THE NEW ASEANS

VIETNAM, BURMA, CAMBODIA & LAOS

EAAU
East Asia Analytical Unit

DEPARTMENT OF FOREIGN AFFAIRS AND TRADE

THE NEW ASEANS

VIETNAM, BURMA, CAMBODIA & LAOS

EAAU

East Asia
Analytical Unit

DEPARTMENT OF FOREIGN AFFAIRS AND TRADE

BHP

The National Library of Australia Cataloguing-in-Publication data: 20 June 1997

The New ASEANs: Vietnam, Burma, Cambodia & Laos

Bibliography. ISBN 0 642 27148 8.

1. ASEAN.
2. Vietnam - Politics and government - 1975-.
3. Vietnam - Foreign economic relations.
4. Burma - Politcs and government - 1988.
5. Burma - Foreign economic relations.
6. Cambodia - Politics and government - 1975-.
7. Cambodia - Foreign economic relations.
8. Laos - Politics and government - 1975.
9. Laos - Foreign economic relations.
I. Australia. East Asia Analytical Unit.

330.959053

Design, typesetting and printing by Green Advertising #8064.

ACKNOWLEDGMENTS

Karen Gilmour, Anne-Marie Humphries and Phillip Stonehouse (director), all of the EAAU, researched and wrote *The New ASEANs* report. Dr Frances Perkins, head of the EAAU, contributed conceptually and editorially at various stages of the project. Dr Harry X. Wu, also of the EAAU, provided valuable editorial assistance.

The EAAU's consultant, Martin Smee and Associates Pty Limited, in association with John Dick of Freehill, Hollingdale and Page, Solicitors, and John Brinsden of the Standard Chartered Bank (both of Ho Chi Minh City) conducted the survey of Australian and other foreign investors in Vietnam, Cambodia and Laos on which Chapters 3, 9 and 12 of the study are substantially based. The EAAU is grateful to the companies that participated in the survey.

Officers of the Department of Foreign Affairs and Trade, AusAID, Austrade, the Office of National Assessments and other government agencies in Canberra and at Australia's overseas posts substantially contributed to the report. The EAAU gratefully acknowledges their invaluable support and assistance.

The EAAU is also indebted to the following people, who generously provided detailed expert commentary on the draft or other valuable input:

Australia: Dr Adam Fforde, Dr Suiwah Leung, Dr David G. Marr and Dr Thaveeporn Vasavakul of the Australian National University; Dr Carlyle A. Thayer of the Australian Defence Force Academy; Frank Frost of the Australian Parliamentary Research Service; Leigh Purnell and Vivien Filling of MTIA; Andrew Selth; Dr Kathy Tannous of the University of Western Sydney; Christopher Nailer of The Economist Intelligence Unit; Peter Church of ASEAN Focus; Robert Stensholt of Monash University; Elizabeth Maitland of Melbourne University; Warren Taylor of the Australia-Vietnam Business Council; Dr Martin Stuart-Fox of Queensland University; and Cisca Spencer and Gitte Heij of the Asia Research Centre, Murdoch University.

Overseas: Dr Le Dang Doanh of the Central Institute for Economic Management, Dr Raymond Mallon, Dr Adam McCarty and Nigel Russell of Phillips Fox, Solicitors, Hanoi; Dr Mya Than, Dr Nicholas Freeman and Dr Russell Heng Hiang Khng of the Institute of Southeast Asian Studies, Singapore; Dr Erich Spitaller of the International Monetary Fund; David O. Dapice of the Harvard Institute for International Development; Alec Christie of LWA Consultants Limited and Richard Partard of the US Embassy, Rangoon; and Bertil Lintner of the *Far Eastern Economic Review*, Bangkok.

However, the views, comments and analysis in the report are those of the EAAU. Unless explicitly stated, they should not be attributed to any person listed above or construed as reflecting the outlook or policies of the Australian Government.

Maps were by Keith Mitchell of the Cartography Unit, Research School of Pacific and Asian Studies, The Australian National University in consultation with Judith Laffan of the EAAU.

Editing was by Ann Duffy, typesetting by David and Lyn Lalor and graphic design by Green Advertising.

EAAU is grateful to BHP for providing corporate sponsorship for this and other projects.

The report was commissioned by the Australian Government's Standing Committee of Deputy Secretaries on East Asia.

EAST ASIA ANALYTICAL UNIT

The East Asia Analytical Unit was established in 1990 as the main agency within the Australian Government responsible for publishing analyses of major economic and political issues in Asia.

Located within the Department of Foreign Affairs and Trade, the Unit has to date undertaken and commissioned 16 studies on a range of topics related to Australia's trade policy interests in the region.

Staffed with 10 professionals, the EAAU also contracts consultants with specific expertise. It draws on a wide range of data and information sources, including Australia's diplomatic and trade missions in Asia.

Reports and working papers produced by the Unit are intended to assist analysts and decision makers in business, the Australian Government and the academic community.

Executive summaries of the Unit's reports can now be downloaded from the Internet. See access details below.

Contact details:

East Asia Analytical Unit
Department of Foreign Affairs and Trade
R. G. Casey Building
Barton
Australia 2600

Head of the Unit:
Dr Frances Perkins

Directors:
Phillip Stonehouse
Andrea Spear

Telephone: 61 6 261 3057

Facsimile: 61 6 261 3493

Internet access code: .http://www.dfat.gov.au/dfat/dept/eaau/eaauhome.html.

INTRODUCTION AND EXECUTIVE SUMMARY

Expanding ASEAN to include Vietnam in 1995, and Burma, Cambodia and Laos in July 1997 unites politically, economically and commercially all ten South East Asian nations for the first time. This is an important development for the region. Until recently, the Cold War divided ASEAN from former Indochina, while Burma isolated itself regionally and internationally pursuing strict non-alignment. Now, growing cooperation and integration among South East Asian nations is increasing the region's political and economic weight and commercial attractiveness. This presents significant opportunities and challenges for government and business in Australia.

This report examines the economic, political, administrative and legal transformation underway in ASEAN's four newest members. It considers the implications of ASEAN membership for the four, for ASEAN and for Australia. The report also assesses progress in developing a 'business friendly' commercial environment in each of the new ASEANs, with practical insights based on in-country surveys of Australian and other foreign investors. Unattributed quotes in chapters 3, 9 and 12 are comments by companies participating in the surveys. No such survey was conducted for Burma.

POLITICAL AND ECONOMIC TRANSITION

The four new ASEANs attained independence from European colonial powers after World War II. Political instability, turmoil and civil war ensued, eventually producing socialist, centrally planned, one party states. National economies inevitably faltered. Facing stagnation or crisis, governments introduced economic reforms, at first hesitantly, then more boldly, abandoning central planning and embracing the market.

Political and economic transition now is occurring in the new ASEANs, although the nature and pace of change is different in each case. Cambodia and Burma formally discarded socialism; Cambodia now has a functioning multi-party democracy of sorts and Burma's military regime has started a process to restore civilian government, albeit under military control, in the future. Only Vietnam and Laos remain one party states committed to building socialism, although no longer based on central planning.

The military in Burma and communist parties in Vietnam and Laos pursue economic reform while safeguarding their political monopolies. Sections of the political leadership in these countries see some reforms, such as reducing the state sector's economic role, as potentially undermining their own leading role, so they resist them. However, leaders also recognise their continued political supremacy depends substantially on raising living standards. This dilemma underscores continuing leadership debate and tension, alternately accelerating then constraining economic reform. Only Cambodia's leaders seem at ease with market-oriented economic reforms, although in the political sphere they show strong authoritarian tendencies and appear uncomfortable with the concept of a political opposition.

In Burma, the military is entrenched in politics and business; in the other three new ASEANs, the military is a major economic player and wields considerable political power, albeit as subordinate to the Government in Cambodia and the Party in each of Vietnam and Laos. Military representation and influence in the Vietnamese and Lao political leaderships is growing.

The new ASEANs except Burma are restructuring and strengthening the institutions of government and expanding laws to support economic reform, as they strive to become modern states. In Vietnam and Laos, more efficiently managing the State also enhances the capacity of the Party to rule. Burma's legal base is being modernised but institutional reform will need to await a new civilian government.

Mobilising substantial domestic and foreign private investment is central to new ASEAN economic growth strategies. New market opportunities, strong comparative advantage in resources and labour, and liberal foreign investment laws and incentives attract significant foreign investor interest. However, economic systems, regulatory regimes and the institutions of government are in transition, making the business environments challenging.

VIETNAM

After more than ten years of reform and opening under *doi moi* (renewal), Vietnam's economy is sustaining strong growth of 8 per cent per year and its society is generally more 'open' and freewheeling. However, the Vietnam Communist Party's political monopoly is not threatened. Vietnam's one party state is stable.

Politics

Applying the lessons from the socialist collapse of Eastern Europe and the Soviet Union in the late 1980s and early 1990s, the Vietnam Communist Party favours economic liberalisation without democratising or risking stability. To consolidate its position as the long term leader of the State, the Party is strengthening its organisational network in state and government institutions and even extending it into the private sector, including foreign joint ventures. However, the Party faces a major challenge to reverse its own diminishing relevance and capacity to provide visionary leadership in a modernising Vietnam. The Party also must stem the increasing corruption undermining its legitimacy and effective government.

Reform Outlook

Debate within the party leadership over the scope and pace of economic reform focuses on negative by-products such as growing wealth disparities, corruption, 'social evils' and the influx of foreign influences threatening to undermine Vietnamese socialism. This creates a dilemma which the leadership has attempted to resolve by confirming the state sector will maintain a central economic role. However, this hampers reforms, private sector development and economic growth.

Administrative and Legal Reform

'Political reform' in Vietnam essentially means administrative reform-strengthening the institutions of government and laws to become an effective management framework through which the Party leads the State. Reforms to curtail bureaucratic abuse unleashed by *doi moi*, streamline the bureaucracy, reduce red tape, build an effective public service, and recentralise state authority under party control have only partly succeeded. Corruption remains a 'national plague'; bureaucratic procedures and arbitrary interference still create long delays; public servants lack skills to manage a market economy; and vested interests continue to resist party and government directives.

