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AUTHOR
Arne Wiig

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Arne Wiig¹

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Executive summary

According to the World Bank, political unrest in Bangladesh in the first part of 2015 resulted in a loss of 1% of GDP.² A previous study by UNDP (2005) estimated the average costs of unrest as even higher during the 1990s. Though these estimates are disputed, they indicate that the economic impacts of political unrest might be significant. This note addresses the effect of political unrest through the trade channel or exports. Is there any empirical evidence that exports from Bangladesh have been reduced by recent episodes of unrest?

Exports, mainly garments, constitutes around one fifth of GDP in Bangladesh and hence is a major channel through which political unrest could influence GDP. Bangladesh is the third largest exporter of garments in the world, and the sector employs around four million people, mainly women. Exports of garments have also been an important channel for poverty reduction in Bangladesh.

Many countries, including Norway, emphasize private sector development in their development programmes. Effectively promoting a vibrant private sector requires knowledge of the context and constraints faces by businesses and investors, and there is theoretical and empirical evidence from other countries that political unrest can curtail exports and investment.

However, based on a descriptive analysis, I do not find any clear evidence that the more recent unrest in Bangladesh has had a significant impact on total exports of garments (though Bangladesh has reduced its exports to the important US market). Excess capacity and flexibility in production are parts of the reason. Nevertheless, while export volumes do not seem to have gone down, unrest may adversely affect the bargaining position of local producers vis-à-vis multinational retailers, reducing profit margins and making it more difficult to restructure the industry and initiate costly security and labour reforms.

More generally, however, investors and international retailers will not focus exclusively on political unrest, but on the overall picture of political stability and competitiveness in the country. In recent years, it seems clear that the Awami League has strengthened its hold on power. The overall political situation is in this sense quite stable, which could be one reason why unrest has had a smaller impact on exports from Bangladesh compared to other countries.

² WB 2015; and <https://bdnews24.com/economy/2015/04/12/political-turmoil-cost-bangladesh-2.2-billion-in-three-months-of-2015-world-bank>

1. Introduction

According to the World Trade Organization, Bangladesh was the third largest exporter of garments in the world in 2016, after China and the EU. Among the ten most important exporters in the world (covering nearly the entire world exports), China contributes 40% and Bangladesh 7%. The export value from Bangladesh constitutes 30.4 billion USD in 2015.³ There are about 4000 garment factories in Bangladesh and 3.5-4 million people are employed in the sector, mostly women. Many factories are extremely large with more than 10,000 employees.

Garments are the most important export article from Bangladesh. Bangladesh produces a standardized and homogenous product, sewing. Fabrics are generally imported, but the share of imports and value added varies across the two main product categories; knitted and woven products. Value added in knitted products constitutes around 40 % of export value compared to 90% for knitted product. The most important mode of serving major clothing retailers is through trade, but there is also some FDI in the garment sector (disaggregated data for FDI in Bangladesh is unfortunately not available). Most investment in the clothing sector is made by domestic firms.

The garment industry in developing countries is generally characterized by low capital intensity and the investments in machinery are reversible (costs of investments are not sunk as they have substantial alternative value after investment). With its high capacity and low labour costs, Bangladesh competes in prices (wage costs). Minimum wages in the garment industry were 4.5 times higher in China compared to Sri Lanka and Bangladesh, the garment exporting countries with the lowest minimum wages in 2015.⁴ Design and marketing are still done by retailers as was the case the late 1980s.⁵ A typical t-shirt is sold from Bangladesh for 3-4 USD. Local profits are achieved mainly through higher volumes or higher productivity (lower costs) – not through product differentiation.

While Bangladesh scores high on exports, its score on the World Bank Ease of Doing Business index is low. It is ranked as number 177 out of 190 where higher score indicates greater constraints. In the last World Bank Enterprise Survey, 36.7 % of the firms (45% for garments) perceived political instability as the greatest obstacle to doing business in 2013, up from 11 % (18% for garments) in 2007.⁶ In a more recent Competitiveness report from the World Economic

³ Based on calculations from Base pour l'Analyse du Commerce International (BACI; see section 5 for an elaboration).

⁴ http://www.ilo.org/wcmsp5/groups/public/---asia/---ro-bangkok/documents/publication/wcms_436867.pdf

⁵ See for instance Wiig (1995).

