

# Chapter 12

## Challenges and Prospects for Upgrading and Diversification of Industrial Structure in CLMV Countries

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# **CHAPTER 12**

## **CHALLENGES AND PROSPECTS FOR UPGRADING AND DIVERSIFICATION OF INDUSTRIAL STRUCTURE IN CLMV COUNTRIES**

*Ruth Banomyong*

### **INTRODUCTION**

Over the last decade, Cambodia, Lao PDR, Myanmar and Vietnam (CLMV) have shown remarkable economic growth. This economic growth was facilitated through sustained foreign direct investment (FDI) that was facilitated by improved physical infrastructure, cheap labour cost and preferential market access treatment by developed countries' market. However, with the exception of Vietnam, most of the FDI in Cambodia, Lao PDR and Myanmar was mainly focused on the textile and garment industries.

The purpose of this chapter is to present an overview of the challenges and prospects for upgrading and diversifying industrial structures in the CLMV countries based on the obtained respective country surveys as well as the lessons that can be learned from past experiences of the more advanced ASEAN nations.

Indonesia, Malaysia and Thailand are considered part of the more advanced economies within ASEAN when compared to the CLMV. These countries have benefitted from remarkable economic growth since the second half of the 1980s when they started receiving FDI. These countries are now fully integrated in electrical, electronics and automotive regional and global production networks.

Since the start of the 21<sup>st</sup> century, competition intensity has increased, especially with the rise of China as a global economic powerhouse. This has led a number of well established industries in the more advanced ASEAN nations considering the possibility of “fragmenting”. This means that they would be inclined to move the more labour-intensive blocs of their manufacturing process to lower-wage countries such as the CLMV. It is under this framework of industries’ potential to “fragment” that CLMV are expected to upgrade and diversify their industrial structures by becoming beneficiary of “fragmentation” and relocation efforts from established industries (Kimura, 2009) such as electronics and automotive from Indonesia, Malaysia, and Thailand.

The chapter starts with an introduction to the corridor concept and its importance to the development of “fragmentation”. The 2<sup>nd</sup> section deals with CLMV challenges and prospects while the 3<sup>rd</sup> section focuses on the experiences of the more developed ASEAN countries in industrialising their respective economies. The chapter concludes with policy proposals to develop network of key industrial corridors targeted for specific industries and commodities.

## **1. INDUSTRIAL CORRIDORS**

The concept of industrial corridor is of critical importance in understanding how “fragmented” production network can be developed. Lower labour cost does not automatically mean that industries’ labour intensive blocs will relocate to areas where labour wages are low. There are a number of other conditions that needs to be established as a pre-requisite for this re-location to occur.

These pre-requisites include having infrastructure that is capable of not only accommodating industrial activities but also industries’ respective inbound and outbound flows. This is a key challenge for the CLMV as infrastructure is still lacking in many areas, the current institutional framework is usually complex and not very business friendly. Even

though labour cost in these countries is cheap, labour skills levels still need to be upgraded. CLMV logistics systems are still under-performing due to current physical and regulatory constraints.

This is why it is important to focus on a corridor development approach in these countries as it is impossible to fully improve holistically infrastructure, the institutional framework, labour or even logistics issues in a single effort. It makes more sense to target specific geographical areas by implementing the corridor concept. A corridor approach will link key nodes both within and between countries. These corridors can then serve as a geographical blueprint for industries to select not only the location of their “fragmented” activities but also their respective logistics linkages. This approach will enable industries to develop regional supply chains that benefits from existing technological expertise and know how in the more developed ASEAN countries as well as lower wage labour in the CLMV for the more labour intensive units. Table 1 hereunder proposes a corridor development stage that could be used in understanding which type of corridor can best support industries’ “fragmentation” approach.

It is not necessary for the targeted corridor to achieve industrial or economic level for “fragmentation” to be considered. The establishment of a transport corridor is the starting level where “fragmentation” can be explored and developed. However, in order to benefit from the completion of the physical infrastructure in the corridor, it is advised that the institutional framework within the corridor be in place to facilitate the movement and storage of freight, vehicles, people and information from node to node within and across borders. This will facilitate the logistics linkages between industries’ activities along targeted corridor. A logistics corridor is the recommended corridor development level in order for disaggregated production networks to inter-link effectively and efficiently.

