputs. And

in the case of cost difference exceeding the tariff exemption and subsidy, the RMG producers will definitely switch to imported inputs. This switching tendency from domestic inputs to imported inputs will increase as the value of the sum of tariff exemption and cash subsidy, $(T+S)$, declines.

With the SC implemented, our RMG exports produced from imported inputs from the SAARC region will qualify for either a maximum 12.8% tariff exemption i.e. $T=0$ or a minimum 2% tariff exemption i.e. $T= 10.8\%$. In both the cases, the value of T declines and so does $(T+S)$. As we have seen that the switching tendency from the domestic inputs to the imported inputs increases with the decrease in the value of $(T+S)$, so it follows that with the SC implemented, there will be a 'switching away' from domestic inputs to imported inputs from the SAARC region. Of course, the extent of such 'switching' from domestic inputs to imported inputs (from the SAARC countries) will depend on the percentage of our RMG exports produced from imported inputs that qualify for a full 12.8% tariff exemption in the EU market. If this turns out to be a small fraction of the total RMG exports, then not much 'switching away' from the domestic inputs to the imported inputs from the SAARC countries is likely to occur.

However a much bigger switching is likely to take place in our external sourcing of inputs. We know that currently about 80%⁴ of inputs (fabrics) for our RMG production is procured from abroad—both SAARC countries and non-SAARC countries. Even in the year 2004, as high as 67% of inputs for RMG production will need to be imported. Presently, all Bangladesh RMG exports produced from inputs (fabrics) imported from the SAARC and non- SAARC countries receive similar tariff treatment in the EU countries. But when the SC is implemented, RMG exports produced from imported inputs from the SAARC countries will receive preferential tariff treatment (ranging from 2% to 12.8%). With this will be added the advantage of 'lead time' reduction. This will create room for additional profits to be made by the Bangladeshi RMG producers by simply 'switching away' from their non-SAARC sources to SAARC source for input (fabrics) supply. Thus following implementation of the SC there is going to be a big 'switch' from the non-SAARC to SAARC countries as far as the imports of fabric for RMG production is concerned.

The SC will allow our RMG producers to make savings on costs by switching the procurement of inputs (fabrics) from non-SAARC to SAARC countries. This savings by the RMG producers will be a net gain for themselves as well as for our country. But if the same cost consideration makes our RMG producers to divert their purchases of inputs (fabrics) from domestic source to other SAARC countries, the RMG producers themselves may benefit but there will be a corresponding production loss in our country, which will be a national loss for all of us.

The available information indicates that presently the cost difference between imported fabrics (from India) and local fabrics is about 40% i.e. imported fabrics is 40% cheaper than the locally procured fabrics⁵. This 40% difference in input cost has been more or less neutralized so long by the cash incentive (25%) given by the Government of Bangladesh and the GSP benefit (12.8%) given by the EU countries, in total, about $(25+12.8=)$ 37.8%. But, from the current fiscal year, the rate of cash incentive given by the Government will be reduced to 15%. This means that the effective cost difference between the imported and domestic fabrics will be widened for the RMG producers. In such a situation, the enforcement of the SC will further widen this margin of effective cost difference by the amount of GSP benefit (at least by 2%, if not by the full amount of 12.8%). Thus the enforcement of the SC is likely to tilt the balance in favor of imported fabrics at least to some extent. Consequently there is possibility of some domestic production loss in the wake of implementation of the SC together with the current reduction in cash incentive. The anticipation of such production loss has got some supporting evidence in the year- to-year growth of imports of cotton, yarn and fabrics in the past.

Table II.4 shows the year-to-year growth rate of imports of yarn, fabrics and RMG. In the year 1997-98, there was a temporary derogation of the Rules of Origin for availing GSP benefits. From October 1997 to December 1998, for woven garments 'one-stage' and for knit garments 'two-stage' conversions were required. This meant that woven garments produced from imported fabric would have qualified for GSP benefits whereas the conversion requirement earlier was 'one stage' higher for each type of garments exports. By implication, this temporary derogation of

Rules of Origin would have negative impact on the import of fabric because now woven garments produced from imported fabric would qualify for GSP benefit. On the other hand, in the case of import of fabric, the derogation of the Rules of Origin supposed to have a positive impact. And this is what we find from the Table above. In the year 1997-98, the import of yarn actually declined as expected and the import of fabric registered a 20.8% growth whereas the previous years had seen negative growth rates. This therefore confirms the view that the enforcement of similar derogation in the Rules of Origin through SC is likely to have a negative impact on the domestic production of fabrics⁶. Then what to do about SC? If it is not enforced, our RMG exporters will be denied the opportunity of making savings in terms of costs of production by relocating the sources of inputs. Contrarily, if implemented, the SC is likely to result in the loss of domestic production by the textile producers. This point of production-loss in the domestic backward linkage industries has been highlighted prominently and rightly in the paper prepared by the MOT on the subject.