⁶ <http://www.enterprisesurveys.org>

Forum, corruption is perceived as the most important problem, while political instability is still a major concern.⁷

Analysing the relationship between political unrest and trade raises a number of methodological problems. Political unrest is just one of many factors influencing trade, and it is difficult to disentangle its effect from that of other variables. Lacking a counterfactual (we do not know what would have happen on trade if there were no political unrest) makes the causal identification problem substantial. Trade and globalization may also have a reverse impact on unrest as there are winners and losers of increased trade. In the following, I will conduct a descriptive analysis where the focus is on the impact of political unrest on trade in the short to medium term. A causal analysis would have required a more rigorous approach which is beyond the scope of this project.⁸

It should be noted here are also other important impacts of political unrest that I do not discuss. These include death, injury and anxiety among ordinary people, increased public and private spending on security, and increased costs of other domestic industries, for instance in the retail sector where shops close during political unrest. In addition, there are measurement problems, in particular in terms of unrest. I apply the frequency of hartals (general strikes mainly initiated for political reasons by the opposition party) and terrorist incidents as my main indicators of political unrest. I also refer to some other measures of policy uncertainty used in the literature in Section 3. In Bangladesh, hartals, violence and terror incidents are intertwined as one normally observes violent activities during hartals.

In the following I first give a short literature review of existing theoretical and empirical findings of the relationship between political unrest and trade. I then briefly analyse the impact on production capacity through investment. Subsequently, I provide some empirical evidence about the extent of political unrest and possible effects on exports and investment from Bangladesh.

2. Violence is a tax on trade

Hartals (general strikes) are the typical manifestation of political unrest in Bangladesh. This is a polarized country where an Awami League alliance won the election both in 2008 and in 2014. The polarization was increased by the creation of The International Crimes Tribunal

⁷ <http://reports.weforum.org/global-competitiveness-index-2017-2018/countryeconomy-profiles/#economy=BGD>

⁸ See Mirza and Verdier 2008 for a more comprehensive methodological discussion of the relationship between terrorism and trade.

(Bangladesh) in 2009, a domestic war crimes tribunal in Bangladesh investigating and prosecuting suspects of the genocide committed during the Bangladesh Liberation War. Leaders of Jamaat-e-Islami, the largest Islamist party in the country, and the largest opposition party BNP (the Bangladesh Nationalist Party) were charged with war crimes (some have already been convicted and executed). The 2014 national election was boycotted by BNP, who argued that a free election could not be held without a neutral interim government. The election was further characterized by arrests of dozens of opposition leaders and members during the run-up. These are all factors that led to a lot of hartals and terror incidents in Bangladesh, particularly around the election in 2014 and in the spring of 2015 (see section 4).⁹ During hartals one observes closure of shops, lack of transport facilities, road blockades and political demonstration in the streets sometimes accompanied by terror incidents. Hartals and terrorist incidents are hence linked in Bangladesh.

Hartals make it more challenging to operate efficient production lines due to absenteeism of workers and increased transport costs. Distribution costs increase when ordinary transport facilities like shipping and truck transport are blocked; exporters need to use more costly airfreight options around hartals. Delays in production arise due to worker absence. When transport facilities of workers are interrupted during political unrest or hartals, workers are often unable to come to the workplace. In general, time represents a significant cost in modern supply chain management (Hummels and Schaur, 2013). Worker absenteeism also has a direct impact on production and thereby exports. More generally, factor productivity can be reduced when conflicts distort the optimal use of input factors (see Amodio and Di Maio, forthcoming). For clothing, imports of fabrics are a key determinant of production, and disruption of imports can therefore have a huge impact on production.

The terror incidents following hartals have an additional effect on the transaction costs of trading by creating uncertainty and anxiety. Anxiety induces economic agents to become more guarded about potential risks of making transactions in the country. Similarly, any counter terrorist policy (inspections, safety regulations, visa allowance, etc.) can add to the impact by generating larger costs of doing international business. Terrorist acts affect also indirectly trade through their impact on real GDP (Mirza and Verdier 2008).

There are a number of existing empirical analyses attempting to quantify the impact of violence on trade. These studies generally find that violence has a negative impact. A cross country study by Blomberg and Hess (2006) finds that violence as measured by the total of terrorism,

⁹ It was also a peak in hartals in 2005-2006 before the military backed caretaker government was inserted in January 2007.

revolutions¹⁰, inter-ethnic fighting and external war, represents a more important trade barrier than tariffs and non-tariff barrier with a tariff equivalent between 7-17%. Terrorism alone appears to lower international trade by 4 percentage points or a tariff equivalent of 1-3% while the impact of significant conflicts between the government and politically organized groups are stronger (approximately three times higher).