**Table 1: Level of Corridor Development**

<b>Stage</b>	<b>Corridor</b>	<b>Definition</b>
<b>Level 1</b>	Transport Corridor	<ul style="list-style-type: none"><li>• Corridor that physically links an area or region</li></ul>
<b>Level 2</b>	Logistics Corridor	<ul style="list-style-type: none"><li>• Corridor that not only physically links an area or a region but also harmonise the corridor institutional framework to facilitate the efficient movement and storage of freight, people and related information.</li></ul>
<b>Level3</b>	Industrial Corridor	<ul style="list-style-type: none"><li>• Corridor that links key industrial nodes in a geographical area through integrated supply chain networks. These supply chain networks provide value-added activities along the corridor in order to meet respective customers' requirements.</li></ul>
<b>Level 4</b>	Economic Corridor	<ul style="list-style-type: none"><li>• Corridor that is able to attract investment and generate economic activities along the less developed area or region. Physical linkages, logistics facilitation and supply chain integration must be in place in the corridor as a prerequisite.</li></ul>

*Source:* The author.

## **2. CLMV CHALLENGES & PROSPECTS**

It is interesting to observe that investment promotion policies and incentive do exist in the CLMV. Each respective CLMV country has developed investment promotion laws and regulations that are attracting foreign direct investment (FDI) with more or less success. This FDI attraction capability is not solely based on policies or investment promotion laws as other pre-requisite factors are needed to make CLMV attractive enough to attract foreign investment.

In theory, the CLMV countries may have the most favourable investment promotion laws but this does not mean that they'll be able to attract much FDI if infrastructure, labour capabilities or logistics linkages are not in place.

CLMV usually relied on obtained GSP privileges in certain industries to attract FDI. These GSP were obtained through the fact that CLMV countries have traditionally been part of the less developed economies in the world and needed preferential access to main markets. This has led a number of industries, in particular the garment industry, to invest and provide export driven “cut & sew” operations in the CLMV. These labour intensive industries not only benefited from cheap labour force but also preferential market access to compete with the more established garment exporting nation. However, the reliance on GSP is in itself not sufficient as the end of the multi-fibre agreement has increased the competitive environment for CLMV countries in this industry.

Industrialisation in the CLMV countries is a relatively recent phenomenon with Vietnam becoming the main FDI recipient country of this sub-regional grouping. This is reflected in the level of economic growth and activities sustained by each CLMV countries. In general most of the FDI, apart from Vietnam, are often relatively “light” industries that do not require much capital or technological input. This is one of the reasons why industrialization in Cambodia, Lao and Myanmar are not very diversified as other investors need to consider a full range of other criteria before making any relocation decisions. The industrial sector does not have, at the present moment, the highest share of economic activities generated in CLMV.

However, there is a strong potential for the development of agro-based industries in the CLMV. The example of Lao PDR is interesting as the manufacturing sector in the country is small, not developed with limited numbers of industries. Lao PDR depends on imports for most consumer products, machinery and manufacturing equipment as well as for raw and semi-processed materials. Agriculture remains the backbone of the economy, accounting for 2008 around 30.1 % of total GDP, followed by the industrial sector at 25.9%. The food and agro-based processing industries have the potential to become a major driving force for economic development. All CLMV countries have strong agricultural base and this needs to

be further explored in order to assess the opportunity to diversify their respective industrial development.

## **2.1. CLMV Common Industrial Development Issues**

CLMV countries suffer from a number of common issues that constrains FDI attractiveness and therefore industrial development. Logistics infrastructure and facilities are lacking in CLMV. Even though there are numerous over-lapping infrastructure development plans, it is acknowledged that these fundamental infrastructures will not be ready until the year 2015. Even after the year 2015, the issue of establishing inter-connected sub-regional logistics facilities will still need to be considered in order to develop an integrated CLMV nodal network.

The consideration for the establishment of this integrated network of logistics facilities need to be done in parallel with targeted zones for FDI in areas such as a specific free trade zone (FTZ), an industrial zone (IZ) or even an industrial estate (IE). The established logistics facilities will serve as a support platform for industrial activities located in such areas.

However, the establishment of such logistics facilities must also be supported by an institutional environment that is able to facilitate export and import procedures. As CLMV countries are export-driven, the export facilitation issue is not as critical as compared to importation issues. These logistics facilities can benefit from a special legal status that will enable them to streamline both export and import procedures for the benefits of industries located within these clearly defined targeted areas.