TABLE II.4 : Year-to-Year Growth of Imports and Demand of Inputs for RMG

Year	Import of Yarn (Million Dollar)	Year-to-Year Growth	Import of Fabric (B/B L/C) (Million Dollar)	Year-to-Year Growth	Demand for Fabric for RMG (Million Meters)	Year-to-Year Growth
1991-92	92	—	741.11	—		
1992-93	127	38.0	874.39	18.0		
1993-94	168	32.3	1033.39	18.2	830	
1994-95	200	19.0	1522.73	47.4	1150	38.6
1995-96	296	48.0	1432.72	-6.0	1322	15.0
1996-97	395	33.4	1265.55	-11.7	1486	12.4
1997-98	327	-17.2	1529.28	20.8	1802	21.3
1998-99	283	-13.5	1389.05	-9.2	1860	3.2
1999-2000	300	6.0	1580.91	13.8	2049	10.2
2000-01	322	7.3				

A Brief Evaluation of the Paper prepared by the Ministry of Textiles on the SAARC Cumulation

The apprehension that domestic production of fabric may decline following implementation of the SC has been rightly pointed out by the MOT in recommending against the enforcement of SC. The other arguments put forward are, however, not so strong. For instance, it has been pointed out that the mills under the BTMA with a yearly production capacity of 510 million meters produced only 123.3 million meters of woven fabrics which was slightly more than 17% of the total fabric requirement for exports in the year 2001. Despite 75% under-utilization of capacity, MOT recommends massive investment in the textile sector in the rather misplaced hope that Bangladesh will be self-sufficient in fabric production by the year 2004 or so. Similarly, the argument that after the enforcement of the SC, the EU countries will prefer the fabric producing countries when placing orders for RMG because of fresh acquaintance with them or because it will save their costs of transporting fabrics to the RMG producing country like Bangladesh is also not well-founded. The enforcement of SC may entice the EU importers to have rapport with the fabric suppliers in the SAARC countries, but imports of RMG from those countries will not qualify for zero-tariff access in the EU market.

Finally, it is true that in a competitive free market world, every firm/industry/sector of production should compete and survive on its own efficiency. In our particular case, it is not economically just and efficient to ask the RMG sector to purchase inputs from the domestic textile sector at a price higher than the international one as much as it will be unjust to ask the domestic textile sector to supply inputs to the RGM sector at a price lower than the international one just to keep the latter internationally competitive. Nevertheless, the fact remains that the enforcement of SC, though may be beneficial for the RMG sector, may still lead to production-loss in the domestic textile sector and this may not be acceptable from the national point of view.

So, is there a solution that will allow the RMG sector to benefit from the implementation of SC without causing production-loss in the domestic textile sector? Here we present, first, the theoretical sketch of such a solution.

SAARC Cumulation without the Loss of Domestic Production: A Theoretical Analysis⁷

Short Term Benefits

Savings in terms of costs of production

Under the GSP Scheme, the exports from Bangladesh to the EU countries are entitled to receive 12.8% tax-exemption. This means, Bangladeshi exporters are able to enjoy a cost-advantage of 12.8% vis-a-vis exporters from other countries in the EU market. However, in order to avail this cost-advantage, the EU Rules of Origin (RO) required previously that the inputs going into the production of Bangladeshi exports should have been entirely of local origin. But under the SAARC Cumulation System, Bangladeshi exports to the EU market will be able to enjoy the same advantage even if the inputs for exports of Bangladesh are sourced from India and other SAARC countries.