Vietnam has progressed considerably in creating a new legal framework for a modern market economy. The National Assembly has enacted a series of commercial laws and established a liberal foreign investment regime. However, bureaucratic processing of investment applications is slow and cumbersome. Resolving commercial disputes in Vietnam is problematic for foreign investors, although recent cases indicate Vietnamese courts are prepared to rule in a foreign investor's favour, even where the other party is a Vietnamese state-owned enterprise (SOE).

Economy

Vietnam's economy has taken off since *doi moi* economic reforms, adopted by the Party in 1986, formally began Vietnam's transition from central planning to a market oriented economy. Since 1990, annual economic growth has jumped to 8 per cent and 6 per cent per capita. Non-state output is now 66 per cent of the total; foreign trade and foreign investment regimes are relatively open; and 95 per cent of prices are market determined. Agriculture is essentially privatised. The authorities have reduced inflation from annual rates approaching 900 per cent in the mid 1980s to less than 2 per cent in early 1997 by reining in the government deficit, financing the deficit via bonds rather than printing money and tightening bank credit policy.

However, Vietnam is still very poor; per capita income is only US$260 in exchange rate terms and $1 000 in purchasing power parity terms, half China's level of $2 000. Growing rural-urban income disparities mean rural incomes average only $100 per capita.

While growth is expected to remain strong if reform momentum is maintained, several major potential constraints to foreign investor interest include corruption, low administrative efficiency and the underdeveloped legal system. While the ratio of savings to GDP, now 27 per cent, is rising rapidly, the banking system remains weak and bank penetration is low. The trade deficit grew rapidly to $4 billion in 1996, almost 20 per cent of GDP, stimulated by high foreign capital inflows. Skilled labour and infrastructure shortages further constrain potential growth. Slow progress in equitising SOEs and policies promoting large SOE conglomerates create uncertainty regarding government commitment to treating equally domestic and foreign non-state enterprises in Vietnam.

Australia-Vietnam Trade and Investment

Over 100 Australian companies currently are engaged in business in Vietnam. However, up to 80 per cent of them sell products or services to other foreigners in Vietnam or outside, rather than to Vietnamese. This leaves Australian companies vulnerable to significant downturns in foreign direct investment to Vietnam.

Australia's trade with Vietnam expanded rapidly in the 1990s from a low base. Australia's merchandise exports to Vietnam increased at an annual trend rate of 45 per cent, five times faster than Australia's overall exports. Australia's merchandise imports from Vietnam increased even faster, also from a low base, at an annual trend rate of 65 per cent. The trade balance is in Vietnam's favour.

By the end of August 1996, Australia was Vietnam's eleventh largest foreign investor with cumulative approved foreign direct investment of $700 million in 50 projects.

Business Environment

Vietnam is one of the most complex and difficult Asian locations for foreign investors. Bureaucratic inefficiency, corruption and lack of adequate skills seriously constrain business. However, the business environment is fluid as the economy continues its transition from centrally planning to a uniquely Vietnamese market-oriented system. Business conditions gradually are improving but progress is unlikely to be either smooth or rapid. The sources of Vietnam's attractiveness to foreign investors remain, and most foreign companies are confident about Vietnam's medium to long term prospects. Vietnam requires a long term commitment, deep pockets, flexibility, patience and persistence. Foreign investors need to be cautious about overly optimistic expectations or overly pessimistic forecasts.

BURMA

Burma's economy grew strongly in the early 1990s but recent signs are of growth tapering or declining. The political impasse that sets Burma's military regime against the civilian opposition, much of the populace and the broad international community clouds the country's economic and commercial prospects.

Politics

Burma's military has monopolised political power for more than 35 years. It has promised to restore civilian rule but will only do so when the country adopts a new constitution borrowing from Indonesia's *dwifungsi* model that formalises the military's central political role. This is still some time away. The military faces a major challenge to persuade Burma's ethnic minority insurgent armies, who seek autonomy from Rangoon, to accept its constitutional plan. The civilian opposition, led by the charismatic General Secretary of the National League for Democracy, Aung San Suu Kyi, opposes the military's continued political monopoly but at present, can do little to unseat it. The military is strong, united, determined and for the time being, appears firmly in command. However, the military's widespread unpopularity and its tight control of virtually every facet of Burmese life create a situation of inherent instability.

Administrative and Legal Reform

The military has left Burma's creaky administrative machinery largely untouched, apart from inserting military personnel at senior and middle levels in all ministries. The military has revived Burma's pre-independence, British common law based commercial laws. These provide the fundamentals, albeit somewhat outdated, for a market economy. Burma adopted a liberal foreign investment regime in 1988.

Economy

Since abandoning socialism and central planning in 1988, Burma's economy has recovered from its poor performance for most of the post World War II period; growth has averaged around 7 per cent per year since 1992. By 1997, per capita income reached $1 000 in purchasing power parity terms, similar to Vietnam's. Inflation is still stubbornly high with official figures well over 20 per cent, and unofficial estimates over 30 per cent. The high government deficit, financed mainly by printing money, drives inflation.

The extreme, almost 30 fold overvaluation of the kyat has generated high levels of smuggling and poor trade performance. Since 1990, trade regime reforms have allowed traders to retain foreign exchange earnings and private firms to engage in trade, stimulating formal trade. However, imports are growing much faster than exports; in 1997, the trade deficit is expected to reach US$700 million, over 40 per cent of annual exports. Foreign exchange reserves are sufficient for only a few weeks of imports and the Government regularly defaults on loan repayments. The balance of payments deficit is lower at just under US$400 million, mainly due to foreign direct investment inflows, which totalled about US$200 million per year in recent years. The bulk of foreign investment is coming from the UK, Japan, ASEAN, USA and other European Union countries.

Savings and investment also have fallen to only about 12 per cent of GDP, due mainly to a significant drop in government investment. While the banking system has seen some reforms, including establishing private domestic and representative offices of foreign banks, the system remains weak. Loans generally are for less than a year and interest rates are below market levels. Most people still borrow from money lenders while some banks launder drug and other 'black' money. Transport, energy and telecommunications infrastructure remain extremely poor throughout the country, although China provides some aid to improve road links. While Burma had a high proportion of educated people pre-World War II, the stock of human capital has been depleted steadily through years of neglect and isolation.

Agricultural pricing, trade and production have been liberalised, stimulating output growth. Fisheries and mining offer good opportunities for foreign and domestic investment. Industrial development has been heavily constrained by shortages of foreign exchange, but now labour intensive manufacturing for export is increasing. To date, planned SOE privatisation has failed, as vested interests in the government and military are reluctant to relinquish control over these assets. The military plays an extremely important role in the economy through companies like the Union of Myanmar Economic Holdings Limited, which controls 10 per cent of Burma's GDP and is prominent as a joint venture partner with foreign investors. Drug trafficking and black marketeering also are rife; commentators believe the black economy may equal the size of the legal economy.

Future prospects for Burma's economy depend crucially on the political environment and commitment to reforms that are often opposed by military vested interests.

Australia-Burma Trade and Investment

Both Australia's trade with and investment in Burma are negligible. This is partly a consequence of the Australian Government's explicit policy of neither encouraging nor discouraging commercial ties with Burma.

Business Environment

Politics overshadow Burma's commercial landscape. Many difficulties foreign investors face in Burma, such as the dual exchange rate and poor infrastructure, are common to other developing economies, although more extreme in Burma. The key difference is the high degree of political risk while the military, which is increasing its economic role, remains in power. Foreign traders and investors face the prospect of economic sanctions, consumer boycotts and shareholder revolts. As a result, a number of major international companies have withdrawn from Burma.

CAMBODIA

Cambodia is seeking to recover from decades of internal conflict that destroyed much of the country's educated elite, economic base, political and administrative institutions. This is a major challenge. However, the economy is responding well to international donor assistance and foreign investment. Recent growth, particularly in Phnom Penh's private sector, has been robust, averaging 6 per cent per year in the 1990s.

Politics

The 1991 Paris Peace Accords and subsequent elections under the United Nations Transitional Authority in Cambodia (UNTAC) brought significant gains to Cambodia. The country no longer is the military focus for international and regional rivalries; democratic institutions and an elected government replaced the one party state; the Khmer Rouge suffered a substantial and rapid decline; and human rights conditions have improved. However, democratic government is fragile. Cambodia's current Coalition Government is unstable as it brings together parties formerly at war with one another. The arrangement is becoming increasingly unworkable with the approach of national elections in 1998. Interrelated corruption and other criminal activities, violations of human rights and political and criminal violence are widespread. The recreation of a stable polity in Cambodia will not occur soon.

Administrative and Legal Reform

The Government with World Bank assistance is attempting to build a smaller, considerably streamlined, more skilled public service. Currently, the bureaucracy is bloated, lacks adequate skills, performs poorly and cleaves along party lines. Foreign investors need to be aware of the party affiliations of officials, but to avoid aligning themselves with either side. The Government is rebuilding the legal infrastructure with new laws combining both civil and common law traditions, but covers legislative gaps by issuing decrees. The National Assembly has adopted several laws supporting Cambodia's market economy. The foreign investment regime is liberal and the regulation of business flexible. Foreign investors normally prefer to resolve commercial disputes offshore.

Economy

Reforms and generous international assistance have helped Cambodia's economy recover from the long civil war, the Khmer Rouge's disastrous economic experiment, and socialist central planning. GDP growth averaged 6 per cent in the 1990s; inflation fell sharply from 140 per cent in the early 1990s to 7.4 per cent in 1996. However, the government deficit has increased as expenditure continues to grow faster than revenue. Large amounts of foreign aid, reaching 7.5 per cent of GDP in 1995, replaced budget deficit financing by printing money, easing inflationary pressures.

