

EXECUTIVE SUMMARY

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1. AIM OF THE STUDY AND BACKGROUND

One of the main roles of the Economic Research Institute for ASEAN and East Asia (ERIA) is to study three topics for the regional integration of East Asia. The topics are deepening integration, narrowing gaps and having sustainable growth. The topic on narrowing gaps has focused on the development of Cambodia, Lao PDR, Myanmar, and Vietnam (CLMV). In 2006, per capita GDP figures in Cambodia, Laos, Myanmar and Vietnam were US\$598, US\$736, US\$216, and US\$837, respectively. While these levels are much lower than those in other countries, the GDP growth rates in the former (except Myanmar), however, are higher than those in the others (Table 1). The economies of CLMV are in fact growing dynamically and the share of secondary industries in the GDP in these countries has clearly risen in the last two decades (Table 2). This is significant since acceleration of industrialization is deemed to be critical in order to sustain a stable economic growth.

Table 1. Per Capita GDP and GDP Growth Rates in ASEAN

	Per Capita GDP in 2006(US\$)	Annual GDP Growth between2000-2007 (%)
Brunei Darussalam	31,076	7.8
Cambodia	598	10.0
Indonesia	1,920	5.1
Lao PDR	736	6.6
Malaysia	6,880	5.7
Myanmar	216	NA
Philippines	1,653	5.2
Singapore	35,206	5.1
Thailand	3,740	5.0
Vietnam	837	7.7

Source: Website of ASEAN Secretariat

Table 2 Industry-wise Share in GDP (%)

	1990			2000		
	Primary	Secondary	Tertiary	Primary	Secondary	Tertiary
Cambodia	55.6	11.2	33.2	37.9	23.0	39.1
Lao PDR	61.2	14.5	24.3	52.6	22.9	24.6
Myanmar	57.3	10.5	32.2	57.2	9.7	33.1
Vietnam	38.7	22.7	38.6	24.5	36.7	38.7
	2006					
	Primary	Secondary	Tertiary			
Cambodia	31.7	27.6	40.8			
Lao PDR	42.6	31.8	25.6			
Myanmar	NA	NA	NA			
Vietnam	20.4	41.5	38.1			

Source: Asian Development Bank, Key Indicators for Asia and the Pacific 2008.

This study aims to examine the present business environment in the manufacturing sector in the CLMV countries and provide policy recommendations to promote industrialization in these countries.

In this study, the focus is on how the CLMV countries can participate in production networks organized by multinational enterprises (MNEs) and form competitive industrial clusters. The study conducted two surveys: interview survey on the basis of the flowchart approach and firm-level questionnaire survey. These surveys will reveal the bottlenecks being faced by the CLMV countries in attracting foreign direct investment, participating in production networks, and forming competitive industrial clusters. The surveys were conducted —with the results examined closely— by the respective CLMV research institutes.

The study also discusses the framework of industrial development strategy, with particular focus on economic corridors, Special Economic Zones (SEZs), border area development, and SME support.

2. STUDY METHODOLOGY

2.1 Flowchart Approach

The flow chart of the manufacturing industry cluster policy proceeds as follows. First, a local government establishes an industrial zone to attract foreign investors. Second, the

government builds capacity to improve the business and living conditions or environment for foreign investors. The elements of capacity building include: (1) constructing physical infrastructure, (2) building institutions, (3) developing human resources, and (4) creating living conditions amenable to foreign investors. Physical infrastructure refers to roads, ports, communications, and the like. Institution building, which is also crucial for the success in attracting foreign investors, includes the streamlining of investment procedures through one-stop services, deregulation, and the introduction of preferential tax systems. Human resources, which are usually an initial condition for foreign investors, include unskilled labour, skilled labour, managers, researchers, and professionals. An anchor firm will be ready to invest after this capacity building has been carried out. The anchor firm is defined as the high value of the backward linkage in the manufacturing industry.

The study carries out surveys of the industrial cluster policy to determine whether problems can be solved using the abovementioned flowchart approach. In the process, ten professionals were interviewed to help in looking for the appropriate policy prescriptions.

CLMV countries have SEZs and industrial zones. But the results of interview show that the efficiency of operation must be improved. The poor development status of infrastructure is the main hindrance to participation of these countries in the production and distribution networks in East Asia in spite of its abundant, reasonably well-educated and low-wage labour.