These clearly defined areas should be understood not only individually but also as part of a network of inter-connected industrial nodes. Reliability with each node is critical and issues such as electricity supply reliability must not be overlooked. These designated areas must be able to guarantee electricity supply service level if FDI is to be attracted. Currently

this is a key problem in Myanmar. Electricity cost is also an important criterion but not as much as the lack of electricity service reliability.

Labour availability and skills is another key criterion that needs to be taken into account when decisions to relocate occur. It does not make any sense to decide on a relocation strategy when labour is not available in the targeted area. This is an even worse case scenario than just having un-skilled labour that needs to be trained. Labour related laws will need to be more employers friendly in order to help investor gain the most from the available cheap labour cost.

## 2.2. Attracting FDI into the CLMV

The capability to attract FDI, as described hereover, is not just dependent on cheap labour cost. A number of criteria are needed for investment decisions to be made. Table 2 illustrates some of the key investment criteria that need to be taken into account. Low labour cost is an insufficient criterion no matter how attractive it is. Low labour cost need to be coupled with labour availability and adequate skill level.

Table 2 clearly demonstrate that there are 2 levels related to the relocation decision-

**Table 2: Foreign Direct Investment**

<b>Investment</b>	<b>Criteria</b>
Investment Qualifiers	<ul style="list-style-type: none"> <li>• Rehabilitated infrastructure.</li> <li>• Facilitating Institutional Framework.</li> <li>• Sufficient labour force and capability.</li> <li>• Political stability.</li> <li>• Ease of access to key markets.</li> </ul>
Investment Winners	<ul style="list-style-type: none"> <li>• Incentive Policy</li> <li>• Integrated Service-link Connectivity</li> <li>• Provision of investors' confidence</li> <li>• Large domestic/regional market</li> </ul>

*Source:* The author.



making process. The first level focuses on the necessary conditions that are needed to consider the possibility of re-locating to the CLMV countries. If these criteria are not met then the intention to consider relocation investment will not even be made. It is only after these conditions are met than the decision-making process can focus on investment winner criteria that will determine the attractiveness and potential of such the investment.

FDI is very much dependent upon investor confidence. It is therefore needed, especially in CLMV, that foreign investor should receive at least equal treatment to domestic investors. The investor need to feel that the local government is pro-business and willing to support. Transparency of procedures is also important as foreign investors need to understand their operating environment. A marketing campaign is therefore needed to build investors' confidence is CLMV countries are selected as destination for the relocation of labour intensive production blocks. The attraction of FDI must also include having the capability to attract supporting industries of key industrial products.

However the marketing campaign and existing investment incentive policies are still not sufficient. The performance of logistics systems within and between CLMV countries need to be considered as a key driver of service-link connectivity.

A common issue is related to the lack of diversified industrial FDI in Cambodia, Lao PDR and Myanmar is the limited domestic market size. FDI maturity is also different among CLMV. This is why a sub-regional integrated market approach encompassing all CLMV countries are required or else most of the FDI will be mainly targeted in Vietnam.

It is important that a supply chain and/or a value chain approach is utilised in order for industrial corridors to be developed. This will enable the identification of strategic locations for key industrial activities nodes at a sub-regional level.

### **3. LESSONS LEARNED FROM THE MORE ADVANCED ASEAN COUNTRIES**

#### **3.1. Common Development Theme**

The more advanced ASEAN countries such as Indonesia, Malaysia and Thailand has benefitted from FDI since the 1960s and 1970s. This has enabled these countries to quickly industrialise themselves. FDI to the more advanced ASEAN nations accelerated due to the sustained investment promotion policies developed by these countries.

It was observed that the success of these more advanced ASEAN nations in attracting FDI was also based on a cluster development approach. FDI that came into these countries did not come alone and supporting industries followed their key industrial customers. Technological know-how was transferred with FDI and this has enabled these countries to start develop their own research design capability.

#### **3.2. Common Issues**

The more advanced ASEAN nations suffer from limited labour skills that need to be enhanced in order to make the workforce still attractive to investors. Labour laws and regulations must be seen as neutral while protecting the interest of both groups. Labour issues are becoming more critical on investors' decision to remain or move out of the more advanced ASEAN nations.

