

Integration and transition – Vietnam, Cambodia and Lao PDR^{*}

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Abstract

In the last decade and a half, international trade and investment links from Vietnam, Lao PDR and Cambodia with the rest of the Asian region as well as with the EU and US have grown very rapidly, making these countries truly open economies by world standards. At the same time, financial linkages in the form of joint ventures and aid flows have also been significant.

Despite rapid external economic integration, internal liberalization and transition have lagged behind, resulting in distorted trade regimes and investment flows, as well as underdeveloped domestic private sectors.

Continued external integration in the form of binding international trade and investment agreements can help promote internal liberalization and the development of domestic private sectors through opening protected sectors to international competition. These have tended to be in the infrastructure/service industries dominated by SOEs. Opening these sectors to international competition has the two-fold effect of firstly, lowering the costs of doing business for both domestic and foreign investors, and secondly, hastening the divestment of SOEs. An important aspect, however, of such opening is the institution of adequate property rights and of regulatory regimes for “natural” monopolies in the case of infrastructure services, and prudential regulation in the case of banking and financial services. In other words, for continued “quality” growth and effective integration within ASEAN, further development of appropriate legal/commercial infrastructure and other market-friendly institutions is essential for the three economies in the Mekong region.

Since the new millennium, Vietnam has gone quite a way towards deepening its reforms. The challenge is for the other two economies to develop and deepen their institutions in order to broaden their export base as well as continue to attract foreign direct investments.

Direction of international assistance in recent years towards developing the human capital for more effective public/legal administration is both timely and appropriate. Assistance in the resolution of trade disputes with developed countries is also needed.

I. Introduction

Post World War II economic and political developments in the three transitional economies of the Mekong region bear some striking similarities and significant differences (see Appendix A for a brief sketch of developments in these three economies). All three countries emerged from French colonial rule in the first half of the 1950s. By 1975, Vietnam and Lao PDR adopted Soviet-style central planning, but in effect, only about 50% of the farms in Lao PDR were collectivized due to the mountainous terrain and poor infrastructure resulting in difficulties of communication and central control in that country (Warr 2000). On the other hand, Cambodia, under the Khmer Rouge, underwent a severe form of central planning, resulting in the destruction of all business and market activities, as well as isolation from the world economy, with its people living on subsistence agriculture. Vietnamese occupation of Cambodia in 1979 saw the continuation of central planning, and heavy reliance on Soviet aid for all three countries. However, with the imminent collapse of the former USSR towards the latter part of the 1980s and the withdrawal of Vietnamese troops from Cambodia in 1989, all three countries embarked on market-oriented reforms, with the implementation of *Doi Moi* in Vietnam in 1989, the *NEM* (New Economic Mechanism) in Lao PDR in 1990, and serious reforms and resumption of relations with international financial institutions in Cambodia in 1993.

Table I.1: Basic Economic and Social Indicators for the new ASEANs

(The indicators are as of 2004 unless indicated otherwise)

Country	Total Area ('000 sq km)	Population (million)	Population growth rate av 1997- 2001 (%)	Per capita GDP	Life expectancy at birth (years)	Infant mortality (per 1000 lives births)	Adult illiteracy rate (%)
Vietnam	332	82.2	1.04	550	70.29	17	7.32
Lao PDR	237	5.8	2.29	423	57.27	69	31.27
Cambodia	181	13.8	1.95	353	56.61	97	26.39
ASEAN(5)	3,048	392	1.44*	1860**	72.28*	17.32*	8.63*

Source: The World Bank 2006d. *World Development Indicators 2006 Database*, [Online], Available at: <URL: <http://devdata.worldbank.org/data-query>>, Accessed date: May 10 2006.

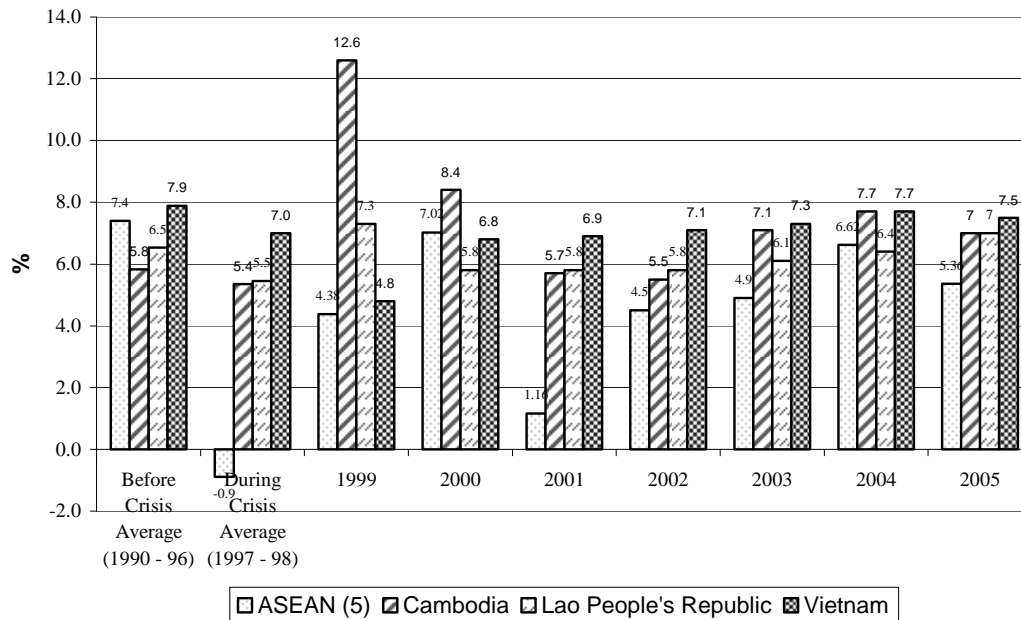
Notes: * Simple average

** Weighted average (with the weight as the country's population).

Table I.1 shows the relevant social and economic indicators of the three Mekong countries compared with ASEAN(5) as at 2004. Vietnam is clearly the best performer of the three economies. This is due in part to the more extensive reforms in Vietnam in the 1990s, and in part to Vietnam's relatively better endowed human resources at the start of the reform period. Reforms of land and agricultural markets in Vietnam resulted in rapid growth in rice productivity from 1988 to 1995 (Kompas 2002), but similar reforms did not occur in Lao PDR and Cambodia. As a result, rural incomes remained static in those two countries. At the same time, skilled human resources were substantially destroyed (or fled) in Lao PDR and Cambodia (ADB 2001).

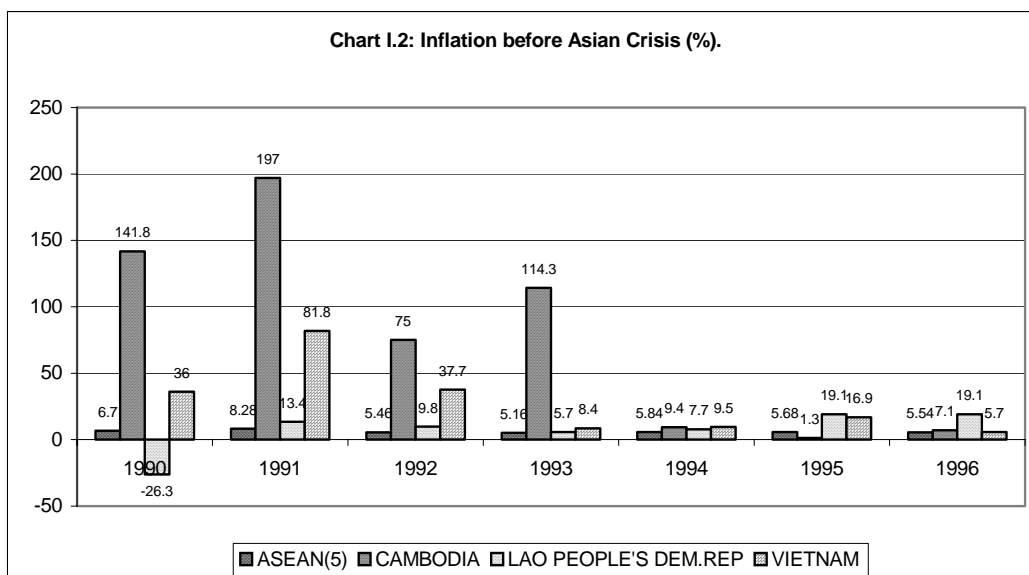
Nevertheless, the initial successes of market reforms are evident in all three countries. While starting from a low GDP base, Vietnam's average annual GDP growth, prior to the Asian financial crisis, exceeded that of the ASEAN(5) while those of Cambodia and Lao PDR were approaching the ASEAN(5) (see Chart I.1).

Chart I.1: GDP growth before, during and after Asian Crisis



Source: IMF, 2006a. The World Economic Outlook Database April 2006, [Online], Available at <URL: <http://www.imf.org/external/pubs/ft/weo/2006/01/data/index.htm>>, Accessed date: May 10 2006.

Inflation rates before the crisis, while generally higher than ASEAN(5), were being brought down rapidly (see Chart I.2).



Source: IMF, 2006a. The World Economic Outlook Database April 2006, [Online], Available at <URL: <http://www.imf.org/external/pubs/ft/weo/2006/01/data/index.htm>>, Accessed date: May 10 2006.

The policy responses of the three economies to the Asian financial crisis, as well as their experiences immediately post-crisis, reflect the incomplete nature of their transition. In Vietnam, an over-valued exchange rate as well as domestic policies resulting in foreign direct investment (FDI) flowing into the unprofitable state owned enterprise sector were already leading to declines in export growth and FDI inflows in the six months prior to the eruption of the Asian crisis (Riedel 1999). In order to protect the already precarious balance of payments situation, draconian controls were imposed on imports and capital flows at the onset of the crisis (Leung and Le Dang Doanh 1998)¹. These administrative controls continued through 1999/2000 and impacted negatively on Vietnam's exports and GDP growth as the region emerged from the crisis. Chart I.1 shows that Vietnam's GDP growth in the immediate post-crisis years was below the pre-crisis average, although growth rates at pre-crisis levels were being resumed since 2003².

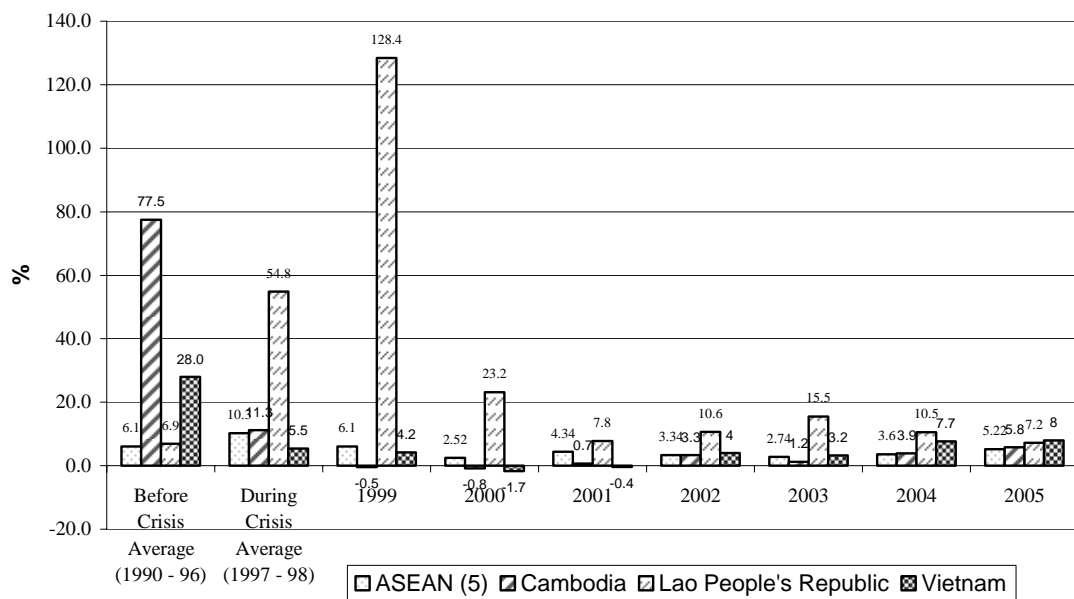
In Lao PDR, the five-fold depreciation of the *kip*, in response to the *baht* depreciation, contributed to inflationary pressures. In addition to this, however, there was a large budget deficit in 1998 well in excess of foreign funding resources, and had to be monetized, adding further to inflationary pressures. The large budget deficit resulted from an administrative edict to maintain food security in Lao PDR by an extensive program of

¹ The number of items under import quotas doubled in 1999.

² Of greater importance, internal reforms in the past few years in Vietnam could mean that the "quality" and hence the sustainability of that growth is being enhanced (see section IV below).

investment in irrigation (about 5% of GDP in 1998 alone). At the same time, the central administration failed to value export taxes using the depreciated value of the *kip*, hence resulting in a substantial fall in tax revenue¹. The administrative edict, the failure to use market values, and the monetization of the resultant budget deficit are all features of a transitional economy which, when under stress, reverted to pre-reform modes of behaviour (Warr 2000). Chart I.3 shows that inflation in Lao PDR averaged over 50% pa in 1997 and 1998, and reached 128% in 1999.

Chart I.3: Inflation before, during and after Asian Crisis



Source: IMF, 2006a. The World Economic Outlook Database April 2006, [Online], Available at <URL: <http://www.imf.org/external/pubs/ft/weo/2006/01/data/index.htm>>, Accessed date: May 10 2006.

