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Economic Factors Shaping Private Sector Development in the Greater Mekong Subregion

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Introduction

The more than 250 million people and six countries that share the Mekong River – Cambodia, Laos, Myanmar, Thailand, Vietnam, as well as Yunnan and lately Guangxi provinces in China – comprise what is known today as the Greater Mekong Subregion (GMS). Apart from the two Chinese regions Yunnan and Guangxi, the GMS usually includes the countries as a whole and not just the areas that are delimited by the Mekong River Basin (see also Nilsson and Segnestam 2001; Ishida 2005).[1] In the GMS the majority of people live in rural areas, but there are also several cities each with a population of more than 3 million, including Bangkok, Ho Chi Minh City, Kuming and Yangon. Laos and Yunnan are deeply landlocked.[2]

The countries of the Mekong cover some 2.3 million square kilometres – almost the size of Western Europe. It is a vast area of enormous wealth and variety of natural resources, including a rich agricultural base, forest and fisheries, minerals and energy sources such as hydropower and coal and petroleum reserves. The most pervasive economic problem in GMS countries

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1 For this reason regional economic indicators are adopted for Yunnan and Guangxi, if they are available, while national economic data are applied for other GMS members. Internationally comparable sub-national economic data are hardly available in these countries.

2 According to Gallup, Mellinger and Sachs (1999), there are three major reasons why landlocked countries are at a disadvantage: (1) cross-border migration is more difficult than internal migration, (2) coordinating infrastructure development is more challenging across borders than domestically, and (3) coastal economies may have military or economic incentives to impose relative costs on landlocked countries. A study by the World Bank (2004) suggests that the estimated transport costs for a 20ft. container for general commercial cargo from Vientiane (the capital of Laos) to Los Angeles is more than 1.4 times from Bangkok or Beijing. The costs of shipping a container from Vientiane to Bangkok are around 40% higher than from Beijing to Bangkok. These facts show that import and export activities of Lao firms though Thailand – the most preferred transit route – are relatively worse off.

has remained poverty and low-income levels especially among the rural population.[3] Cambodia, Laos and Myanmar in particular are defined as least developed countries (LDCs) by the United Nations and the OECD. Although rapid and sustainable development has been achieved during recent years, Cambodia (US$354) and Laos (US$478) still have a lower (real) gross domestic product (GDP) per capita than Vietnam (US$545), while Myanmar's GDP was reported to be approximately US$170 in 2003. Thailand – the most developed country in the group – has a GDP per capita of only around US$2,300. This is the major reason why the Asian Development Bank (ADB) and other donors have been financially supporting the economic activities of these less developed countries.[4]

Yunnan and Guangxi are mountainous, poor provinces in China. In 2004 their gross regional product (GRP) per capita was less than 70% of the national GDP of approximately US$1,315 per capita. Eight prefectures of Yunnan Province border on Myanmar, Laos and Vietnam. Guangxi is located in southern China between Guandong, Guizhou, Hunan and Yunnan provinces. It shares a border with Vietnam and has a southern coastline along the Gulf of Tomkin. As is the case in Yunnan, Guangxi also has a diverse mix of ethnic minorities.

The GMS area is now undergoing greater changes than ever before. In the context of economic transformation the GMS countries are currently carrying out structural changes from subsistence farming to a more diversified economy, and to a more open, market-based system. Modernisation and industrialisation are proceeding rapidly. Yet, it should be noted in the context of the economic development stage approach that a rather clear regional

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3 In Laos the incidence of poverty fell from over 40% in 1997–98 to around 34% in 2002–03, while a more dynamic reduction took place in Vietnam, from 58% in 1993 to 20% in 2004. In Cambodia the comparable poverty incidence rate amounted to 35% in 2004, ranging from 4.6% in Phnom Penh to 35% in some rural areas (ADB 2006).