There are also country studies of particular important export sectors exposed to political unrest, particularly during election periods. Ksoll, Macchiavello, and Morjaria, (2014) use panel data to document a 38% reduction in flower exports for firms in violence-affected areas in Kenya relative to those in nonviolence-affected areas after the election in 2007. They find a 50% increase in worker absence during the violent period. In this study, the absence of workers and higher wage costs are the most important channel through which violence influence production and exports, rather than transport costs. However, they also found that the negative impact of unrest varied across firms depending on the institutional structure of the supply chain. Firms engaged in stable contractual relations with buyers, registered smaller proportional losses in production compared to firms competing at arm's length.

Similarly, Muhammad et al. (2013) found a significant impact of political unrest on exports. The impact of the post-election violence in Kenya was estimated as being equivalent to a 17.2% tariff on flowers. The study showed that even a short period of violence can have a long-term effect on trade since instability in an exporting country causes importers to source from other countries where risks are perceived to be lower. Even when political order was restored in Kenya, EU imports of flowers persisted in being lower than before the election in 2007. Due to adjustment costs in switching exporters, exports do not recover quickly after a period of violence.

The flower industry in Kenya shares some characteristics with the garment industry, which makes a hypothesis of similarly negative effects of unrest in Bangladesh important to analyse. However, there are also important differences. While the terror incidents in Kenya were not completely predictable, investors know that hartals are common in Bangladesh so in a sense these incidences are foreseeable. At the same time, garment retailers know that the exporters have to cover the higher transportation costs and absenteeism during hartals in Bangladesh. If that is the case, one would expect that in the short run export value is more stable in Bangladesh than in the Kenyan case. At the same time, one would expect that the exporters' costs are increasing during hartals, leading to a reduction in profit margins. Hartals may also reduce the

¹⁰ Significant (more than 100 fatalities) conflicts between the government and politically organized groups seeking to overthrow those in power.

bargaining power of the suppliers as retailers might threaten to source products from other countries due to unrest, as observed in Kenya. With extensive available capacity in a competitive market like garments, exporters are highly vulnerable to changes in sourcing strategies by the retailers.

3. Not only unrest, but the totality of policy uncertainty affects investment

Unrest may affect not only trade at a given production capacity, but also the capacity of the garment sector through reduced investments. However, investors can be assumed to be rational and will reconsider investment decisions only to the extent that political unrest constitutes new information suggesting that expectations need to be revised. Moreover, political unrest and terrorist activities are only one form of political uncertainty that influence decisions. Before making investment decisions, a rational investor would analyse all types of (political) uncertainty, and if increased risk of one type is counterbalanced by decreased risk of another type, investment decisions do not necessarily change.

To the extent that they are unexpected, terrorism and unrest may influence investment through the same channels as they do trade (such as absenteeism, transport cost and perceived risk). One significant difference between investments (either domestic or foreign) and trade, however, is that the agent's investment in manufactured capital, while giving ownership right of assets, at the same time exposes the investor to potential hold-up problems. When the capital investment is irreversible (it does not have full secondary value after it is invested), investors may be vulnerable to changes in government policies. Investors accordingly need guarantees to secure their investments, particularly in times of substantial uncertainty in government policies. Investors might therefore delay or drop irreversible investment if unrest makes government policies more uncertain (Rodrik, 1991).

An additional theoretical mechanism that might reduce investments is that the risk of default may increase under policy uncertainty, leading to higher external costs of financing (Pastor and Veronesi, 2013). More generally, unrest tend to depress the expected return on capital invested, which shifts investment elsewhere. This might reduce the stock of productive capital and the flow of productivity-enhancing technology to the affected nation (Bandyopadhyay, Sandler, and Younas 2015).

A number of empirical studies find evidence that both mechanism are at work. Gulen and Ion (2015) find significant negative impacts of policy uncertainty in industries with irreversible (as measured by the ratio of fixed to total assets) investments, but not for competitive industries.

The impact was largest for capital- constrained firms. Their study is based on analyses in developed countries like the United States, Canada, the United Kingdom, France, Germany and Italy. Policy uncertainty is measured by an index consisting of three components, two of which measure uncertainty related to taxation, government spending and monetary policy. The third component is a more comprehensive measure derived from a count of newspaper articles containing key terms related to policy uncertainty.