Cambodia experienced political as well as economic instability in 1997 as fighting broke out between the two coalition parties. The vulnerability of a narrow development base was made clear when tourism and construction were brought to a standstill by the political crisis, with garment exports to the EU and US providing the only buffer to an otherwise bleak outlook in industrial and employment growth. The Enhanced Structural Adjustment Facilities program with the IMF collapsed, and economic reforms were disrupted. Between

¹ Export taxes were valued at administered prices rather than at international prices denominated in \$US. If the latter prices were used, the devalued kip would have meant significant increases in export prices and hence in the tax base.

1996 and 1998, household incomes declined and unemployment rates doubled (Sok Hach 2000).

Since 2000, Lao PDR has regained macroeconomic stability, while Vietnam has begun to deepen its reforms and further develop its institutions. The political environment in Cambodia, despite a stalemate after the July election in 2003, had finally been resolved one year later.¹

However, the countries' responses to the Asian financial crisis, as well as their experience post crisis, highlight the fragile nature of their transition process. Even in Vietnam, the most successful and advanced economy in the Mekong region, many of the institutional reforms had, until very recently, been more apparent than real. For example, the inadequate courts and judiciary system has meant that, although the Bankruptcy Law was enacted in 1993, up until 2000, only 22 cases of bankruptcy had actually been brought to the courts in Ho Chi Minh city, the commercial hub of the country. Of these 22 cases, only three were eventually declared bankrupt, the other cases having been either dismissed or still pending. By comparison, in the first nine months of 2001, more than 300 companies disappeared without formal liquidation (Youth 2/11/2001).

In both Vietnam and Lao PDR, although the "two-tiered" banking system has the appearance of a modern financial sector, the dominant state ownership and the lack of skills on the part of the state-owned "commercial" banks have meant that credit has been going to the SOEs, and the domestic private sector (including the rural sector) has been stymied by lack of finance. In Cambodia where the SOE sector is relatively small, insufficient legal protection of lenders, together with poor dispute resolution mechanisms, has meant that an estimated 54% of savings in Cambodian banks were lent to investors outside the country, in spite of relatively high domestic interest rates (CDRI 2002).

Indeed, as pointed out by Perkins (2000), the transitional economies of Asia such as China achieved initial gains through utilizing (and re-activating) pre-existing institutions, such as those related to foreign trade and foreign investment through their nationals living abroad. But continuing transition requires building new market institutions and deepening of reforms.

¹ Although the Cambodian Peoples' Party won a landslide victory in the July election in 2003, the other two political parties refused to recognize the election results. Protracted negotiations finally resulted in the formation of a coalition government in July 2004.

This paper holds as a premise that *effective* integration of the three Mekong economies with the “old ASEANs” involves the former developing market institutions that can sustain “quality” growth which will take them out of the transitional economy status. The paper therefore documents the progress towards external integration on the part of the three economies, analyzes the consequences posed by the lag in internal liberalization, and explores ways in which continuing integration into the world economy can help the transitional economies of the Mekong deepen their reforms and institutions. International trade agreements (such as the Vietnam-US bilateral trade agreement, regional agreements such as AFTA, arrangements such as APEC, and of course, the WTO) bind domestic governments to undertake deeper legal, industrial and financial sector reforms. International integration in the form of foreign direct investment can, if properly managed, boost the domestic private sector while allowing time for the reform of SOEs. International capital flows in the form of development assistance can help build both physical and social/economic infrastructure, as well as help ease the pain of transition.

Section two therefore documents the countries’ progress so far towards trade, investment and financial integration, emphasizing the openness of these economies to trade and investment flows, particularly within the Asian region, whilst trying administratively to close their borders to short-term capital flows. Section three points out that, despite rapid external integration, internal liberalization is lagging behind, resulting in protectionist trade regimes, underdeveloped domestic private sectors, and declining FDI flows into the region relative to the rest of the developing world. Whether continued international and regional integration can further the transition and internal liberalization process of the economies, as well as the risks involved, is addressed in section four.

II. How far has integration progressed?

Trade and Investment Links

At an aggregate level, international trade and investment links from Vietnam, Lao PDR and Cambodia have grown very rapidly, making them some of the most “open” economies in the world.

Trade growth and openness

**Table V.1: Vietnam - Export and Import Growth Rates, and Shares in GDP
(percentages)**

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Export growth rate	34.4	33.2	26.6	1.9	23.3	24.0	4.5	11	20.6	31.5	21.6
Import growth rate	40.0	36.6	4.0	-0.8	1.1	30.8	2.3	22.1	28.3	26.5	15.4
Exports/GDP (fob)	26.3	29.4	34.3	34.5	40.2	45.6	46.2	48.0	50.7	59.2	61.3
Imports/GDP (cif)	39.3	45.2	43.3	42.4	40.5	48.5	49.5	56.6	63.6	71.3	70.2
Trade balance/GDP	-13.1	-15.8	-9.0	-7.9	-0.3	-2.8	2.9	-8.7	-12.9	-12.2	-8.8

Source: - 1995 –2001: GSO and CIEM data base.

- 2002 - 05: The World Bank, 2006c. *Vietnam: key economic indicators*, [Online], Available at <URL: http://siteresources.worldbank.org/INTEAPHALFYEARLYUPDATE/Resources/550192-1143237132157/Key_Indicators_Tables_Vietnam.pdf>, Accessed date: 10/5/2006.

In Vietnam, the impact of the initial liberalization and reforms of *Doi Moi* resulted in average export growth of about 12.5 % pa in the decade prior to the Asian crisis, and around 17% pa since then (see Table V.1 above for export growth rates). Rapid growth in rice production (at 6.1% pa between 1988 and 1994) was responsible for the healthy export performance in the first half of the 1990s, when Vietnam turned from a net rice importer to the world's second largest rice exporter. As mentioned in section 1 above, the downturn in export growth in 1998 is probably attributable to an over-valued exchange rate¹ and to the government's policy response of restricting imports (which dropped sharply in 1997, 1998 and 1999) as much as to the crisis in the region. The slowdown in 2001 and the downturn in 2002 are attributed mainly to falling prices of Vietnam's commodity exports (rice, coffee and petroleum) as well as the general slowdown in the world economy. Export growth picked up in 2003. Furthermore, as Table V.1 shows, the ratios of exports and imports to GDP approach 60% to 70%, indicating that Vietnam's economy is indeed "open" to international trade by regional and world standards.

Not surprisingly, the trade regime in Lao PDR is much more restrictive than that of Vietnam's. Import and export licensing systems are still in place, and SOEs continue to

¹ It has been shown that the administered interest rate paid on dong deposits in Vietnamese banks were not sufficient to compensate for the expected depreciation of the dong after the Asian financial crisis. Hence, an uncovered interest differential opened up in favour of US dollar deposits in Vietnam (Leung and Kompas 2003).

dominate the export of timber and furniture. The restrictive regime, together with a narrow export base, accounts for the single-digit export growth rates for most of the years since 1995 (see Table L.1 below for export growth rates). The burst of export growth in the last three years is largely attributable to the high world prices of gold and copper.

Table L.1: Lao PDR - Export and Import Growth Rate (percentages)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Export growth rate	4	3	-1	6	3	3	5.8	2.2	21.6	11.1	31.8
Import growth rate	4	17	-6	-15	0	3	-9.4	-2.6	9.6	40.8	14.2
Exports/GDP							20.6	20.3	20.7	19.4	23.0
Imports/GDP							37.0	34.8	31.9	37.9	38.9
Trade balance/GDP	-13	-16	-13	-8	-7	-5	-16.4	-14.5	-11.2	-18.5	-15.9

Source: - Data from 1995-2000: IMF country report from various issues.

- Data from 2001 – 05: The World Bank 2006b, *Lao: key economic indicators*, [Online], Available at <URL: http://siteresources.worldbank.org/INTEAPHALFYEARLYUPDATE/Resources/550192-1143237132157/Key_Indicators_Tables_Lao.pdf>, Accessed date: 10/5/2006.

Official statistics indicate that export and import as percentages of GDP average about 30%. However, estimates by the Bank of Thailand indicate that unofficial cross border trade with Thailand is about 50% of officially recorded trade (Bank of Thailand 2003). This would put the trade/GDP figure well into the 40% to 50% range, indicating that the economy is quite well-integrated with world trade.

Unlike Vietnam and Lao PDR, Cambodia had relatively early access to the US market (in 1996) which, together with access to the EU on the GSP basis, provided ready markets for Cambodia's garments export. Trade grew at a rapid pace prior to the Asian financial crisis, and export and import as proportion of GDP is well over 50% (see Table C.1 below for export growth rates). Largely as a result of temporary safeguards imposed by the US and EU against garments export from the PRC, garments export from Cambodia continued to grow strongly in volume terms (23%) even after quotas were abolished in 2005. However, in value terms, the growth was only 12% because of price falls in the increasingly competitive environment. In the longer term, Cambodia's heavy dependence on garments

export and its relative lack of competitive advantage in this respect pose serious challenges in a quota-free world as a result of the WTO Agreement on Clothing and Textiles.¹

Table C.1: Cambodia's Export and Import (1993-2005)
(Percentages).

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Export growth rate	90.9	37.8	-20.1	61.9	8.8	26.7	38.7	11.4	15.9	15.5	22.1	9.4
Import growth rate	33.6	47.8	-1.6	16.1	9.3	28.3	31.3	8.1	12.2	10.4	24.7	17.1
Exports/GDP	22.6	26.2	19.2	28.3	26.3	29.5	38.9	41.1	44.2	46.4	50.9	50.4
Imports/GDP	34.2	42.6	38.5	40.7	38.0	43.1	53.8	55.2	57.5	58.6	65.7	69.6
Trade balance/GDP	-11.7	-16.4	-19.3	-12.4	-11.7	-13.6	-14.9	-14.1	-13.3	-12.2	-14.8	-19.2

Source: - Data from 1993 to 2002 is from the National Institute of Statistics (2003), *Statistical Year Book 2003*, Ministry of Planning, Phnom Penh, Cambodia.

- Data from 2003 - 05 is calculated from The World Bank, 2006a, *Cambodia: Key Indicators*, [Online], Available at <URL: http://siteresources.worldbank.org/INTEAPHALFYEARLYUPDATE/Resources/550192-1143237132157/Key_Indicators_Tables_Cambodia.pdf>, Accessed date: 10/5/2006.

Narrow export base leading to large fluctuations in revenue

In spite of rapid growth, however, the export base (with the exception of Vietnam) is quite narrow. Even in Vietnam commodity exports, although falling in recent years, still represent over 60% of Vietnam's exports, with manufacturing rising to about 37%. There is, however, a reasonably wide range of export products in both commodities and manufactures. Vietnam's imports are mainly machinery and fuel, reflecting the dominance of imported inputs.

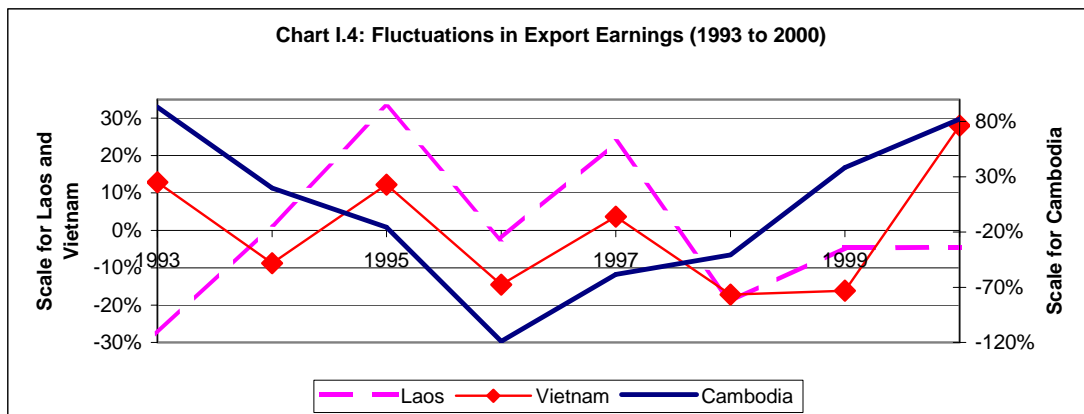
Unlike Vietnam and Cambodia, Laotian manufactures did not have access to the US market. It did, however, begin receiving GSP from the EU starting 1997². This has been

¹ As at 2002, garments constituted about 75% of Cambodia's total exports, 30% of Lao exports, and only about 16% of Vietnam's total exports. Furthermore, whilst almost all of Cambodian and Laotian garment exports were to quota countries of US and EU, only 1/3 of Vietnam's garment exports were under quotas to the EU. Therefore, the removal of quotas was expected to impact most negatively on Cambodia, neutral on Lao PDR, and even some positive impact on Vietnam (IMF 2004).

² In addition to GSP, the EC-Lao PDR Trade in Textiles Agreement became effective in Dec 1998. This enabled unlimited (quota free) access of Lao PDR exports to the EC for the period 1999-2001. This has now been extended to all goods other than arms trade.

chiefly responsible for the growth in garment exports comprising about 31% of merchandise export. Electricity to Thailand is about 27% of merchandise export and timber and furniture (23%) being exported chiefly to Japan and the US. These three items, in addition to tourism, constitute the rather narrow export base.

Despite rapid export growth prior to the Asian crisis, Cambodia's export base is extremely narrow, comprising essentially of garments and tourism -- GSP exports and service export represent over 85% of total exports. Excessive logging has led to serious de-forestation, resulting in a ban on log exports. At the same time, inadequate land reform and distribution of property rights in land have severely retarded agricultural development, including rice and forestry. Cambodia has the second lowest productivity in rice growing in Asia, and very little rice exports¹.