Since 1994, the official exchange rate has been set daily to keep the national currency (riel) within 1 per cent of the informal market rate. Official transfers, a stable external environment, improved export performance and increased foreign direct investment have improved Cambodia's balance of payments. In September 1996, official reserves equalled three and a half months of imports. Realised foreign direct investment, mainly from ASEAN countries, rose sharply from US$10 million per year to US$171 million per year in 1996. Reforms have successfully stimulated Cambodia's private sector. The country now has a highly competitive domestic market and one of the region's most liberal retailing regimes.

Despite recent economic gains, Cambodia remains one of the world's poorest countries with a per capita income of US$260 on an exchange rate basis. Economic and social indicators generally are much lower than those of neighbouring countries and sub-Saharan Africa. They are also lower that those of East Asia's newly industrialised counties 25 years ago.

Cambodia faces serious challenges to continuing economic development and growth. The high level of dependence on foreign aid, the rapid depletion of the country's forestry resources (often for personal rather than national gain) and the heavy reliance on import taxes for revenue are unsustainable. Above all, Cambodia needs good governance.

Australia-Cambodia Trade and Investment

Australia is a major aid donor. Trade and investment are small but rising.

Business Environment

Cambodia's Government is keen to encourage foreign investment. The level of government and bureaucratic interference in business matters is low once initial approvals are granted. The business environment is unregulated and freewheeling, attracting 'fringe' foreign investors as well as mainstream ones. Corruption is widespread and transparent. Lawlessness and violence in the capital and the countryside add to the risk of doing business.

LAOS

The Lao People's Revolutionary Party introduced market-oriented economic reforms in 1986. In the 1990s, the economy has enjoyed healthy average annual growth of 6.5 per cent. However, while encouraging economic openness, the Party rejects political pluralism.

Politics

The Lao leadership does not fully understand free market reform. However, as in Vietnam, it recognises the market can improve living standards without which the Party's political monopoly could be increasingly questioned. The Party is for the moment unchallenged. However it needs to rejuvenate its leadership and ensure Laos' majority rural dwellers and its ethnic minorities can participate more fully in the political process and share in the gains of economic growth.

Reform Outlook

As in Vietnam, elements in the party leadership are uncomfortable with some of the negative social by-products of economic reform. They insist on the state sector's central economic role.

Administrative and Legal Reform

In the late 1970s and early 1980s, most of Laos' educated elite left the country. As a result, the bureaucracy lacks skills to manage the complexities of a market economy including processing foreign investment applications. The Government is endeavouring to streamline and re-skill the public service. It also restructured and reorganised ministries to make them more efficient. However, decision making power is concentrated in the Prime Minister's Office, clogging the approvals process.

Laos' legal system is still in its infancy; in 1996, the entire body of Lao legislation consisted of just 34 laws. The Government is developing gradually a body of commercial laws but covers the gaps by issuing decrees. Laos' foreign investment regime is one of the most liberal in the region. Foreign investors prefer to resolve commercial disputes through foreign arbitration.

Economy

Laos has a 'dual' economy; commerce is concentrated in the capital, Vientiane, but most of the population engages in subsistence agriculture. Despite several years of impressive economic growth, Laos remains one of the world's least developed countries, with a per capita GDP of US$350 on an exchange rate basis. Conditions in Laos are similar to those elsewhere in South East Asia 30 years ago. Poverty is widespread and often extreme, and health indicators are among the poorest in Asia.

A distinctive feature of economic reform in Laos is the speed and intensity with which the New Economic Mechanism reforms were implemented after 1986. Bold and rapid restructuring of Laos' economy has been helped by four main factors: the small, underdeveloped nature of the economy; the primarily subsistence agrarian base that could be reoriented fairly easily to market demands; the limited role of SOEs; and the lack of an entrenched, reform-resistant bureaucracy.

Reforms have lifted economic performance. Agriculture's share of production is declining while industry's share is expanding, helping stabilise growth. Inflation is broadly under control, mainly as a result of sound fiscal and monetary policies. Exports, mainly based on natural resources (forestry and hydro-electricity) have grown strongly, as have imports. Between 1988 and 1996, the Government issued over 600 new investment licences worth more than US$7 billion. Hydro-electric projects account for three quarters of this. The exchange rate is pegged to the informal market rate under a managed floating system. The private sector's share of production is expanding.

Growth constraints in Laos include a lack of skilled labour, weak institutional capacity and inadequate infrastructure.

Australia-Laos Trade and Investment

Australia-Laos trade is limited and fluctuating. However, Australian investment is considerable and growing. By June 1996, Australian companies held 42 investment licences for projects worth US$303 million. Australia is one of Laos' largest bilateral aid donors. Aid projects attracted many Australian companies to Laos.

Business Environment

While Laos' Government is business friendly, the bureaucracy is slow and underskilled. Legal uncertainty concerns larger investors more than smaller ones. Corruption is not serious but is rising. Personal security is generally good.

ASEAN INTEGRATION

The four new ASEANs are at a roughly similar stage of development in transition from centrally planned to market-oriented economies. They are at a lower level of development than other ASEAN members but are growing strongly, equalling or exceeding average ASEAN growth.

Enriching ASEAN

ASEAN's expansion has important implications for both the group's established and new members. Expansion enriches ASEAN economically, but marked political and economic dissimilarities between old and new members could strain cohesion. Expanded ASEAN's GDP equals nine tenths that of China's. Its population, encompassing all of South East Asia, is almost 500 million.

Economic Integration

Trade among ASEAN's older members is growing substantially faster than their trade to the world. Trade between ASEAN's older and new members also is growing rapidly. The new members increase trade complementarity within ASEAN and enhance the regional division of labour based on comparative advantage. This increases opportunities for trade and investment, and should lead to expanding economic interaction within ASEAN and between ASEAN and the world. Better coordination of economic and investment policies in South East Asia should improve ASEAN's attractiveness to non-ASEAN investors.

Other benefits of ASEAN economic integration include the stimulus provided to economic reform, greater economic weight and access to world markets and cooperation in upgrading infrastructure.

ASEAN Free Trade Area (AFTA)

New ASEAN members' capacity and willingness to meet the obligations of ASEAN membership, particularly to adhere to the AFTA timetable of intra-ASEAN tariff reductions, is open to doubt. Institutional capacity in each of the four members is not yet well developed and AFTA requirements may clash with domestic economic objectives, such as nurturing infant industries.

Like Vietnam, ASEAN's newest members will be granted longer than established members to reduce their intra-ASEAN tariffs to 0 to 5 per cent. However, if new ASEANs feel unable to keep up with the agreed pace of tariff reductions, and can resist pressure from older ASEANs to comply, a multi-track process will develop. The new ASEANs also could retard ASEAN's customs harmonisation and standards conformance programs.

Straining Cohesion

New members may test ASEAN's consensus decision making. Burma's membership may strain cohesion, solidarity and ASEAN's relations with the rest of the world, particularly the USA and European Union, both of which have instituted economic sanctions against Burma's military regime. However, ASEAN integration also may provide a framework for increasing positive influence on Burma.

Greater Mekong Subregion

ASEAN's four new members participate actively in initiatives to make the Mekong subregion, consisting of Burma, Thailand, Vietnam, Laos, Cambodia and China's Yunnan province, a 'corridor of commerce'. The Asian Development Bank-supported Greater Mekong Subregion is the major initiative. Australia is among bilateral donors supporting the subregion's development. Priority sectors such as transport, tourism, water resources management, energy, trade and investment and human resources have been identified for development as part of a subregional master plan. Many projects already are underway. US$40 billion is required over the next 25 years for infrastructure alone. This is well beyond the funding capacity of governments and aid donors and will require commercial investment, suggesting that implementing many infrastructure projects may be slower than envisaged unless significant policy reform is achieved.

AUSTRALIA ENGAGING AN EXPANDED ASEAN

Continuing economic transformation in Vietnam, Burma, Cambodia and Laos and ASEAN's and AFTA's expansion create significant opportunities and challenges for Australian business. These are based on stronger GDP growth, likely increased market access, faster trade growth, increased investor confidence, promotion of large scale infrastructure projects, development of natural resources and rapid growth in legal, financial and education services.

Business Opportunities in the Mekong Subregion

Developing the Mekong subregion opens up a range of commercial opportunities, particularly major infrastructure projects. Many business opportunities are directly related to the activities of international aid agencies. The subregion also constitutes a large potential market and possesses substantial human resources offering development potential based on unskilled or semi-skilled, low cost labour. However, the nature of many opportunities in the Mekong, particularly those involving aid funds for infrastructure projects or resource projects, require long term commitment. International competition for major aid funded infrastructure projects is intense. To secure these projects, Australian companies will need to be highly competitive and offer skills in emerging areas such as infrastructure management reform.

Subregional Corporate Strategies

A number of foreign companies are adopting subregional strategies by establishing operations in two or more countries. This is because a successful project in one country, winning the trust and support of the national government, can be an important advantage in bidding in a neighbouring country. Moreover, as the new ASEAN economies become more open and market-oriented, experiences gained and techniques developed in one market can be applied successfully to others. The needs of each market also are broadly similar for both goods and services. Improvements in transport and communications links and harmonisation of documentation and controls on crossborder movements create opportunities for integrating distribution networks in the subregion. This suggests that treating the subregion as a whole may prove more profitable than operating in separate markets.

New Partnerships

New partnership opportunities are emerging; for example, ASEAN companies are increasingly active in all Mekong subregion countries. This can be expected to gain momentum with Laos, Cambodia and Burma as members of ASEAN. The emerging private sectors in each country in the subregion also offer opportunities to develop new partnerships, particularly in supplying expanding domestic markets.

AFTA-A Single Large Market

Increasingly, AFTA will be promoted as a single, large market. Expanding AFTA increases the scope and breadth of tariff reductions and economic cooperation in South East Asia. Commercial opportunities should increase from improved access (as tariffs and non-tariff barriers fall), standards conformance and customs harmonisation, and an enlarged market, causing business costs across the region to fall and increasing the scope to rationalise operations and regional strategies.