4 Since 1992, the GMS countries have embarked on a program of economic cooperation (the GMS Program) that aims to promote development through closer economic linkages. The GMS Program, with support from ADB and other donors, helps the implementation of high priority subregional projects in transport, energy, telecommunications, environment, human resource development, tourism, trade, private sector investment, and agriculture. Substantial progress has been achieved in implementing GMS projects over the past 12 years. Priority infrastructure projects worth over US$6 billion have either been completed or are being implemented. As of the end of June 2006, the 26 GMS projects cost an estimated US$6.5 billion, of which ADB has (1) extended loans amounting to US$1.8 billion, (2) generated US$2.6 billion for co-financing these investment projects, and (3) mobilised a total of US$148 million of grant resources, US$69 million of which have been provided by ADB, to finance 124 technical assistance projects focusing on human resource development, tourism, environment, trade and investment (see www.adb.org/GMS/Program/default.asp).

hierarchy exists among the GMS members.[5] There are also growing commercial relations among the countries involved, notably in terms of cross-border trade, investment and labour mobility. Furthermore, natural resources, especially hydropower, are beginning to be developed and utilised on a subregional basis.[6]

Serious political instability tends to impede economic development significantly. Such a danger currently prevails in Myanmar, for example. Moreover a large share of the population in the GMS experienced or have been experiencing how an unjust political system, unbalanced, central economic policy-making and rapid "capitalist" development worsen the situation of economic disparity, human rights violations and many other forms of social injustices. In particular, it is difficult for the rural poor who have been through a long period of political suppression to defend their basic rights and improve their living standard. Overcoming this culture of fear would involve a painful process to enable those people to gather experience and confidence to face economic, social and political challenges.

Yet there are positive signals of transformation in a large number of GMS member states and the key role of the private sector in economic growth and structural change as well as poverty reduction seems also to be recognised. In this context governments in some countries consider (a) giving the private sector equal rights and reducing the market entry restrictions for private firms, (b) facilitating private sector development through a favourable policy environment, making registration and licensing procedures for new firms more simple and transparent, (c) removing the existing biases in administrative procedures and regulations that favour SOEs over domestic or foreign private firms, (d) strengthening market institutions including dispute resolution and contract enforcement, (e) guaranteeing equal treatment of domestic and foreign investors, (f) improving land rights and the use of

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5 According to such an evolutionary logic, each nation is on a continuum within one of various economic development stages, and as it moves forward, it takes on a new series of competitive tasks in the world economy and leaves less sophisticated, private-sector activities to countries at the lower level of economic development. By and large, there are three stage types: (1) natural resource and labour driven, (2) capital and imported technology driven, and (3) R&D and innovation driven. However, these phases now overlap, due partly to the rapid integration of the world market and the intensive globalisation of business activities of multinationals including trade, FDI as well as technology transfer. Moreover, it is likely that the innovation-imitation lag between advanced and developing countries has been reduced, thanks to the greater flexibility and divisibility in production technology and to a rapid accumulation of physical and human capital in some developing countries which has enabled them to introduce new technologies embodied in capital goods and accelerated the learning and catching-up process (Ranis 2004; Nam 2006).

6 See www.adb.org/GMS/about.asp.

land as a collateral, and finally (g) promoting and increasing exports and facilitating trade and regional integration (Tran-Nam 2005; World Bank 2006a).

This study deals primarily with the economic problems and examines the critical economic factors that determine future opportunities and risks for private sector development in the GMS countries. Multilateral efforts to stimulate private sector development in developing and transition economies show that their success is largely dependent upon (a) general economic growth and market potential, (b) the region's or country's infrastructure endowment and geographic situation, (c) cross-border co-operation or competition for attracting FDI and future production activities, (e) industrial specialisation and competitiveness in the global and regional markets, (f) natural and human resources, and (g) institutional and macroeconomic (i.e. monetary and fiscal) stability (Nam and Radulescu 2004).[7] In turn, most of these determinants are also significantly affected by private sector development in the countries or regions involved in such co-operation.

Economic Development and Structural Transformation

According to ADB (2006), Cambodia achieved a real GDP growth rate of over 8% in 2005, triggered mainly by increased agricultural production. In addition, the medium term outlook up to 2010 anticipates an annual growth rate of 6%. A relatively slow growth in the agricultural sector and clothing industry is likely to hinder a more rapid economic expansion.[8] In Laos GDP growth reached around 7% in 2005[9] and the same annual growth rate is also expected in the medium term. Agricultural (mainly rice production) growth has recently remained stable at the rate of ca. 5%, while service growth has accelerated, reflecting the rapid expansion of the trade and tourism sector in this country. Agricultural production will be more strongly accompanied by related commercial activities and contract farming, and a continuous, strong growth is expected for tourism in the medium term (over 11%). Yet industry

[7] See, for example, UNDP's International Tumen River Development Programme aimed at exploring the economic potential of a North Asian subregion bordered by North Korea, China and Russia (Nam and Radulescu 2004).