Baker et al 2016 find that policy uncertainty raises stock price volatility and reduces investment and employment particularly in policy-sensitive sectors like defense, healthcare, and infrastructure construction in the US and in 12 other main economies.

As for terrorism and FDI, empirical studies have shown that a relatively small increase in the perceived risk of terrorism can cause a reduction in a country's net stock of foreign direct investment (Abadie and Gardeazabal, 2008; Bandyopadhyay, Sandler, and Younas, 2014). Terrorism increases uncertainty and reduce expected return of investment. But it also has a large impact on the allocation of productive capital across countries, as international investors diversify other types of country risks through their investment strategies. Hence, terrorism might have a large impact even if it represents a small fraction of the overall economic risk (Abadie and Gardeazabal, 2008).

One might expect that the above referred mechanisms are not of vital importance in the clothing sector as investments have a second-hand value and clothing is a competitive industry where costs of delays are high as investment opportunities are short lived and strategic first-mover advantages are large. Furthermore, political unrest does not necessarily mean that the investors perceive policy as uncertain. In Bangladesh, Awami Leage has strengthened its hold on political power in recent years, making the political situation more predictable and quite stable. This might counterbalance the negative effect of political unrest.

4. Hartals and violent incidents in Bangladesh more prevalent, particularly around elections

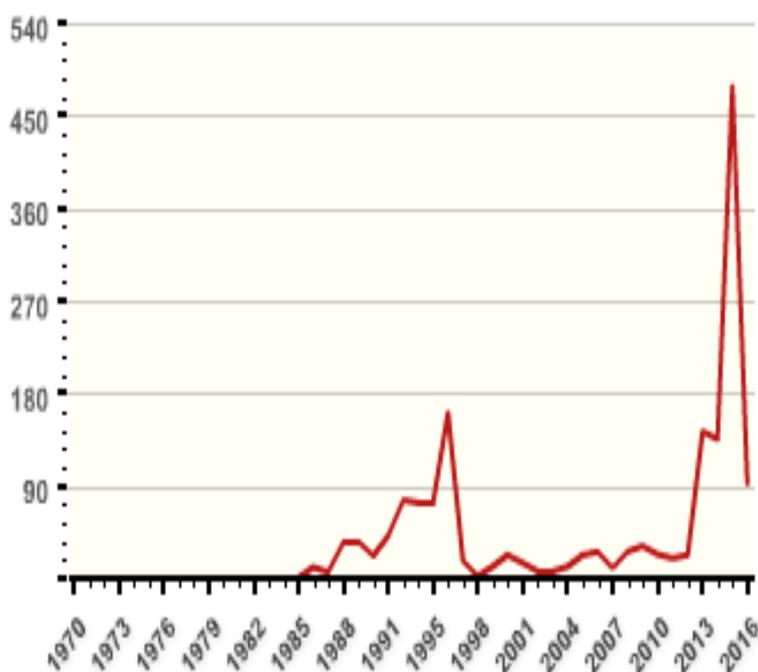
The available data on hartals are mainly based on anecdotal evidence and systematic gathering of newspaper material. Sabet and Tazreen (2013; quoted from Ashraf et al 2015) found that over the period of January - mid May 2013 there were about 55 days of political unrest including 27 national strikes. A total of 143 lives were lost, more than 3,500 people were injured, and more than 1,500 vehicles were destroyed because of strike violence. Another study by Ashraf et al

(2015) found that during the period January 2012 through July 2014, there were 96 hartal days (in Dhaka) in 46 separate hartal events, 19 of which lasted for more than one day. Two conclusion seems to emerge from this evidence which is in line with the findings of Ahsan and Iqbal (2014). Hartals have become more *prevalent* in Bangladesh in recent years (up from 53 during 2005-2009 to 99 during the period 2010-2013), they have also become more *violent and intense*.

In Figure 1, it is very clear that the number of terror incidents were very high in 2014 and 2015. Particularly in 2014, the main target of these incidents was the government.

Figure 1. Yearly number of terror incidents in Bangladesh.¹¹

Source: Global Terrorism Database <https://www.start.umd.edu/gtd/search/Results.aspx?country=19>



¹¹ Each incident had to be an intentional act of violence or threat of violence by a non-state actor. In addition, two of the following three criteria also had to be met for inclusion:
The violent act was aimed at attaining a political, economic, religious, or social goal;
The violent act included evidence of an intention to coerce, intimidate, or convey some other message to a larger audience (or audiences) other than the immediate victims; and
The violent act was outside the precepts of International Humanitarian Law.