Linking Markets

With support from governments, business is spearheading efforts to forge a single large market by linking the ASEAN Free Trade Area (AFTA) with the Australia-New Zealand Closer Economic Relations Trade Agreement (CER). The two areas are diverse and complementary; trade between them doubled between 1990 and 1995, from US$7.9 billion to $15.9 billion.

Australian Business and AFTA

AFTA trade and investment liberalisation benefits companies operating within its boundaries, but could disadvantage Australian exporters. However, many AFTA tariff reductions are on a non-discriminatory most favoured nation (MFN) basis.

Strategic Alliances

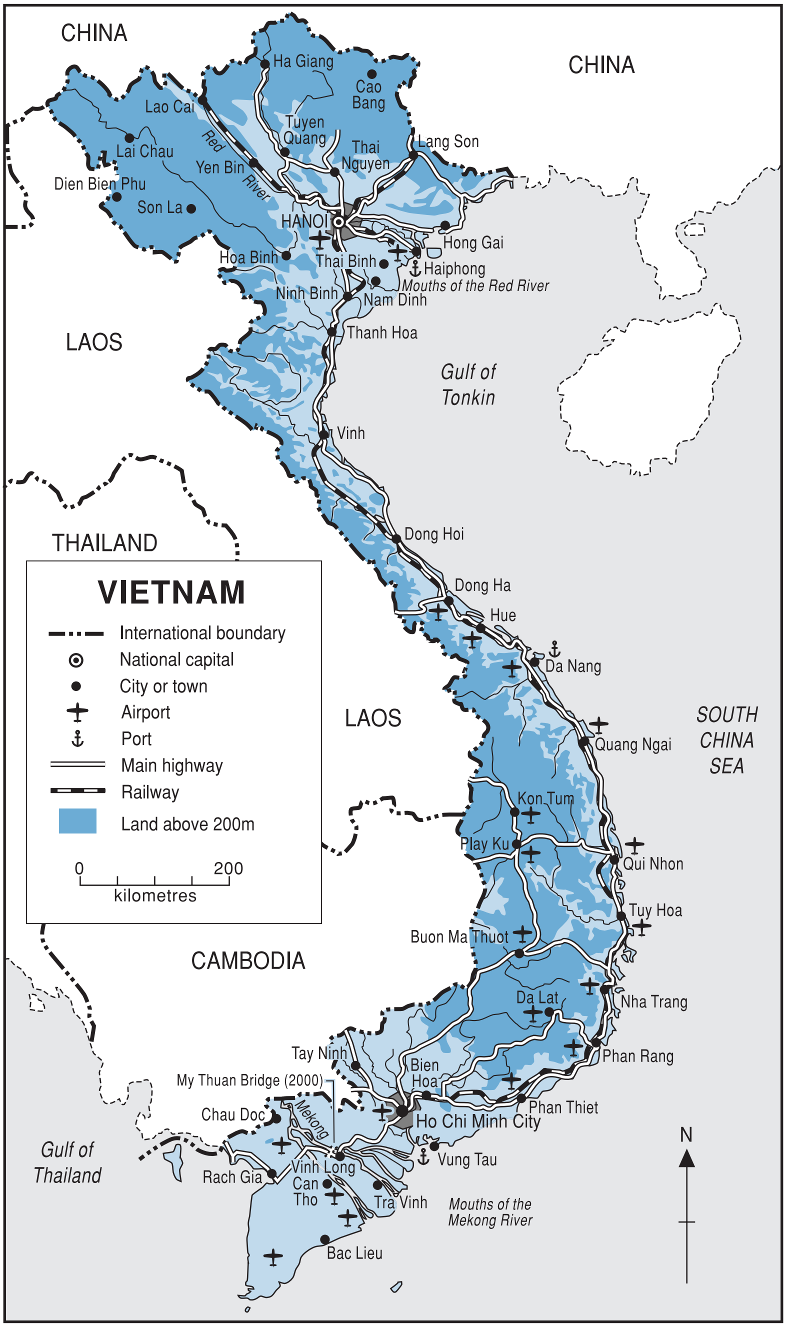
Expanding ASEAN to include low cost, new ASEAN economies provides Australian companies with opportunities to establish an ASEAN base alone or allied with an ASEAN company. Australian companies forming strategic partnerships or consortia with ASEAN companies can maximise the competitive advantage of each participant and receive favourable treatment in ASEAN.

Future Opportunities

The new ASEANs are South East Asia's least developed economies. While success is not assured, integrating with the more advanced economies of the region provides their best opportunity to improve economic and administrative frameworks, overcome poverty and move up the development scale to become modern and prosperous nations of the twenty first century. The new ASEANs will remain difficult business environments for the forseeable future; however, conditions will improve gradually as the transition process in each country proceeds. Australian companies therefore should continue to seek opportunities in these emerging economies and make an important contribution to their economic advancement and to Australia's developing, mutually beneficial partnership with the region.

P A R T O N E

VIETNAM


CHINA
CHINA
Ha Giang
Cao Bang
Lao Cai
Tuyen Quang
Thai Nguyen
Lang Son
Lai Chau
Red River
Yen Bin
Dien Bien Phu
Son La
HANOI
Hong Gai
Hoa Binh
Thai Binh
Haiphong
Mouths of the Red River
Ninh Binh
Nam Dinh
Thanh Hoa
LAOS
Gulf of Tonkin
Vinh
THAILAND
Dong Hoi
Dong Ha
Hue
Da Nang
VIETNAM
International boundary
National capital
City or town
Airport
Port
Main highway
Railway
Land above 200m
0
200
kilometres
LAOS
SOUTH CHINA SEA
Quang Ngai
Kon Tum
Play Ku
Qui Nhon
Tuy Hoa
Buon Ma Thuot
CAMBODIA
Nha Trang
Da Lat
Tay Ninh
Phan Rang
Bien Hoa
My Thuan Bridge (2000)
Phan Thiet
Chau Doc
Mekong
Ho Chi Minh City
N
Gulf of Thailand
Vung Tau
Rach Gia
Vinh Long
Can Tho
Tra Vinh
Mouths of the Mekong River
Bac Lieu

Chapter 1

CONSOLIDATING THE ONE PARTY STATE

Vietnam is one of a handful of orthodox one party communist states to survive the collapse of socialism in the late 1980s and early 1990s. The Vietnam Communist Party has pursued market based economic reforms for more than a decade but retains its political monopoly.

The Government, the bureaucracy and, importantly, the army are all subordinate to the Party. Essentially, the 19 people who make up the Politburo, the most senior decision making body of the Party and State, set national policy (Fforde and Goldstone, 1995, p. 99).[1]

With the potential exception of China, no nation yet has combined successfully a market economy with socialist one party rule, so no functioning role models exist for Vietnam (Turley, 1993a, p. 1). Like China, Vietnam combines economic liberalism with political conservatism, but the question remains-how far can change proceed within a socialist one party framework before the framework is undermined? Economic reform and growth could create momentum for fundamental political change (Turley, 1993a, p. 9). This dilemma is reflected in the continuing tension and debate between conservative and more progressive elements in the Vietnamese leadership.

This chapter examines the Party's efforts to secure a leading role in a changing Vietnam by consolidating its relationship with the modernising institutions of the State. The prospects for continued stable government and political loosening are assessed.

POLITICAL REFORM

The Party began to tinker with economic reforms in the late 1970s and early 1980s, largely endorsing experiments already occurring at the grassroots. (See Chapter 2 - *Vietnam: Economy*.) Adopting *doi moi* or 'renewal'[2] as basic policy at the Sixth Party Congress in December 1986 marked the formal beginning of a 'new age' in Vietnam's postwar development. However, the Party's zeal for economic experiment under *doi moi* has not been mirrored in its approach to political reform (Turley, 1993b, p. 262).

Vietnamese leaders use the expression 'political reform' to mean strengthening the state institutions, the National Assembly, government administration and the legal

....

1 Political power became even more concentrated after the 1996 Eighth Party Congress, which created a five member Standing Board within the Politburo to act as the Party's policy inner sanctum.

2 *Doi moi* is a compound expression that combines elements of newness and change; 'renewal' is the closest English language approximation. In 1986 to 1989, *doi moi* explicitly included equal attention to political and economic reform ('walking on two legs') and even today, Vietnamese leaders nod in that direction (Marr, 1997).

base, as an effective management framework for the Party to exercise its constitutionally guaranteed leadership.[3] This enables the Party to preserve its position as ultimate arbiter and to meet its objectives of delivering stable economic reform, durable growth and, ultimately, a Vietnam that is prosperous, strong, and developed, yet still 'socialist'.[4]

Maintaining stability is paramount to the Party, so political reform has little to do with Western ideas of democratisation. The Party's monopoly on political power is not open to public question or discussion, nor are concepts of multi-party democracy or pluralism.[5] Even the most reform minded leaders take a firm line here. They intend to avoid the 'contagion' that brought down socialist regimes in Eastern Europe and the Soviet Union and led to the Tiananmen incident in China.

For most Vietnamese leaders, popular political participation means the populace actively implements party decisions (Turley, 1993b, p. 260). Party members have an added capacity to participate in selecting party leaders and debating policy. Minority opinions within the Party are recognised explicitly in the revised party statute the 1996 Eighth Party Congress adopted, but those who hold such opinions 'must implement resolutions scrupulously and must not propagate their opinions at variance with the party resolutions'.[6]

Nevertheless, *doi moi* has liberalised Vietnamese society, making it more open and freewheeling than at any time since 1975, or the 1950s in the north (Marr, 1995, p. 19). Freedom of expression, for example, has increased, although it also waxes and wanes according to circumstances.[7]

THE PARTY

The Vietnam Communist Party was founded in 1930[8] under the guidance of Ho Chi Minh,[9] recognised leader of the Vietnamese communist and nationalist movement until his death in 1969.

....