The more advanced ASEAN nations has been subject to competitive pressure from China and are starting to suffer from a loss of competitiveness. This loss of competitiveness is not solely based on labour cost or relationship issues but also because there is a lack of local innovation capability that could enable more capital intensive types of FDI thus transferring the more labour intensive production units to lower cost location such as the CLMV countries.

## 4. SUMMARY & POLICY RECOMMENDATIONS

“Hard” infrastructure in the CLMV is still an important issue but not as high as expected. The highest issues were more focused on the “soft” aspects of infrastructure, in particular those related to institutional complexity and improving service-links to connect fragmented production blocks. It is therefore of great importance for CLMV policies to be developed according to these recommendations proposed hereunder if CLMV countries are going to diversify their current industrial structure.

- A CLMV sub-regional cooperation framework is needed for investment policy coherence between and within countries. CLMV should be considered as a sub-regional grouping in its own right and marketed as a single investment destination.
- Existing policies, laws, regulations need to be implemented in a fair and transparent manner in order to convince foreign investors of equal treatment.
- Logistics linkages within CLMV must be improved for further integration that is based on key development corridor axis. These corridors need to achieve at least a logistics corridor development level in order to facilitate the efficient and effective flow and storage of goods, vehicles, people and information from origin to destination.
- The development of these corridors should be based on a supply chain/value chain development strategy that focuses on the integration of key identified industries or sectors. This will enable the establishment of industrial corridors with multinational firms FDI as a key driving force. There will be industrial corridors dedicated to supporting specific types of commodities as illustrated in the proposed list herebelow:
  - The key proposed industrial corridor for the automotive sector is:

- Thailand-Lao-Vietnam (Hanoi)
- The key proposed industrial corridors for electronics are:
  - Thailand-Malaysia (Penang)-Thailand
  - Thailand-Lao-Vietnam (Ho Chi Minh)-Thailand
  - Thailand-Cambodia-Vietnam (Ho Chi Minh)
- The key proposed industrial corridors for the agro-industry are:
  - Thailand-Cambodia-Vietnam
  - Thailand-Lao-Vietnam
  - Thailand-Myanmar-Thailand
- The key proposed industrial corridors for textiles and garments are:
  - Thailand-Lao-Thailand
  - Thailand-Cambodia-Vietnam
  - Indonesia-Cambodia-Vietnam

This list of proposed industrial corridors is not exhaustive and is based on the survey results of the more advanced ASEAN with CLMV countries and on their potential linkages in terms of having a fragmented production network approach.

The success of these industrial corridors will depend very much on the improvement of the service-links that will connect each key industrial node in the CLMV. These service-links need specific development policies if fragmentation is to be successful in the sub-region. Table 3 describes the types of policies needed to improve CLMV service-link.

In order for the fragmentation of production networks to occur in the CLMV countries, it is necessary that a holistic approach is taken in the decision to relocate labour intensive production blocks. This relocation cannot be solely based on labour cost or availability alone. A number of different criteria are taken into account with service-link capability becoming a main issue. The efficient and effective movement and storage of freight,

vehicles, people and information is representative of strong service-link connectivity. This improved service-link

**Table 3: Service Link Related Policies**

<b>Perceived problems</b>	<b>Proposed Guidelines</b>	<b>Concrete Policies</b>
Lack of adequate CLMV service links	Improve CLMV service links	<ul style="list-style-type: none"> <li>• Accelerate establishment of service links within CLMV</li> <li>• Accelerate CLMV connectivity with outside markets</li> </ul>
Uneven performance level between corridors	Develop common performance guidelines for industrial corridors	<ul style="list-style-type: none"> <li>• Harmonised procedures</li> <li>• Standardised procedures</li> <li>• Transparent procedures</li> </ul>
Uncertainties at key nodal points	Eliminate uncertainties at key nodal points	<ul style="list-style-type: none"> <li>• Improve border facilities</li> <li>• Develop specific infrastructure required for identified freight flows</li> </ul>
Limited understanding of industrial corridors concept	Convince investors of industrial corridor benefits	<ul style="list-style-type: none"> <li>• Expansion of domestic market access</li> <li>• Improved regional and global market access</li> <li>• Facilitate establishment of a network of industrial zones along industrial corridors</li> </ul>

*Source:* The author.

connectivity will support enhanced integration of production networks across the CLMV. Highly connected service-links plays a key role in the re-location decisions.

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