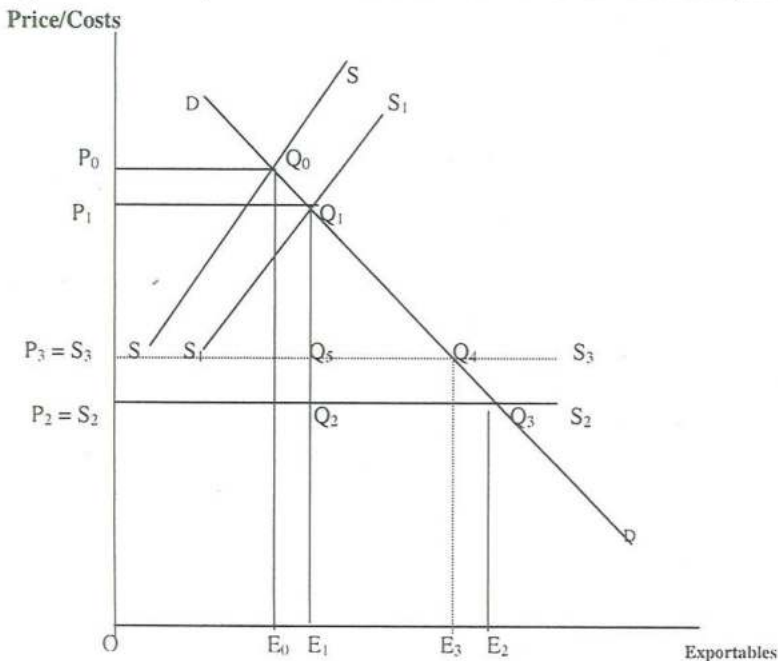
Now if the inputs for producing exports could be procured at the same costs from both domestic source and the SAARC countries, Bangladeshi exporters would be indifferent between the two sources. If, however, the inputs for exports could be sourced at, say x percent cheaper price, from the SAARC countries, then the cost-advantage of the Bangladeshi exporters in the EU market would stand at $(12.8+x)$ percent. This would lead to a direct saving by the Bangladeshi exporters in the EU market as shown in the following diagram: Let us assume that SS is the supply curve of Bangladeshi exportables to the EU countries without GSP benefit. DD is the normal downward sloping demand curve (Fig.II.1). The equilibrium price and quantity of exportables are, respectively, OP_0 and OE_0 . Now, with the GSP benefit

included, the supply curve of Bangladeshi exportable shifts rightward to S_1S_1 and the equilibrium price decreases and quantity of exportables increases to OP_1 and OE_1 , respectively. But with the introduction of SAARC Cumulation System, the supply curve of Bangladeshi exportables not only rotates to horizontal position but also shifts downward to S_2S_2 .⁸ The new equilibrium price and quantity of Bangladeshi exportables shift to OP_2 and OE_2 respectively. Before implementation of the SAARC Cumulation System, the quantity of Bangladeshi exports to the EU markets was OE_1 . On this amount of exports, the exporters' savings are equal to $P_1Q_1Q_2P_2$ and it is needless to mention that this saving is possible because of implementation of the SAARC Cumulation System. It may be pointed out here that the savings on costs result in two ways: (i) from both cheaper inputs and tariff-exemption, (ii) from tariff exemption only on exports hitherto not covered by GSP since those exports have been produced from imported fabrics.

Gains from Trade Creation

SAARC Cumulation System not only can create an opportunity for making savings on production costs of exportables, it also opens the door for reaping benefits from the additional trade-creation. We have assumed a downward sloping demand curve for our exportables in the EU market. The savings made by our exporters on the cost of exportables will enable them to reduce price and,

Figure II.1 : Analysis of the Effects of the SAARC Cumulation System



consequently the market for exportables will expand to E^2 . The gains from additional trade-creation are represented by the triangular area $Q_1Q_2Q_3$ in the figure above.

Short Term Losses

Loss from Trade Diversion

However, corresponding to the gains from the simple implementation of the SAARC Cumulation System, there are some losses also to be incurred. This loss will arise because of trade-diversion. Since the producers of our exportables are likely to procure inputs, after implementation of the SAARC Cumulation System, from the SAARC countries, our domestic input suppliers will lose business to the extent our exporters procure inputs from the SAARC countries. So the positive savings made by our exporters on input costs will be offset by the negative trade diversion effect on our domestic input suppliers, following implementation of the SAARC Cumulation System. In the extreme case when all the inputs for exportables are procured from the SAARC countries, Bangladeshi input producers will lose business equal to the area $P_1OE_1Q_1$ and the net loss will be equal to the area $P_2OE_1Q_2$ (net of savings made by the exporters equal to $P_1Q_1Q_2P_2$).

