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THE MEKONG REGION
TRADE
TRENDS, PATTERNS AND POLICIES

ABBREVIATIONS

ACMECS	Ayewady-Chao Phraya-Mekong Economic Cooperation Strategy Organization
ADB	Asian Development Bank
AFTA	ASEAN Free Trade Area
ASEAN	Association of Southeast Asian Nations
CASP	Core Agricultural Support Program
CBTA	Cross-Border Transport Agreement
CEPT	Common Effective Preferential Tariff
CPI	Committee for Planning and Investment
CDRI	Cambodia Development Resource Institute
CIEM	Central Institute for Economic Management
CLMV	Cambodia, Lao PDR, Myanmar, Viet Nam
CLV	Cambodia, Lao PDR, Viet Nam
CUTS	Consumer Unity and Trust Society
DAN	Development Analysis Network
EIC	Economic Institute of Cambodia
EU	European Union
FDI	foreign direct investment
FIEs	foreign-invested enterprises
FTA	free trade area/agreement
GDP	gross domestic product
GMS	Greater Mekong Subregion
GSP	General System of Preferences
Guangxi Zhuang AR	Guangxi Zhuang Autonomous Region, PRC
IL	Inclusion List
Lao PDR	Lao People’s Democratic Republic
MFN	Most-favored nation
MoP	Margin of preference
MPI	Ministry of Planning and Investment
NERI	National Economic Research Institute
NSC	National Statistics Center
NTR	Normal trade relations
PRC	People’s Republic of China
SOEs	state-owned enterprises
SPS	Sanitary and phytosanitary
TBT	Technical Barriers to Trade
UN	United Nations
UN COMTRADE	United Nations Commodity Trade database
UNDP	United Nations Development Program
US	United States
WTO	World Trade Organization

NOTES

In this report, “$” refers to US dollars

CONTENTS

I. INTRODUCTION

1. The Greater Mekong Sub-region (GMS) economies[1] have grown impressively over the past decade and a half as many of them started the process of transition from centrally-planned to market-based systems and forged closer integration with external markets. As reforms began in the latter half of the nineteen eighties, the dominance of state-owned enterprises was reduced; restrictions on private sector were eased; and prices and trade of goods and services were liberalized.

2. Enhancing trade further is an important element of the development strategies of the GMS economies.[2] Policies to enhance trade, set within a broad reform agenda, can promote growth and reduce poverty. Trade can lead to specialization according to a country's comparative advantage and a more efficient allocation of scarce economic resources. It can enlarge the market for products and enable domestic producers to benefit from economies of scale. It can also increase productivity growth by enhancing competition, raising foreign direct investment, and providing access to new products and ideas.

3. This paper outlines the trends and patterns of merchandise trade of the GMS economies. It discusses tariff and non-tariff barriers as well as supply-side constraints to trade in Cambodia, Lao PDR, and Viet Nam (CLV). A lack of information precludes an equal focus on Myanmar, as well as Guangxi Zhuang Autonomous Region and Yunnan Province of PRC. Thailand and PRC are included primarily as reference points. The paper concludes with some policy implications.

II. TRENDS IN TRADE

4. External trade of the GMS economies rose steadily until about the mid-nineties, when the rate of expansion slowed somewhat reflecting adverse effects of the East Asian financial crisis (**Figure 1a**). The slump in the global information and communications technology sector in 2001 and the consequent economic slowdown in East Asia also contributed to a pause in overall trade growth. In recent years, trade has again expanded strongly. Regional markets have recovered, PRC's role as a locomotive for trade has increased, global prices of commodity exports have risen, and CLV countries' efforts to liberalize trade further and to improve their business environment have continued, partly on a unilateral basis and partly with the impetus from various agreements to enhance trade and economic cooperation.[3]

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[1] The GMS countries comprise Cambodia, People's Republic of China (PRC), Lao People's Democratic Republic (Lao PDR), Myanmar, Thailand, and Viet Nam. Cambodia, Lao PDR, Myanmar, Thailand, Viet Nam, Yunnan Province of PRC and Guangxi Zhuang Autonomous Region of PRC participate in the GMS Economic Cooperation Program. This report refers to participants in the GMS Economic Cooperation program as GMS economies.

[2] For example, the medium-term development plans for 2006-2010 of Cambodia, Lao PDR, and Viet Nam, list increased trade as a key strategy to achieve their development objectives.

[3] Memberships of the Association of Southeast Asian Nations (ASEAN) and the World Trade Organization (WTO), along with various bilateral agreements, have contributed to the reform efforts. Cambodia became a member of the ASEAN in 1999; Lao PDR became an ASEAN member in 1997; and Myanmar and Viet Nam in 1995. Under the Common Effective Preferential Tariff (CEPT) scheme of the ASEAN Free Trade Area (AFTA), Viet Nam was scheduled to reduce the tariff rate on the items in its Inclusion List (IL) to 0-5% by 2006; Lao PDR and Myanmar by 2008; and Cambodia by 2010. All tariff preferences are expected to be reduced to zero by 2015 in the four countries. More recently, Cambodia became a member of the

5. Exports from the seven GMS economies rose from $37 billion in 1990 to $153 billion in 2005, or at a compound annual rate of 11.6%, about twice as fast as the rise in world exports. Despite the impressive growth of trade, the GMS economies are small in world markets, with a combined share in world trade of 1.5%. Among the individual economies, average annual export growth during the period ranged from 9% in Guangxi Zhuang AR, PRC to 22% in Viet Nam (**Figures 1b-1h)**. Export growth of Cambodia was also persistently faster, at an annual average of 21%. The trends in imports are similar, as would be expected from the symmetry between the two, both for GMS as a whole and for individual economies. Thailand's export value is by far the largest, although its share of exports from the sub-region's seven economies declined to 72% in 2005 from 87% at the beginning of the nineties. There was a corresponding rise in Viet Nam's share from 7% to 21% during the period.

6. Lao PDR's trade growth has been more erratic, largely attributable to its trade dependence on Thailand, which faced a crisis in 1997-98, and its own macroeconomic instability during the period. Following a successful stabilization program launched in 1999, Lao PDR's export growth accelerated and by 2006, it was higher than the regional average. Much of the growth in the past few years reflects a sharp increase in mineral exports. Myanmar's exports rose until 2001, but have generally stagnated since then, reflecting policy slippages and restrictions on access to developed country markets. In 2005, exports picked up sharply on higher prices for natural gas. External trade constitutes a relatively small proportion of the economies of Yunnan Province and Guangxi Zhuang AR of PRC. However, exports from these regions have also grown rapidly in recent years, albeit at a slower rate compared to that for the whole of PRC.

7. The degree of openness to trade, measured by the ratio of trade (exports and imports) to GDP has increased in most economies during 1992-2006.[4] The increase is sharper for Vietnam and Cambodia. Thailand's openness ratio also rose sharply as its economy contracted at the onset of the 1997 crisis in contrast to a steady increase in exports. The external trade orientation of Guangxi Zhuang AR and Yunnan Province of PRC rose in recent years, but it is modest reflecting their naturally tighter trade linkages with the wider PRC economy. In comparison, PRC as a whole showed an impressive increase in the openness ratio from an average of 27% in 1992 to 66.0% in 2006.

8. These trends are based on recorded trade flows. The GMS economies engage in a substantial amount of informal trade amongst themselves (**Box 1**). One estimate puts the volume of informal (unrecorded) trade at 20-30% of total cross-border trade in the region (DAN, 2005, p.12; see also ADB, 2006f, Chapter 4). Based on this estimate, the recorded trade flows presented above underestimate somewhat the actual flows, but the overall trends are unlikely to differ significantly.

WTO in 2004. Viet Nam became a member in 2007, and Lao PDR is currently in the fact-finding stage of the WTO accession process.

[4] Myanmar's data are excluded because data for GDP are unavailable.

III. Evolution of Export Structure

9. There are no comparable data across economies for the commodity composition of their trade (**Box 2**). The following discussion is based on partner country data compiled from the *UN Comtrade* database for the six GMS countries.

10. The increase in GMS countries' trade has been accompanied by a marked change in the commodity structure of exports (**Figure 2**). The structure has evolved according to each country's comparative advantage. The GMS countries are generally rich in agricultural and natural resources and, with a low cost of labor, possess a competitive edge in labor-intensive manufactured goods. Liberalization of trade and investment, improvements in infrastructure, and greater access to external markets have contributed to the shift in exports from primary commodities to labor-intensive manufactured goods.