[8] In 2005 Cambodian clothing exports rose by 23% in terms of volume, due largely to the temporary safeguard measures imposed on textile and clothing exports from China to the EU and the US (ADB 2006).

[9] This growth is to a large extent led by foreign investment inflows in mining and hydropower and the rise in mineral exports (World Bank 2006a).

will remain the main source of growth (approximately 25% of GDP at present) although a substantial growth of commodity export is unlikely in the short term[10] (World Bank 2004 and 2006c). Myanmar's GDP grew by ca 14% in 2004, mainly as a result of improved performance in agriculture, fisheries, manufacturing and trade. Rice self-sufficiency appears to have been achieved, whereas the expansion of bean, cotton and sugarcane production has recently contributed to export growth. About 50% of total output comes from agriculture, fishery and forestry, while industry (dominated by less productive SOEs) contributes to ca. 15% of GDP. Growth prospects are likely to remain modest without significant macroeconomic reforms in Myanmar (ADB 2006).

In Thailand the GDP growth rate will remain at the level of ca. 5% in the medium term. Consumption and private investment will remain the major contributor to GDP growth, although the former aggregate will gradually lose importance over the next few years (ADB 2006). Export of agricultural products and manufactured goods like electronic equipment (including integrated circuits, computers and hard disc drives) has revived economic development in this country. Thailand will have to focus on improving competitiveness to raise the returns on private investments and sustain high export growth rates in the future as well (World Bank 2006c). Economic performance continues to be robust in Vietnam with a growth rate of over 8% in 2005. A similar rate is also expected in the medium term. Private investment and domestic demand are the main determinants of this rapid growth. For instance, the ratio of total (i.e. public and private) investment to GDP for 2005 is reported to be around 39% (compared to 29% in 1998) and the private sector provided 46% of all investment in 2001–2005 (ADB 2006; World Bank 2006b). Exports have remained strong too. In 2005 total exports grew by 22.4% in terms of value, and the trade deficit narrowed to 1.6% of GDP. The industrial sector (41% of GDP in 2005) will continue to drive growth in Vietnam, exploiting the comparative advantage resulting from cheap labour and improved infrastructure. Furniture and electronic goods are rapidly gaining in importance, while clothing and footwear production has slowly decelerated, although they are still major export items.[11] Buoyant results can also be observed in finance, tourism, trade, transport and tele-

[10] There are several reasons for this rather unfavourable expectation, namely (1) poor transport infrastructure endowment, (2) relatively lower purchasing power in neighbouring economies, (3) similarity of agricultural products in Laos and neighbouring countries, (4) risk aversion of small-scale production base and weak links to export opportunities (World Bank 2004).

[11] Vietnam's textile and clothing exports rose by 9.6% in 2005 compared to the average annual growth rate of 30% in 2002–2004 (ADB 2006).

communications. The share of agriculture in the economy continued to decline to about 20% of GDP in 2005 as a consequence of the slower growth rate of less than 4% that year. Yet the agricultural sector still accounts for the bulk of employment in Vietnam.

In 2004 the GRP growth rate reached 11.5% in Yunnan and 11.8% in Guangxi, compared to the national GDP growth rate of 9.5% in China. Since 2001 Guangxi's growth rate has continuously been higher than the national rate, while Yunnan's growth rate has exceeded the national average since 2004.[12] In the medium term China's economy is likely to grow at a rate of around 9% (ADB 2006). And one can expect that the GRP growth rate of these two provinces will be at least 1 to 2 percentage points higher than the national average, because they have recently started to grow rapidly from a lower economic level. Although agriculture and fisheries have slowly lost their importance, Yunnan and Guangxi have a larger share than the national average.[13] According to the classification of GDP (or GRP) components in 2004, this sector comprised around 24% in Guangxi and 20% in Yunnan, compared to the national average of 15%. The industrial sector – the present engine of growth for the entire country – is weakly represented in these provinces: its GRP share amounted to 45% in Yunnan and 39% in Guangxi in the same year, whereas the sector's national average share of GDP was around 53%. Yet the growth of the industrial and service sectors in these two provinces has recently been more rapid than in the country as a whole. In 2004, for example, the sectoral growth rate for industry and services amounted to approximately 15% and 11% in Yunnan and 17% and 11% in Guangxi, i.e. much higher than the corresponding national growth rate of around 11% and 8%, respectively. In China as a whole the extremely high levels of investment have led to industrial overcapacity, which, in turn, has caused rising inventories and declining prices in sectors that have invested excessively over the last few years, including aluminium, automobiles, cement and steel. Several factors have contributed to overinvestment and inefficiency, e.g. directed lending by banks, subsidies to energy and incentives related to capital investment (ADB 2006). A comparably serious industrial problem has not yet emerged in Yunnan and Guangxi.