In the same period, there was labour unrest related to demands for better working conditions including higher minimum wages, payment for overtime and improved safety regulation. An increasing international focus has been devoted to labour and safety regulations in Bangladesh, particularly after the fire at Tazreen Factory in November 2012 and the Rana Plaza collapse in April 2013. In July 2016, Bangladesh was again on the front pages of international newspaper as terrorists (belonging to the Islamist terror group Jamaat-ul-Mujahideen) killed 24 people at the Holey Artisan Bakery. Some of the victims were connected to the garment business.

After the attack IS proclaimed that this event was the first in a series of coming terrorist attacks in Bangladesh. As a result, perceived risks of terror have risen among foreign buyers, investors and donors. Buyers became reluctant visiting Dhaka, and some donors like the World Bank do not allow their staff to bring with their family members during their secondment to Dhaka.¹²

The authorities have invested in countermeasures to terrorism, and a security industry has rapidly developed protecting houses, hotels, roads and infrastructure, making it more cumbersome to visit public offices and private businesses.

5. Empirical findings from Bangladesh show minor impacts of political unrest on exports and FDI, but lower mark-up

There are a few empirical studies analysing the impact of political unrests on the exports of garments from Bangladesh. Ahsan and Iqbal (2016) focus on the increasing costs in distribution and find a minor (4.5% reduction over a 7-day period around hartal) overall effect on exports when taking into account the fact that firms adjust shipment date or mode of transport. The study is based on daily customs data combined with daily information about hartals during the period 2005-2013. More air freight increases *transport costs* as air freight is more expensive than the ordinary way of shipping goods. Truck and bus transport costs are also rising around the dates of hartals. Particularly small firms faced higher transport costs.

Ashraf et al (2015) focus on absenteeism among workers and combined daily production level data in garment factories with daily information about hartals. Short duration hartals (one or two days) had very little effect on productivity or worker *absenteeism*. In spite of hartals, workers were able to come to the factories and work as normal as they generally lived close by. Larger

¹² Interviews with Bangladesh Garment Manufacturing Association and the World Bank.

factories that had flexibility in the setup of production lines and flexibility in working hours (for instance using night work) were able to complete orders in time. Longer lasting hartals on the other hand were found to have larger impacts, particularly due to the restraints on securing *inputs* (fabrics).

None of the above referred studies have directly analysed the overall impacts on exports or long-term sourcing strategies by the buyers, but they have emphasized some of the mechanisms at place analysed in section 2, such as increased distributional cost, absenteeism of workers and increased costs of inputs. The general findings of these studies are that costs have increased, and profits decreased, but they only find a minor negative impact on production and exports. This may indicate that the bargaining power of the suppliers has decreased, as discussed above.¹³

In the following, I will first provide information about the development of garment exports from Bangladesh based on yearly data from the World trade database developed by the CEPII (BACI). Trade data is derived from COMTRADE, but where data in BACI is constructed using an original procedure that reconciles the declarations of the exporter and the importer to get around inaccuracies in reporting from individual countries (therefore COMTRADE and BACI data may differ).¹⁴

Based on data from BACI, Figure 2 shows that there has been a steady increase in garment exports during the period 2012-2015 although the growth path decreased around the election (early 2014) as marked with the vertical line in Figure 2. Both woven and knitted garments have shown the same trend (but slightly lower growth for knitted products) and these sectors are about the same size.

In Figure 3, we have controlled for changes in the world market of exports. Also, the world market had a dip in 2014, indicating that political unrest in Bangladesh was not the main reason for the reduction in exports of knitted garments from Bangladesh. Notice that the exports of woven garments increased from Bangladesh at a time the world market was reducing both for woven and knitted products.

¹³ However, these studies also show that the impact of labour unrest seem to be much larger than the impact of political unrest.