Source: - UN COMTRADE, IEDB, ANU, Canberra, Australia.
 - Annual data normalized to 1993.
 - Fluctuations measured as deviation from time trend.

The openness of the three economies, together with narrow export bases, results in relatively large fluctuations in export incomes (see Chart I.4 below). In Vietnam, for example, the large fall in coffee prices in 2000/02 accentuated the hardship of small coffee growers and resulted in temporary stockpiling of coffee (De Fontenay and Leung 2001). Even though the ineffective and wasteful stockpiling policy has been abandoned, more sustainable methods of managing commodity price fluctuations (such as the use of futures trading) is not yet possible due to the lack of human resources as well as developments in the financial sector.

¹ The government is currently trying to remedy this situation through investments in irrigation.

Trade with East and Southeast Asia

In all three countries, the share of trade with East and Southeast Asian countries has been high, ranging between 60% to 80% (see charts V.1, L.1, and C.1 below). However, exports to the US from Vietnam continue to rise strongly (by some 90% against an average 25% growth in total exports since 2003). The US will increase in dominance as Vietnam's trading partner as the Vietnam-US bilateral trade agreement continues to take effect.

Chart V.1: The share of ASEAN and East Asia in Vietnam's exports and imports (%)



Notes: * Here East Asia includes: Japan, Hong Kong SAR, South Korea, China and Taiwan.

** Data for 2003 – 04: Share of Asia in Vietnam's import and export

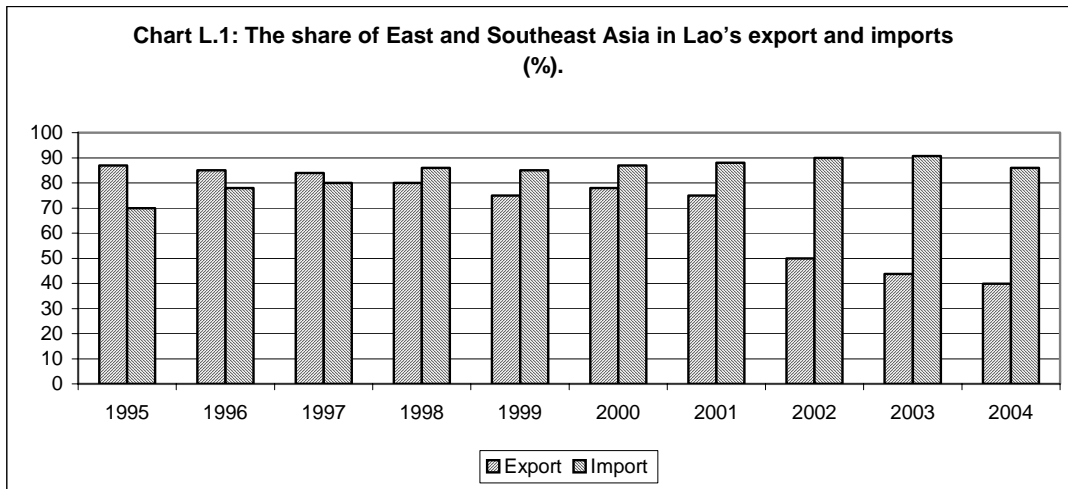
Source: - 1995-96: International Monetary Fund, 2002. "Vietnam: Selected Issues and Statistical Appendix", Country Report No: 02/5, Washington D.C., USA.

- 1997-02: International Monetary Fund, 2003. "Vietnam: Statistical Appendix", Country Report No: 03/382, Washington D.C., USA.

- 2003 – 04: Asian Development Bank, 2005, *Key Indicators 2005: Labor Markets in Asia: Promoting Full, Productive, and Decent Employment*, Available at: <URL: http://www.adb.org/Documents/Books/Key_Indicators/2005/default.asp>, Accessed date: 10/5/2006.

Finally, much more so than Vietnam and Lao PDR, official statistics indicate that Cambodia's exports to the Asian region have dropped significantly over 1990s (from almost 90% in 1995 to less than 10% of total exports in 2004 (see Chart C.1). This reflects the result of a ban on log exports in recent years as well as increased textiles and garments quotas to the US and the EU. Informal cross-border trade between Cambodia and Thailand is reported to be thriving—particularly for the export of low value agricultural produce into

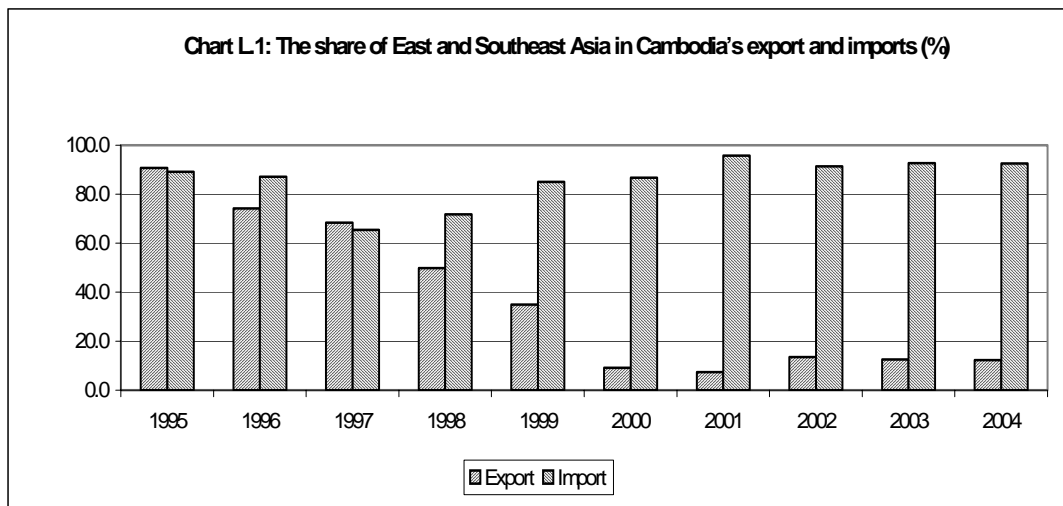
Thailand and the smuggling of beverage and portable tanks of nitrogen gas into Cambodia¹. However, no quantitative estimates exist as to the value of this trade.



Note: Data for 2002 – 04: Share of Asia in Lao's import and export

Source: - 1995 – 2001: Customs and Excise Department, Ministry of Economy and Finance

- 2002 – 04: Asian Development Bank, 2005, *Key Indicators 2005: Labor Markets in Asia: Promoting Full, Productive, and Decent Employment*, Available at: <URL: http://www.adb.org/Documents/Books/Key_Indicators/2005/default.asp>, Accessed date: 10/5/2006.



Note: Data for 2002 – 04: Share of Asia in Cambodia's import and export

Source: - 1995 – 2001: Customs and Excise Department, Ministry of Economy and Finance

- 2002 – 04: Asian Development Bank, 2005, *Key Indicators 2005: Labor Markets in Asia: Promoting Full, Productive, and Decent Employment*, Available at: <URL: http://www.adb.org/Documents/Books/Key_Indicators/2005/default.asp>, Accessed date: 10/5/2006.

¹ Private communication with official of Ministry of Commerce, Cambodia, 2001.

Openness to FDI – particularly from east and Southeast Asia

As well as being relatively open economies in terms of international trade, the Mekong economies are arguably some of the most open economies in terms of foreign direct investment (FDI). As at 2003, FDI as a percentage of GDP in Vietnam was about 4% (similar to the PRC), whilst that of Cambodia was 2% (similar to Malaysia) and Lao PDR was 1% (similar to Thailand) (UNCTAD 2005).

Asian investors rank amongst the highest foreign investors in all three countries. As at the end of 2005, the top five foreign investors in Vietnam (in terms of percentage of total capital invested) are Taiwan (15.2%), Singapore (14.9%), Japan (12.3%), South Korea (10.4%) and Hong Kong (7.3%) (Ministry of Planning and GSO, Vietnam, 2006). Thai investors are dominant (50% of total capital pledged) in Lao PDR while Malaysian investors are dominant (almost 50% of total capital pledged) in Cambodia. The reliance on Asia for FDI inflows has been one amongst other factors, for the slow pickup in FDI into the Mekong region post-Asian financial crisis. The distortions in the trade and investment regime accounting for the poor “quality” of FDI and the slowdown, until very recently, in FDI flows are discussed in Section three below.

Financial Links

Apart from FDI inflows into the three Mekong countries, aid flows in the past decade have also been significant, and represent some of the highest ratios of aid to GDP in the developing world (see Table I.2).

Table I.2: Aid Flows

	2002		2003		2004		Net ODA/GNI %
	Net ODA	Multilateral share in Net ODA	Net ODA	Multilateral share in Net ODA	Net ODA	Multilateral share in Net ODA	
	(Mil. USD)	%	(Mil. USD)	%	(Mil. USD)	%	
Cambodia	510.44	35	476.15	45	590.72	36	14
Lao PDR	333.95	48	246.06	47	281.28	30	12
Vietnam	1899.44	44	2193.88	37	2467.94	30	5
Total for developing countries	67552.12	24	90629.97	22	98320.7	23	1

Source: OECD, 2006. "DAC online - Annual aggregated statistics on aid and other resource flows", [Online], Available at: <URL: <http://www.oecd.org/dataoecd/50/16/5037775.htm>>, Accessed date: 13/5/2006.

Of greater importance than the dollar amounts is the increasing emphasis given by some bilateral and multilateral donors to technical assistance and human resource development. Towards the latter part of the 1990s, Japan's aid to Vietnam, Lao PDR and Cambodia has been shifting from infrastructure building to technical assistance (Vo Tri Thanh 2003). One initiative by the ADB, using Japanese funding, was a package to enhance capacity building and human resource development to complement the Public Administration Reforms being carried out in the three countries. The significance of this change in emphasis in terms of institutional capacity-building will be discussed in Section four below.

In contrast to the relative openness of the three countries in trade and investment, particularly to the Asian region, their external financial sectors remain administratively closed to short term portfolio flows. However, in the case of Vietnam, there is evidence that short term capital flows have, throughout the 1990s, been interfering with the State Bank's ability to conduct an independent monetary policy in the context of a pegged exchange rate regime (CIEM 2003)¹. Given the regulated domestic banking sector at the time, and the existence of exchange controls, this result indicates that administrative controls were more porous than previously thought, and that short-term financial linkages existed to some extent. In addition, the balance of payments statistics indicate fairly large short- term capital outflows from Vietnam since 1997. This was accompanied by increases in private transfers into the country starting about 1996. The transfers were a response to the government's policy to encourage US dollar deposits in Vietnamese banks on the part of overseas Vietnamese. Finding that the US dollar deposit rates in overseas banks were higher than the administered US dollar deposit rates in Vietnam, Vietnamese banks siphoned their "excess" US dollar deposits abroad to earn the interest differential which, in 2000, was as high as 2% (Leung and Kompas 2003). This indicates that Vietnamese financial institutions were quite ready to engage in short-term arbitrage activities whenever they were permitted to do so.

Although data are not readily available for Lao PDR and Cambodia, the openness of these economies to cross-border trade and the high incidence of US dollars circulating in these

¹ The degree to which capital flows offset the effectiveness of monetary policy was estimated at -0.55 to -0.79 (CIEM 2003).

economies¹ would indicate that capital controls are porous and that short-term financial flows could be quite high.

III. Is transition lagging behind integration and what are the consequences?

Distorted trade regimes

Despite rapid growth in trade, investment, and aid flows during the last decade, the countries' actual pace of trade liberalization and the structure of their trade regimes are considerably less impressive.

In Vietnam where protection of the SOEs has been a main consideration of trade policy, nominal tariff rates actually rose from a mean of 12.3% in 1996 to 15.7% in 2001, in order to compensate for a reduction in import quotas (Parker and Riedel 2002). In spite of numerous changes to the structure of tariffs, "Vietnam's tariff structure is still out of line with the general patterns of the ASEAN countries and China" (Athukorala 2006)²

Furthermore, the "cascading" nature of the tariff structure means that the effective rate of protection is much higher than the nominal rate.³ Chart I.4 shows the high effective rates of protection of Vietnam and Cambodia compared with some other ASEAN countries and South Korea⁴. The incentive is then for firms to sell in the domestic market rather than to export, thereby limiting the opportunities for export growth and diversification.⁵ Continued growth in labour-intensive manufacturing exports is needed in Vietnam for creating the estimated 1.4 million new jobs each year in order to accommodate the population growth as well as the displaced labour from the countryside. As discussed in Section two above, the relative lack of export diversification results in large fluctuations in revenues, and increases the importance of developing skilled human resources and financial instruments to manage the fluctuations in a sustainable manner.