3 Article 4 of the 1992 Constitution declares the Party 'is a leading force of the State and society'.

4 In Vietnamese, *dan giau nuoc manh xa hoi cong bang va van minh* ('a wealthy people, a strong country and an equitable and civilised society'). The preamble to the revised party statute adopted at the Eighth Party Congress in 1996 describes the Party's goals as 'to build an independent, democratic, prosperous, and powerful Vietnam and to successfully practise socialism and eventually communism'.

5 Political pluralism was a permissible subject for discussion in 1986 to 1990, but not since. The regular denunciations of pluralism by Vietnamese leaders suggest, however, that the concept retains some support within senior party ranks.

6 Article 9 (v) of the 1996 party statute.

7 Relatively open debate of political issues introduced by then General Secretary Nguyen Van Linh in 1987 was abruptly curtailed in 1989 as regimes in Moscow and Eastern Europe began to fall. Discussion of political pluralism was banned, and its foremost advocate within the Party, Tran Xuan Bach, was expelled from the Politburo in 1990.

8 The party traces its formal origins to the Vietnam Revolutionary Youth League formed in 1925, also under Ho Chi Minh's guidance. In late 1930, shortly after it was founded, the Vietnam Communist Party changed its name to the Indochinese Communist Party (ICP). The ICP dissolved itself in 1945, reappearing in 1951 as the Vietnam Workers' Party. The original name, Vietnam Communist Party, was resumed after the reunification of north and south as the Socialist Republic of Vietnam in 1976.

9 Ho Chi Minh ('Ho the enlightened one') was the last and best known of the approximately 120 pseudonyms used during his lifetime by the man born Nguyen Sinh Cung. At the time he helped found the Party, he used the name Nguyen Ai Quoc ('Nguyen the patriot').

The Party is an elite organisation. Its hierarchical structure is codified in the revised party statute. Article 9(iv), for example, states that lower echelon party organisations must submit themselves to higher echelon party organisations. At the Eighth Party Congress, 1 198 delegates represented the 2.2 million party members, who account for less than 3 per cent of Vietnam's population of 75 million. The delegates voted to endorse a Central Committee of 170 members; the Central Committee in turn endorsed the selection of a General Secretary and Politburo of 19 members; the Politburo then endorsed a Standing Board of five members to act as its executive body. Mostly, the level above selects the candidates to be endorsed at the level below.

Party committees operate in tandem with the state administration (the people's committees) at every level from the province to the commune. Party organisations also operate in ministries and state-owned enterprises (SOEs) and, following a call by the Eighth Party Congress, are being created in the private sector, including foreign joint venture enterprises.[10]

Legitimacy Renewed

Unlike the former communist regimes of Eastern Europe, the Vietnam Communist Party's leading role is grounded in broad popular legitimacy, although not in universal or outright support.[11] Initially, that legitimacy rested on the Party's historical achievements: the August 1945 Revolution;[12] the military defeat of the French colonial occupants at Dien Bien Phu in 1954; the victory over the US backed South Vietnamese regime in 1975; and the formal reunification under the socialist banner of North and South Vietnam a year later.

Postwar euphoria faded quickly with the Party's manifest failure to 'win the peace'. Economic mismanagement produced falling living standards. Repression combined with economic hardship produced a massive outflow of refugees that damaged national unity. This and further warfare with its neighbours left Vietnam isolated in the region. Furthermore, Vietnam's Soviet bloc alliance cut it off from the dynamic international forces associated with market based economies.

With impoverishment threatening to render meaningless Vietnam's hard won independence, and the reservoir of popular goodwill largely squandered, the leadership recognised that the Party's continued legitimacy would depend on converting historical achievements into national reconciliation between north and south and improving living standards. Since 1986, the Party's approach to reform has reflected a belief that, provided it delivered growth and prosperity, it could survive the transition to a market economy.

....

10 The Politburo issued a directive confirming this decision of the Congress in December 1996. However, party organisations already had begun expanding into the private sector earlier in the year. In May, even before the Congress, the Haiphong Party Committee reportedly began establishing party cells in joint ventures (Vasavakul, 1997, p. 19).

11 With the exceptions of Yugoslavia and Albania, communist parties were placed in power in Eastern Europe by the Soviet army.

12 This is when Ho Chi Minh seized power for a short time at the end of World War II.

With annual growth now averaging around 9 per cent, this calculation so far has proved accurate. The Party also has strengthened its domestic and international legitimacy through recent foreign policy successes, in some cases overturning costly foreign policy choices it had made earlier: extricating Vietnam from the Cambodian quagmire; normalising relations with China; concluding a framework agreement with the European Union; and in 1995, normalising relations with the USA and securing Vietnam's full membership of ASEAN.

Socialism Challenged

Faced with the reality that Vietnam could not prosper under central planning, party leaders have responded pragmatically to the ideological challenge of market based economic reforms. Even the most conservative recognise that ideology is worth little if the Party falls, so ideology has been adjusted to preserve the Party's leading role. However, this has been accompanied by sometimes fierce debate. 'Building socialism' remains the stated, face saving, goal. However, the leadership concedes that to build the necessary economic premises of socialism, Vietnam must pass through a period of state initiated capitalism. *Doi moi* understood in this way attempts to reconcile capitalist and socialist forms under state guidance.

What do Vietnamese leaders mean when they now talk of 'socialism'?[13] The concept lacks a precise contemporary definition, but two elements are clear: it maintains the Party's vanguard role; and it continues the central economic role of the State, which extends, for example, to ruling on foreign investment projects.[14] The political report tabled at the Eighth Party Congress in June-July 1996 explicitly recalled the constitutional provision according the State the leading economic role and declared the combined state and cooperative sectors would form Vietnam's economic foundation.

Leadership Stable

The Party's leadership is remarkably stable; until the Seventh Party Congress in 1991, just 30 people had served on the Politburo (Fforde and Goldstone, 1995, p. 102). For most of its existence, and until very recently, the generation of revolutionaries who survived French repression before 1945 led the Party. A few still advise the current leaders.

Party purges in 1950 to 1951, 1955 to 1956 and 1964 to 1966, while significant, did not compare with the severity of those in China during the Cultural Revolution. Nor did the deliberate idolisation of Ho Chi Minh from the late 1940s approach the Chinese cult of Mao (Marr, 1997).[15] The Party has institutionalised a process of

....

13 'Socialism' appears to mean different things to different leaders. Thus, in the run-up to the Eighth Party Congress, Prime Minister Vo Van Kiet argued in a politburo memorandum later leaked to the public that 'the degree of development of the state sector was not indicative of a socialist orientation'. Party General Secretary Do Muoi, however, expressed a contrary view in an interview with the *Vietnam Economic Times* around the same time (Vasavakul, 1997, p. 5).

14 Another important element appears to be the concept of *cong bang xa hoi*, which conveys ideas of equality of opportunity and social services, including some form of social safety net for the less able in society (Marr, 1997).

15 Ho Chi Minh is widely-although not universally-venerated in Vietnam and Ho Chi Minh Thought-like Mao Zedong Thought in China-now supplements Marxism-Leninism as the Party's official credo.

reasonably smooth generational change; since 1991, leadership turnover follows a fairly consistent pattern of the regular, phased retirement or quasi-retirement of those at the top and the gradual injection of a little new blood (Wurfel, 1993, p. 22).[16]

The leadership is outwardly cohesive and unified. This is achieved by balancing carefully viewpoints and regional representation (roughly north, centre and south). It is risky to categorise factions within the party leadership; the ideological positions of party leaders and their supporters seem to vary from one policy area to another (Vasavakul, 1997). Nevertheless, three broad leadership groupings appear to operate at the moment (Marr, 1997):

- ‘economic reformists’ advocate more active policy reforms and support a stronger private sector, contraction of the state sector, and Vietnam’s economic integration into the world economy
- a ‘defence and security’ faction brings together leaders with a military or interior ministry background, who worry that increasing the pace of economic reform could undermine political stability and social harmony. Members of this group are highly nationalistic, often conservative and concerned about the effect of the influx of foreign influences. Foreign influences sometimes are portrayed as forming part of an international ‘conspiracy’ to win by ‘peaceful evolution’[17] what could not be won by war, the downfall of Vietnam’s socialist regime
- an ‘ideology and culture’ faction shares many views of the ‘defence and security’ group, but emphasises adhering to the Party’s ideological and cultural roots.

In the past decade, appointments and policy decisions revealed shifts in the relative strength of these broad groups. In pre-*doi moi* Vietnam, the factional struggles inevitable in any elite normally were masked by adhering to the principle of consensus or collective leadership. Since 1986, the principle of collective leadership often has been cast aside, with different leaders or factions separately pursuing initiatives in their areas of policy responsibility. Nevertheless, overall policy changes have been incremental rather than radical; Vietnam has not seen the sharp swings in policy that have occurred in China, for example.

THE STATE

Vietnam’s 1992 Constitution reaffirmed the interrelationship between the Party and the State, designating the Party as ‘leader’, the People as ‘master’, and the State as ‘manager’. In 1986 to 1992, political reform aimed to separate the Party’s leadership role from the State’s management function and to strengthen both; more recently, there has been a shift back towards overlapping roles (Marr, 1997).

In practice, the Party and the State remain closely interwoven. The President, the Prime Minister and the Chairman of the National Assembly are all senior politburo

[16] Thus, the Politburo emerging from the Eighth Party Congress comprised ‘the first revolutionary generation’, but ‘most of the central committee members were from the 1955 to 1975 and post-1975 generations’ (Vasavakul, 1997, p. 25).

[17] In Vietnamese, *dien bien hoa binh*.

members. Almost all the current Cabinet are central committee members. Around 90 per cent of national assembly delegates are party members, with the Politburo and Central Committee well represented. Party members are prominent at middle and senior levels of the bureaucracy. This pattern is repeated at every level, from the centre to the commune. The Party-army nexus is also strong. In the mid 1980s, 90 per cent of army officers and 33 per cent of the rank and file were party members (Fforde and Goldstone, 1995, p. 99).