¹⁴ http://www.cepii.fr/cepii/en/bdd_modele/presentation.asp?id=1

Figure 2. Exports from Bangladesh of knitted and woven garments (HS61-62). 2012-2015. Billion USD. Source: BACI

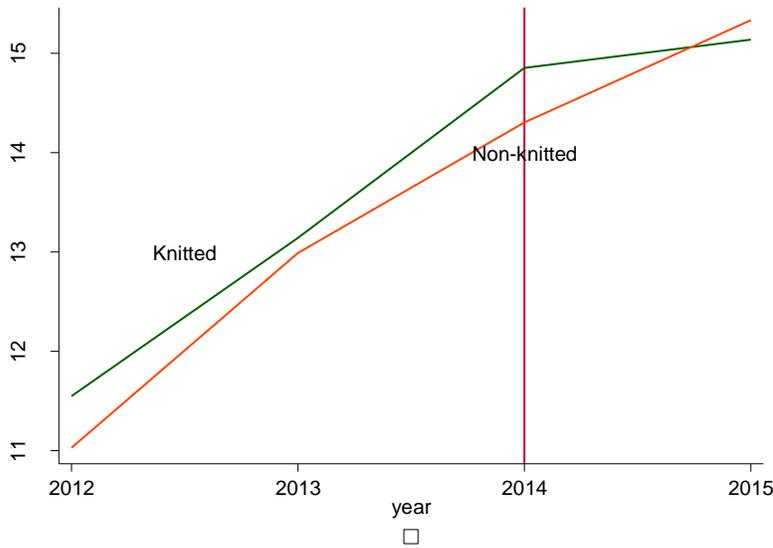
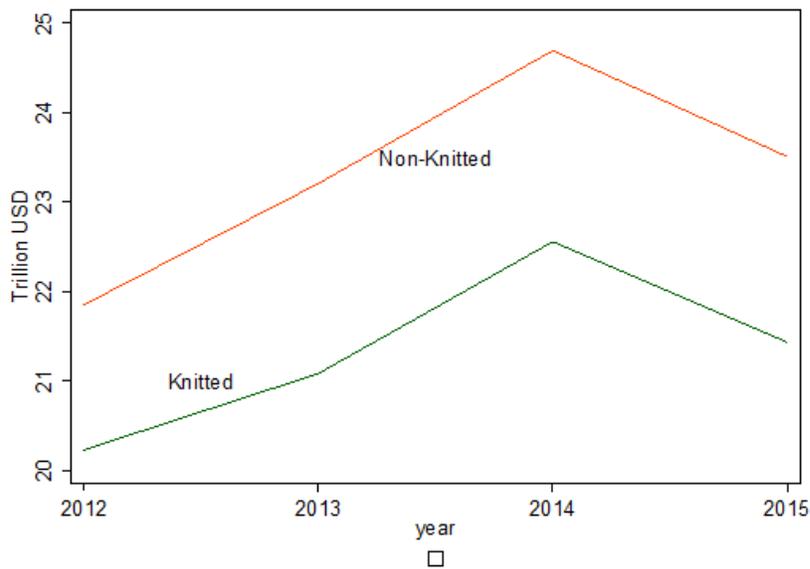


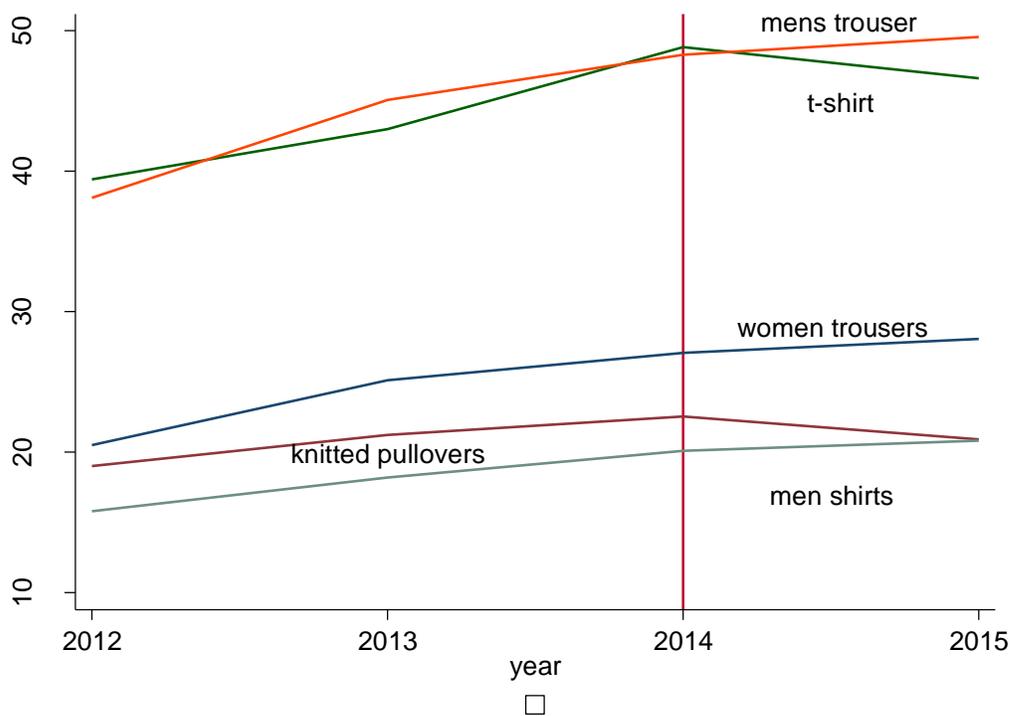
Figure 3. World exports of knitted and woven garments (HS61-62). 2012-2015. Trillion USD. Source: BACI