11. This shift is evident in all the countries. It is particularly large in Cambodia, where clothing exports benefited from earlier access to markets particularly in the US (**Figure 3**).[5] Foreign direct investment in Cambodia's garment industry from Northeast Asia (primarily Korea; Taipei,China; and, more recently, PRC) helped propel exports. The shift to Cambodia reflects partly the eroding competitiveness of garment production in Taipei,China and Korea with rising wages. In the case of PRC, by shifting location to Cambodia, investors were able to bypass the quotas in the main markets on garment imports from PRC.

12. Manufactured products from Lao PDR and Viet Nam have also risen significantly, comprising over half of total exports. Primary products remain important in these countries. Clothing exports comprise about 80% of Lao PDR's manufactured exports, mostly destined to the EU. The remainder consists mainly of resource-based manufactures.

13. Viet Nam's manufactured exports are also dominated by light consumer goods, but they are more diversified (**Figure 4**). Apart from clothing and footwear, processed food, wood products, plastic goods, and, significantly, machinery and equipment have gained in importance. Most of the machinery exports consist of electrical and electronic products whose share rose from 0.2% of total exports in the early nineties to 5.6% in recent years. This reflects the country's increasing strength in labor-intensive assembly operations in vertically integrated high-tech industries, and is similar to the earlier experience of Thailand and PRC.

14. The import structure has remained relatively stable and is dominated in all countries by manufactured products, primarily machinery and equipment and resource-based manufactures. This is not surprising considering their need to import capital goods, and the import intensity of their manufactured exports, such as the import of textile for clothing and of electronic products for assembly and re-export.

[5] Cambodia received most-favored nation (MFN) treatment on its exports to the US in 1996; Lao PDR received MFN status in the US in 2005, and Viet Nam in 2001. Cambodia, Lao PDR, and Viet Nam were eligible for General System of Preferences (GSP) in the 1990s and, more recently, the Everything-But-Arms initiative of the European Union (EU), as well as GSP treatment from other countries.

IV. Direction of Trade

15. GMS countries' trade expanded rapidly both within the sub-region and outside over the past decade and a half. The exports of GMS (excluding PRC) to other countries in the GMS (excluding PRC) rose at an annual average rate of 25% during 1990-2006, while their exports to other countries increased at an annual average rate of 13%. The rise in exports to PRC, non-GMS AFTA (Indonesia, Malaysia, Philippines, Singapore), other East Asia (Hong Kong, China; Korea; and Japan), and the rest of the world (primarily the US and EU) was all at double-digit rates, with exports to PRC rising at a particularly strong 27% on average annually. The pattern for imports was similar, with imports from all country/regional groups increasing at healthy rates. The increase in trade with all major regions is reflective of the outward-oriented trade strategies of the GMS countries.

16. The evolution of trade shares of GMS countries (excluding PRC) with different country/regional groupings is presented in **Figure 5**. Their share of trade with other GMS countries (excluding PRC) and with PRC rose sharply, albeit from a low base. Their share of trade with non-GMS AFTA countries also rose, while that with other East Asian economies and the rest of the world declined modestly over the ten-year period considered. Both the shares of exports and of imports follow this pattern, although it is more notable for imports. In spite of the rise in intra-GMS trade shares, however, countries outside the ASEAN region are the GMS countries' largest trading partners, reflecting their size and higher incomes per capita.

17. Much of this trend in the geographic orientation of trade reflects the change in the trade share of Thailand, the largest trader among the GMS countries (excluding PRC) (**Figure 5**). For the smaller countries, there are marked differences.

18. The share of Cambodia's trade with other GMS countries (excluding PRC), and with non-GMS AFTA countries fell sharply over the past decade.[6] Its share of exports destined to all regional groupings declined with its specialization in garments, most of which are sold in the US and, to a lesser extent, the EU. The pattern of trade is closely related to that in foreign direct investment (FDI).

19. Lao PDR is the most dependent on the GMS for its trade, partly reflecting its land-locked geography. As the country becomes more linked with regional and global economies with improvements in cross-border infrastructure and greater market access, this dependence on the sub-region is declining, albeit from a high base.

20. Viet Nam's trade share with other GMS countries rose modestly over the past decade. PRC is increasing in importance to Viet Nam as an export market and as a source of imports. As access to markets in the EU and, more recently, the US, increased, their share in Viet Nam's exports also rose. The share of trade with non-GMS AFTA and other East Asian economies declined over the past decade, but they remain important trading partners, especially as a source of imports.

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[6] GMS economies' market access to ASEAN, as well as the US and EU, has mostly been determined by MFN, rather than preferential, tariff rates. The rate of utilization of the Common Effective Preferential Tariff (CEPT) rates under the ASEAN Free Trade Area (AFTA) is low as ASEAN countries have historically lowered their MFN rates along with their CEPT rates, and the difference between the two is not significant enough to compensate for the administrative complexity of complying with rules of origin requirements (Baldwin 2007; Feridhanusetyawan 2005).

21. Trade with East Asia will likely intensify as Viet Nam is increasingly linked to regional production chains, as suggested by the gradual structural shift in export composition toward assembled electrical and electronic products. Foreign-invested enterprises (FIEs) are driving this process. Many of these FIEs so far have been small- and medium-scale assembly plants with few exceptions such as Fujitsu and Hitachi. The decision last year by Intel to invest $1 billion in a chip assembly and testing factory has provided a significant boost to the industry. FIEs are also driving exports in other key products such as footwear and garments. Overall, they accounted for 44% of total non-oil merchandise exports in 2005, up from 3% in 1991 (ADB 2006d, p.35).

V. OPPORTUNITIES TO ENHANCE TRADE

22. The preceding results suggest that, coupled with better access to world markets, the policies implemented over the past two decades by GMS countries to liberalize their economies and to improve infrastructure and institutions have led to increased trade with neighbors and with the outside world.

23. The opportunities for enhancing trade further are large as the potential demand for products from GMS is likely to increase. The GMS economies themselves have grown at one of the fastest rates over the past decade and a half, and are located close to the rapidly growing markets in PRC and India. Market access has continued to improve in recent years both in ASEAN and in developed countries outside the region, for example, with Lao PDR's NTR status in the US since 2005 and Viet Nam's WTO membership in 2007. Furthermore, in spite of the rapid growth of exports in the past, the GMS economies' share of world imports remains small. These factors suggest ample scope for further growth of trade.

24. As noted earlier, CLV countries have a comparative advantage in agricultural and natural resources and in labor-intensive manufactured goods. The change in export structures over the years reflects the evolution of their comparative advantage from predominantly primary products toward labor-intensive manufactured goods, mainly clothing and footwear. The "revealed" comparative advantage indices confirm these patterns. Lao PDR shows an advantage in a number of primary products, including vegetables, cereals, and crude rubber, in addition to that in clothing, manufactured wood products, and mineral products (**Figure 6**).[7] Cambodia's advantage in primary products has generally eroded over the years, largely reflecting its specialization in garment exports.

25. Viet Nam possesses an advantage in a number of primary products, such as processed fish, and fresh fruit and nuts, in addition to its traditional exports of rice, coffee, spices and fish. Within manufacturing, apart from clothing and footwear, Vietnam's advantage lies in leather products, wood products, and it has gained advantage over the

[7] The revealed comparative advantage (RCA) index is the ratio of the share of a product in a country's exports to the share of the product in world trade. It is an indicator of the relative importance of a particular country, as a source of exports of a given product, compared to the relative importance of that product in total world merchandise trade. If the value of the RCA index exceeds unity for the product, then the country is said to have a 'revealed' comparative advantage in that product. If the RCA index is below one, the country does not show a comparative advantage in the product.

past decade in others, including cutlery, jewelry, and, notably, machinery and equipment. The growing importance of East Asia in component assembly mean that newcomers to export-led industrialization such as Viet Nam will have increased opportunities for export expansion for goods produced in vertically integrated global industries.

26. The revealed comparative advantage figures may not capture the full export potential of these countries that is untapped because of supply-side impediments. With agricultural sector accounting for more than 70% of employment in Cambodia and Lao PDR and slightly less in Viet Nam, production and exports from this sector will be necessary to improve incomes and reduce poverty. The increasing globalization of processed food markets as a result of changes in technology and tastes provides significant opportunities for diversification and sustainable growth of exports in the CLV countries that are rich in agricultural resources.