As shown above, all the GMS economies have recently recorded favourable economic growth. Yet the narrow base of growth caused by low com-

12 The GRP growth rate amounted to 6.5% in Yunnan compared to the national GDP growth rate of 7.5%, while that of Guangxi reached 8.2% in 2001.

13 Although migration is strictly controlled in China, the movement of human resources from the rural to the urban economy will continue, triggered even further by the widening income disparities and the decline of the agricultural sector.

petitiveness and productivity of the manufacturing sector, for example, remains a concern in some countries, although they attempted to diversify their economies through the development of small- and medium-sized enterprises (Cambodia for example). Moreover, the limited growth potential of such small scale firms has placed significant constraints on the ability of the industrial sector to adopt new technology and expand employment and exports.[14] For these reasons, most GMS economies should, ideally, improve their agricultural and simple industrial performance in the short/medium term and develop more sophisticated manufacturing and services as a long-term growth engine while continuing to improve the growth contribution of human and natural resources. The future development strategies of Guangxi, for example, include (a) optimising its economic structure with agriculture as the base and rapid industrialisation as a focus, (b) transforming the economic system, (c) opening further to international trade and investment in the context of establishing free economic zones, and (d) combining scientific and technological development with economic development. [15]

Apart from strengthening agricultural services and land administration, sustaining the performance of agriculture requires some additional measures to facilitate better distribution of products while maintaining food security at the same time. Such measures comprise the promotion of market integration through improving transport infrastructure (especially rural roads) and the removal of policy distortions which cause fragmentation of domestic markets and affect farm gate prices. Development of manufacturing and services can be further stimulated by, for example, strengthening market institutions including dispute arbitration and contract enforcement, improvement of logistic infrastructure to access regional and international markets, facilitating access to financial resources, and productivity enhancement through educating and training human resources (World Bank 2004).

Private Investment and Social Overhead

In most GMS countries, economic growth has recently been supported by an increase in private investment in response to an improved investment climate, whereas development of the private sector has been seriously dis-

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[14] In Laos nearly 97% of manufacturing units are small (with less than 10 employees). Of the relatively small number of medium-sized and large entities, 35% are privately owned by Lao citizens and 55% are joint ventures with foreign companies, while the rest are SOEs owned by central and provincial governments (World Bank 2006a).

[15] See www.gxi.gov.cn.

turbed by infrastructure shortages and other disadvantages like the high cost of credit, lack of skilled labour and weakness in governance. Governments in most GMS countries (except Myanmar) are increasingly adopting laws aimed at creating a simple and transparent rules-based private sector environment, improving competitiveness, encouraging private participation in infrastructure and promoting industrial diversification (through the establishment of free trade zones), etc. Yet progress in legal and judicial reform has been rather slow, which has hindered the effective implementation of laws, forcing the private sector to operate according to uncertain market rules (ADB 2006). Additionally, the private sector has quite often complained about corruption and arbitrary decisions by public institutions, which were inconsistent with existing laws (Kato et al. 2000).[16]

Vietnam is the country where private investment has recently been a powerful contributor to economic growth. In this country the enactment of the Enterprise Law in 2000 introduced a change in the official mindset, from a business license system, where the government perceived its role in terms of restraining and redirecting private sector activities, to a business registration system, where the government sets the ground rules and lets the private sector act freely within prescribed limits. The response was dramatic, with about 80,000 new enterprises registered between 2000 and 2003. Furthermore, thanks to a Unified Enterprise Law and a Commercial Investment Law in 2005 aimed at promoting private investment, new business registration amounted to 40,000 in 2005, representing an increase of 9% in number and 43% in registered capital compared with the previous year. The average business capital of these new enterprises, approximately 170,000 dollars, has, though small, doubled in the last five years (World Bank 2006b).