EIGHTH PARTY CONGRESS

The Eighth Party Congress in June-July 1996 continued gradual generational change and careful balancing in the party leadership. Newcomers to the 19-member Politburo lowered the average age a little, and a woman joined the previously all male line up. The factional balance between economic reformists, the defence-security group and the ideology-culture group, and between northerners, southerners and those from the centre was broadly maintained, although the defence-security faction increased its representation in the leadership.

Difficult leadership decisions, the subject of much pre-Congress speculation, were postponed. The three top leaders maintained their positions, pointing to disunity and difficulties in achieving consensus around a new, factionally balanced leadership ticket.

In the run-up to the Congress, a leadership ‘struggle’ was more evident than in the past. One conservative politburo member was expelled two and a half months before the Congress and two of his associates were omitted from the new politburo line-up.

In keeping with a policy the previous Congress adopted, the Central Committee changed 40 per cent of its membership. Military officers, provincial party chiefs and key figures in various social institutions were prominent among the new members.[18]

The congress policy outcome was largely a compromise, with a ‘socialist’ overtone. Reform will continue to be cautious, particularly in ideologically sensitive areas such as land ownership and the restructuring of SOEs.

National Assembly

Under the 1992 Constitution, the National Assembly, which is elected every five years, is the highest organ of state (as against party) power and the highest legislative body in Vietnam. It is Vietnam’s parliament, and it alone can enact legislation and alter the Constitution. It also elects (albeit at the Party’s direction) the President, the Vice-President and the Prime Minister, all of whom must be national assembly delegates.

18 Although, overall, the influence and strength of provincial level figures dropped at the Congress to below pre-1986 levels (Thayer, 1997).

In keeping with a strategy the 1986 Sixth Party Congress adopted, the National Assembly is taking on more legislative responsibilities. This reflects a small but important move away from rule by party directive towards constitutional government under the rule of law.

The National Assembly has shed some of its earlier tendency merely to rubber stamp party decisions. It now engages in vigorous debate and alters draft legislation, although it almost never initiates new legislation. Ministers' performances receive close and intense scrutiny. Now it is more assertive, the National Assembly can check the unfettered exercise of power by the Party, even though most delegates also are party members.

National Assembly delegates on the whole are younger, better educated and more technocratic than in the past and than the party leadership. They are hampered, however, by inadequate resources, lacking, for example, a parliamentary library, independent research staff and an adequate administrative budget.

Moreover, with just two sessions per year, each only three to four weeks long, the National Assembly does not have sufficient time to pass sufficient substantial legislation. There are suggestions to extend the sessions, add a third session mid year, or increase the overall number of delegates and the number of full-time delegates (most are part timers). Until Vietnam has a full-time legislature, its ability to develop a modern legal framework will be constrained. In the interim, the Standing Committee considers matters before the National Assembly, but so far, it has not reduced the backlog of legislation waiting to be passed.

National Assembly elections are becoming more open and 'democratic'. At the last elections, in 1992, the Party slightly loosened its control over the selection of candidates and permitted a greater choice of candidates for each seat. Currently, 8 per cent of national assembly delegates are independent non-party members. In April 1997, the Chairman of the Office of the National Assembly, Vu Mao, said the Assembly intended to lift non-party representation to around 20 per cent. These steps increase the sense of popular political participation, although the Party's organisational body, the Fatherland Front,[19] probably will vet candidates to ensure their views are compatible with the Party's outlook. The next national assembly elections are scheduled for mid 1997.

The Government

The collective style of management of the old Council of Ministers could not cope with the challenges of *doi moi* (Fforde and Goldstone, 1995, p. 113). The 1992 Constitution replaced the Council of Ministers with a government consisting of a Prime Minister and a Cabinet that the Prime Minister appoints with the National Assembly's approval. Unlike the Prime Minister, cabinet members need not be national assembly delegates.

The Government is the executive arm of the National Assembly. It manages the affairs of the State, including supervising government agencies at all levels and managing the economy. Decision making power now is concentrated in the office of

....

19 In Vietnamese, *Mat Tran To Quoc.*

the Prime Minister, although his powers are balanced partly by the specific powers conferred on the President, who is concurrently Commander-in-Chief of the Armed Forces and can recommend the Prime Minister's dismissal.

The Prime Minister and his Cabinet exercise their functions through ministries, other government agencies and SOEs. Reform and streamlining of this vast bureaucracy is an important element of Vietnam's political reform program.

ADMINISTRATIVE REFORM

Although Vietnam is a Leninist one party state, administrative decision making power is relatively dispersed. This is partly a legacy of centuries of Vietnamese history and particularly the long period of war, first with the French, then with the USA and the South Vietnamese regime. During the latter period, the top party leaders set the 'line' and communicated it to lower levels. However, local leaders then had considerable discretion, although they were subject to constant scrutiny, corrective warnings and, on occasion, removal by the centre (Marr, 1997).

The breakdown of the central planning system that accompanied the adoption of *doi moi* in 1986 reinforced the tendency towards local autonomy. Local autonomy, aiming to foster economic initiative, was a major thrust of *doi moi*, but it inevitably undercut the pre-*doi moi* state hierarchical structure. Middle and local level party and administration officials, usually one and the same, parlayed their political power, connections and autonomy into administrative and economic power. The directors (usually also party members) of profitable SOEs and middle level officials (usually also party members) in the ministries that controlled them were particularly well placed to become the chief beneficiaries of the new order (Vasavakul, 1996, p. 46).

In his opening speech to the Central Committee Plenum of January 1995, Party General Secretary Do Muoi announced the need to build a clean and effective state apparatus. He criticised the inefficiency of the administrative machinery, singling out state officials' lack of expertise and moral fibre. He complained they had formed power blocs, become 'mandarins', corrupt, 'bossy' and alienated from the people. He also recognised that creating a new state administration would attack the interests and habits of these power blocs and mandarins. The Plenum endorsed the reform of the state administration, focusing on three areas: bureaucratic institutions, procedures (red tape) and the public service (Vasavakul, 1996, p. 53).

Administrative reforms aim to bring abuses (some actual, some perceived) under control and reassert the central authority of the State and, through it, the Party. However, the strengthening of the state administrative system does not imply a transfer of power from the Party to the State; rather, it is meant to be a new form of state-society relationship under party leadership. The Party is determined to redress administrative aberrations that in the long term could undermine its political credibility and legitimacy (Vasavakul, 1996, p. 64).

Administrative reforms confronting the economic and political power base of middle and low ranking state officials-party members have been resisted. Violations continue, for example in licensing foreign investment. Economic scandals involving state officials at all levels remain commonplace. Local people's committees still operate as party fiefdoms, frustrating Hanoi's authority. Administrative reform in

Vietnam will continue to reflect a tug of war between the Party and the State on one side and those with vested interests in maintaining the previous status quo on the other (Vasavakul, 1996, p. 64).

ADMINISTRATION: PARTY AND STATE

Below the centre are three basic levels of party and state administration in Vietnam:

- provinces or municipalities
- districts or provincial towns
- rural communes, urban quarters and district towns.

Each level has:

- a party committee headed by a secretary and
- (on the 'state' side) a popularly elected people's council, which selects a people's committee to take charge of day-to-day administration.

These party and state administrative bodies operate in parallel, but with considerable overlap of both personnel and responsibilities.

The Prime Minister has power under the 1992 Constitution to dismiss (but not to appoint) the chair and deputy chair of provincial and municipal people's committees.

Streamlining the Bureaucracy

A product of its historical influences, the Vietnamese bureaucracy is an unhappy amalgam of Chinese Neo-Confucian, French Third Republic and Soviet Stalinist traditions (Marr, 1991, p. 12). Vietnamese and foreigners alike see it as seriously impeding economic reforms and foreign investment projects.

The government structure is being streamlined as a fundamental step towards overhauling the bureaucracy, although these measures may not promote efficiency. The number of government agencies at all levels has been reduced through mergers. Ministries and equivalent agencies were reduced from 27 in 1992 to 22 in 1995. A further eight ministries and agencies were merged to form three 'mega-ministries' at the end of 1995.

Among these were two bodies of special interest to foreign investors, the State Planning Committee and the State Committee for Cooperation and Investment, now merged to form the Ministry of Planning and Investment, the Government's 'one-stop shop' to process foreign investment proposals. This simplifies procedures, although the long wait for approvals has not changed much (Peregrine, 1996, p. 4).

Centre-local government relations also were reorganised. Under a 1994 law, local government was integrated into the state administrative system to form a unified state apparatus. The political autonomy of people's committees theoretically has been reduced. Now all levels are treated as local representatives of central government in Hanoi, implementing central government instructions. However, they still execute resolutions of the local people's councils, so the overlap of central and local authority continues, albeit on a smaller scale (Vasavakul, 1996, p. 57).

The representatives on people's councils and people's committees at every level and administrative offices have been reduced. State economic and administrative functions are being separated. This means separating the SOEs from the ministries that once controlled them. Reform measures involve creating conglomerates each consisting of several SOEs. It is too early to assess their success, and the move may be aimed not only at increasing efficiency but also as a further measure to demolish or circumvent nepotistic fiefdoms in government administration; however, the effect may be to create new ones (Vasavakul, 1996, p. 54).

SOEs also were streamlined: following a 1992 council of ministers (now government) directive, they were reduced from over 12 000 to around 6 000, of which 5 000 are targeted for eventual 'equitisation'. However, the process is being resisted and is proceeding slowly. (See Chapter 2 - *Vietnam: Economy*.)

Reducing Red Tape

The second major thrust of administrative reform is to improve and streamline administrative procedures, reducing bureaucratic red tape.

Red tape, inter-ministry rivalry, non-cooperation, inconsistency, graft, corruption, nepotism, and wastage are endemic to the Vietnamese bureaucracy. Furthermore, these problems have grown larger under *doi moi*. After 1986, ministries often intensified the regulation of SOEs under their control to generate revenue no longer available from the central Government. Then, faced with rapidly changing market conditions in the early 1990s, they increased the bureaucratic steps required to obtain permits, licences and approvals.