VI. IMPEDIMENTS TO TRADE AND CHALLENGES

27. As the CLV countries integrate more closely with external markets competitive pressures on domestic industries will increase. The abolition of textile and garment quotas with the expiration of WTO Agreement on Textiles and Clothing at end-2004 illustrates the potential rise in competitive pressures. The CLV countries emerged largely unscathed as the quotas were removed partly because they have developed a comparative advantage in these products since the mid-nineties. The safeguard measures invoked by the US and the EU in the second half of 2005 on imports of garments from PRC for the period 2006-2008 also provided temporary relief from competition (ADB 2006b; ADB 2006c). The potential increase in competitive pressures both from within the sub-region and from other developing countries underscores the need to raise overall economic competitiveness and, especially in the case of Cambodia, to diversify its economy.

28. The realization of the benefits of closer regional and global integration will depend on reducing impediments to trade and improving the general business environment. Unleashing the export potential of the CLV countries will require further rationalization of tariff and non-tariff (e.g. quotas, licensing) barriers, measures to facilitate trade and transport, and efforts to relieve constraints on private sector development.

29. Despite the reduction in tariff rates over the past decade and a half, there is scope for further rationalization of trade policy. In Lao PDR, for example, even with the improvement in trade policy over the years, licensing requirements for imports and exports, especially at the provincial level, remain cumbersome. Furthermore, in Cambodia and Viet Nam, as well as in Lao PDR, although average tariff rates have fallen, they follow a cascading structure, with the tariff rate escalating with the degree of processing of a product.

30. Tariffs and non-tariff barriers raise the cost of imported inputs for companies. Since exporters from the CLV countries are small in relation to world markets, they cannot raise their prices in international markets to absorb the higher cost of imported inputs. Producers for the domestic markets, on the other hand, are protected by the tariff on their products. When tariff rates escalate with the degree of processing, the effective rate of protection is higher than that implied by the nominal rate for final goods produced for the domestic market relative to those for exports. Exporters are thus at a disadvantage relative to producers for the domestic markets when tariffs exist.

31. In order to reduce this anti-export bias, the CLV countries allow exporters duty-free access to intermediate imports. Effective duty rates in the CLV countries are generally low ranging from 3.6% for Cambodia to 7.9% for Viet Nam, partly reflecting their progress in reducing tariff rates and partly reflecting duty exemptions.[8] However, the procedures for determining duty exemption are onerous and allow for substantial administrative discretion.

32. **Table 1** presents the simple (un-weighted) averages of the MFN rates applied on non-ASEAN imports and the CEPT rates. It also shows the rate of dispersion of the MFN rates around the average rate. The average MFN rates are relatively low for Lao PDR and are on the high side for Cambodia and Viet Nam. The dispersion is relatively high for Viet Nam partly reflecting its more diversified economy. But it also suggests more scope for uniformity of tariffs across products. As long as tariffs are not zero, some anti-export bias will continue to exist. A move toward a (low) uniform tariff rate across products would minimize this bias.

[8] Import duties as a share of total merchandise imports were 3.6% in Cambodia in 2003-2005 and 7.9% in Viet Nam during 1998-2000; in comparison, they were 2.7% in Thailand during 2003-2005 (WTO Country Profiles, April 2007). In Lao PDR, they were 5% in 2003-04 (CPI et.al. 2006, p.28).

Table 1 : Tariff Rates (2005)

	MFN	CEPT	MoP	Dispersion
Cambodia	14.3	9.7	4.6	70.7
Laos	9.6	4.4	5.2	77.2
Vietnam	16.9	2.5	14.4	114.6

Note: MFN = Simple (un-weighted) average of Most-favored Nation tariff rate applied on imports from most countries.
CEPT = Simple (un-weighted) average of Common Effective Preferential Tariff rates applied on ASEAN imports.
MoP = Margin of preference, computed as the difference between average MFN and CEPT rates.
Dispersion is calculated as the coefficient of variation of the MFN rates.
Source: Compiled from tariff data in ASEAN Secretariat database, available www.aseansec.org

33. Furthermore, since Viet Nam was scheduled to reduce tariffs to 0-5% on most products under the CEPT scheme by 2006, its CEPT rate is lower, and comparable to Thailand's. The margin of preference in Viet Nam is thus higher than for the other three countries suggesting scope for greater uniformity in intra- and extra-ASEAN tariff rates. The scheduled reduction in its MFN tariff rate under WTO to an average of 13.4% over the next 7 years would still leave the margin of preference high since by that time tariff rates on ASEAN imports will likely have been reduced to close to zero under AFTA.

34. A high margin of preference raises the risk of trade diversion as well as trade deflection. If the difference between tariff rates applied on imports from non-ASEAN countries relative to those applied on ASEAN imports (margin of preference) is high, this will create an incentive for CLV importers to source imports from ASEAN suppliers even if they are less efficient (more costly) compared to those outside of ASEAN. This diversion of trade can be costly to the importing countries because of the loss of tariff revenues from the lower rate applied on ASEAN imports and the higher cost of imports.

35. A high margin of preference also raises the risk of trade deflection. Under AFTA, ASEAN members are allowed to individually determine tariff rates on non-ASEAN imports. This creates an incentive for non-ASEAN imports to enter ASEAN through its member with the lowest tariff, thus depriving the member which eventually consumes the imports of tariff revenues. The rules of origin that are implemented to minimize trade deflection are cumbersome to administer especially for developing countries such as the CLV where administrative capacity is limited. Furthermore, in recent years, ASEAN has negotiated or is considering free trade agreements (FTAs) with other countries, such as PRC, Japan, India, Korea and the EU members. The increasing number of FTAs, with different tariff schedules, has the potential to complicate customs administration further.

36. One concern is the possible adverse impact of low tariffs on government revenue, especially in Cambodia and Lao PDR. Both countries rely significantly on customs receipts as a source of government revenues.[9] However, a number of factors are likely to mitigate the impact of lower tariff rates on government revenues. First, the loss of revenues from lower tariffs will be offset to some extent by the likely increase in the volume of imports. Second, lower and more uniform tariff rates should reduce the incentives for smuggling, and result in higher receipts to the government. Third, improvement in customs administration, partly aided by more uniform tariffs, has the potential to increase customs receipts significantly. Developing countries that

[9] Customs revenues as a share of total revenues were 24% of total revenues in Cambodia in 2004 (EIC 2005); 40% in Lao PDR in 2004 (ADB 2006e); and 10% in Viet Nam in 2005 (CIEM 2006).

implemented customs reforms have in many cases increased revenues by a factor of 2, and sometimes more, within a short period of time (Engman 2005).

37. Furthermore, the high share of customs receipts in government revenues of Cambodia and Lao PDR to a large extent reflects a narrow domestic tax base and insufficient rigor in tax administration. Government revenues in the two countries amount to a modest 11% of GDP, compared with more than 20% in Viet Nam, underscoring the need to improve tax administration. Over the medium- to longer-term, revenues from exports of minerals and electricity in Lao PDR and prospective oil receipts in Cambodia are also likely to reduce their dependence on customs revenues.

38. Among non-tariff measures, the CLV countries' capacity to meet the requirements for product quality in major export markets will be an important determinant of their export growth. With the potential for a significant increase in processed food exports, the WTO Sanitary and Phytosanitary Measures (SPS) Agreement and the related dispute settlement mechanisms are of particular significance.[10] Harmonization of national standards with international norms where appropriate would facilitate CLV countries' exports. As in other developing countries, the main constraint in this respect is the low level of technical and scientific know-how and the costs involved in propagating standard SPS practices among producers and setting up a national monitoring system. The CLV countries have gradually begun to develop capacity with the assistance of donors. Cambodia and Viet Nam are further along this process reflecting their WTO commitments. Regional cooperation could also aid in this process. Thailand, for example, has a proven track record in meeting sanitary and phyto-sanitary standards for processed food exports and in resolving SPS-related trade dispute. It thus has the potential to assist CLV countries in building their institutional capabilities to meet international food-safety standards.