2.2 Business Environment Survey

When production fragmentation happens, a firm can save labour costs by transferring labour-intensive production activities (or production blocks) to low-wage countries. And while there are always incentives for a firm to do so, additional costs are also incurred in the process.

First, business setup costs are incurred when the firm sets up a new factory in the low-wage (less developed) country. For example, the firm needs to collect information on the regulatory framework and legal procedures, and obtain licenses and permits in the host country. These costs will be reduced substantially if the government of the host country provides efficient services such as one-stop location for services.

Second, additional business operation costs are incurred when the less developed country or host country of the investment has a less favourable business environment than the developed country. For example, infrastructure services such as utilities (electricity, water, and gas supply), transportation and communication services are less efficient and often more expensive in less developed countries. Institutions and governance are also generally weak in these countries, thereby giving the firm serious uncertainty in conducting business there. Typically lacking in the less developed countries is also a pool of qualified workforce, including engineers and middle management. However, if less developed countries can offer generous investment incentives, said additional business operation costs may be somewhat offset to a certain degree.

Third, additional service link costs or logistic costs are incurred when (as a result of production fragmentation) intermediate inputs are carried back and forth between the developed and less developed countries. Logistic costs include import duty and time cost for custom procedures. Moreover, communication costs are incurred in the coordination of the production activities internationally.

For production fragmentation to become economically feasible, these business setup costs, operation costs and logistics costs must be reduced substantially. The ERIA questionnaire survey, especially the questions in Sections 1, 2, and 3, is specifically aimed at finding how such costs may be reduced. The CLMV countries can increase their chances of participating in production networks by taking appropriate measures to reduce these costs.

The results of survey show common phenomena in CLMV countries. Unstable macro economies, government regulation and poor development of infrastructure particularly electricity are bottlenecks of doing business. At present, total additional costs including business set up, business operation and logistics exceeds net present value of the benefits by saving labour costs.

3. FINDINGS AND CONCLUSION

Liberalization in trade and investment was critical in the spread of production networks in Southeast Asia. Thus, it is expected that a similar development would happen in the CLMV countries in view of the economic transition taking place in their countries since the mid-1980s and their accession to the World Trade Organization (WTO) and participation in Free Trade Agreements (FTAs) since the late 1990s.

Considering the two constraints that the CLMV countries face, namely, shrinking policy space and limitations in state capabilities, generic policies that improve the overall business environment in the host countries should be given priority. Consequently, measures that promote the industrial clustering of specific industries may become more relevant as industries become more mature and upgraded, and if, at the same time, the institutional capability of the state sufficiently grows.

In Southeast Asia, production networks expanded in the electronics and automotive industries. In particular, the electronics industry developed dense production networks and became a leading force of economic integration. The CLMV countries are already involved in the apparel production network but it is becoming difficult for them to be engaged in other promising industrial activities. Their governments thus need to adopt clear and decisive policies to attract as many production blocks as possible and to diversify and upgrade their industrial base. Specifically, Lao PDR, Cambodia and Myanmar need to improve their business environment and attract more production blocks while Vietnam should give more attention to industrial cluster development since its lack of a strong industrial base affects the competitiveness of its industry.

Meanwhile, four “categories” of areas that may be considered as potential candidates in the setting up of SEZs have been identified. These include “metropolitan” and “port and harbour” areas, examples of which may be provided by the experiences of the forerunners among the ASEAN countries. “Border area” and “junction”, on the other hand, are defined in accordance with the design of economic corridors of the Greater Mekong Subregion Economic Cooperation Program (GMS-ECP).

The metropolitan area is important as a market and a production location supplying labour force. As for the port and harbour areas, while depth is important, the

industrial development in the surrounding areas is equally important because the shipping frequency becomes small if the quantity of goods to convey is small. A port city is not attractive to investors if the shipping frequency is small and thus, the economic scale around the port and harbour should be large. For the border area, it can utilize better infrastructure such as electricity and access to harbours of relatively developed countries as well as enjoy the benefits of a cheaper labour force and preferential treatment of relatively less developed countries. And junctions of major roads, on the other hand, can be utilized as a dry port or inland container depot.