Reform is to simplify procedures and abolish unnecessary procedural steps by decreasing the agencies and officials entitled to exercise authority in a given transaction. In particular, mergers and centralisation reduced the different agencies that grant approvals. These changes represent a start, but the entrenched bureaucratic networks which rely on circumlocution and obfuscation to serve their interests will not be dismantled overnight. Moreover, many foreign investors found new procedures created new problems. For the foreseeable future, foreign companies will encounter procedural delays and associated frustrations in dealing with the Vietnamese bureaucracy. (See Chapter 3 - *Vietnam: Business*.)

Building an Effective Public Service

Vietnam's public service needs to adjust to the State's new role as macroeconomic manager rather than central planner. Existing public servants trained under the old system generally possess neither the technical skills nor the outlook needed for current tasks (Vasavakul, 1996, p. 62). In 1996, Vietnam's State Committee for Government Personnel Organisation[20] reported 40 per cent of public servants were qualified to do their jobs; 20 per cent were barely adequate; 20 per cent were weak; and the bottom 20 per cent needed replacing (Tran, 1996, p. 3).

20 In Vietnamese, *Ban To Chuc Can Bo Chinh Phu*.

The Government established two important bodies charged with public service reform and retraining: the State Committee for Government Personnel Organisation and the National Institute for Public Administration. The first studies government management and makes recommendations; the second conducts training. Australia and other bilateral and multilateral donors assist with this high priority task, which will require increased emphasis in future.

These two bodies so far have had little impact on rebuilding the Vietnamese public service to meet the needs of a market economy. Although the number of ministries has been halved, the number of central and local government employees, currently 1.3 million, also needs to be reduced further.[21] Public service salaries are unrealistically low, encouraging low productivity, moonlighting and corruption. Public servants also lack a code of conduct and need extensive retraining in priority specialist areas (Irvin, 1995, p. 742).

The Government is recruiting younger and better educated people to senior positions. In July 1996, the State Committee for Government Personnel Organisation set age limits for senior promotions, continuing the trend in some areas of the bureaucracy. However, the bureaucracy is not ready for a rigid policy that rewards youth, professional qualifications and abilities (Tran, 1996, p. 3). Younger managers also need the personal connections and status that are vital in the Vietnamese system.

LEGAL REFORM

A substantially reworked legal base supports Vietnam's program of reform. As the nation moves from central planning to market economics, it needs new laws to define the rules of the marketplace, including legal obligations and the rights of individuals and companies. Rights, such as private property rights, that did not exist under the old system need defining as do the means to enforce them (World Bank, 1996a, p. 87). However, the new legal system will also be a new tool maintaining the Party's established political authority through state control (Sidel, 1993, p. 223).

The following are necessary elements in Vietnam's new legal framework (Lichtenstein, 1994, p. 1):

- a legal basis for different kinds of property ownership
- company and business laws and regulations
- a system of commercial laws, including contract law and intellectual property rights, and means of protection and enforcement
- appropriate bankruptcy and related laws
- financial laws such as a securities law and regulations, a banking system and supporting law, a land law to define land use (including mortgage and transfer rights), and labour laws
- foreign investment laws

[21] Although, six or seven years ago, the number of public servants probably was twice the current figure.

- environment protection laws
- legal institutions and dispute resolution mechanisms (such as court litigation and arbitration) and administrative enforcement mechanisms.

Origins

Like the administrative system, Vietnam's legal system is a blend of several traditions: a centuries old Vietnamese tradition with strong Chinese influences; 70 years of French influenced codes overlaid by 40 years of socialist norms; and a small measure of US common law influence in the pre-reunification south.

After introducing market reforms, Vietnam initially borrowed laws on an ad hoc basis, especially from China. However, Vietnamese law makers soon realised this approach was flawed; now they are systematically drafting laws to cover the substantial regulatory gaps, although difficulties remain, with many different agencies issuing overlapping or contradictory regulations. Basic laws and frameworks in many areas now exist or are being developed, but the process of building a new legal infrastructure for Vietnam will take many years.

LAW MAKING BODIES

Several of Vietnam's state institutions issue laws. The laws so issued are not of equal weight and often contradict each other.[22] The **National Assembly** passes laws and resolutions and can amend the Constitution. Its **Standing Committee** issues ordinances. The **Government**, which is the executive body of the National Assembly, issues decrees to implement laws, as well as decisions and instructions. Individual **ministries** issue circulars, instructions and decisions as do **people's committees**.

The Ministry of Justice coordinates the preparation of all laws, ordinances, decrees, and so on, but often has to balance competing demands from different interest groups. It also exercises functions relating to the administration of justice (including the system of courts) as well as training, research and legal education.

When the Government, Prime Minister, ministers or heads of state bodies with ministerial status issue laws, they are published in the official gazette (in Vietnamese, *cong bao*). Gazettal, however, is incomplete and frequently delayed.

Private Property

Private ownership rights, though not extending to land, were first formally recognised and protected in the 1992 Constitution, which recognised three classes of property ownership: state, collective and private. All are declared equal before the law. The first two, however, are 'fundamental' and therefore presumably have more standing than the third, which is said to supplement them.

....

22 In November 1996, the National Assembly passed a law on the promulgation of legal documents to establish a hierarchy of precedence to overcome the problem of conflicting circulars, directives etc. issued by different government agencies.

Private property cannot be nationalised. It can be expropriated only for limited reasons of state, and compensation must be paid. These constitutional provisions clearly signal to potential domestic and foreign investors that private activity is sanctioned and will receive legal protection.

Land Use Rights

Land use rights are very important in Vietnam. Land is the main non-labour asset and, as in other countries with a high population to land ratio, its value is high. Land ownership, transfer and mortgage rights are important to private sector development. However, this remains an area of much legal uncertainty, and one in which ideology plays an important part.

Under the 1992 Constitution, land is the property of the people but the State administers it on their behalf. Since land is 'owned' by the people as a whole, it is not possible for individuals (or corporations) to own land, although they (and foreigners) can own and transfer structures such as houses built on land. However, Vietnamese (but not foreign) individuals, households and organisations can hold and transfer *rights to use* land. The State issues land use rights through people's committees at the district and commune level.

Under the 1993 Land Law, the ability to transfer, lease, exchange, mortgage or inherit land use rights varies between different categories of land, land holders, and land use rights. Transactions are subject to official approval case by case.

Many perceived the Land Law as making land use rights proxies for land ownership. The Government put an end to this perception by issuing Decree CP-18 in February 1995, but in doing so muddied the waters. The decree converted long term non-agricultural (that is, essentially urban) land use rights to leaseholds from the State, for which rents must normally be paid. This aimed to encourage the mortgaging of land use rights and to place SOEs on the same footing as domestic private enterprises; historically, only SOEs were allocated long term urban land use rights.[23] However, by converting urban land use rights to leases, the decree made them less secure and so undermined their transferablity and use as mortgage collateral or as Vietnamese contributions in joint ventures with foreign investors.

Commercial Framework Established

Private property rights in Vietnam were developing before the 1992 Constitution was adopted. The 1990 Law on Private Business and the separate Law on Companies established the legal basis for private business. The two laws and their implementing decrees laid down rules for Vietnamese individuals and legal entities to create and operate three new forms of enterprise outside state or collective ownership: private enterprises (essentially sole proprietorships), limited liability companies, and share holding companies. The laws provided for the long term development of businesses and the generation of profits.

[23] This explains in part the attractiveness of SOEs as joint venture partners for foreign investors. Moreover, a December 1996 decree specifically excluded private or joint stock companies from the class of Vietnamese entities entitled to use land use rights as a capital contribution to foreign joint venture enterprises.

Other specialised laws, providing important building blocks in Vietnam's commercial legal structure, followed:

- the 1993 Land Law and the Environment Protection Law
- the 1994 Bankruptcy Law, which for the first time in Vietnam provides a comprehensive legal framework for restructuring or liquidating insolvent enterprises. It applies equally to all enterprises, including state-owned and foreign-funded ones
- the 1994 Labour Code, which deals with all aspects of employer-employee relations
- the 1994 Domestic Investment Promotion Law, which gives Vietnamese investors access to incentives, including tax breaks and investment support funds, for investment in selected regions and sectors
- the 1995 State Enterprise Law, which serves as the legal basis for managing, restructuring and divesting SOEs. (See Chapter 2 - *Vietnam: Economy*)
- the 1996 Mining Law, which should serve as the legal basis for foreign involvement in exploiting Vietnam's mineral resources. Under the law, foreign exploration companies can be granted secure and exclusive rights to mine new discoveries. However, as it stands, the law gives little encouragement to foreign investors, who doubt the guarantees on exclusive rights it provides.

Vietnam's intellectual property laws offer close to international standards of protection to copyright, patents, trademarks and designs.[24] The Government however, must approve any transfer of such rights and enforcing them is difficult. Vietnamese judges have little knowledge or understanding of the concept of intellectual property. Refinements in this area will be necessary to encourage technology transfer to Vietnam.

In 1995, after some ten years of drafting and extensive public consultation, Vietnam adopted a comprehensive Civil Code. The 834-article code consolidates the legal foundation for a market economy and the rights of the individual. It sets out guidelines for almost every aspect of Vietnamese life, from inheritance rights to rules for copyright protection, technology transfer and property mortgages. The code also protects individuals from bureaucratic harassment (Vasavakul, 1997, p. 931). However, to implement the new code in its entirety will require scores of follow-up regulations.

A new Commercial Law, to be issued shortly, will supplement the Civil Code. It will regulate the new types of companies; the 1990 Law on Companies deals with only three basic types of companies. The new Commercial Law also will aim to assure standards of accountability and equity, which are required before the future opening of a stock exchange in Vietnam and will try to remove inconsistencies between existing laws (Le Dang Doanh, 1996).

....

[24] Some piracy occurs in the software industry, but Vietnam has not seen the proliferation of pirate CD or designer clothing factories of China or some other parts of Asia.