In Figure 4 we have shown the development of exports of the five most important export items from Bangladesh in 2012. These made up around 60% of total garment exports in 2012. Men trouser and T-shirts are the most important export items with exports value of about 5 billion USD each in 2015. Notice that we reveal the same pattern as the aggregate figures above for knitted and non-knitted products. T-shirts and knitted pullovers have shown a dip since 2014, while the woven categories have increased. It is difficult to see the different trajectories at product level as an indication that product categories more vulnerable to political risk than others have decreased more. A closer look at the world market of T-shirts also show that it has fallen.

Figure 4. Trends in exports of the five most exported garment products in 2012

Source: BACI



More recent monthly data from the Export Promotion Bureau show that during FY2017 (July 2016- June 2017), the year succeeding the terror incident at the Holey Artisan Bakery, the growth rate decreased to 0.2% (from 10.2 % in FY2016). It is difficult to assess whether this was a result

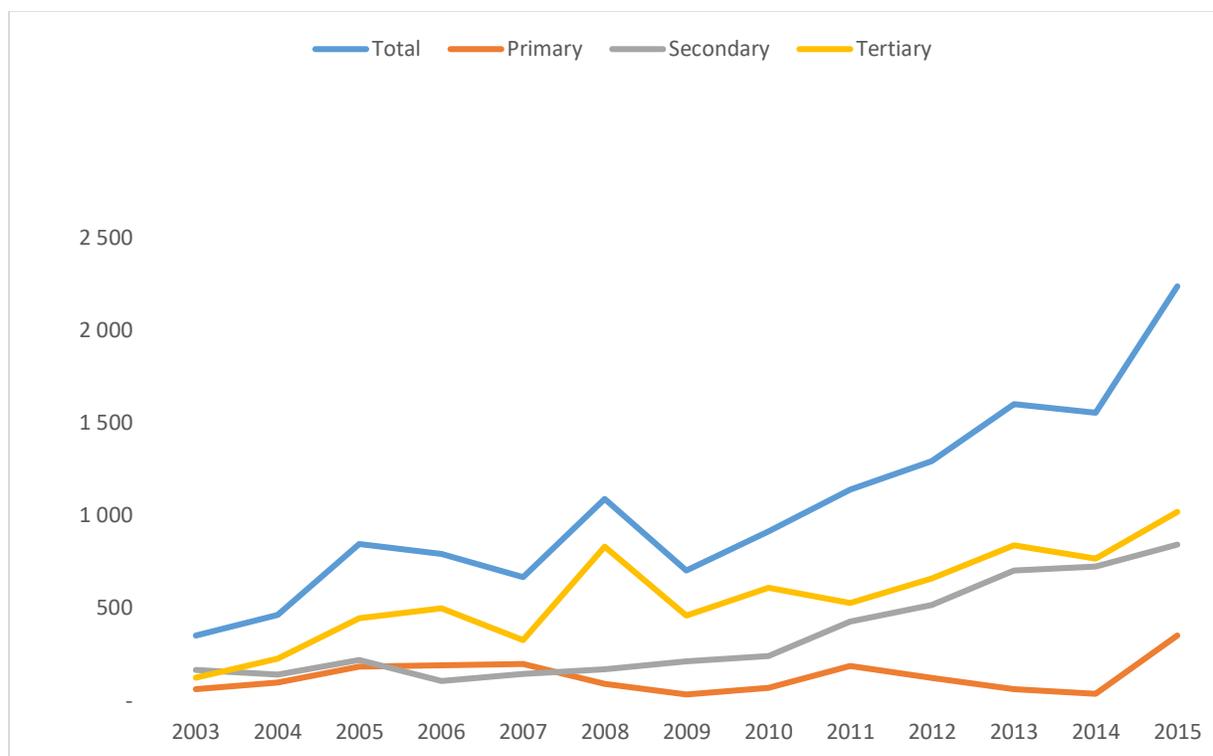
of the terror incident or due to other reasons. Overall it seems that this was a temporary reduction as exports during the first part of FY2018 (July to November 2017) has increased by 7.5% compared to the same period in FY2017. It is too early to know whether this increasing trend continues or not.