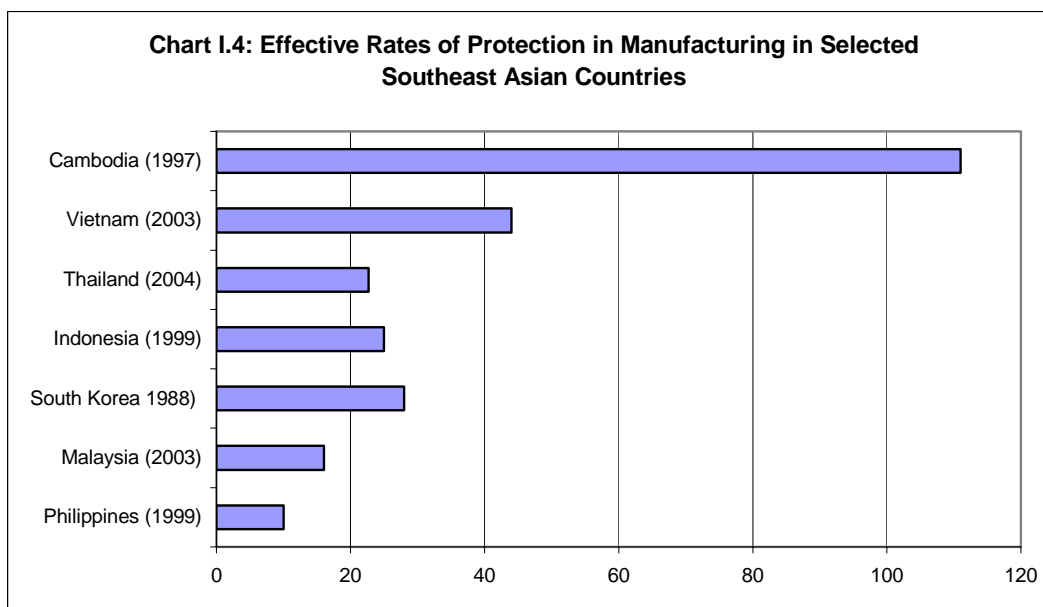
¹ The foreign currency deposit to M2 ratio in Cambodia in 2000 was well over 65% whilst that for Lao PDR was as high as 75% (IMF 2002).

² The average (unweighted) nominal tariff rate and the dispersion of nominal rates are higher in Vietnam than in a number of ASEAN countries and China.

³ "Cascading" nature means that tariffs on final goods are higher than tariffs on intermediate inputs. The much higher effective rate of protection means that producers have a greater incentive to sell in the domestic market than to export because of the higher prices prevailing in the domestic market.

⁴ Effective rates of protection in Vietnam has fallen from 121% in 1997 to 95% in 2002 to 44% in 2003 (Athukorala 2006).

⁵ Even after taking into account pro-export measures such as duty clawbacks and export subsidies, the anti-export bias in Vietnam's tariff structure is still significant (Athukorala 2006).



Source: For Cambodia, see Ministry of Commerce 2001 (data for 1997). For other countries, see Athukorala, Prema-chandra (2006).

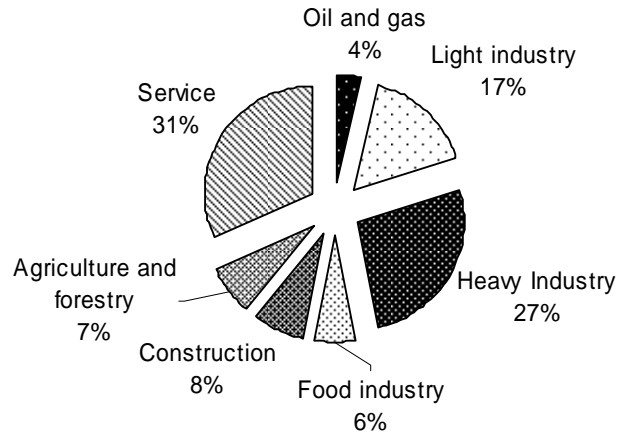
In addition to protection of SOEs, import tariffs are an important source of government revenue in all three countries – about 12% in Vietnam (down from 23% in 2002), 13% in Lao PDR (down from 24%), and about 25% in Cambodia (down from almost 50%)¹. The reduced reliance on trade taxes in recent years is encouraging. However, revenues from VAT and corporate and personal income taxes need to continue increasing in the future in order to allow room for further tariff reductions.

Distorted FDI flows

Because of the historical protection of the state sector in Vietnam’s trade regime, 98% of the foreign joint venture have been with the SOEs. As a result, 31% of FDI projects by value are in heavy industries and oil and gas (see Chart V.2). As expected, these are also highly-protected industries such as car and motorbike production, cement, steel and consumer-electronic assembly. Therefore, despite the fact that foreign-invested companies in 2001 contributed about 13% to Vietnam’s GDP, 35% to industrial output, 23% to export, and 25% to total state budget, the contribution of FDI to overall employment was only 0.3% (Le Dang Doanh 2002).

¹ Sources: IMF 2006 Vietnam Statistical Appendix; Economic Institute of Cambodia 2005; private communications with Ministry of Finance official, Lao PDR. Also, the introduction of VAT in Lao PDR has been postponed from 2003 to 2008 due to the need to install some form of centralized tax administration prior to the implementation of the VAT.

Chart V2: FDI by sector, Vietnam 1988 - 2005



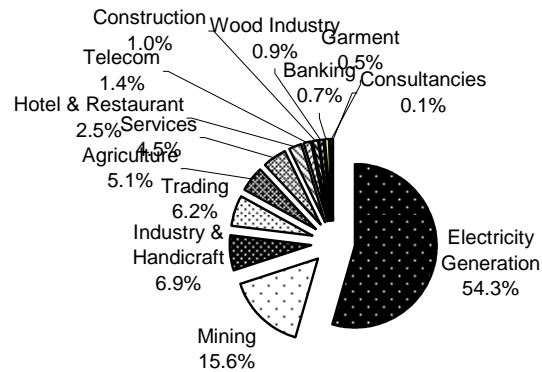
Source: Foreign Investment Department – Vietnam Ministry of Planning and Investment

Some improvements are, however, in train. With greater liberalization of FDI laws in recent years, the share of joint ventures in total FDI has fallen to 42.5% whilst the share of wholly foreign-owned enterprises now comprises 45.5% of committed foreign investment. The remaining 12% consists of build-operate-transfer schemes and business cooperation contracts in oil and gas exploration. The average size of the projects has become smaller, and the sectoral composition is also changing, with greater flows of FDI into services (including hotel and tourism, transportation, telecommunication, education, and finance). This is consistent with increased FDI inflows into Vietnam in 2003, 2004 and 2005.

The bulk (70%) of FDI inflows into Lao PDR is in hydropower industry and mining (see chart L.2).

Although the number of projects has remained constant, the average size of the project has dropped, even after achieving macroeconomic stability subsequent to the Asian crisis. The general “unfriendly” government policy towards domestic business development in the past, together with the need for import and export licenses, has proved to be problematic for foreign investors (Pholsena 2002). Unlike in Vietnam, there is not yet any discernible trend increase in FDI into Lao PDR in 2003, 2004 and 2005.

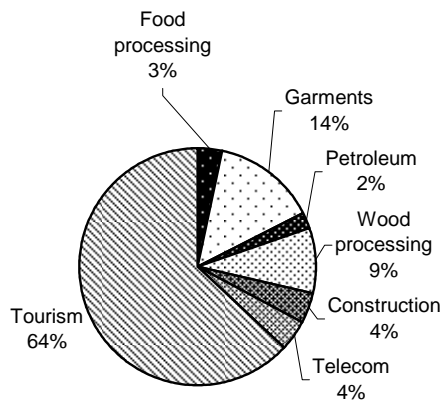
Chart L.2: FDI by sector, Lao, 2000 - 05



Source: US Department for Promotion and Management of Domestic and Foreign Investment (DDFI), 2006, *Investment climate statement: Lao*. Available at: <URL: <http://www.state.gov/e/eb/ifa/2006/62007.htm>>, Accessed date: 26/05/2006.

In contrast to Vietnam and Lao PDR, the lack of a substantial SOE sector in Cambodia means that over 80% of FDI is in services and tourism, and light industry (see Chart C.2). Between 1995-96, FDI into Cambodia concentrated on tourism and construction in an effort to exploit the historical sites around Angkor Wat. From 1996-98, the second wave of FDI concentrated on logging. The third wave of FDI occurred in the garment industry.

Chart C.2: FDI by sector, Cambodia, 1995 - 2004

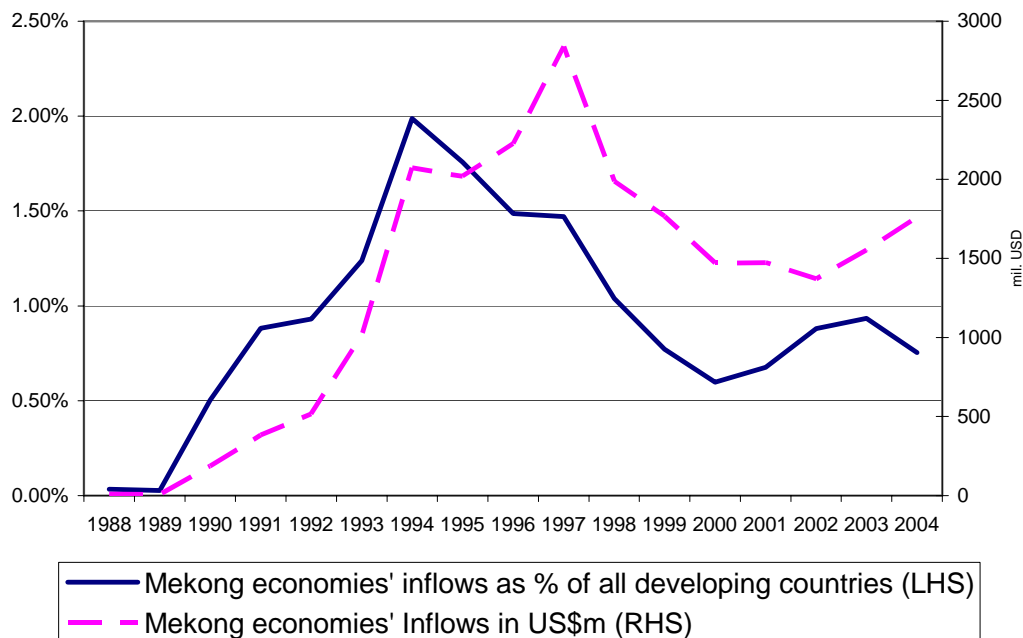


Source: US Department for Promotion and Management of Domestic and Foreign Investment (DDFI), 2005, *Investment climate statement: Cambodia*. Available at: <URL: <http://www.state.gov/e/eb/ifa/2005/41991.htm>>, Accessed date: 26/05/2006.

As a result, the employment-generating effect of FDI has been much higher than in Vietnam. For 2001 in the garment sector alone, the new projects were expected to create 12,457 jobs, accounting for 78% of all the expected jobs to be created in that year (Thoraxy 2002). However, the termination of garment quotas in 2005 created considerable uncertainties. In particular, a significant portion of FDI flows from China to Cambodia was to take advantage of the unfilled quotas after the Chinese firms had themselves filled up their own quotas, and this would still appear to be the case because of the temporary safeguard measures imposed on PRC garment exports by the EU and the US. This type of rent-seeking behaviour, however, is not sustainable as long-term investment strategies.

Therefore, in spite of improved performance of Vietnam in the last three years, FDI flows into the region is still well below the peak in 1997 (see Chart I.5). Furthermore, FDI inflows to the Mekong economies as a percentage of inflows to all developing countries peaked in 1994 (well before the Asian financial crisis), and have not returned to their former heights.

Chart I.5: FDI inflows to Mekong economies



Source: - UNCTAD, 2005. UNCTAD Handbook of Statistics, [Online], Available at: <URL: http://www.unctad.org/en/docs/tdstat30_enfr.pdf>, Accessed date: 2/05/2006 and UNCTAD, 2003. FDI Statistics, [Online], Available at: <URL: http://r0.unctad.org/en/subsites/dite/fdistats_files/fdistats.htm>, Accessed date: 13/10/2003.

- Data for Cambodia from 1988-1991 is not available

An important factor behind the concern over FDI flows lies in the recognition that modern production technologies and processes in manufacturing often involve making components of the final product in different countries, and then assembling the final product in yet a third country (the so-called “component production and assembly within vertically integrated production systems”). This means that investment and operation in one country have to be closely co-ordinated with the operations of companies in several different countries. An implication is that multinational companies are increasingly looking for mergers and acquisitions with domestic companies to engage in component production and final assembly rather than go into joint ventures in “green field” projects. Mergers and acquisitions are still limited in Vietnam as foreign investors are permitted to purchase only a maximum of 30% in a domestic enterprise, including an SOE, although the enterprise may be operating in an area where 100%-owned foreign companies are permitted to operate (Le Dang Doanh 2002)¹. In this regard, Lao PDR has moved further than Vietnam in having sold to foreign investors substantial equity in a number of SOEs².

Another implication of the component production and assembly process is that low cost labour, easy access to plentiful natural resources, and large and protected domestic markets – traditional advantages of the mekong transitional economies -- are no longer sufficient to attract foreign investors. Instead, cheap and reliable telecommunication and transport systems, access to local finance and skilled labour, protection of property rights (partly as security for accessing finance) as well as efficient court systems for resolving disputes have become important areas of comparative advantage for attracting foreign investment. These were some of the factors identified in the First Foreign Investment Forum held in Lao PDR in May 2002 (Pholsena 2002). Interestingly, addressing issues of property rights and generally building the commercial/legal infrastructure for doing business would go a long way towards enhancing the development of the domestic private sector as well as attracting foreign business investments. Similarly, reducing infrastructure costs such as electricity and telecommunications would also help domestic as well as foreign businesses.

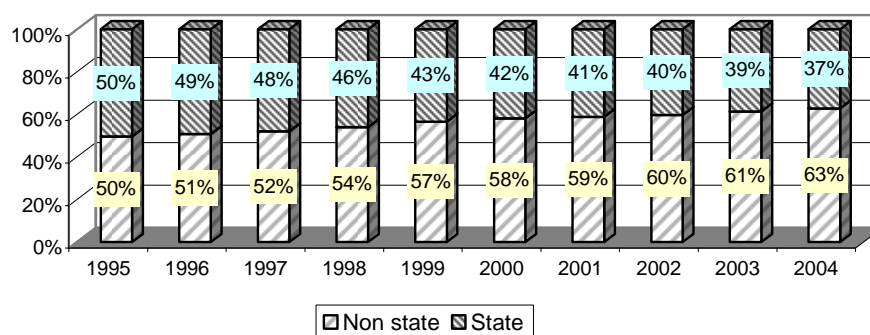
¹ The more liberal Unified Enterprise Law and the Common Investment Law are about to be implemented on July 1, 2006. However, the actual licensing requirements and criteria for foreign investment projects will have to be clarified through the implementation of those laws.