Traditionally FDI from Japan, the EU, the US and Asian NIEs has been one of the most important forces behind the shift in Thailand's economic structure and modernisation (Poapongsakorn and Tangkitvanich 2001). Foreign investors were initially motivated by low labour cost, local market potential, political stability and generous tax incentives provided in this country. FDI has also been strongly export-oriented. In Vietnam FDI growth has been triggered mainly by investors from Singapore, Taiwan, Japan, Korea and Hong Kong and its strong concentration in the areas of semiconductor assembly and manufacture of electrical and non-electrical ma-

16 Moreover, the main political initiatives introduced in Vietnam for fighting and controlling corruption include increased public disclosures and transparency in areas like public procurement, civil works, SOE management and privatisation, auditing of the state budget, management and use of land as well as personnel management (World Bank 2006b).

chinery is expected.[17] Such a concentration will, in turn, make a crucial contribution to industrial modernisation, productivity growth and the introduction of new technology. Unlike the case of Thailand, Vietnam's FDI can be characterised as regional rather than global (Tran-Nam 2005). In recent years the on-going, large-scale mining and hydropower projects have attracted some FDI (approximately US$27 million in 2005) in Laos, whereas FDI in agriculture has also grown, as more foreign investors have showed their interest in rubber, eucalyptus, palm plantations, etc., agro-processing industries and crop-farming (ADB 2006).[18]

As mentioned above, transport and energy infrastructure are seen as prerequisites for economic development in the GMS countries. For example, Laos has neither a railway system nor a direct access to seaports (World Bank 2004). On the other hand, fast economic growth and high investment rates have caused serious environmental damage in China: the key environmental concern in Yunnan is forest conservation, for example.[19] This again signals the need for additional investment in environmental infrastructure in order to guarantee sustainable development in the future. In turn, the development of infrastructure and the protection of the environment provide further opportunities for private sector development.

Governments in many developing countries are often unlikely to be able to realise large infrastructure projects which exploit economies of scale better than small projects, without private sector assistance. This is presently true for Laos, Myanmar and Cambodia where fiscal stress limits resources available for investment in the infrastructure. In this case, a public-private-partnership model with adequate sharing of risks is suggested as one solution to attract private and foreign capital and thereby overcome the financial constraints inherent in the public sector (Kato et al. 2000; World Bank 2004). For example, the Thai government initiated a huge US$42 billion mega infrastructure investment programme to improve the physical and social infrastructure in the period 2005–2009, an amount equivalent to about 5% of GDP per year. The programme, which is expected to be financed by external borrowing to the extent of 17.5% and significant private sector participation (World Bank 2006c), targets substantial transport projects,

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17 In 2005 the FDI inflows amounted to around US$2.4 billion in Vietnam (ADB 2006).

18 The bulk of recent FDI in Laos stems from Thailand, Malaysia, Singapore, Vietnam and China (World Bank 2006a).

19 Yunnan's provincial environmental protection has recently concentrated on reforestation, watershed management as well as prevention and control of soil erosion, which also requires intensive public involvement and participation. It aims at speeding up eco-agricultural development, readjusting rural energy structure, controlling agricultural pollution, promoting the structural adjustment of township village enterprises, etc.

water resource development, energy, low-cost housing, and health and education. Large scale infrastructure projects also have positive external effects on private sector development and economic growth. For example, these infrastructure projects could contribute 0.5–0.7 of a percentage point to GDP growth each year as from 2007, taking into account the direct and multiplier effects. Moreover, such public investment activities will encourage the capacity to expand for firms producing cement, steel, and construction materials and contribute to the creation of new jobs (ADB 2006).

Problems related to the provision of infrastructure can also be solved in the context of cross-border cooperation, for GMS economies are connected by infrastructure linkages. Most of the priority road projects in the GMS have become integral parts of the ASEAN Highway Network. The routes identified by ASEAN for the Singapore-Kunming Rail Link also coincide with those projected for GMS. In addition, Laos, Thailand and Vietnam have worked out a comprehensive agreement covering transit, inter-state and multi-modal passenger transport. Another example of GMS moving ahead is the agreement on river transport among China's Yunnan Province, Laos, Myanmar and Thailand to promote trade and tourism along the Mekong. The members of GMS are also keen to establish a trans-regional energy network towards which first attempts have been made in the context of the ASEAN Power Grid and the Trans-ASEAN Gas Pipeline programmes. Several power-purchase agreements already exist among GMS countries, though they clearly require interconnection. The security and sustainability of the power supply that these programmes foster would be of great benefit to investments in the GMS area.