Several areas have been identified and enumerated in the CLMV countries in terms of how they may suit or fit such categories. Per the descriptions and characteristics indicated in the survey questionnaire and in the flowchart-based survey, potential locations have been identified and issues on what may cause bottlenecks for the CLMV countries to meet the requirements as well as recommendations on what possible country strategies the CLMV countries may adopt have been put forward.

Underdeveloped infrastructure, including transportation, communications and electricity, and poor business and investment environment hinder the CLMV countries from participating in such networks in East Asia. Service link costs and other business costs in the CLMV countries have not become low enough to realize total cost reduction.

In this regard, border area development can offer a solution. The CLMV economies can be connected to the regional and global economy through their borders with their neighbours, Thailand in particular, which already have logistic hubs such as deep-sea ports, airports and trunk roads as well as reasonable and reliable utility services. The border areas could be an effective candidate for industrial clusters in the CLMV countries.

Experience in the Vietnamese motor cycle industry shows that expansion of demand and competition would encourage entry of local small and medium enterprises (SMEs). Policies cannot control demand but they can facilitate imports of components and capital goods and exports of products. It is thus important to develop local SMEs to accumulate skills and know-how. There are two possibilities of new entry. One, domestic-oriented SMEs like replacement parts manufacturers can join supporting industries. And two, employees in existing factories of MNEs can set up their own

enterprises to supply components to them. In both cases, however, there are bottlenecks in terms of low technology, unskilled management and unskilled workers.

Most of the SMEs in the CLMV countries belong to domestic market-oriented industries and cottage industries. The most serious problem is that they are not registered and are operating illegally. To address this, tax concession might serve as incentive to registration.

Most of the cottage industries depend on middle persons to procure material and sell products. Moreover, middle persons are playing an important role in informal financing to help augment household budgets. The distribution of cottage industries should be modernized in order to have a dynamic development of markets. And since public organizations can and should substitute for middle persons only in the marketing promotion in the domestic and export markets, microfinance and cooperative societies should therefore also support the households of the crafts manufacturers.

4. POLICY RECOMMENDATIONS

Promotion of industrialization is necessary to maintain stable economic growth. To join production networks is an efficient way to push for industrialization in the CLMV countries. On the basis of their geographical proximity and significant wage gaps, the CLMV countries are well located to attract production blocks especially from neighbouring East Asian countries. In this connection, this study hereby recommends two basic strategies as shown below.

4.1 Improvement of Business Environment

It is more practical for the CLMV countries to focus on the improvement of the overall business environment such as preparation of the legal framework, macroeconomic stability, provision of general infrastructure, and free trade and open investment policies. Because human development is important for industrialization and engineering and vocational education is a base, institutions for training should therefore be established. These conditions are necessary for the development of a private sector, including foreign firms, in the CLMV countries.

To minimize business setup costs, operation costs, and service link costs, regional integration through the ASEAN Free Trade Area (AFTA), preparation of transportation infrastructure like economic corridors, and implementation of the GMS Cross Border Transport Agreement (CBTA) is important. Some big cities are located near borders. In Lao PDR, in particular, one of the bottlenecks for SME development is limited demand which has also been enhanced by fragmented domestic markets. Lao PDR should therefore make effort to shift from limited domestic demand to much larger foreign demands.

4.2 Promotion of Industrial Clustering

4.2.1 Short-term Strategy

It is difficult to improve business environment at the whole country level due to constraints in resources. Hence, this study recommends that operating SEZs are to be given priority in resource allocation. MNEs will hesitate in making additional investments due to the current world economic crisis. Official development assistance (ODA) from donors may also be reduced. Thus, SEZs can be a show window to attract FDIs. If efficient administration like the presence of one-stop shops for services and , the effective and efficient delivery of infrastructure services like electricity, water supply and telecommunications are secured in the SEZs, then more foreign firms may set up factories in the area in the future.

4.2.2 Long-term Strategy

Before the world economy recovers and MNEs restart to increase FDIs, the CLMV countries should prepare to accept such situation. . The SEZs can become the starting point of industrial clustering. The CLMV countries should set up new SEZs in the future plan and improve business environment at the country level.