² For example, its telecommunications company and the Beer Lao brewery.

Underdeveloped domestic private sector

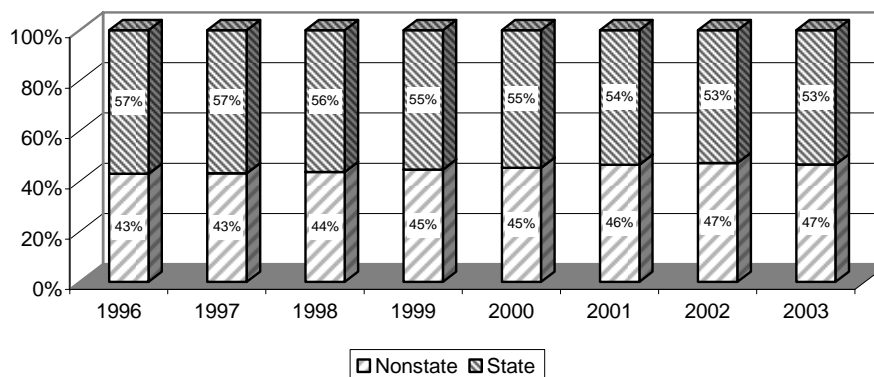
The “litmus test” of inadequate internal liberalization is an underdeveloped domestic private sector. After one and half decade of transition, SOEs still form just over half of the service sector and over a third of the industrial sector in Vietnam, although the latter is on a decreasing trend (see Chart V.3)¹.

Chart V.3a: Vietnam GDP in industry sector by ownership



Source: Vietnam General Statistics Organization (2006) Available at: <URL: <http://www.gso.gov.vn/default.aspx?tabid=391&idmid=3&ItemID=3628>>, Accessed date: 20/05/2006.

Chart V.3b: Vietnam - GDP in service sector by ownership



Source: IMF, 2006b. Vietnam: Statistical Appendix, February 2006, *IMF Country Report No. 06/52*. Available at: <URL: <http://www.imf.org/external/pubs/ft/scr/2006/cr0652.pdf> >, Accessed date: 20/05/2006.

¹ Production from foreign invested enterprises is counted in the non-state sector even though these enterprises are in joint ventures with SOEs. Agriculture, fishing and forestry are mainly in individual (non-state) ownership.

An important constraint on private sector growth is the lack of credit flowing to private businesses from the banking system. A fundamental issue here rests with the problem of providing collateral which, in Vietnam, usually takes the form of the Certificate of Land Use Rights (CLUR). In a survey of the private sector in 2002, it was found that only 16.8% of the urban population in Vietnam have been issued with Certificates of Land Use Rights. Furthermore, even for those issued with CLURs, their valuations are determined by provincial price committees rather than by the market. Hence, most CLURs are undervalued, and the firms surveyed claimed that some of them were able to borrow only about 10% of the market value of their real estate (International Finance Corporation 2002). Perhaps as a result of the difficulties surrounding collateralized lending, since 1999, banks have been permitted to move away from collaterals to “credibility-based” lending. However, in practice, collateralized lending is still the norm (International Finance Corporation 2002). In addition, the state-owned commercial banks are still under direction to give preference to the SOEs and to big projects (CIEM 2003). The non-bank financial institutions are underdeveloped and cannot, as yet, be a significant channel of credit for the domestic private sector (CIEM 2003).¹

In Lao PDR and Cambodia, grossly underdeveloped financial sectors result in low levels of credit going to their domestic private sectors. In 2001, only 9.6% of GDP in Lao PDR, and 7% of GDP in Cambodia went as domestic credit to their private sectors compared with 127.2% in China, 20.5% in Indonesia, 149.2% in Malaysia, and 40.1% in the Philippines (The World Bank 2003). As mentioned in Section one above, lack of legal protection for lenders and inadequate dispute resolution mechanisms in Cambodia have resulted in 54% of bank credit going to investors outside the country. Like in Vietnam, lack of clear property rights and hence assets to be used as securities for bank loans are important underlying reasons for poor credit supplies to the domestic private sector.

IV. Can integration further internal liberalization and transition?

For the first five years since *Doi Moi* (1989 to 1994), Vietnam’s entry into international trade and investment had been done on a unilateral basis. The government wanted to boost economic growth and development through opening its economy to world markets and foreign direct investment and aid flows. However, towards the end of the 1990s, and increasingly in the new millenium, Vietnam’s international integration is being carried out

¹ Private sector developments are, however, beginning to impact on the Vietnamese economy (CIEM 2003).

in the form of binding international agreements (Warner *et al* 2001). Vietnam has been a member of AFTA since 1995 and of APEC since 1998. A trade and investment agreement has been implemented with the European Union, and the bilateral trade agreement with the US was ratified in December 2001, and is being implemented. The path is also cleared for Vietnam to join the WTO in the very near future.

Similarly, Lao PDR and Cambodia both committed themselves to trade liberalization under AFTA. Cambodia joined the WTO in 2003 and Lao PDR is actively seeking to join.

These binding international agreements set a time frame within which the three countries have to open up sectors of their economies to international competition, thus propelling the momentum of reforms as well as posing risks for non-compliance.

How can economic integration in the form of binding international agreements, as well as FDI and international assistance, help to further the development of internal market-friendly institutions and provide a better environment for business?

Help domestic private sector by lowering the costs of doing business

As discussed in section three above, the vertically integrated systems of component production and assembly involving simultaneous investments in several countries means that not only are labour costs an important item in manufacturing costs, but services such as telecommunication, transport, electricity, insurance and banking have also become significant costs of manufacturing. As shown in Chart I.6(a) to (d), the charges for international phone calls, container transportation, and electricity in the major cities of Vietnam, Lao PDR and Cambodia were, as at 2002, amongst the highest in East and Southeast Asian cities, even though their labour costs were (and still are) relatively low. However, in the last three years, Vietnam and Lao PDR have significantly lowered their international telephone charges. Container transportation and electricity costs in Vietnam have also been reduced to levels roughly comparable with other Asian cities. This is consistent with increased FDI inflows into the country in the last three years, reversing the declining trend since the Asian financial crisis. The bilateral agreements already in place and the WTO agreements (when negotiated for Vietnam and Lao PDR) will set deadlines for the three countries to open their service sectors to entry by international firms. Competition is likely to continue driving down the prices being charged for those services (as is seen in the case of telephone charges in Vietnam and Lao PDR), thereby benefiting the domestic private sectors as well.

Chart I.a: Worker's salary/month

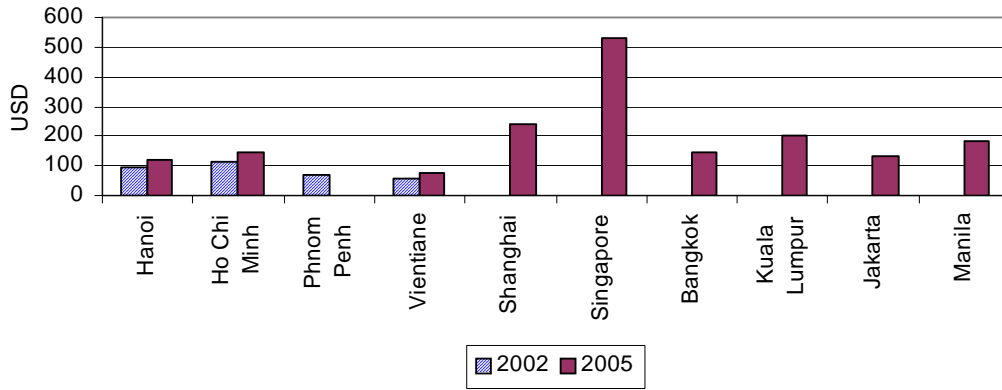


Chart I.6.b: International telephone cost (a 3 minute call to Japan)

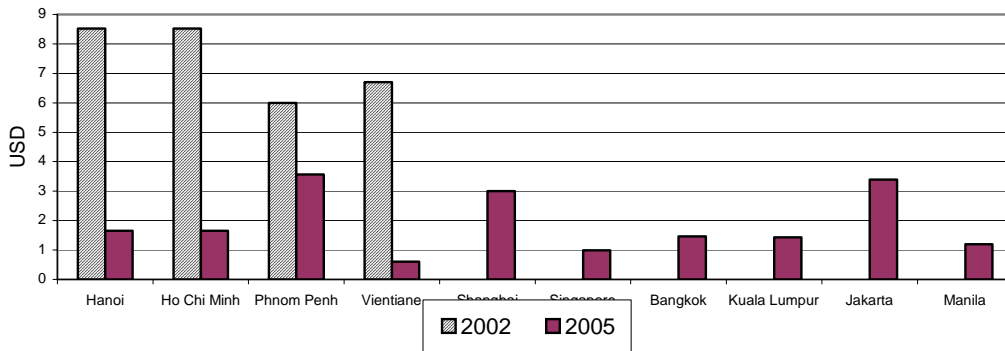


Chart I.6.c: Container transportation (40 foot container) from factory to Yokohama port

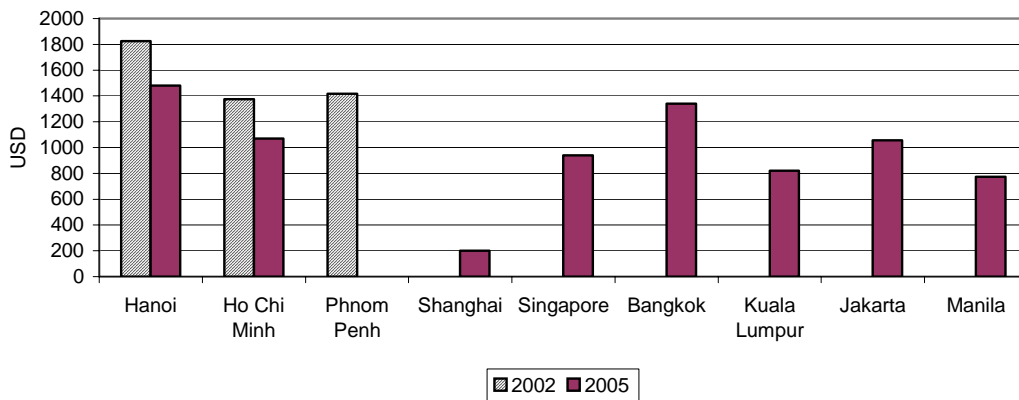


Chart I.6.d: Electricity cost for business/Kwh

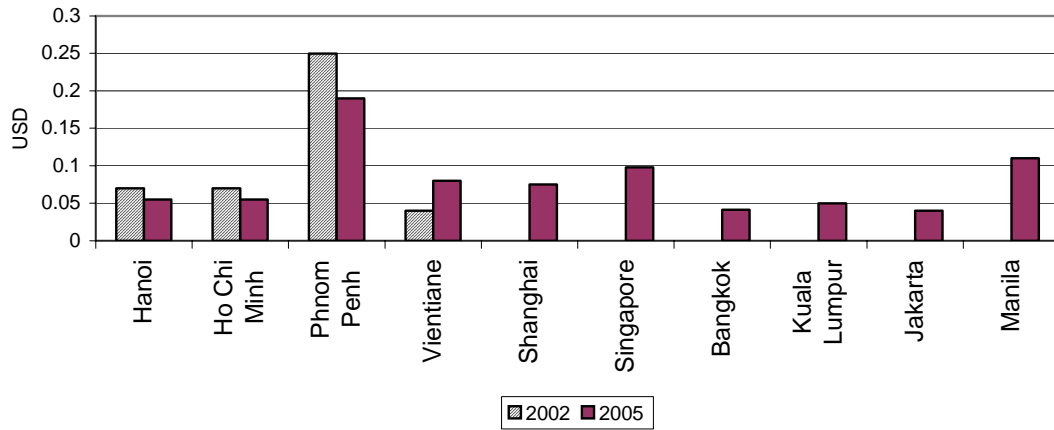


Chart I.6.e: Expenses for office lease/month/m2

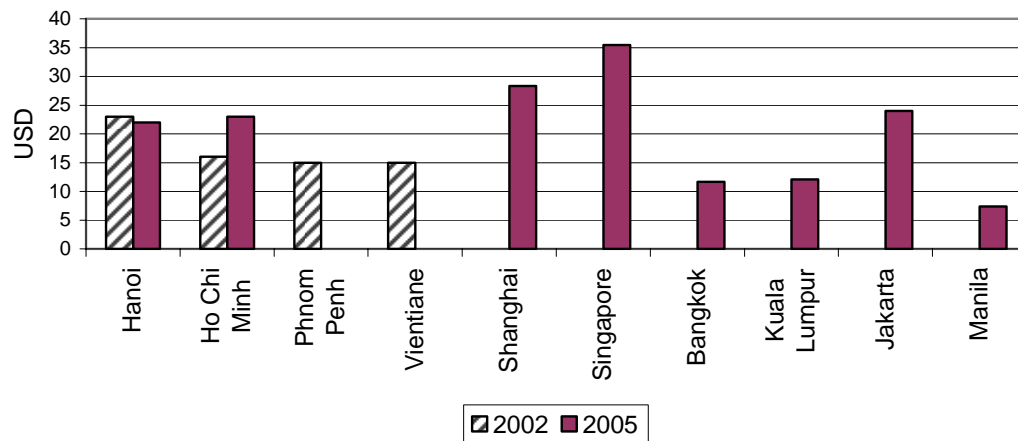
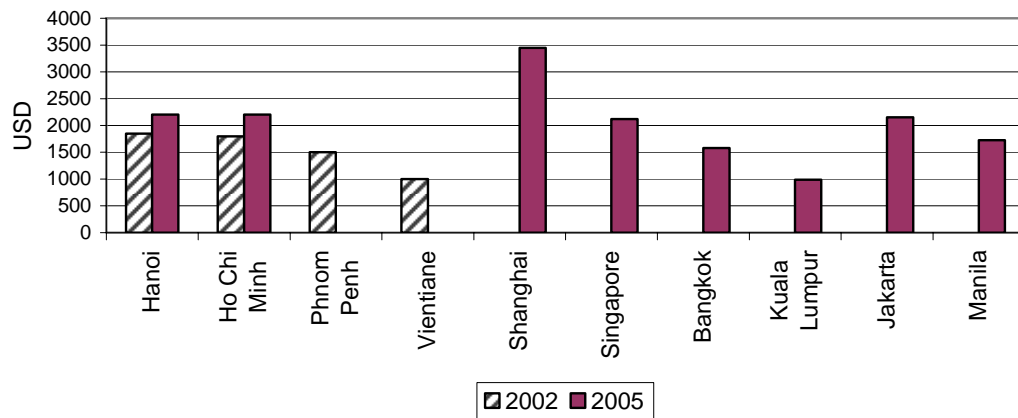


Chart I.6.f: Expenses for house rent for foreign representative



Source: See Appendix Table B.1.