Intra-GMS Trade and Globalisation

Strong bilateral cross-border trade relations already exist between the GMS economies and these could be intensified in the future. In general, Cambodia and Laos show trade deficits with Thailand, Vietnam and Yunnan. For example, in 2003 the composition of imports from Thailand was 27% of total imports in Cambodia and ca. 59% in Laos. Exports from Laos to Vietnam accounted for about 17% in 2003, and Vietnam was Laos' second largest export partner after Thailand (see also Ishida 2005). For Myanmar, trade links with robust neighbouring economies provide a basis for expansion of export industries. The major destination of Yunnan's exports has recently been Myanmar and Vietnam, approximately 49% and 18% respectively of total exports. On the other hand, imports from Myanmar, Vietnam, Laos and Thailand amounted to around 40% of Yunnan's total regional imports (Ishida 2005). Yet its export to GDP ratio reached 5.3% in 2002, only one-fifth of the national average (26.0%), while the corresponding ratio for imports amounted to only 3.0% compared to the national average of 23.6%. Myanmar and Laos export mainly primary agricultural goods while importing cheap consumer goods from Yunnan. Although Thailand appears to be the only riparian country among the GMS members capable of supplying the province with know-how and technology, trade between them has remained rather weak (Poncet 2006).

Cambodia, Laos, Myanmar, Thailand and Vietnam belong to ASEAN. A full exploitation of opportunities provided by ASEAN would enable rapid trade and economic growth as well as private sector development for the GMS countries. In particular, for a landlocked country like Laos, such regional linkages are of more importance than for Thailand or Vietnam, since its export of low-cost, labour-intensive manufactured goods to major world markets is hardly expected to be a crucial source of growth for Laos, as is the case with the neighbouring countries mentioned above. Tariffs on most products traded within ASEAN are now below 5%, while non-tariff barriers are no longer commonly used. Products of companies operating in two or more ASEAN countries under the ASEAN Industrial Cooperation scheme can be freely exchanged across national boundaries for further processing. Customs procedures are being coordinated, regulations and standards harmonised, which makes intra-regional trade easier. Negotiations have also been launched on trade in several services like air and maritime transport, financial services, telecommunications and tourism. In this way, ASEAN is being steadily integrated into one huge market of half a billion people with a gross regional product of almost US$800 billion. An investor in any of the ASEAN members in GMS has, therefore, this large integrated market for his products. Investments from an ASEAN member now have free access to other ASEAN countries. Exceptions from this are to be phased out within a specific timeframe.

China is a member of the WTO, Vietnam's accession is in sight and countries like Laos are pursuing membership of this international organisation. Therefore, the global implementation of WTO agreements also has effects on the GMS countries' trade performance and private sector development. In the context of the WTO, the realisation of liberalisation measures is currently being negotiated in order to achieve consensus. In the field of agriculture, the structure of formulas for market access and domestic support is taking shape. Export subsidies are to be phased out by 2013, with frontloading cuts. On non-agricultural market access, agreement was reached to adopt a so-called Swiss formula for tariff reduction commitments (i.e. higher tariffs will be subject to deeper cuts). Concerning special and differential treatment for LDCs it was agreed at the Sixth WTO Ministerial Meeting in 2005 that advanced countries will provide duty and quota free access on a lasting basis by 2008, covering a good 97% of tariff lines, thereby permitting the exclusion of key products in which LDCs are competitive.

With regard to services, developing countries are not strongly involved in WTO negotiations, although many East Asian developing economies stand to secure substantial economic gains from services liberalisation in particular (Medalla 2005). This does not, however, apply to Vietnam. In the context of WTO membership this country has also made substantial commitment to open up key service sectors like telecom (including satellite services), distribution, financial services and energy services to foreign participation. Vietnam additionally offered to open up for branching in (non-life) insurance and securities, and it already provides for bank branching (World Bank 2006b). According to the World Bank (2006c), liberalisation of sectors such as retail and wholesale trade, logistics, air transport and electricity generation will generate large economic gains in Asian developing countries, because these services provide important inputs for production in the rest of the economy. This finding also underlines the importance of service sector liberalisation for the long-term private sector development strategies in the GMS countries.