39. As tariff and quantitative restrictions on trade have been progressively reduced, other trade costs arising from regulatory burden, inadequate infrastructure, and generally inefficient customs procedures and logistics of moving goods across borders have become much more significant. The costs to trade of inadequate infrastructure and cumbersome regulatory environment are believed to be substantially higher than those from tariffs and non-tariff barriers.[11] Poor transport and logistics networks not only raise the direct costs of freight and storage but impose substantial costs from delays in transit time.[12] Lengthy and uncertain transit times will require a larger buffer-stock of inventory at destination to accommodate the uncertain time of delivery of goods. The cost of transit delays is particularly high for time-sensitive goods, such as perishable agricultural products, seasonal or fashion apparel, and holiday toys. These are some of the products in which the CLV countries have a comparative advantage. As countries specialize in particular stages of production in a regional or global supply chain, as Viet Nam is beginning to do, improved quality of transport infrastructure becomes even more important. The frequent need to import intermediate goods for processing for re-export will require a reliable transport and logistics network.

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[10] Under AFTA and the WTO, member countries have to ensure compliance with the WTO agreements on Technical Barriers to Trade and on Sanitary and Phytosanitary Measures. The agreements allow countries to set their own standards, but (i) they must be based on science; (ii) they should be applied only to the extent necessary to protect health and the environment or to meet other consumer interests; and (iii) they should not arbitrarily or unjustifiably discriminate between countries where identical or similar conditions prevail.

[11] For industrialized countries, Anderson and van Wincoop (2004, pp.692-3) estimated trade costs equivalent to a tax of 170%, comprising 55% in local distribution costs and an additional 74% in international trade costs. Of the international trade costs, transport costs accounted for 21% and border-related barriers accounted for 44%, of which tariff and nontariff (policy) barriers accounted for 8%.

[12] Hummels (2001) estimated that, for ocean shipments of manufactured goods to the US, each day saved in transit time is worth 0.8% of the value of the goods. Similarly, Djankov et.al. (2006) estimate that, on average, each additional day that a product is delayed prior to being shipped reduces trade by at least 1 percent.

40. **Figure 7** associates the cost of trading across borders with trade openness (the sum of exports and imports as a percent of GDP) for a group of East Asian economies. Not surprisingly, trade tends to be higher if costs to trade are lower. **Figure 8** shows a similar relationship between the time required to trade across borders and trade openness. The figures generally suggest that CLV countries' ability to enhance trade further will depend on their success in reducing the direct costs to trade and, perhaps more importantly, the time to trade. The cost and time required to trade in Lao PDR is especially high and is partly attributable to its land-locked geography and rugged terrain.

41. Most of the time required to trade in all the GMS countries is spent on preparation of documents (**Figure 9**). However, the time required in the CLV countries for document preparation is significantly higher than in PRC and Thailand. The time required in Lao PDR is particularly high, reflecting elaborate licensing and approval procedures for imports and exports. There are, for example, 16 documents required for imports in Lao PDR compared with 12 in Cambodia and 9 in Viet Nam. For exports, 12 documents are required, twice the number in Cambodia and Viet Nam.

42. The time required to clear customs takes relatively longer in Lao PDR and Viet Nam, at an average of 7 and 5 days respectively for exports and imports, compared with about 2 days in PRC and Thailand. These figures indicate considerable scope for increasing the efficiency of trading across borders in the CLV countries. The high cost of transit times underscores the importance of more efficient regulatory procedures, better logistics and customs reforms.

43. Apart from impediments to trade, other constraints on the domestic investment environment can impose heavy costs on businesses, damping their ability to compete in international markets. Investment climate surveys of businesses on their perceptions of the main constraints indicate that poor governance, regulatory burden and uncertainty, inadequate access to land and to finance, deficient infrastructure, all impose substantial costs (see e.g. ADB and World Bank, 2006; World Bank, 2004).

44. The top constraints vary by country. In Cambodia, businesses perceive broad governance issues, including corruption, crime, legal and regulatory uncertainty as the main constraints. In Lao PDR, businesses perceive deficient infrastructure, regulatory uncertainty, and access to finance as the main obstacles. Firms in Viet Nam identify inadequate access to land, insufficient access to finance, and deficient infrastructure as the main obstacles. These constraints are perceived to be higher by firms in Cambodia, Lao PDR, and Viet Nam respectively, than by similar businesses in either East Asia or other developing countries.

45. Relieving these constraints would reduce the costs of doing business, increase predictability of the policy environment, and help increase private sector investment. In Cambodia, this will require quicker implementation of policies to simplify regulations, improve enforcement, and reduce administrative discretion. In Lao PDR, provision of infrastructure, cited by businesses as the main constraint, will require policies to encourage participation of private investors, especially foreign ones. Raising public investment in infrastructure will also require further progress on fiscal reforms in order to raise sufficient revenues to meet financing requirements.

46. In Lao PDR and Viet Nam, the constraints underscore the importance of ongoing reforms to restructure state-owned banks, which are dominant in the provision of finance, with the aim of ultimately privatizing them. In Viet Nam, access to land will depend on developing markets for land-use rights, which can then be used as collateral by companies. Much of the commercial property is owned by state-owned enterprises (SOEs). In preparation for its WTO membership, Viet Nam in 2006 started to implement the Unified Law on Enterprises and the Common Investment Law that seek to level the playing field for SOEs and domestic and foreign

private firms. The ongoing equitization of SOEs, restructuring and equitizing state-owned commercial banks, nurturing healthy capital markets, and developing a sound regulatory environment for private sector participation in infrastructure are key reform priorities.

VII. POLICY IMPLICATIONS AND CONCLUSIONS

47. GMS economies' trade has expanded rapidly over the past decade and a half as they liberalized their economies toward a market-based system, gained greater access to regional and developed country markets, and improved their infrastructure and institutions to promote trade. Expanding trade further is a key element of the development strategies of the CLV countries. With their proximity to rapidly growing markets in the region, further increase in their access to developed country markets, and their still-small share in world markets, the CLV countries have significant opportunities for export growth. However, increased integration will also raise competitive pressures for domestic industries, underscoring the importance of relieving constraints on trade and investment to improve overall economic efficiency.

48. There is further scope for rationalizing trade policy. Achieving greater uniformity in tariff rates across products and countries, especially in Viet Nam, would be desirable to reduce the bias against exports, and the risk of trade diversion as the CLV countries participate, through their membership in ASEAN, in an increasing number of free trade agreements. Meeting product quality standards to take advantage of the potential for agricultural and other exports will require concerted efforts to develop necessary regulation and domestic capacity.

49. As tariff and quantitative restrictions on trade have been progressively reduced, the costs to trade of cumbersome regulations, inadequate infrastructure, and general inefficiencies in customs and logistics of moving goods across borders have become much more significant. These impediments not only dampen trade by raising the direct monetary costs but also from the delays in transit times. There is significant scope to reduce these impediments, especially relatively longer times required to trade, in Lao PDR in particular, but also in Cambodia and Viet Nam, through streamlining of documents and procedures, customs reforms, and better infrastructure and logistics.

50. Apart from impediments to trade, other constraints on the domestic investment environment impose heavy costs on businesses, damping their ability to compete in international markets. Investment climate surveys conducted by ADB and the World Bank suggest that in Cambodia, businesses perceive broad governance issues, including corruption, crime, legal and regulatory uncertainty as the main constraints. In Lao PDR, deficient infrastructure, regulatory uncertainty, and access to finance are listed as the main obstacles. Firms in Viet Nam identify inadequate access to land, insufficient access to finance, and deficient infrastructure as the main obstacles. These constraints are perceived to be higher by firms in Cambodia, Lao PDR, and Viet Nam respectively, than by similar businesses in either East Asia or other developing countries. Relieving these constraints would reduce the costs of doing business, increase predictability of the policy environment, and help increase private sector investment.

51. Multilateral and bilateral organizations have been supporting the Governments' efforts to better the environment for trade and investment. Improving the overall climate for trade and investment is a process and will require not just funding but also technical assistance to explore international good practice in regulatory reform and adapt it to local circumstances, build capacity of Government agencies, especially in Cambodia and Lao PDR, and help countries comply with commitments under AFTA, WTO and other agreements.