Contrary to the reduction in service costs, rentals for businesses have increased in Vietnam (see Chart I.6.e and I.6.f). As mentioned above, more needs to be done on the issue of the availability and valuation of urban land use rights.

In Cambodia, the pressure on the garments sector to adapt to a quota-free world has recently resulted in a cut in export clearance time from 6.6 days to just 20 hours. As electricity costs are high in Phnom Penh, the re-location of export processing zones to take advantage of cheaper electricity elsewhere should help. There are also moves to strengthen supply chains through closer integration with other ASEAN countries (Asian Development Outlook 2006).

Focus on reducing the entire spectrum of business costs in Vietnam, Lao PDR and Cambodia, and not only on labour costs, will also have the added benefit of ensuring that these countries do not fall into the “low cost labour trap” and become marginalized at the lower end of the income/industrial structure of ASEAN (Vo Tri Thanh 2003).

Hasten the divestment of SOEs

As mentioned in Section three above, perhaps as a result of the changed production processes, foreign companies are moving away from joint ventures in “green field” investment projects as a foreign investment strategy in favour of mergers and acquisitions of existing domestic enterprises. Currently, Vietnam has an upper limit of 30% of an existing enterprise permissible for foreign acquisition, presumably to protect its SOEs¹. In sectors where 100% foreign ownership is allowed, this regulation is obviously not effective as a protective device against foreign competition. The issue is therefore whether the government will, in its effort to protect the SOEs, resist opening (particularly the services) sectors to foreign acquisitions, thereby risking non-compliance with the international agreements to which it has already committed or in the process of negotiating.

There are certainly political costs involved in selling off the large SOEs to foreign companies. On the other hand, given that SOEs in Vietnam currently provide less than 9% of total employment (McCarty, 1999), the static re-structuring costs in terms of jobs lost may not be very high. At the same time, there is the potential for new types of jobs to be created. The issue then rests with the re-training of workers. China appears to be preparing for its WTO commitments by rapidly selling off its SOEs at the provincial level (Garnaut and Song 2003). A roadmap could then be formed for eventually opening its protected

¹ Decision no. 36/2003/QD-TTg

sectors to foreign investment and competition. Once this happens, the pressure on divesting SOEs in Vietnam would be very strong indeed.

As mentioned earlier, Lao PDR has gone further than Vietnam so far in selling equities in its SOEs to foreign interests.

Improve the countries' legal and regulatory institutions

Like China, the three Mekong countries' integration with the world economy has meant that more of their goods and services are traded in international markets and more of their capital formation has been funded by foreigners. However, the countries' laws and regulatory practices (their "commercial/legal infrastructure") have lagged behind external integration. For example, there are no pro-competition or anti-trust laws, and the judiciary and dispute settlement systems are poorly developed (CIEM 2003). Much of this will have to change as the countries pursue their accession to the WTO as well as comply with other agreements such as the Vietnam-US bilateral trade agreement¹. During 2003, support for small medium-sized enterprises has been strengthened through the establishment of the Department for Small and Medium-sized Enterprises within the Ministry of Planning and Investment, as well as technical support centres in three regions. In theory, issues arising from uneven playing field between domestic and foreign investments are to be addressed in the Unified Enterprises Law and the Common Investment Law to be implemented in Vietnam in July 1, 2006. It remains to be seen whether licensing requirements and evaluation criteria for foreign investment projects will, in fact, remove many of the remaining obstacles, thereby further enhancing the allocation of resources within the economy.

It has already been pointed out that the lack of clear property rights over urban land in Vietnam has constrained the development both of its domestic financial and domestic business sectors, while poor dispute settlement mechanisms have hindered financial development in Cambodia. The streamlining of cumbersome laws and regulations, as well as improvements in the judiciary, will help domestic businesses and foreign investors, thereby improving the environment for the business sector generally.

¹ As pointed out by Bosworth and Duncan (2002), WTO accession can provide the impetus for domestic institutional changes. However, the actual commitment rests with individual governments to make those institutional changes so that the countries can derive maximum benefit from participation in the WTO and other trade agreements.

Provide technical and financial assistance through aid

Section two above already notes that aid flows per dollar of GDP to the three Mekong countries are high relative to other developing countries. Increasingly also, greater emphasis is being placed on human resource development and institutional capacity building. Even in large multilaterally-funded projects such as the World Bank's Rural Finance Project II, considerable effort is being placed on training the staff in Vietnamese banks in the business of banking and risk assessment. Given the strong need for legal and regulatory reforms, a particularly urgent requirement is for human resource developments to complement the countries' public administration reforms. A recent Asian Development Project, with the help of Japanese funding, is targeting exactly this area.

In addition to building the legal/commercial infrastructure for the development of the financial sector, removal of administrative controls over the domestic banking system is another necessary step in strengthening the domestic financial sector. In the last two years, Vietnam has abolished quantitative credit controls and administered interest rate ceilings on banks, and is rapidly moving from direct to indirect instruments of monetary policy. At the same time, it is maintaining a pegged exchange rate regime with the help of (albeit porous) exchange controls. Vietnam was shielded to a considerable extent from the macroeconomic instability of the Asian financial crisis through administrative controls over trade, capital flows and financial intermediation (Leung and Le Dang Doanh 1998). As these controls are being dismantled, the country faces increased risk of macroeconomic instability until its domestic financial sector is adequately strengthened and sound prudential controls in place. Similar challenges apply even more so to Lao PDR and Cambodia where financial sectors are even less developed. Policy dialogues and assistance with training are particularly useful during this period of vulnerability from countries in the region which have had recent experience of currency and banking crises.

Another challenge for the "New ASEANs" is the protectionism of the developed countries with whom they have entered trade agreements. The "catfish dispute" between Vietnam and the US in recent years is a case in point. After having successfully entered the US market as a result of the Vietnam-US bilateral trade agreement, the Vietnamese catfish farmers at first faced the charge that Vietnamese catfish could not be called "catfish" as they apparently differed from catfish farmed in the US. This ploy not having found to be successful in deterring the import and sale of catfish in the US, the Vietnamese farmers were charged with dumping catfish on the US market. Dispute over shrimp export is

another example. Financial and legal assistance is needed to settle these types of disputes in the international courts. Unless protectionist measures such as these can be countered and disputes resolved in an open and transparent manner, they could undermine the developing countries' domestic political support for increased integration and internal liberalization.

Conclusions

This paper points out that, in the last decade and a half, international trade and investments links from Vietnam, Lao PDR and Cambodia with the Asian region as well as with the EU and the US have grown very rapidly, making these countries truly open economies by world standards. At the same time, financial linkages in the form of joint ventures and aid flows have also been significant. Even though administrative controls exist to prevent short-term capital flows, there is some evidence that these short-term flows do exist.

Despite rapid external economic integration, however, internal liberalization and transition have lagged behind, resulting in distorted trade regimes and investment flows as well as underdeveloped domestic private sectors. For continued "quality" growth and effective integration within ASEAN, the further development of appropriate legal/commercial infrastructure and other market-friendly institutions is essential.

Continued external integration in the form of binding international trade and investment agreements can help promote internal liberalization and the development of domestic private sectors through opening protected sectors to international competition, thereby lowering the costs of doing business in the three economies. As is shown in Vietnam in the past three years, this process can occur quite rapidly, with beneficial effects, *inter alia*, on FDI inflows. Further international opening could also hasten the divestment of SOEs in Vietnam and Lao PDR, and improve the legal and regulatory institutions in all three countries. However, "WTO membership" (and indeed, membership of ASEAN and APEC) "is at best a complement and not a substitute for what is essentially a national task" (Sally 2002). Furthermore, there are risks involved in terms of possible macroeconomic instability and speculative attacks in the course of domestic and external financial sector openings. There are also risks of non-compliance, and even backtracking away from international agreements, if protectionist measures from developed countries were not countered and disputes settled in a transparent manner.

China's integration into the world economy is providing a big impetus for the smaller transitional economies in the region. In the past three years, Vietnam has taken steps to deepen its institutions in order to meet the challenges of integration. In the near future, Cambodia and Lao PDR will have to face the issue of widening their export base and adopting market-oriented institutions which will give sustained "quality" growth. Appropriate assistance from the international and regional community is needed.

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Appendix A.

Table A1: Vietnam – Brief summary of Political, Legal, and Economic Systems.

Years	Legal system	Political system	Political Power	Economic system
Before 1945	French-based civil law	Under French regime	Held by the French	Colonial
1945-1954 (Democratic Republic of Vietnam)	French style civil law and communist model	Split between French regime and communist party	Split, some part controlled by Vietnam Communist Party, some part by French	War economy
1954-1975				
North Vietnam (Democratic Republic of Vietnam)	Communist model	Socialist Republic, One Party system	Vietnam Communist Party	Centralized and command economy
South Vietnam (Republic of Vietnam)	Based partially on French and US systems	Pro-American, supported by USA	Unstable, backed by USA	Market and war economy
1976-1986 (Socialist Republic of Vietnam)	Communist model	Socialist Republic, One Party system	Vietnam Communist Party	Centralized economy (with some micro-reforms)
1986-present (Socialist Republic of Vietnam)	Greater economic rights	Socialist Republic, One party system	Vietnam Communist Party	Transition towards market economy

Table A2: Lao PDR – Brief summary of Political, Legal, and Economic Systems.

Years	Legal system	Political system	Political Power	Economic system
Before 1954	French-base civil code and	Under French protectorate Colonial judiciary	Held by the French	French Colonial
1955-1975 Country separated into two systems				
(1) The Kingdom of Lao led by King Souvanna Phouma	French-base civil code and judiciary	Monarchy	Held by King Souvanna Phouma and strongly supported by USA	Market Economy
(2) The independence territory led by Kaysone Phomvihhan the leader of the Lao People's Revolutionary Party	Soviet Union-based system	Communist Party, Central committee and local committees	Held by leader of the Lao People's Revolutionary Party, Kaysone Phomvihhan, supported by Vietnam and Soviet Union	Soviet Union model
1975-1986 Lao People Democratic Republic	Soviet Union-based system	Socialist Republic	Held by leader of the Lao People's Revolutionary Party	Centrally planned economy, Soviet Union model
1986-present Lao People Democratic Republic was established	Transition to common law system	Republic, one party system	Held by leader of the Lao People's Revolutionary Party	Transition to market economy

Table A3: Cambodia – Brief summary of Political, Legal, and Economic Systems.

Years	Legal system	Political system	Political Power	Economic system
Before 1953	French-based civil code and judiciary	Under French protectorate	Held by the French	Colonial
1953-1970 (The Kingdom of Cambodia)	French-based civil code and judiciary	Constitutional Monarchy	Held by Prince Norodom Sihanouk as prime minister	Market and then nationalized
1970-1975 (The Khmer Republic)	French-based civil code and judiciary	Republic	Held by Lon Nol	Market, war economy
1975-1979 (Democratic Kampuchea)	Legal system destroyed	All previous systems abolished, extreme Maoist agrocommunism	Khmer Rouge	Agrarian, centrally planned
1979-1989 (The people's Republic of Kampuchea)	Vietnamese communist model	Communist party, central committee, and local committees	Cambodian People's Party (Vietnamese backed)	Central planning
1989-1993 (The State of Cambodia)	Greater economic rights	Communist party, central committee, and local committees	Cambodian People's Party (Vietnamese backed)	Central planning
1993-present (The Kingdom of Cambodia)	French-based civil code combined with common law in certain sectors	Constitutional Monarchy	As from 2004 shared between FUNCINPEC*, SRP (Sam Rangsai Party) and the Cambodian People's Party	Transition to market economy

* National United Front for an Independent, Neutral, Peaceful, and Cooperative Cambodia.

Source: - Chandier (1991), Mekong Law Group et al, 1999.