Overall Short-Term Gains/Losses

The overall gains/losses from the implementation of the SAARC Cumulation System will depend on the size of the rectangle $P_2OE_1Q_2$ and the triangle $Q_1Q_2Q_3$. If the area of $Q_1Q_2Q_3$ exceeds that of the rectangle $P_2OE_1Q_2$ then there are clear short-term gains to be had from the implementation of the SAARC Cumulation System. In the opposite case, however, the short-term loss is evident.

Long-Term Loss

Growth of the Linkage Industries

With the short term gains/losses we should take into account the long term losses arising from the impact of the SAARC Cumulation System on the growth of the backward linkage industries. Although we cannot venture to depict this loss diagrammatically, it is for sure that if the implementation of the SAARC Cumulation System diverts the domestic demand for inputs to the SAARC countries, it will impair the future growth of industries producing inputs for our exportables.

Should the SAARC-Cumulation System Stay or Go?

The question that naturally arises is whether the SAARC Cumulation System should stay or go. The answer to this question becomes somewhat subjective. While it is possible to make an estimate of the gain and loss quantitatively for the short term, to make a similar estimate for the long term becomes rather complex and not so definite. Those who put more weight to the long term losses that are assumed to follow from the implementation of the SAARC Cumulation System, will reject the short term gain, if any, very lightly. According to them, if we go for the implementation of the SAARC Cumulation System, we may make short term gain but we may be loser in the long run. On the other hand, if we opt against the implementation of the SAARC Cumulation System, we will perhaps prevent the long term losses but the short term gains, if any, will be foregone.

So, is there a way that will enable us to avail the short-term gains without sacrificing the long run benefits? Here we suggest an alternative way and demonstrate that it takes care of both the short term and long term interests of the country. What is that alternative? It is a crafty implementation of the SC: (i) Go for the implementation of the SAARC Cumulation System and (ii) impose an export duty on the exportables, produced from imported inputs and destined for the EU countries (qualified for GSP facility), to match the GSP-benefit obtainable on our exports to the EU. The latter measure will take away the advantage of using the imported inputs over the domestic inputs following implementation of the SAARC Cumulation System. (iii) However, a certain portion of the exportables produced from the imported inputs and destined for the EU market may be exempted from this proposed export-duty provided that a corresponding pre-specified level of similar exports has been made using domestic inputs. (iv) The ratio of the exports made from imported inputs and qualifying for exemption from the export-duty vis-a-vis the exports made from domestic inputs will depend on the supply capacity of domestic inputs and the amount of expected increase in exports resulting from the implementation of the SAARC Cumulation System. This will put the supply curve S_3S_3 (in the Figure) of our exports to the EU market a little higher than the one with simple implementation of the SAARC Cumulation System, SS_2 .

The resulting gain from trade-creation, $Q_1Q_4Q_5$ though a little smaller, is nevertheless positive. There is also short-term savings in terms of input costs equal to $P_1Q_1Q_5P_3$. Additionally, the net short-term loss from trade-diversion, $P_3OE_2Q_5$ and the long term loss in terms of negative effect on the growth of the backward linkage industries are both escaped. Thus a crafty implementation of the SAARC Cumulation System will enable Bangladesh to reap the short-term benefits without surrendering both the short term and long term gains.

In concrete terms, the abovementioned ‘crafty implementation’ of the SC may be interpreted as follows: **We have seen that the domestic supply of fabrics for RMG will stand at roughly 33% of the RMG exports⁹. So our exporters of RMG may be granted GSP certificate (Certificate of Origin Form A) for 200 taka worth export produced from imported inputs (fabrics) for every 100 taka worth export produced from domestic input (fabric). Otherwise, the exports of RMG (to the EU) produced from imported fabrics may be subjected to an export tax equal to the amount of GSP benefits (2%, if value-addition is less than 50%, or 12.8%, if value-addition is more than 50%) in order to qualify for the Certificate of Origin Form A to be issued by the Government of Bangladesh.** The implementation of the SC in this manner is expected to prevent the loss of domestic textile production while allowing the RMG exporters to obtain GSP benefits on exports made from imported fabrics and also make savings in terms of costs of production from the cheaper imported inputs.

SAARC Cumulation on Non-Textile Exports

Another argument in favor of implementing the SC will be its possible beneficial effects on non- textile exports of Bangladesh to the EU market. Recently the EU has offered that everything but arms (EBA) from the LDCs may enter the EU market free of duty. This means that the SAARC cumulation rules can be applied to all sorts of products except the harmful ones like arms, drugs etc..