52. Under the GMS Economic Cooperation program, for example, assistance from multilateral and bilateral agencies has led to greater connectivity among the GMS countries. The focus of cooperation has expanded to include more efficient customs and logistics. The Strategic Framework for Action on Trade Facilitation and Investment (SFA-TFI) aims to improve trade logistics, and strengthen the capacity of GMS economies to meet SPS standards, among other initiatives. The agreement among GMS countries in March 2007 on the remaining annexes and protocols of the GMS Cross-border Transport Agreement (CBTA) raises the prospects of freer movement of goods (and people) across the sub-region. Capacity development of key agencies involved in trade is a key element of the support for SFA-TFI and CBTA provided by development partners. Similarly, the endorsement of the Core Agricultural Support Program (CASP) in April 2007 by the GMS countries should contribute to enhanced trade within the sub-region in agricultural products, a key source of export earnings for many countries in the sub-region.

53. Table xx in the Appendix provides a preliminary and indicative pipeline of projects proposed to be supported by ADB, in cooperation with other development partners, under the GMS Economic Cooperation Program. Many of these projects, both in the form of lending and non-lending products directly support trade-related infrastructure and capacity-development in the GMS. The requirements for such assistance are large. The pipeline of projects comprises a portion of the priority projects identified by nine sector working groups of the GMS program. It would also be complementary to the national programs of each GMS country, many of which are supported by other donors as well as ADB.

Box 1. Cross-Border Trade in GMS

54. The long and porous borders of GMS economies make it difficult to estimate precisely the volume of cross-border trade. For land-locked Lao PDR, cross-border trade is synonymous with its trade with neighboring countries. Based on recorded trade flows, over 60% of Lao PDR's trade occurs with other GMS countries and hence can be considered cross-border trade. In Cambodia, over 90% of total imports from Thailand are cross-border. Viet Nam's cross-border trade with PRC, Cambodia, Thailand and Lao PDR is believed to account for around 20% of its total imports and 10% of its total exports.

55. Informal (unrecorded) trade seems to account for a significant share of cross-border trade in the region. According to a recent study based on field surveys conducted in selected border provinces in Cambodia, Lao, Vietnam and Thailand, informal trade could account for 20-30% of total cross-border trade in the region (DAN 2005, p 12). This share varies significantly among the countries and among different product categories.

56. Informal cross-border trade is carried out predominantly by small traders, who operate individually or as agents/subcontractors to larger traders. As elsewhere in the world, informal trade in the GMS thrives on personal links and 'trust', based on repeated transactions which have substituted for missing institutions in business financing, law enforcement and insurance. Informal traders mostly deal in consumer goods, such as cigarettes, electronics and electrical goods, which are banned or come under high-duty brackets in official tariff schedules. They operate through both formal (international) and informal border crossings and trade in local markets mostly within the border area.

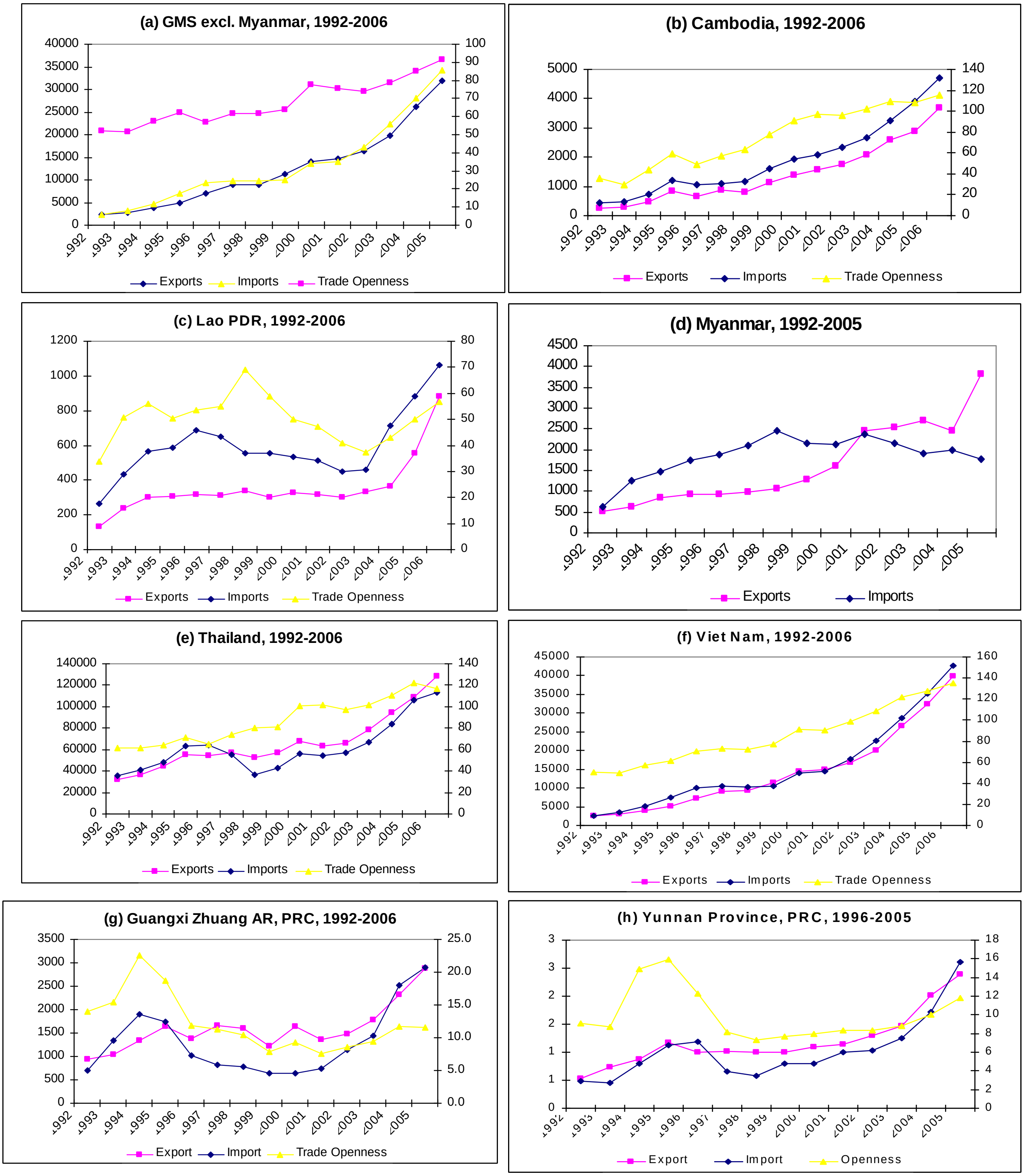
57. A number of factors contribute to informal trade. Poor transport facilities and lack of understanding of formal trading practice place producers and consumers in remote areas at the mercy of informal traders. High and variable import duties and various other restrictions on imports and exports have the unintended consequence of dissuading traders from the use of formal channels. The costs of complying with regulations and corruption at formal border check points also provide strong incentives for traders to look for informal trade routes. These factors suggest that low and more uniform tariffs; better enforcement of streamlined regulations; efficient, transparent, and predictable customs procedures would ease the burden on small traders and reduce their incentives to skirt formal channels of trade.

Box 2. Data Sources

58. Among the GMS countries the only country which has been providing the UN Statistical Office with trade data on a consistent basis is Thailand. Vietnam and Cambodia began to provide data only in 1997 and 2000 respectively. Lao PDR is not yet a contributor to the UN data system and no data on Myanmar are available from this source after 1992. The only option in compiling data on commodity composition of trade was to rely on partner country records. We use trading partners' import records to compile data for a given county's exports and export records of partner countries to compile a given country's imports. The value of trade flows of a country based on partner country records can differ from those based on own records because of differences in valuation since exports are on FOB basis and imports are on CIF basis; the actual timing and reporting of trade transactions; and irregularities in reporting systems, such as unrecorded cross-border trade, under invoicing/over invoicing, smuggling etc.

59. It is generally believed that the use of reporting country or partner country data do not make much of a difference to the analysis of trade composition. Some analysts prefer partner country data to reporting country data for trade analysis on grounds of consistency and accuracy (Feenstra *et al.* 2005). First, developing countries tend to trade more with developed countries which generally have better data reporting systems. Second, in the presence of entrepot trade, export data from importers' records are less susceptible to double counting and erroneous identification of the source/destination country than are data based on reporting country records. Third, there are normally legal penalties for incorrectly specifying import information on customs declarations. Data compiled from importer records may thus be less susceptible to recording errors and reveal the origins and composition of trade more accurately than reporter countries' export data. Finally, in the GMS, where unrecorded cross-border trade is significant, importers' data on exports of trading partners would include some of this missing information on cross-border trade.