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Appendix B:

Table B.1: Business Costs in Selected Capital Cities (US\$) 2005

	Hanoi	Ho Chi Minh	Phnom Penh	Vientiane	Shanghai	Singapore	Bangkok	Kuala Lumpur	Jakarta	Mamila
Worker's										
salary/month	121.5	148	72.5**	75	237	530	146	205	131	182
Engineer's										
salary/month	293	311	250**	300**	463	1.668	316	790	270	279
Middle-level										
manager's										
salary/month	556	813	500**	400**	1147	2993	584	1643	618	649
Expenses for office										
lease/month/m2	22	23	15**	15**	28.35	35.42	11.67	12.09	24	7.4
Expenses for house										
rent for foreign										
representative	2,200	2,200	1,500**	1,000**	3,450	2,119	1,581	990	2150	1726
International										
telephone cost (A 3										
minute call to Japan)	1.65	1.65	3.57	0.6	3.00	0.99	1.46	1.43	3.39	1.20
Electricity cost for										
business/KWh	0.055	0.055	0.19	0.08	0.075	0.098	0.0415	0.05	0.04	0.11
Container										
transportation										
(40/fl/container)										
(from factory to										
Yukohama port)	1480	1070	1418**	N/a	200	940	1340	820	1055	775
Petrol price (1 liter)	0.47	0.47	1	0.4**	0.50	0.65	0.54	0.34	0.43	0.59
Personal income tax										
(Highest tax rate, %)	40	40	30**	37*	45	21	37	28	35	32

* Income tax rate for foreign investor is only 10% (flat rate) for 2002

** Data for 2002

Source: - Phnom Penh: private communication with an official from Cambodian Ministry of Commerce.

- Vientiane – for 2002 from National Statistics Bureau, Lao PDR; for 2005: private communication with an MOF official.

- Other cities – Japan External Trade Organization (JETRO), 2006, “The 16th survey of investment related cost comparison in major cities and regions in Asia”.

Integration and transition – Vietnam, Cambodia and Lao PDR

By Dr Suiwah Leung

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Presentation prepared for the seminar “Accelerating Development in the Mekong Region—the Role of Economic Integration”, Siem Reap, Cambodia, June 26–27, 2006. The views expressed in this presentation are those of the author and should not be attributed to the International Monetary Fund, its Executive Board, or its management.

Market Oriented Reforms

- “Doi Moi” (Economic renovation) in Vietnam in 1989
- NEM (New Economic Mechanism) in Lao PDR in 1990
- Resumption of external relations in Cambodia in 1993

Selected Indicators as at 2004

Country	Population (million)	Per capita GDP (US\$)	Life expectancy at birth(yrs)
Vietnam	82.2	550	70.29
Lao PDR	5.8	423	57.27
Cambodia	13.8	353	56.61
ASEAN(5)	392	1860**	72.28

** weighted average with the weight as the country's population

Chart I.1: GDP growth before, during and after Asian Crisis

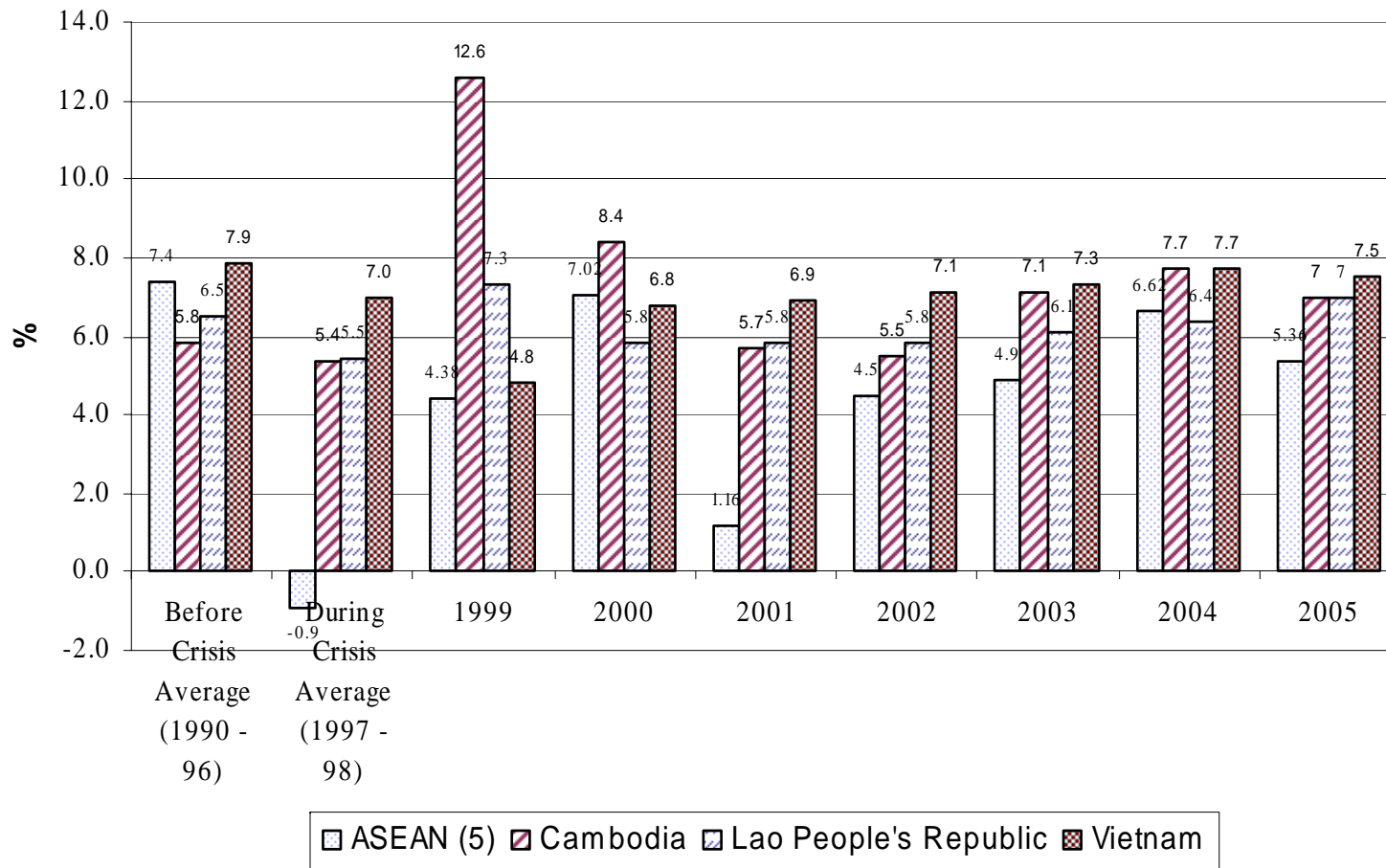
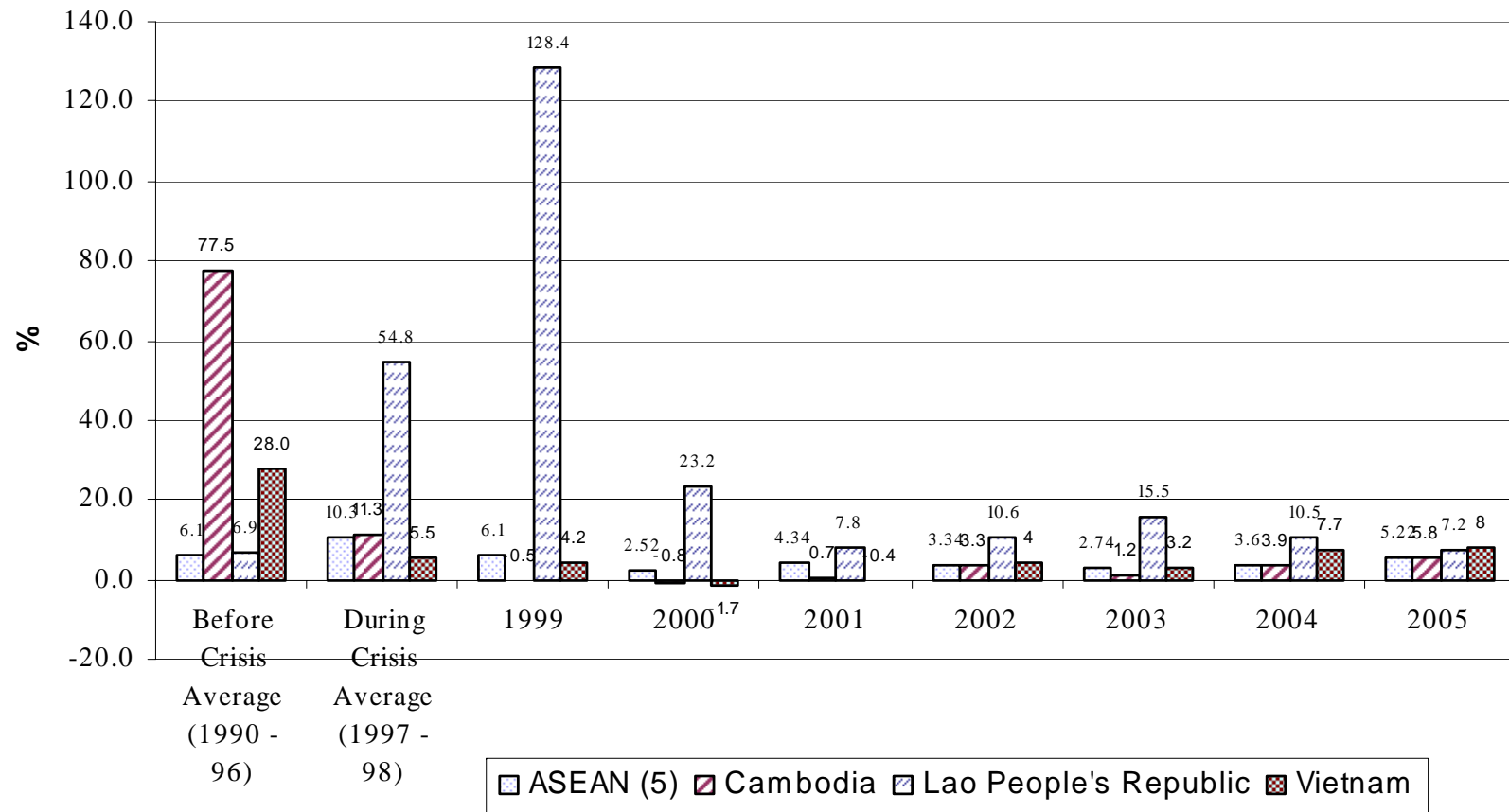


Chart I.3: Inflation before, during and after Asian Crisis



Issues Addressed

- How far has integration progressed?
- Is transition lagging behind integration and what are the consequences?
- Can continuing integration further internal liberalization and transition?

How far has integration progressed?

- Export/GDP ratios over 50%
- Share of imports from East and Southeast Asia ranges between 60% to 80%
- Asian investors rank amongst the highest foreign investors
- Aid to GDP ratios represent some of the highest in developing world
- Some evidence of short term capital flows despite administrative controls

Is transition lagging behind integration?

- Distorted trade regimes
- Distorted investment flows
- Underdeveloped domestic private sectors

Distorted Investment Flows

- In Vietnam in 2001, FDI companies contributed about 13% to GDP
- 35% to industrial output
- 23% to export
- 25% to total state budget
- Only 0.3% to overall employment

