

The Economic Context

The GMS is currently undergoing multiple transitions in a growth environment. The roles of markets and governments are being redefined, and their economies are becoming more diversified and open. A variety of indicators suggests that the region has made substantial progress over the past decade. Despite the Asian financial crisis of 1997–1998, the estimated annual real increase in per-capita income was a remarkable 2.7% from 1992 to 2002.⁵ This implies that income poverty should have been sharply reduced,⁶ but isolated communities did not benefit equally.⁷

Growth continued in 2003 despite severe acute respiratory syndrome (SARS) and avian flu outbreaks. Factors contributing to growth included strong consumer spending, improved agricultural output thanks to better weather, and increased demand for exports. Trade increases in Thailand, Viet Nam, and Yunnan Province that began in 2002 continued into 2003 due largely to improved external demand and, in the case of Viet Nam, to high crude oil prices. SARS and other global uncertainties appear to have had only a muted impact on trade expansion. Generally prudent fiscal, monetary, and external policies have also ensured sustainable levels of external debt.

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5 As measured in purchasing power parity US dollar terms (Appendix 4, Table 4.4), deflated by the US consumer price index.

6 See Adams, R. 2002. Economic Growth, Inequality and Poverty: Findings from a New Data Set, *Policy Research Working Paper 2972*. Washington DC: World Bank.

7 Infrastructure deficiency and lack of access to markets account for a substantial amount of the poverty in Asia. See Yao, X. 2003. Infrastructure and Poverty Reduction-Making Markets Work for the Poor, *Economics and Research Department Policy Brief No. 14*. Manila: ADB.

Economic Challenges within the GMS

Because they are in transition from centrally planned to market economies, there are common problems that Cambodia, Lao PDR, Myanmar, and Viet Nam (CLMV countries) face. Each is, however, at a different stage in this transition, and other country-specific factors suggest that there are also differences in the types of challenges that each must address. At the other end of the spectrum lies Thailand, a market economy that is still grappling with many of the challenges of a developing Asian country.

In Cambodia, the effects of the destruction of social, economic and political institutions during the Khmer Rouge period are still evident, but progress has been made, and the focus is shifting from rehabilitation to economic advancement through growth and development. Lao PDR is the least developed of the GMS countries. It is landlocked, sparsely populated, and has a mountainous terrain. It has a very narrow resource base that limits its capacity to diversify production and exports. Institutions remain weak, and human resources are underdeveloped. The pace of economic reform has been slow, so its transition to a full-fledged market economy remains a long-term challenge. The country is keen to promote connectivity with its GMS neighbors to explore development opportunities. Myanmar's economic constraints range from a highly managed foreign exchange regime to a plethora of controls on production and export in its most important sector: agriculture. Myanmar has limited access to assistance from international donors because of its political situation. Yunnan Province, PRC, and Viet Nam are the more economically advanced of the GMS transitional economies. Viet Nam has been making steady progress toward a market economy, but it needs to accelerate the pace of reforms including those relating to governance.

Thailand has the most developed and largest market and is an important source of knowledge and capital. It is also a communication and transportation hub and is the vantage point from which many potential foreign investors view the GMS. Despite recent, impressive growth,

reducing poverty remains a significant challenge, particularly near the northeastern border with the Lao PDR and in the border regions with Cambodia and Myanmar. There is also a need to continue reforms to consolidate growth. Completing Thailand's banking and corporate restructuring is vital for the recovery of business investment and the medium-term prospects for the GMS economies.

Managing Economic Transition

The future of the Subregion will also depend on how successfully its members manage a number of critical transitions. The first is economic diversification. Subsistence agriculture is giving way to commercialized agriculture, and the share in total income is beginning to fall as manufacturing, including agroprocessing, expands. This is both a cause and a consequence of rising income levels and greater prosperity. As diversification progresses, people will drift from the countryside to towns and cities.

A second important transition is the changing role that the state and markets play. There is a growing acceptance that markets are more effective than governments in allocating scarce resources. In most of the Subregion, the economic activity of the private sector has been growing more quickly than that of the state, and the proportion of the economy occupied by markets and the private sector is likely to expand. Progress in governance and anticorruption reforms may also encourage informal economic activities to enter the formal sector. This will allow governments to refocus their energies and scarce resources on improving the business environment and delivering needed public goods.

Finally, the Subregion is becoming more "open" economically. Informal cross-border trade has always been important, but there has been a resumption of growing subregional integration in formal trade and investment flows since the Asian financial crisis. Recorded cross-border exports from Thailand to Cambodia, Lao PDR, and Myanmar combined increased by 44% in baht terms in 2002.

