

EXECUTIVE SUMMARY

The inaugural issue of *The Mekong Region: An Economic Overview* (MREO) gives context and background to complement and support the Greater Mekong Subregion (GMS) Regional Cooperation Strategy and Program (RCSP) of the Asian Development Bank (ADB).

The MREO analyzes, in detail, topics covered in Chapter II of the RCSP, particularly on external debt. The MREO also analyzes other key economic issues, including how the modalities of economic cooperation—subregionalism, regionalism, and multilateralism—can help overcome the economic challenges that GMS economies face, and take full advantage of new opportunities.

Particular attention is paid to delineating complementarities among those different modalities of economic cooperation.

For instance, the MREO looks at how subregionalism can promote regionalism or even multilateralism, and how regionalism can be employed toward globalization. In other words, we examine how subregionalism and regionalism can act as building, rather than stumbling, blocks toward free and open trade and investment in the Mekong region.

The GMS economies comprise five countries and one province: Cambodia, Lao People's Democratic Republic (Lao PDR), Myanmar, Thailand, Viet Nam, and Yunnan Province of the People's Republic of China (PRC). Its combined land area is 2.34 million square kilometers (km²). Its population was 257.5 million in 2002, with a population density of about 110 people/km². The average per capita gross domestic product (GDP) was \$3,288 in 2002.

The GMS is one of the world's fastest-growing subregions. Growth was robust in 2002 in all of GMS, ranging from 5.5% in Cambodia to 7.0% in Viet Nam. Available data suggest that growth has strengthened in most cases in 2003 despite the Severe Acute Respiratory Syndrome (SARS) epidemic and the uncertainties induced by the war in Iraq. All of GMS except Cambodia is expected to have grown by about 6% or higher in 2003, with Viet Nam again topping the list at 7.1%. This economic growth is remarkable, by any standard.

The CMLV countries (Cambodia, Myanmar, Lao PDR, and Viet Nam) face a set of common problems because their economies are in transition from centrally planned to market economies. These countries are undergoing multiple transitions, which present both challenges and opportunities. The future of GMS will largely depend on how successfully its member economies manage these transitions.

The first important transition is in the changing roles played by the state, and in markets. Acceptance is growing that markets and the private sector can do many things better than government. Consequently, the private sector's contribution to total economic activity has been growing faster than the state's contribution in most GMS economies.

A second important transition is the increasing diversification of most GMS market economies. Subsistence agriculture is giving way to commercialized agriculture, and the share of agriculture in total income is beginning to fall with the expansion of emerging manufacturing activities, including agro-processing. This diversification pattern is both a cause and a consequence of rising incomes and greater prosperity.

Social changes will also affect GMS economic conditions. Populations are still young, but the proportion of the working-age populations will rise over the next two decades. Low-productive, subsistence agriculture will not be able to fully absorb new entrants to the labor force. Economic diversification is already taking place, but much is a natural process associated with economic growth. Unless there are specific interventions to complement and speed the pace of this natural diversification, unemployment will probably rise significantly in the future.

Finally, and related to the development of markets, the GMS economies are becoming more “open” economically. The ratio of total trade to GDP in Cambodia, Thailand, and Viet Nam is already higher than 100%. Informal cross-border trade has always been important, but there is now a growing resumption of integration in formal trade and investment flows in the subregion.

Many of these transitions are direct or indirect results of reform programs—but overcoming their challenges and fully realizing their opportunities is in no sense preordained. Much will depend on choices that are made in going forward, and how policy makers address individual and collective challenges. The different modalities of economic cooperation of GMS economies will play an important role in overcoming these challenges, and in taking the region forward.

Economic cooperation and integration are taking place at three levels: subregional, regional, and multilateral. We define the subregion to comprise GMS members. The region, on the other hand, is defined as including all 10 countries that are currently members of Association of Southeast Asian Nations (ASEAN). Multilateralism or globalization is defined as a residual, and refers to engagement with countries outside the subregion or region.

At the subregional level, the GMS program is helping the Mekong economies forge the links and trust that are vital to exploit complementarities, to address shared problems, and to generate economies of scale. Through priority initiatives such as the East-West, North-South, and Southern Economic Corridors, ADB plays a catalytic role in promoting trade and spreading development benefits throughout the GMS. The GMS program also supports a range of measures to facilitate trade and investment, as well as a GMS single visa scheme, which are designed to promote integration.

The GMS program is a classic case of market integration, as opposed to institutional integration. Institutional integration is characterized by legal agreements and institutional arrangements that promote trade among members of the agreement on a preferential basis. Market integration, on the other hand, relies on nonofficial institutions that provide regional public goods that reduce transaction costs associated with the international movement of goods, services, and other production factors.