4.3 Present Bottlenecks in the Formation of Industrial Clusters

At present, Phnom Penh, Sihanoukville, Vientiane, Savannakhet, Yangon, and Danang are facing the following bottlenecks.

Phnompenh and Sihahoukville

- Regarding SEZs, the need to provide more attractive non-fiscal incentives, that is, to improve transparency on fees and charges, introduce the unified employment contract, reduce costs for vocational training, exempt investors from advanced profit tax, and allow semi-annual payment of the said tax. There is also a need to give more favourable conditions to zone investors or to allow investors to freely import production inputs, apply a “single window” system for exports-imports control, apply the post-clearance audit method to all imports, exempt on-site inspection before packing, and restrict labour strikes inside the zones.
- Regarding water supply, the need to clean up water sources to ensure food safety and better livelihoods in accordance with the Cambodian Millennium Development Goals (CMDGs), and preserve the ecosystem of unpolluted water and clean environment.
- Regarding electricity supply system, the need to increase electricity supply capacity and reduce tariff to an appropriate level while strengthening institutional mechanism and management capacity.
- Regarding telecommunication infrastructure, the need to develop the post and telecommunication system and promote the development of information and communication technology to ensure a high quality that conforms with international standards, low price and reasonably nation-wide coverage.
- Regarding transport infrastructure, the need to give high priority to the maintenance of national roads, and the reconstruction of provincial and rural roads, expand ports and rehabilitate railways in order to connect to the rail network of the neighbouring countries within the Greater Mekong Sub-region (GMS) framework. There is likewise a need to privatize the operations of the Cambodian railway and encourage private sector participation in the rehabilitation of infrastructure and transportation services.
- Regarding governance reforms, the need to enhance effectiveness in the implementation of policy and delivery and management of public goods. There is also the need to improve the quality of education services, paying more attention to information, technical and vocational training, and higher education. Moreover, there should be more attention paid to technician and engineer training through the

establishment of technical and vocational training schools and higher education.

Vientiane

- Regarding industrial zones, the need to invest in infrastructure in the zone and institute laws and regulations on industrial zones.
- Regarding water, the need to expand the water supply system.
- Regarding electricity, the need to increase power supply and to control prices.
- Regarding transport, the need to develop transport channel options for exporters, dry ports for exporters, and road networks connecting to neighbouring countries.
- Regarding social infrastructure, the need to improve school infrastructures, quality of education, hospital infrastructures, and quality of health care services.

Savannakhet

- Regarding industrial zones, the need to invest in infrastructure in the zone and institute laws and regulations on industrial zones.
- Regarding water, the need to expand the water supply system.
- Regarding electricity, the need to increase power supply and to control prices.
- Regarding transport, the need to develop transport channel options for exports.
- Regarding social infrastructure, the need to improve school infrastructures, quality of education, hospital infrastructures, and quality of health care services.
- Regarding skilled labour, the need to improve quality of vocational training curriculum
- Regarding unskilled labour, the need to improve quality of vocational training curriculum and labour regulation

Yangon

- Regarding roads, the need to construct highway 1 to link Mue and Myawaddy, new express way to link Yangon and Mandalay, and road to link Yangon and Thilawa Port.
- Regarding electricity supply, the need to increase power supply, and install new transmission lines and transformers.
- Regarding ports, the need to upgrade Yangon Ports.

- Regarding institutional reforms, the need to relax trade procedures, and introduce quick processes and online licensing.
- Regarding unskilled labour, the need to employ labour from rural areas.

Danang

- Regarding the transportation system in general and the road transportation system in particular, the need to improve roads connecting Danang city with neighbouring provinces and to build highways from Danang to the Dung Quat finery factory;
- Regarding electricity, the need to increase power supply particularly during peak season, such as summer.
- Regarding ports, the need to increase water depth, to build roads, railways and warehouses and set up logistics service companies in order to improve efficiency of Danang port.
- Regarding regulations, the need to improve transparency and inconsistency as well as their enforcement.
- Regarding human resources, the need to improve quality of education and training system. Local governments can support this endeavor providing more incentives to firms to train their workers on the job. They should also provide incentives to companies to attract more professionals and engineers to work in Danang. Curriculum reform should be pursued alongside overseas education and training in some cases