Privatisation, Financial Sector Reform and Macroeconomic Stability

Implementation of economic reforms in various areas has continued in the GMS countries. Important steps have been taken towards creating a better investment and business environment and a more open trade regime. The programme aimed at strengthening public expenditure management has gained momentum and state-owned enterprise (SOE) restructuring and attempts to increase transparency in the SOE sector have continued, albeit slowly, due to bureaucratic delays and weak capacity (World Bank 2006a). In Thailand privatisation of SOEs was seen as a structural reform measure to improve SOEs' efficiency and their access to private funding. Major enterprises to be privatised include PTT (a state petroleum company) and AOT (the airport authority). But this did not materialise because of strong protests by employees and concern about regulatory deficiencies and transparency of the share offerings (ADB 2006).

In Vietnam the government has carried out an intensive privatisation programme in recent years. In the period 2001–2005, 3,590 entities were restructured out of 5,655 SOEs, 2,347 of which were privatised. However, on the whole only small-sized firms were targeted.[20] Large SOEs with capital exceeding US$650 million and the potential to become global players, are scheduled to be converted into parent-child holding companies after the structural transformation.[21] The parent company of the transformed entity will be a fully state-owned limited liability company which will operate under the Enterprise Law (World Bank 2006b).

Privileges of SOEs through regulatory and administrative procedures create biases against the private sector. For example, in the forestry sector of Laos, allocation of logging quotas generally favour SOEs. The range of products that can be imported by private sector companies is more restricted than for SOEs as a result of a Ministry of Commerce regulation. SOEs are particularly dominant at the provincial level and sub-central governments are more supportive of them than private firms in many cases. Furthermore, SOEs and businesses affiliated with the Lao government have quite often received more favourable interest rates (World Bank 2004).

Private sector development can also be impeded by the incomplete reforms in the financial sector. The Laos government embarked on a banking sector reform programme in 2000, aimed at restructuring the two state-owned commercial banks, strengthening bank supervision and improving the overall banking environment. Yet the financial sector still remains highly concentrated, consisting of the two insolvent state-owned banks, which has led to poor access to financial services for private enterprises and consumers. Apart from the inadequate regulatory, accounting and disclosure standards, weak capacity and enforcement in commercial banks and central bank supervision also prevail in most GMS countries. Cambodia's experience in 2005 of a sudden private sector credit growth of 21.3%, which was triggered by the boom in hotel and residential construction, highlights the importance of commercial banks in developing countries (ADB 2006). Furthermore, the reduction of barriers to entry and expansion for private and foreign commercial banks (including increased private ownership in domestic banks) is an urgent necessity and should be accompanied by the establishment of (private) non-bank financial institutions like microfinance, insurance, leasing, factoring, mortgage lending consumer finance, etc.

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20 According to ADB (2006), around 1,000 Vietnamese SOEs (ca. 20% of the total) either incurred a negative return on equity or were insolvent in 2003.

21 There are presently eight large SOEs in Vietnam undergoing such a privatisation policy. They include: Baoviet (insurance), Vinacomin (minerals), VNPT (telecommunications), Vinashin (shipping), Vinatex (garments and textiles), EVN (electricity) Vietnam Rubber Corporation and Petrovietnam (oil), the first five of which have received approval for their transformation plans (World Bank 2006b).

Overall macroeconomic stability – price and interest rate stability in particular – reduces uncertainties related to business performance and private investment decision. Many Asian open economies began tightening monetary policy in 2005, which should help forestall the danger of rising oil prices embedded in a sustained rise in core inflation (i.e. excluding food and energy). That too should help underpin the conditions for growth in the medium/longer term (World Bank 2006c). In the next five years the inflation rate is likely to rise in Cambodia from 5.8% in 2005. It is estimated that the price increase will reach more than 10% in Laos and Myanmar in the medium term. Currency devaluation is the consequence, which makes imports more expensive. In recent years, high food prices combined with import prices for oil products, steel, cement, fertilisers have also led to high inflation in Vietnam (over 8% in 2005). In addition increased demand for workers in industry and services caused a rise in the salaries of professionals and wages for skilled labour.