Table II.5 shows the commodities that are currently exported to the EU countries and which may benefit from the implementation of SC. Vegetables, fruits, spices,

TABLE II.5 : Non-Textile Exports to the EU Countries

Items of Export	Country of Exports	Value of Exports in 1999-2000 (Thousand US \$)
Vegetables	UK, Germany, Italy, France, Netherlands, Switzerland, Sweden, Belgium, Greece	3657
Fruits	Switzerland	
Bicycle	UK, Germany, Denmark, Belgium, Ireland	10058
Stainless steel Tableware	UK, Germany, Netherlands	734
Spices	EU countries	

Source: EPB, *Export Statistics* 2000-2001.

bicycle, stainless steel tablewares etc. are presently exported to the EU countries from Bangladesh. We can import these commodities and parts thereof from India and other SAARC countries and may re-export them to the EU after full or partial processing in Bangladesh, taking the advantage of tariff-exemption given under the GSP scheme.

2005 and Beyond

The year 2005 will be a milestone in the evolution of the free trade regime worldwide. The previous 31st night would have seen the end of the MFA and January 2005 will welcome the return of textile trade within the fold of worldwide free trade regime envisaged by the WTO. Good or bad, it is true that Bangladesh has been one of the beneficiaries of the outgoing MFA regime. The year 2005 will see an end to such benefits flowing from the MFA. Consequently, Bangladesh will have to face competition in the international market from all the WTO member countries – not only from the countries of the SAARC region. Bangladesh will have to be ready to face fierce competition in all of its exports including the RMG exports. In that competition, the ‘key’ to success will be the competitive advantage enjoyed by Bangladeshi producers vis-à-vis their international counterparts— particularly in India and Pakistan.

Competitive Advantage & Spinning

Available information confirms the common idea that both India and Pakistan enjoy natural advantage over Bangladesh in producing yarn. This advantage stems from the supply of raw material (cotton), because both India and Pakistan produce cotton which Bangladesh imports from these two countries, among others. Since the raw materials are the major cost item in the spinning process, accounting for around 65% of the total yarn costs, Bangladesh will be trailing behind these countries as far as the production of yarn is concerned. Considering the glut in yarn supply in the international market, Bangladesh should consider, as a matter of policy, whether it should try to specialize in yarn production.

Competitive Advantage and Weaving

Weaving is the next higher stage after spinning in the textile production and therefore involves more processing than yarn production. Following the logic of Heckscher-Ohlin’s Factor-Endowment Theory, it is in this stage where Bangladesh can use its cheap labor supply, production skill and ingenuity to overcome the natural disadvantage in the lower ladder (spinning) of textile

production. The cost structure of new weaving projects show that in this stage of production Bangladesh stands at a comparable level with India and Pakistan as far as the cost of production of fabrics is concerned.

Dumping by India and China

Regarding the Indian and Chinese dumping practices in fabric supply, it may be pointed out that in the year 2005, MFA will be abolished and redress will be available from the WTO against 'harmful' dumping as both of them are members of the WTO.

Financial Assistance

Besides, Bangladesh will be able to provide, if she desires and can afford, indirect financial support to textile production via incentives to RMG exports and she can do so without violating the WTO-rule until her per capita income reaches 1000 US dollar benchmark.

Section III

Conclusions and Recommendations

In the present study, we have examined the past growth and performance of our RMG and Textile sectors, their present state and future prospects both before and after the abolition of the MFA in the year 2004. We have also tried to analyze the impact of the SC on the performance of our RMG and Textile sectors.

It has been found that the EU takes about 70% of our Knit-RMG exports and more than 45% our woven RMG exports, which is indicative of the importance of the EU as a destination of our exports in general and RMG exports in particular. Again it has been observed that nearly 70% of fabric requirement of our knit-RMG exports and only about 20% of the fabric requirement of the woven-RMG exports are met from domestic source thus making them eligible for GSP benefits offered by the EU.

It has been further observed that if the RMG exports and the domestic supply of fabrics continue to grow at the current rates, the latter will meet roughly 33% of the total fabric requirement for the RMG exports in the year 2004.

The theoretical analysis of the impact of the SC has revealed that if the SC is not implemented, it will deprive Bangladesh from the short term benefits of savings to be accrued from cheap imported inputs, GSP coverage of RMG exports

produced from imported fabrics (from SAARC countries) and also from the additional exports resulting from the additional trade-creation. On the other hand, the exercise adequately demonstrated that the short term gains from the SC may be far outweighed by the production-loss due to trade-diversion effects and its negative impact on the growth of the domestic backward linkage industries to the RMG sector.