Figure 1: Exports, Imports and Trade Openness

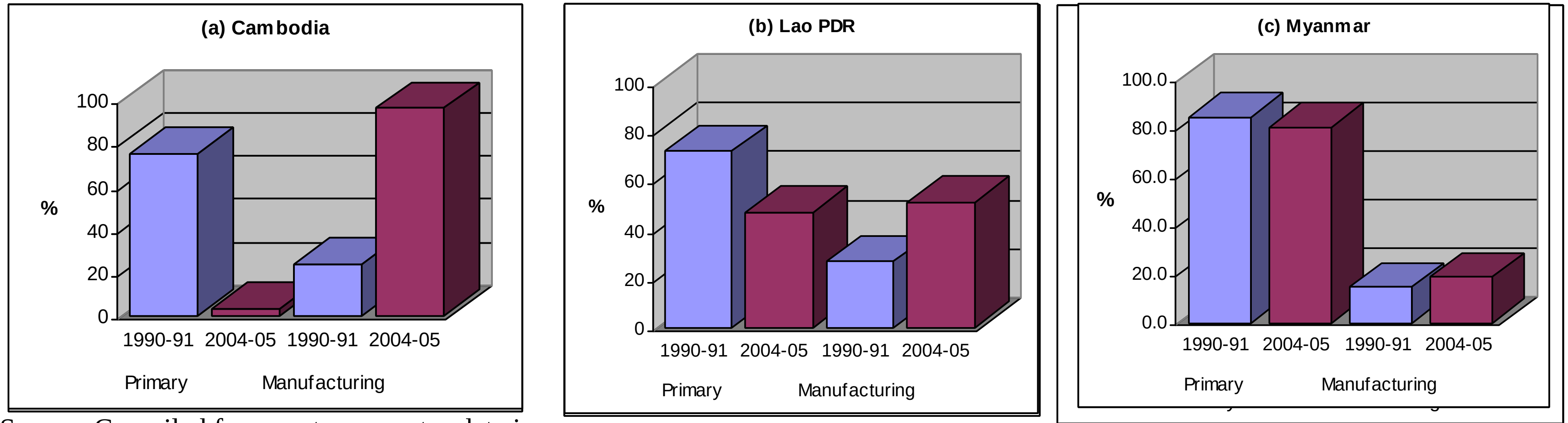


Notes:

1. GMS includes Cambodia, Yunnan Province and Gunagxi Zhuang AR of PRC, Lao PDR, Myanmar, Thailand, and Viet Nam. Myanmar is excluded from the aggregate for GMS because its GDP data are not available.
2. Openness ratio is defined as the ratio of total trade (exports+imports) to GDP.

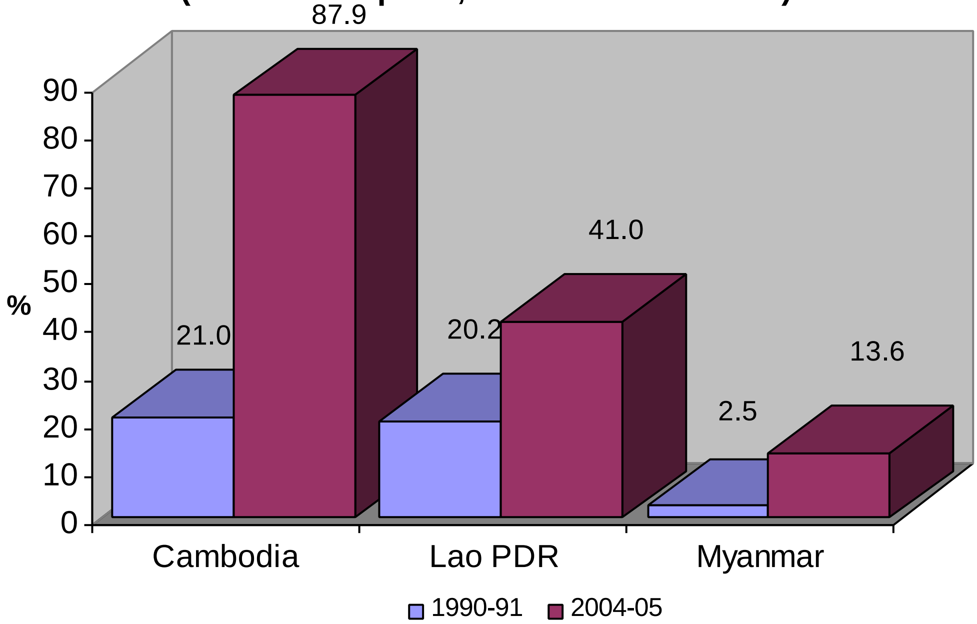
Source: Asian Development Bank. Statistical Database System (SDB) Key Indicator Series, downloaded 25 July 2007; National Bureau of Statistics of China. C*hina Statistical Yearbook, various issues*

Figure 2: Composition of Merchandise Exports (% of total exports)



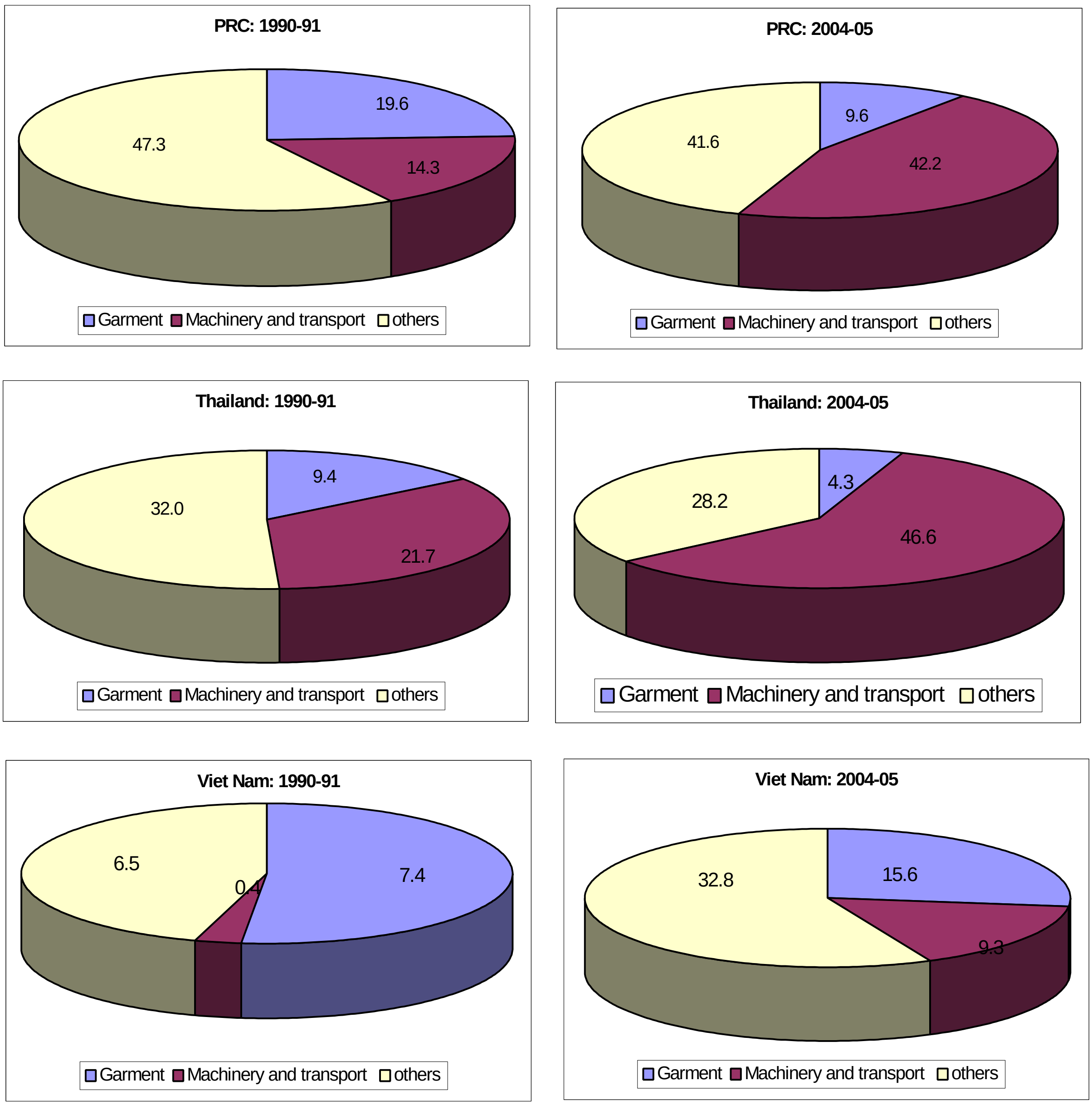
Source: Compiled from partner country data in UN COMTRADE database.