One important negative sign is that not all markets are responding similarly. The important US market has reduced its import from Bangladesh by 5.6 % in Jan-Sept 2017. Currently, Vietnam exports more than twice as much as Bangladesh to the US, and Indonesia, India and Mexico have become big competitors. These are important trends to consider for Bangladesh, but their relation to political unrest is uncertain.

Similar to the findings regarding exports, we do not find strong evidence that FDI or the growth trajectory of FDI change around the periods of political unrest.

Figure 5. FDI inflows to Bangladesh. 2003-2015. USD Mill

Source: UNCTAD



As noted earlier, disaggregated sector FDI data for Bangladesh is not easily available. There has been a steady increase in total FDI and FDI in manufacturing, but the share (and total amount) of FDI in textiles and garments has been reduced. According to the Bangladesh Bank, FDI in textiles and garments constituted 16% of FDI in FY2017, down from 20% in FY2016. South Korea was the largest investor in textiles both in FY2017 and FY2016. FDI as a share of GDP is low and in FY2017 FDI was around 2.5 billion USD.

6. Conclusion

In the short run it seems that political unrest has had a minor impact on exports and foreign direct investment in Bangladesh. This finding is in contrast to much of the theoretical and empirical findings from other countries and sectors discussed in sections 2 and 3 but may be explained by different characteristics of the incidents and industries studied.

There are many factors determining trade and investment of which political unrest is only one. Our findings are based on simple descriptive statistics, we have not established the necessary counterfactual required for causal analysis of the impact of unrest. Had the country avoided unrest, exports might have been even higher, or the composition of exports could have been more diversified with higher value-added product.

Exports of garments have grown steadily during the last three decades in spite of internal political turmoils, extensive corruption, labour unrests, loss of trade preferences and terrorist attacks, to mention some of the many internal and external problems facing the economy. The economy in general and trade in particular are perceived resilient to external shocks whether they come from political unrest or other factors such as flooding. There are probably many explanations for this resilience in exports, but at the supply side there is extensive available export capacity. Labour costs are low compared to other low cost suppliers, and flexibility in working hours (night shift, overtime etc) eases the adjustment of production after interruptions during hartals.

At the demand side, prices are low, Bangladesh has received a reputation for high quality of standardized garment products, and buyers (and potential investors) may already have discounted the political risks. Retailers and investors know that there are periods of political unrest in Bangladesh. At the same time, they are well informed of their suppliers' export capacity, the potential risk faced, and they also know that air freight is an option if delays occur. As argued by Ksoll, Macchiavello, and Morjaria (2014), this information is probably different across buyers.

Potential new buyers without relations to potential suppliers in Bangladesh may lack this information and are probably more reluctant to sourcing products from Bangladesh.

In any case, unrest represents an economic costs (tax) for exporters both in terms of distribution (air freight) and production (absenteeism and overtime payment), leading to lower profit margins. Lower margins lead to the necessity of increasing production and capacity, which in turn might reduce the bargaining power of the supplier (buyers are aware of idle capacity), particularly in a case where the supplier does not control the distribution channel as is the case for garments produced in Bangladesh.

Although the short-term impact of political unrest might be small both on trade and investment, long term reputational effects can be strong. Bangladesh has now overcome the reputation of producing low quality products, but at the same time faces the challenge of having a reputation as an insecure country. In addition to reputational effects, political unrest also influences the strategic choices of suppliers in terms of markets and products to produce. Finally, but not least, political unrest has economic impacts on other sectors that could be substantial (for instance in retail business).

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cmi@cmi.no
www.cmi.no

P.O. Box 6033,
N-5892 Bergen, Norway
Jekteviksbakken 31, Bergen

CMI CHR.
MICHELSEN
INSTITUTE