Chart L.2: FDI by sector, Lao, 2000 - 05

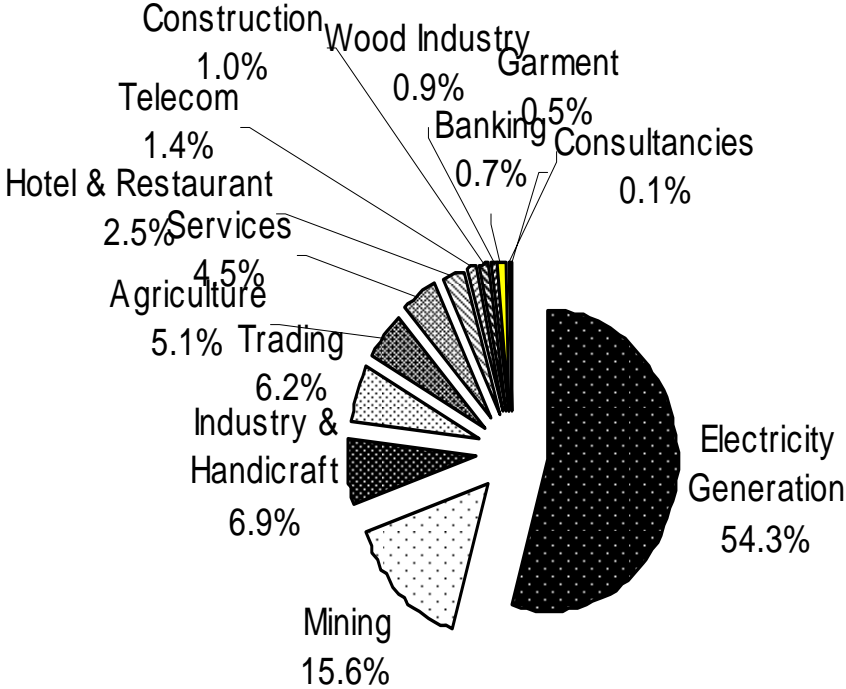


Chart C.2: FDI by sector, Cambodia, 1995 - 2004

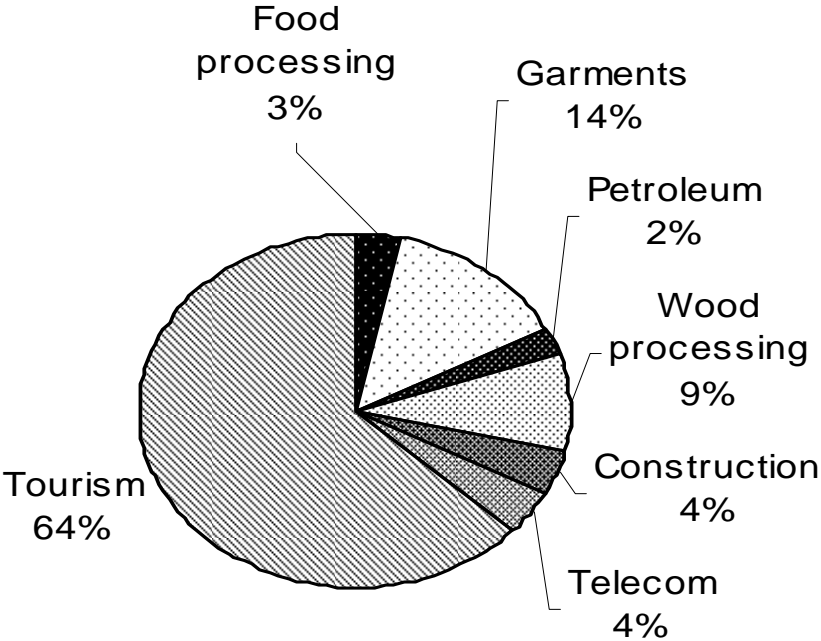
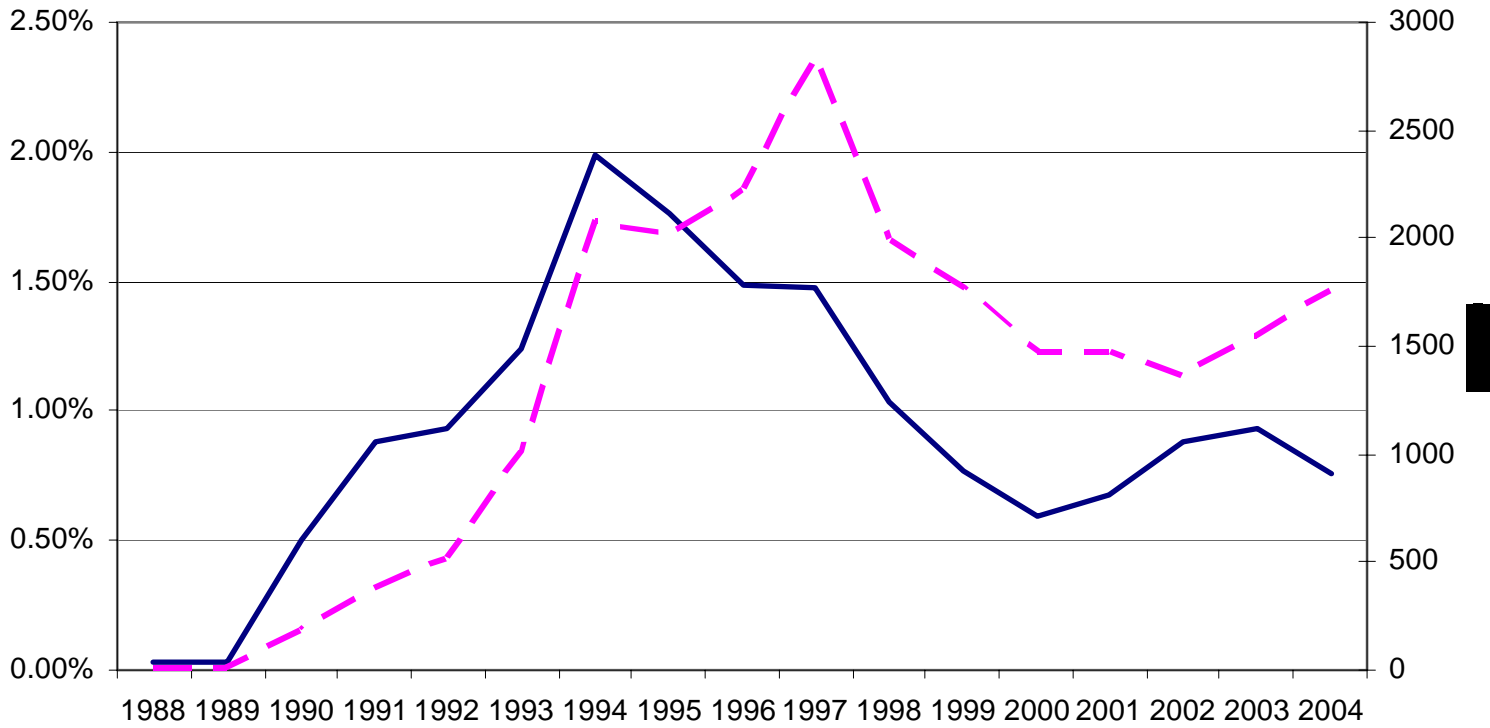


Chart I.5: FDI inflows to Mekong economies



— Mekong economies' inflows as % of all developing countries (LHS)
- - Mekong economies' Inflows in US\$m (RHS)

Chart V.3a: Vietnam GDP in industry sector by ownership

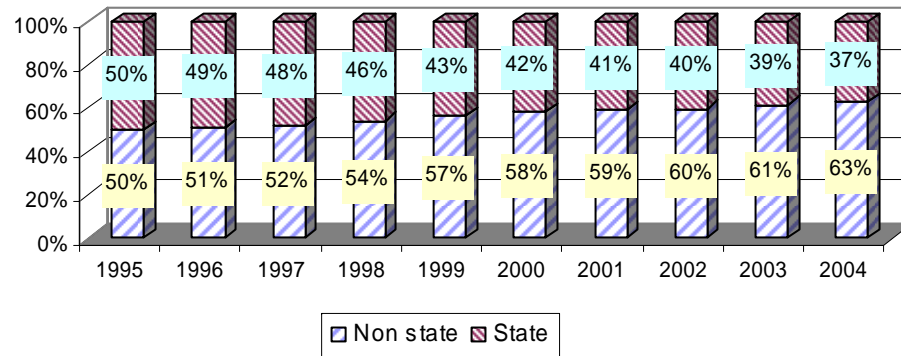
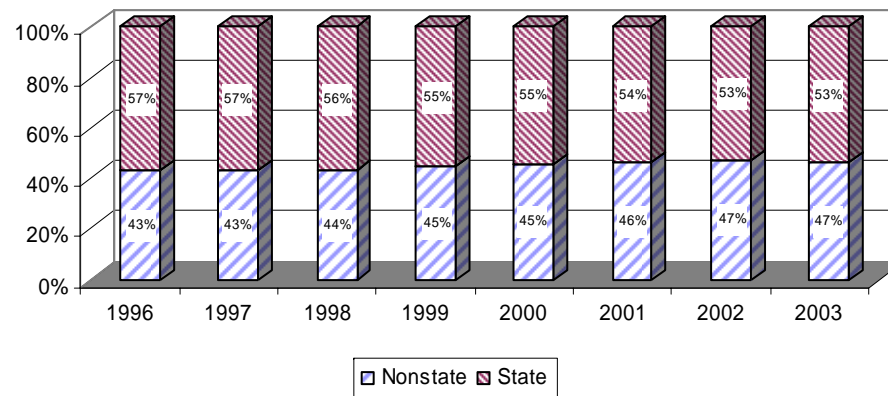


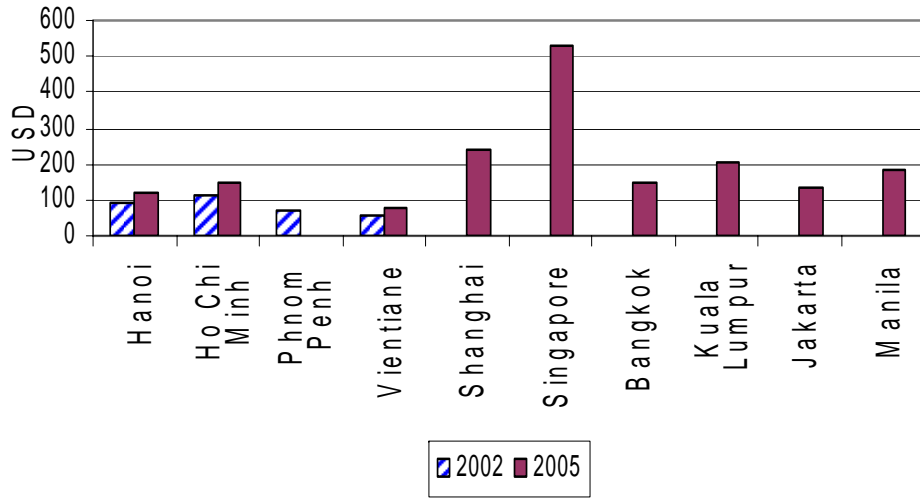
Chart V.3b: Vietnam - GDP in service sector by ownership



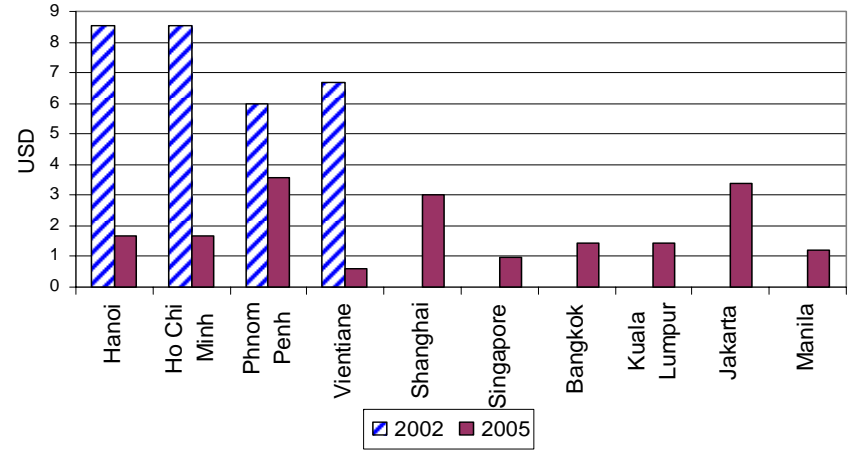
Constraints on Private Sector Growth

- In all three countries, lack of clear property rights to be used as collaterals for bank credit
- In Vietnam, Certificate of Land Use Rights (CLUR) not valued at market prices
- In Cambodia, lack of legal protection for lenders and inadequate dispute resolution mechanisms major reasons for inadequate credit supplies to domestic private sector

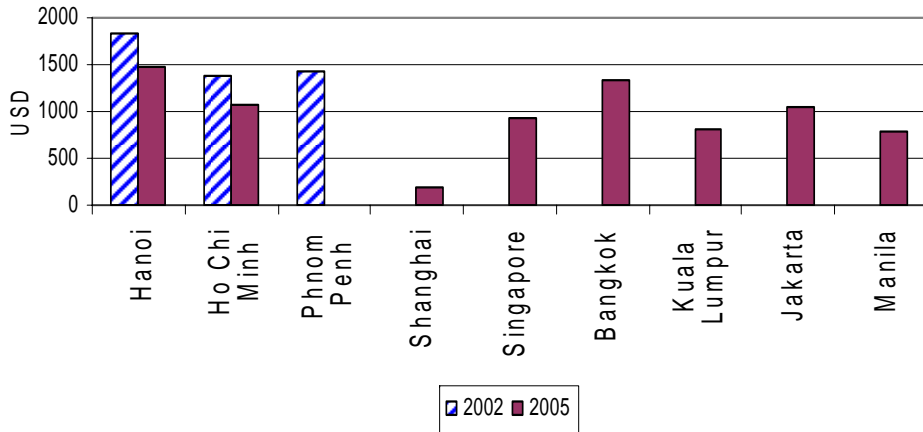
Worker's salary/month



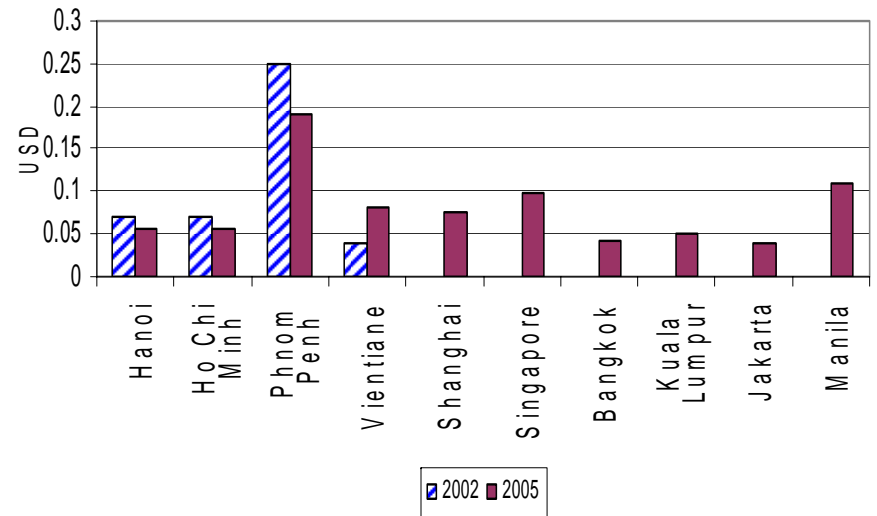
International telephone cost (a 3 minute call to Japan)



Container transportation (40 foot container) from factory to Yokohama port



Electricity cost for business/Kwh



Can continuing integration further transition?

- Help domestic private sector by lowering costs of doing business
- Hasten the divestment of SOEs
- Improve the countries' legal and regulatory institutions
- Provide technical and financial assistance through aid

Challenges Ahead

- Human resource development, particularly in public administration and judiciary reforms
- Macroeconomic stabilization in the course of capital account opening
- Protectionism in the West