Figure 3: Garment Exports
(% of total exports, 1990-91 and 2004-05)



Source: UN COMTRADE database - compiled from partner country data.

Figure 4: Composition of Manufactured Exports
(% of total exports)



Source: UN COMTRADE database – compiled from partner country data.

Figure 5: Direction of Trade, Destination of Exports and Sources of Imports

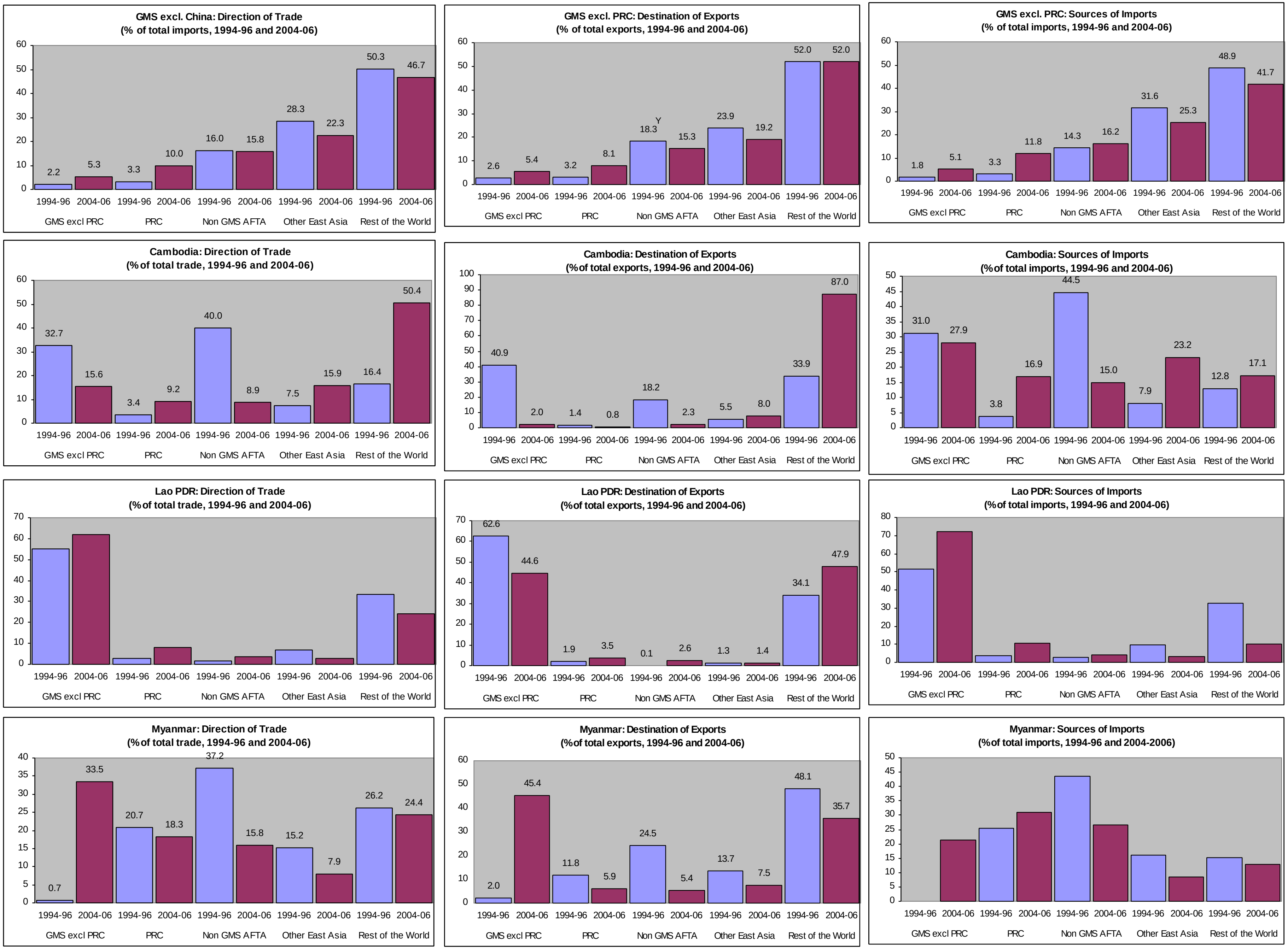
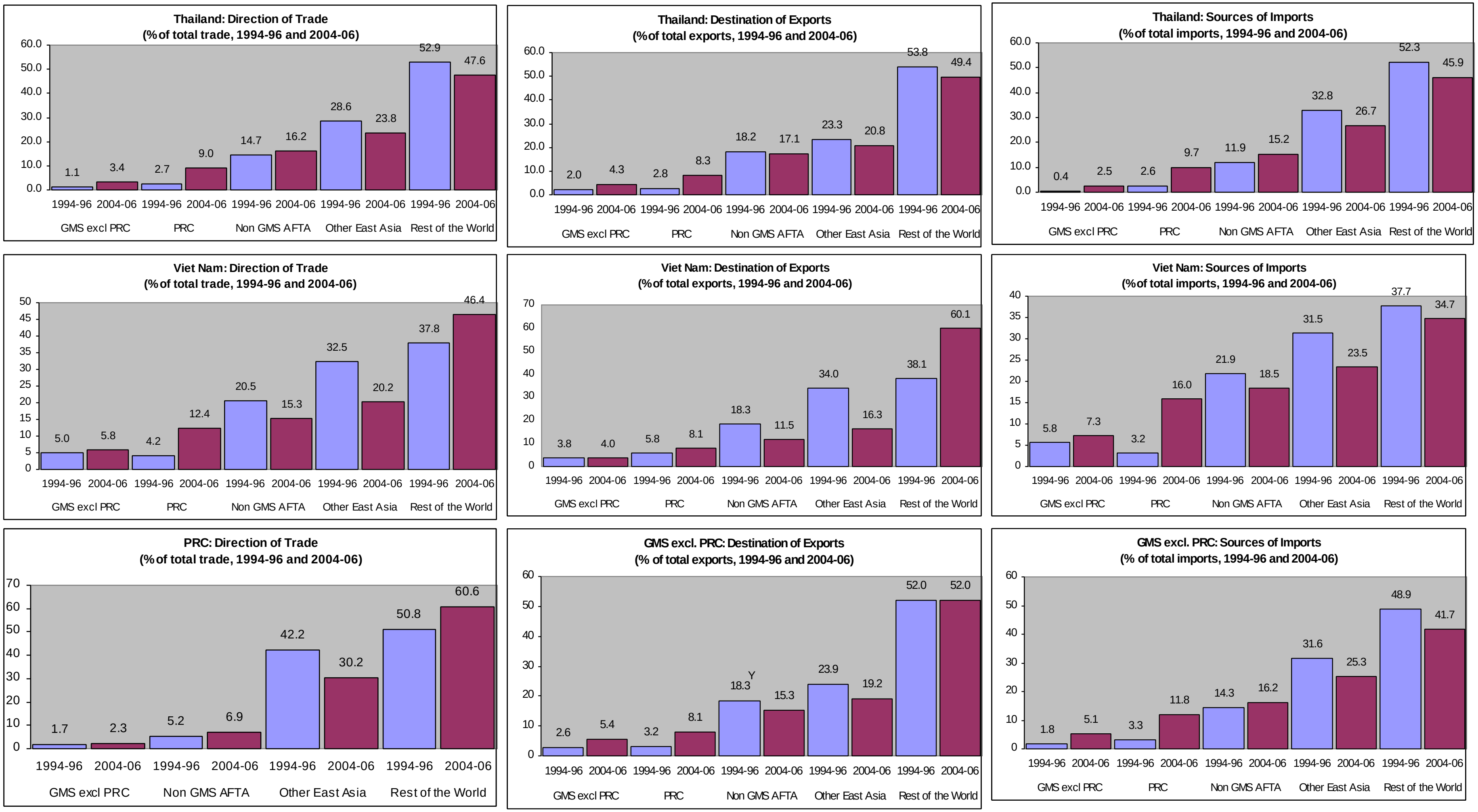
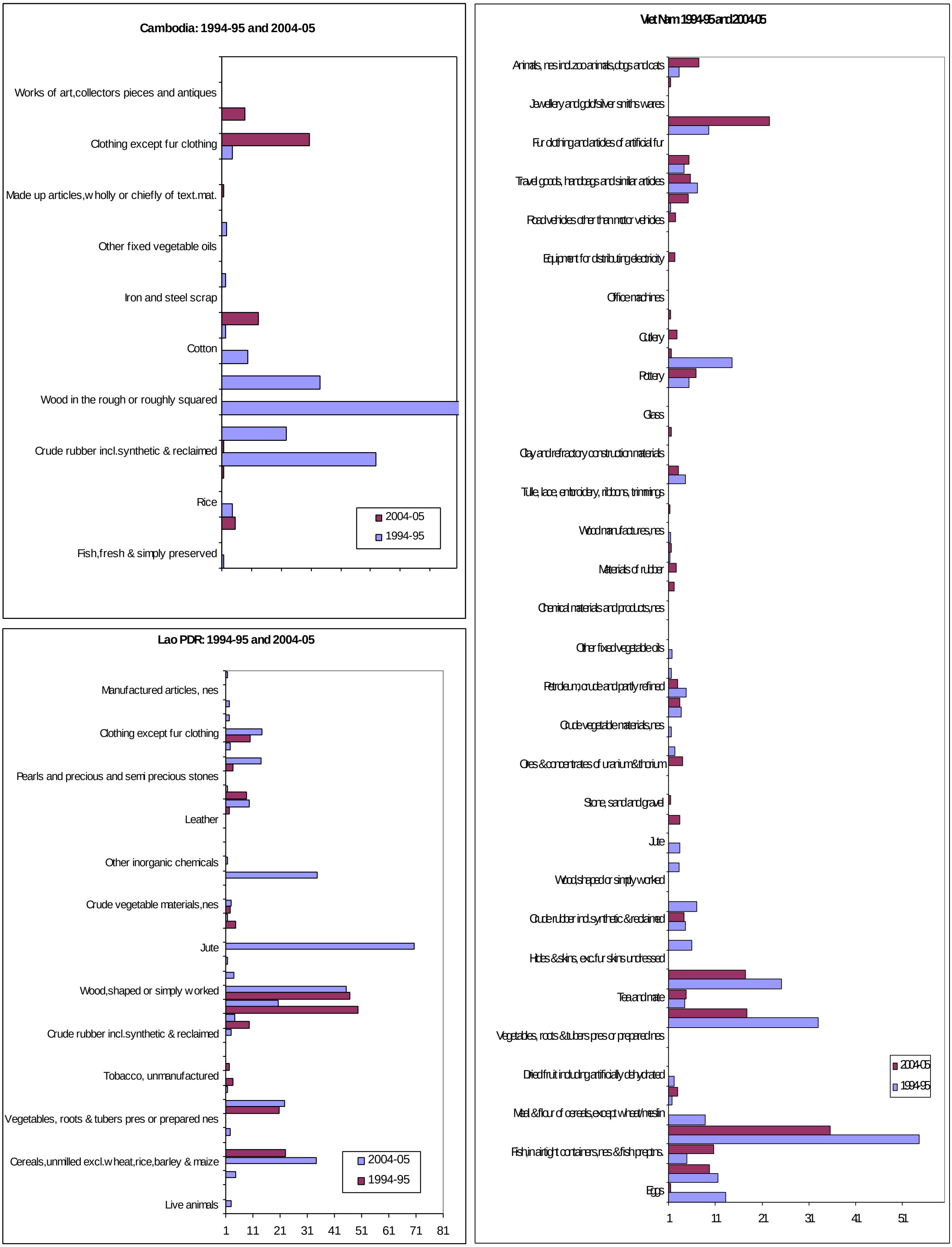