Market integration is causing subregionalism to drive regionalism and multilateralism through positive spillover effects. The benefits that accrue from improved infrastructure or from measures to facilitate trade and investment are not confined to the subregion. Emerging transport networks and economic corridors in the subregion are transforming the economic geography of the region as a whole. Subregional measures to facilitate trade and investment complement measures being pursued by the ASEAN Free Trade Area (AFTA), which are consistent with the World Trade Organization (WTO). Thus, countries outside the subregion will also have access, directly or indirectly, to these initiatives and measures, so they will generally contribute to increased trade and investment.

At the regional level, ASEAN and AFTA are driving trade liberalization and the opening of markets. Tariffs have already fallen sharply for a wide range of commodities as a result of meeting AFTA commitments. The CLMV countries are getting closer to their target dates when 0–5% tariffs will apply to most of the intra-ASEAN trade. Also, the ASEAN Integration System of Preferences (AISP) is accelerating the integration of the CLMV countries into the regional market.

Regionalism through ASEAN membership also provides the Mekong economies an opportunity to pursue multilateralism. If the new member countries emulate the original ASEAN members and adopt a nondiscriminatory approach to regionalism by multilateralizing their trade preferences, the extent and pace of their integration with the global economy will be maximized. The new members will be able to avoid trade diversion, as well as trade, production, and investment deflection. They could also eliminate the tedious and costly implementation of rules of origin and measuring domestic content of their imports. This would be the first-best option.

But a myriad of political economy considerations may stand in the way of this first-best option. In light of this, the question is: Will the pursuit of discriminatory regionalism necessarily impair multilateralism? This need not be so for the GMS economies in AFTA. There are other ways through which regionalism can work as a vehicle to promote closer integration with the rest of the world.

Regional integration is bringing globalization to the doorstep of the Mekong through strong links of the original ASEAN countries with industrialized nations. The strategic location of the GMS region also provides opportunities for integration beyond the region. Location between the burgeoning economies of India and PRC gives significant potential to boost trade, tourism, and investment. The recent signing of agreements to establish free trade areas between ASEAN and these economies significantly increases the potential to exploit such opportunities. It also highlights how regionalism is promoting multilateralism by extending integration beyond the region's boundaries.

Some GMS economies are pursuing globalization directly and independently through WTO membership, while others are seeking to join them in doing so. Thailand and Myanmar have been members for some time, while PRC and Cambodia joined only recently. The other GMS economies are aggressively pursuing membership. Since Lao PDR and Viet Nam have come a long way in their liberalization efforts through their active participation in subregional and regional cooperation initiatives, the most significant benefit of WTO membership for them may be through demonstration effects. WTO membership will signal to the rest of the trading world that these economies have successfully satisfied a demanding set of international trade and investment rules and guidelines.

Finally, the MREO assesses the external debt burden and analyzes its sustainability in the CLV countries (Cambodia, Lao PDR, and Viet Nam). Debt vulnerability in the CLV countries seems to largely be a legacy of their past. Its historical roots can be traced back to the command economies that operated during the Soviet era. A common feature in the composition of debt in Lao PDR, Viet Nam, and Cambodia is the significant share owed to the Russian Federation. In all of these countries, more than half the debt stock has historically consisted of Russian debt. All three countries have been negotiating with Russia on final disposition of this debt.

A significant breakthrough came in September 2000, when Viet Nam and the Russian Federation agreed to have most of the Russian debt written off, with the remainder serviced on

highly concessional terms. This led to an agreement similar in principle between Lao PDR and Russia in June 2003. Although agreement on resolving Cambodia's debt to Russia is still pending, the breakthroughs in Viet Nam and Lao PDR give hope for a speedy resolution under similarly favorable terms.

Putting aside nonserviced debt (to Russia in Lao PDR and Russia and the US in Cambodia), debt as a share of GDP in 2002 ranged from less than 20% in Cambodia, to about 40% in Viet Nam, to 70% in Lao PDR. The external debt service ratio in 2002 ranged from a low of about 4% in Cambodia, to 8% in Lao PDR, to about 10% in Viet Nam. All debt service indicators in the CLV countries suggest that current debt levels appear sustainable.

Viet Nam's experience suggests that once the Russian debt is resolved favorably, the situation improves to such an extent that a country no longer looks vulnerable in terms of any of the stock or flow indicators of external debt. It is also unlikely that these countries will again face a debt overhang problem like with the Russian debt. The move toward a market-based economy, and the institutions that have emerged since the Russian debt was accumulated, stand as safeguards against a future repeat of such debt problems.

Thus, it is reasonable to conclude that the debt situation in the Mekong economies will be considered sustainable if the Russian debt is resolved favorably. Even with the Russian debt on the books, the debt situation can still be considered sustainable because the debt is not being serviced. So either way, it is fair to conclude that these economies are in a position to continue to absorb more lending, particularly if on concessional terms, and if the lending leads to improved productivity, policy reforms, and revenue generation in excess of servicing costs. Indeed, as transitional economies, further inflows of aid and loans will be essential to assist in their pursuit of economic development. Rather than adding to economic vulnerability, recent borrowings have worked to reduce it. This should continue.