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Economic Cooperation and Integration

It is no coincidence that these transitions have occurred following the return of peace to the region. Conflict arrested connectivity within the region, between the region and the rest of Asia, and with the rest of the world. This is now rapidly changing. ADB is helping draw the GMS closer together so that the inhabitants may take full advantage of the opportunities that peace provides.

Many of the traditional factors that motivate economic cooperation present themselves in the GMS. Complementary resources and levels of income suggest important opportunities for intraregional trade and investment. Economic cooperation can lower transaction costs by reducing structural and institutional impediments to the movements of goods, people, and capital. By acting together, GMS partners can exploit economies of scale and competitive efficiencies enabling activities that otherwise might not occur. The strength of the structure of the GMS program for managing economic cooperation is that it is less formal and hence more flexible than other such agreements.

Global and regional integration encourages GMS economies to become more diversified. In the original Association of Southeast Asian Nations (ASEAN), stable political and macroeconomic environments coupled with reliable and transparent investment rules provided the catalyst for industrial development and structural change. Foreign investment in internationally integrated production systems (e.g. electronics, motor vehicles, etc.) transformed the original ASEAN economies; the GMS will need to tap these funds to fuel growth. GMS economies will be well placed to receive investments as wages rise in the original ASEAN countries if they continue to strengthen macroeconomic performance and institutional, regulatory, and legal systems.

The path toward an integrated Asian economic community is likely to be uniquely Asian. The emergence of formal mechanisms defining this community raises the need for closer relationships among the GMS program,

ASEAN, and ASEAN's supporting institutions. The PRC's accession to the World Trade Organization opened up a vast new market with enormous opportunities for the GMS. The PRC's impressive growth, which is likely to continue as it opens up, presents a large, expanding market right at its doorstep that will be directly accessible through the planned ASEAN-PRC free trade association. Strong growth prospects in India underscore the importance of strengthening GMS ties with South Asia. The recently announced trilateral agreement to improve transport linkages between Thailand, Myanmar, and India is an important step.

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Debt Burden and Sustainability

As transitional economies, the CLMV (Cambodia, Lao PDR, Myanmar, Viet Nam) countries need substantial assistance and support from bilateral donors and multilateral financial institutions (MFIs) to meet the developmental, social, and policy reform challenges that they face. In trying to assist these countries, however, it is important to avoid overburdening them with debt. Development partners need to carefully assess debt sustainability when they formulate lending and other programs.

The three Asian countries that are officially classified as highly indebted poor countries (HIPC) are Lao PDR, Myanmar, and Viet Nam. MFIs now view Viet Nam as a sustainable case. Lao PDR has chosen not to take advantage of debt relief under the HIPC Initiative. None of the MFIs currently have lending operations in Myanmar.

A common feature of debt in the three HIPC is the significant share owed to the Russian Federation. In each of these countries, more than half the debt stock is Russian. This debt is not being serviced, and all three countries have been negotiating on its final disposition. In September 2000, the Russian government agreed to discount its claims on Viet Nam by 70%. Of the remaining debt (valued at one transferable ruble per US dollar), 50% will be written off, and the balance of \$1.7 billion will be repaid over 23 years, 10% in cash and 90% in goods. In June 2003,

Nurturing and improving the private sector remains the key to long-term regional growth and development and to increasing employment opportunities for the poor.

the Russian government agreed in principle to write off 70% of the Lao debt and to service the remaining \$380 million over a period of 33 years at a preferential interest rate. However, agreement on other repayment terms is still pending. In Cambodia, discussions with the Russian Government in June and September 2002 reached an understanding on the broad terms for the pre-cutoff date, but further negotiations are required for the post-cutoff date. About 15% of Cambodia's debt is owed to the United States and is also subject to negotiation. A number of exchanges have occurred since April 2002 to determine the precise amount to reschedule, but final agreement has yet to be reached.

Resolution of its Russian debt has significantly reduced Viet Nam's total debt burden. The Lao PDR's debt position will also improve markedly if Russia applies similar terms. Incorporating Russian discounts, total external debt to GDP is now about 70% in the Lao PDR and about 40% in Viet Nam. Debt service as a share of exports is about 10% in both countries, assuming comparable terms are extended to the Lao PDR. Although no agreement has been reached on Cambodia's debt to Russia, the developments in Viet Nam and the initial follow through with the Lao PDR bode well for a favorable, speedy resolution. Putting aside the unserviced debt owed to Russia and to the US, Cambodia has low and manageable external debt in both stock and flow terms. The total external debt is only around 10% of GDP, while debt service is less than 5%. In general, the debt situation in the GMS is moving toward sustainability, and the Subregion can continue to absorb more lending, particularly on concessional terms, if it leads to improved productivity, policy reforms, and revenue generation in excess of servicing costs.