The theoretical exercise further demonstrates that a crafty implementation of the SC will enable the country to escape the negative trade-diversion loss and its effect on the growth of the domestic Textile industry. Since the domestic fabric supply for the export-oriented RMG is projected to stand at roughly 33% of the total demand, the said crafty implementation of the SC may be designed as follows: **Go for enforcement of the SC. But exports to the EU of RMG made of imported fabric and eligible for GSP may be subjected to an export tax equal to the GSP benefit (2%, if value-addition is less than 50%, or 12.8%, if value-addition is more than 50%). However, such export taxes may be waived for 200 taka worth RMG exports for every 100 taka worth exports of the same produced from domestic fabrics.**

As regards the comparative advantage of Bangladesh in RMG and Textile production vis-a-vis India and Pakistan, it has been pointed out that Bangladesh's natural advantage is likely to lie at the upper end of the manufacturing process. So Bangladesh should do better in specializing in cutting-making (RMG), fabric processing and weaving instead of spinning, at least initially.

Further it has been shown that Bangladesh's RMG exports are likely to face stiff competition in the post-MFA period but Bangladesh, as an LDC, can take the advantage granted by the WTO of continuing present financial assistance to the RMG exports till her per capita income level reaches the 1000 US dollar benchmark.

Notes

Section I

1. International Business & Technical Consultants , Inc., 'Report on Impact of SAARC Cumulation Agreement on Bangladesh RMG and Textile sectors and on the Overall Economy of Bangladesh', report submitted to the Ministry of Commerce, GOB, Dhaka, December, 2000.
2. Rahman, M and D. Bhattacharya, 'Regional Cumulation facility under EC-GSP : Strategic Response from Short and Medium term Perspective', Center for Policy Dialogue (CPD), Dhaka, Nov. 2000.

3. When the product of two or more countries of a regional group are used in manufacturing a particular commodity, conflict or uncertainties may arise regarding the originating status of the product. RO specifies the criteria for the determination of origin of different products in such cases for tariff purpose.
4. The stages of conversion are as follows:
 Stage 1: conversion of cotton to yarn (spinning)
 Stage 2: conversion of yarn to fabrics (weaving)
 Stage 3: conversion of fabric to RMG (cutting & making)
5. Rahman, M and D Bhattacharya, op. cit., p. 5.
6. Currently, similar regional cumulation are allowed by the EU to countries belonging to three regional groupings, for instance, the Association of South east Asian Nations (ASEAN), Central American Common Market (CACOM) and the Andean group.
7. The BTMA claims that presently they supply roughly 20% of the fabric required for woven RMG and about 70% of the fabric requirement of the knit RMG.

Section II

1. International Business & Technical Consultants, Inc., and Rahman and Bhattacharya, op. cit.
2. Rahman & Bhattacharya op. cit. p.11.
3. It should be noted that the duty rebate under the GSP is actually received by the importer of RMG in the importing country. Nevertheless, the effect of the scheme provides an edge to the Bangladeshi exporters over the potential competitors and works as a force similar to that causing rightward shift of the supply curve.
4. Domestic fabric supply for RMG, according to BTMA, was about 19% in the year 1999-2000 while the BGMEA claims it to be around 10%.
5. One study shows that price difference between Chinese fabric and Bangladeshi fabric is 43 to 51% in some cases. Since India is a rival supplier of China in Bangladesh, so the price of Indian fabric also should be similarly competitive. Dr. Martelli Associates, 'Bangladesh Textile Study', IFC, Washington, D.C, May 1999.
6. This is exactly what the MOT apprehends strongly. MOT, 'Recommendation on the SAARC cumulation in respect of Five Categories of RMG exports to the EU under the GSP Scheme', March 2002.
7. This analysis has been reproduced from Azad, A.K., 'A Theoretical Note on the SAARC Cumulation System', paper presented at XIV Biennial Conference of the Bangladesh Economic Association held at Dhaka on 18-20 September 2002.

8. Because of cost advantage resulting from the use of imported inputs and because of huge supply of inputs (from imports) compared to domestic supply.
9. Although, according to BTMA, the rate of GSP-utilization has been 46% in the year 2001, around 35% of that took place in the knit-Garments exports. It is the woven-Garment exports which is our weak point as far as the domestic supply of fabric is concerned. And here the implementation of SC is likely to yield benefits.

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