In Thailand external price shocks like the increase in the price of oil have had a less significant effect on inflation (1.6% of the core inflation rate). Inflationary pressure is expected to further diminish, thanks to a tight monetary policy and price control. Such a restrictive monetary policy tends to lead to an increase in interest rates, which will, in turn, slow spending on automobiles, household goods and housing. Inflation (1.8% in 2005) is now also well under control in China (ADB 2006).

Excessive government spending (in terms of accruing large scale external debts, for example[22]) can lead to an increase in interest rates and can crowd out private investment. Yet fiscal positions remained strong in Thailand, as the collection of corporate income tax and VAT continued to rise. At the same time, government spending was kept well within the original budget target in this country. The overall fiscal performance is also satisfactory in Vietnam. However, revenues from cross-border trade may fall further in the near future as a result of the country's commitment to the ASEAN free trade area (AFTA) and the WTO and the decision to cut the tariff-levels. In comparison, central and local governments' fiscal positions appear to be neutral in China, and the deficit reached around 1.6% of GDP in 2005 (ADB 2006).

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22 In Laos, for instance, the ratio of external debt to GDP is forecasted to remain at the high level of approximately 80% to 90% in the medium term (ADB 2006).

Conclusion

The Greater Mekong Subregion covers a large area of Asia and is endowed with abundant natural and human resources. Unfortunately the most pervasive economic problem in this area has remained poverty and low income levels. Since 1992, the GMS countries have embarked on a programme of economic cooperation that aims to promote development through closer economic linkages. In the framework of such multilateral cooperation programmes, supported financially by ADB and other donors, a number of subregional projects have been implemented in areas like transport, energy, telecommunications, environment, human resource development, tourism, trade, and agriculture.

This study sought to identify some crucial economic factors shaping the future opportunities and risks for private sector development in the GMS region. All the GMS economies are carrying out structural changes from substantially agricultural to modern industrial economies. In addition, a favourable economic growth is expected in the medium term. On the other hand, the narrow growth base caused by the low competitiveness of the manufacturing sector remains a concern in some countries. Moreover, the limited growth potential of small industrial firms has limited the ability to adopt new technology and to increase employment and exports. For most GMS countries, therefore, a step-by-step economic development policy seems to be desirable, based on the improved agricultural and simple (natural resource-based) industrial performances in the short/medium term, in order to generate more sophisticated manufacturing and service activities in the long run.

Governments in most GMS countries are gradually adopting laws to create a simple and transparent rules-based private sector environment in a market-oriented system, are improving competitiveness, encouraging private participation in infrastructure and promoting industrial diversification, accompanied also by a series of SOE reforms. Consequently, economic growth has recently been supported by an increase in private investment in response to an improved investment climate, although there are serious infrastructure shortages, the cost of credit is high, there is a lack of skilled labour and governance is poor.

Strong bilateral cross-border trade relations already exist between the GMS economies, which will be intensified in the future. If the opportunities provided by the huge ASEAN market are properly exploited, this will lead to rapid trade and economic growth as well as private sector development. Taking the economic development stage of most GMS countries into account, FDI is assumed to be motivated by low labour costs, local market potential, political stability and generous tax incentives provided in the host country. A large share of FDI will also be strongly export-oriented, aimed at meeting the demand in regional and global markets. In this context it should also be borne in mind that the possibility of FDI competition among the GMS countries certainly prevails and that the countries with a more favourable geographical location and a modern industrial structure will benefit most.

Due to the financial constraints inherent in the public sector, many GMS countries are unable to realise large (energy and transport) infrastructure projects without private sector involvement. Here, the application of public-private-partnership models will be a policy option to attract private and foreign capital. The infrastructure problem can also be solved in the context of cross-border cooperation, since the GMS economies are also bound together by infrastructure linkages. For example, most of the priority road projects of GMS have become integral parts of the ASEAN Highway Network.

Price and interest rate stability reduce uncertainties related to business performance and private investment decisions. Many GMS countries will continue to pursue a restrictive monetary policy in the medium term in order to control inflation. Excessive government spending can not only cause a large budget deficit but also lead to an increase in the interest rate and crowd out private investment. Yet fiscal positions of most GMS countries will probably remain robust in the coming years. Private sector development can be further triggered by rapid financial reforms. In general, the financial sector is still dominated by a few state-owned banks which has led to poor access to financial services for private enterprises and consumers. Therefore, the reduction of entry barriers and expansion for private and foreign commercial banks seems to be an urgent necessity.

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