Figure 5 (cont'd): Direction of Trade, Destination of Exports and Sources of Imports



Source: IMF Direction of Trade Statistics

Figure 6: Revealed Comparative Advantage Indices



Source: Compiled from UN COMTRADE database partner country data.

Figure 7: Cost to Trade Across Borders and Trade Openness

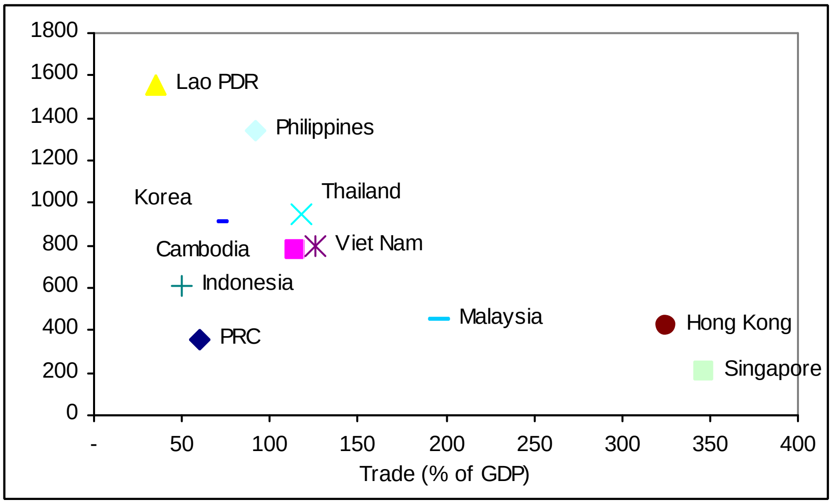


Figure 8: Time to Trade Across Borders and Trade Openness

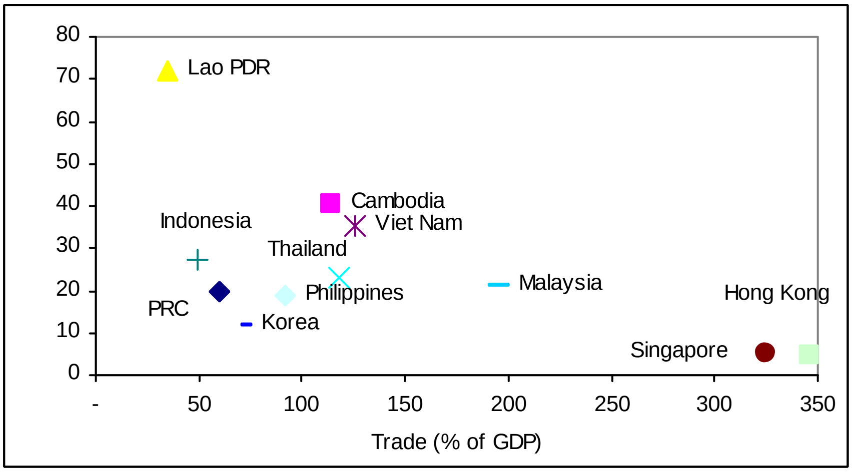
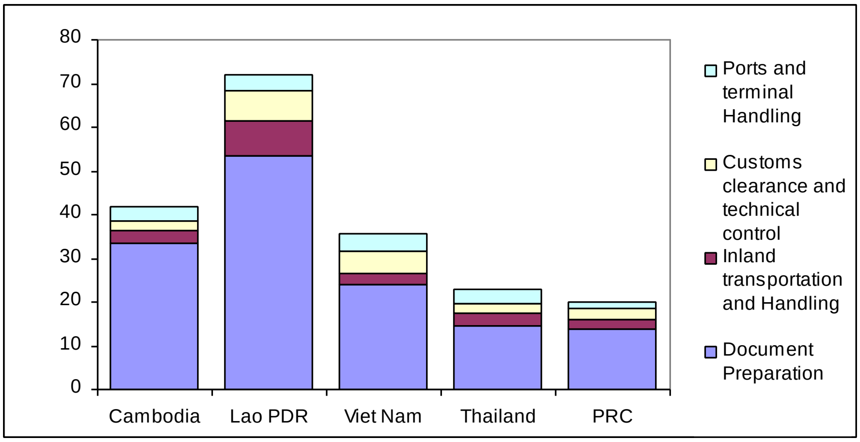


Figure 9: Time to Trade Across Borders and its Components



Source: Doingbusiness database, available http://doingbusiness.org; and ADB.

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