Liberal Foreign Investment Regime

Vietnam adopted its first post-*doi moi* Law on Foreign Investment in 1987 to lay a stable legal foundation for the emergence of a modern, internationally-oriented, multi-sector economy (Dick and Do, 1997, p. 1). The 1987 law repealed and replaced laws passed in 1977, and was itself amended in 1992 and 1993. In November 1996, the National Assembly replaced the existing legislation with a new Law on Foreign Investment. Implementing regulations for the new law were issued in February 1997 and administrative requirements in March 1997.[25]

Foreign investors theoretically can invest in any sector of the economy. The new law particularly encourages foreign investment in export production, agriculture, high technology, labour intensive activities, infrastructure, and in mountainous, remote and economically disadvantaged regions. This list differs from the one in the old law by adding agriculture and removing production of import substitutes and foreign currency services (such as tourism, ship repairing, air and sea ports). The list is to be updated from time to time with an indication of industry areas where foreign investment is either restricted (possibly only to joint ventures) or prohibited.

The three foreign investment options in Vietnam are: joint ventures, wholly foreign-owned enterprises, and business cooperation contracts. In addition, production sharing contracts are permitted in the oil and gas sector, and build-operate-transfer (BOT) contracts are permitted for foreign investment in infrastructure projects.[26] Special provisions encourage foreign investment in export processing zones and industrial zones.

The new law no longer requires the foreign investor to contribute at least 30 per cent of the legal capital of a joint venture enterprise; it can be reduced to 20 per cent in certain circumstances. Among the incentives offered to foreign investors are the following:

- corporate income tax rates of between 10 and 25 per cent, depending on the project and the actual or potential economic benefit to Vietnam
- tax exemptions or reductions in certain circumstances
- waivers on some import and export duties
- repatriation of profits, subject to a withholding tax of between 5 and 10 per cent
- state guarantees of fair and equitable treatment, protection of industrial property rights and rights in respect of transferred technology, and no nationalisation or expropriation without compensation.

In practice, up to 90 per cent of foreign investment projects are joint ventures with SOEs, although the proportion is declining. The Vietnamese partner normally contributes its equity (usually at least 30 per cent) as land use rights, often much over-valued. The foreign partner normally provides all capital, technological, management and marketing requirements for the project and trains Vietnamese staff.

25 Administrative requirements are in Ministry of Planning and Investment Circular No. 3 of 15 March 1997.

26 The new law extended the BOT concept to include Build-Transfer-Operate (BTO) and Build-Transfer (BT) arrangements.

Under the new law, the Ministry of Planning and Investment theoretically is a 'one-stop shop' to handle foreign investment applications so foreign investors do not deal with a multiplicity of government authorities. Investment licences are supposed to take 60 days to issue, from application. In practice, most foreign companies find they need to deal with a range of ministries and provincial authorities. (See Chapter 3 - *Vietnam: Business*.)

The Prime Minister approves high value and other projects considered nationally important.[27] Under the new law, people's committees of provinces and cities under central authority will be granted authority to issue investment licences for certain types of foreign investment projects. Export Processing Zones and Industrial Zones will be granted similar authority. This should remove layers of bureaucratic decision making, but will not lessen the difficulties (such as with taxation and customs) investors face when implementing projects.

Initial foreign investor reaction to the new law was lukewarm. Investors commented that the new law consolidated existing laws rather than reforming substantively Vietnam's legal framework for foreign investment (Russell, 1997, p. 1).

Vietnam adopted distinct and different frameworks for domestic and foreign investors, although its stated aim is to provide similar conditions and incentives for both. This is causing growing irritation among some domestic entrepreneurs who feel that foreign investors have an advantage (Marr, 1997).

Dispute Resolution

The foreign investment legislation allows a degree of latitude in resolving disputes. Negotiation and conciliation are encouraged. If these fail, arbitration or litigation before Vietnamese courts is available.

The Supreme People's Court, Vietnam's highest judicial authority, is directly accountable to the National Assembly. At the next level is the People's Court, consisting of a civil court, economic court, administrative court, labour court and criminal court.

In 1993, the Vietnam Chamber of Commerce and Industry established the Vietnam International Arbitration Centre with authority to settle all disputes arising out of Vietnam's international economic transactions. The Chamber selects arbitrators, who need not be Vietnamese; however, foreign lawyers have no right of appearance; the arbitrator's decision is final; and there is no right of appeal.

Foreigners (other than those from former CMEA member countries[28]) rarely if ever refer disputes to the Arbitration Centre. If a dispute cannot be resolved through negotiation, legal opinion normally favours nominating a foreign arbitration centre (such as the one in Singapore).

....

[27] 'Group A' projects requiring prime ministerial approval are listed in Article 93 (1), Chapter 12, of the implementing decree (No. 12 of 18 February 1997) for the 1996 Law on Foreign Investment.

[28] CMEA also known as 'Comecon', short for Council for Mutual Economic Assistance was the trade regime under which Vietnam and other members of the former Soviet bloc bartered goods and services. The regime disintegrated with the collapse of Soviet and Eastern European communism in the late 1980s and early 1990s.

Until very recently, foreign judgments and arbitration awards were difficult to enforce in Vietnam. Theoretically, this position changed in 1995, when Vietnam joined the 1958 New York Convention on Arbitral Awards. The Convention imposes a number of duties, including a duty to recognise and enforce arbitration agreements and awards to which the Convention applies. International rulings are therefore theoretically enforceable through the People's Court in Vietnam. However, it is difficult to find any precedents for this having been done. (See Chapter 3 - *Vietnam: Business*.)

More To Be Done

To date, the legal framework works as a good beginning, but the system is weak. A comprehensive framework for private business operating in a market based system still needs developing.

The National Assembly's two short annual sessions are insufficient to deliberate, amend and pass the volume of laws required for Vietnam's rapid transformation to a modern state. Furthermore, the implementing regulations often are not prepared until the 'parent' law is passed: this renders the law virtually useless during the time regulations are being prepared, except to state intent or policy. This system leads to delays, uncoordinated regulations and excessive bureaucratic power and discretion. Worse still, some regulations directly contradict laws passed by the National Assembly. In addition, the various forms of legislation are often opaque and contradictory. Vietnamese legal practice is based on the French civil law system rather than British common law, so a precedent cannot provide a firm basis for interpretation (Peregrine, 1996, p. 27).

Vietnam does not yet have a framework of laws to create a competitive environment for all, prevent unfair market competition or regulate monopolies. Rather, rules vary according to the origin of an enterprise's capital, preventing fair competition among enterprises. Individuals cannot yet rely on the State to prosecute or defend their private rights and preserve commercial freedoms (Gillespie, 1993, p. 145).

Legal personnel are in short supply and inexperienced in commercial law; this undermines the enforcement and application of laws. A foreign company can take a Vietnamese company to court, and even win the case but what happens then is not altogether certain. (See Chapter 3 - *Vietnam: Business*.) Extrajudicial relief is heavily relied on because judgments are not always enforced.

Law making is becoming more transparent; for example, debates over the 1995 Civil Law were public. However, laws still have a low degree of penetration in Vietnam. Even where laws exist, the concept of adhering to law, a principle underlying the rule of law, is not widely accepted. Disregard for central laws at the local level is common. Government agencies are inclined to regard the judicial system as an equal and often resist or are indifferent to its authority (McCormick, 1995, p. 17).

LEGAL SERVICES

In practice, two separate categories of legal services are available in Vietnam: those for domestic users of the Vietnamese legal system, and those for foreign investors in the country.

Officially, bar association services in the courts and the so-called legal consultancy services are distinct. Membership of the Bar Association is, in theory, a prerequisite for practising law. In 1995, the Bar Association had 570 members.

Vietnamese lawyers are concentrated in criminal and family law practice. In the north, few lawyers outside government are experienced in commercial law. In the south, lawyers with pre-1975 commercial experience are practising again. The first private Vietnamese law firm was founded in 1992 in Ho Chi Minh City. Several more firms have followed.

Twenty five foreign law firms operate with 34 representative offices; at least three firms are Australian. Several other Australian firms 'fly in-fly out'; also Australian lawyers work in non-Australian foreign law firms. Foreign lawyers provide a range of services, including preparing documents on behalf of foreign clients and acting as consultants to local and international companies and organisations. Most of their work centres on interpreting the mass of complex and contradictory implementing regulations and decrees. Foreign lawyers also advise and assist the Vietnamese Government in modernising its legal infrastructure.

In September 1995, the Government tightened the already limited role of foreign lawyers. They are not permitted to rule on Vietnamese law, set up joint ventures with Vietnamese firms, or hire Vietnamese lawyers (although Vietnamese lawyers can be taken on as 'legal trainees' for a maximum two-year period). All questions relating to Vietnamese law must be referred to Vietnamese firms, which cannot employ foreign lawyers. These measures make it even more difficult for foreign investors to grapple with Vietnam's challenging legal environment and, contrary to the Government's intention, tend to undermine the development of an indigenous legal profession (Peregrine, 1996, p. 27).

THE RULE OF LAW AND CIVIL SOCIETY

Law has an essentially top-down function in Vietnam, affording the authorities a means of selectively declaring and enforcing their will. Vietnam's efforts to strengthen the role of law as part of its metamorphosis to a modern state 'ruled *by* law',[29] should be understood in this light and should not be confused with the development of an autonomous system of 'rule *of* law'. The rule *of* law is still weak in Vietnam.

....

29 In Vietnamese, *nha nuoc phap quyen.*

The essence of the rule of law is that everyone is equal before the law and no one is above the law. Moreover, law takes precedence over custom or 'Realpolitik'. This principle also extends to the highest state institutions and to the Party.[30] The rule of law therefore is the antithesis of the arbitrary 'rule of man' and incompatible with the Party's rule by directive.

The rule of law is the foundation of civil society. The absence or weakness of the rule of law in Vietnam means that civil society also is similarly absent or weak.

In reality, economic and political reforms have created a substantially more open and autonomous society in Vietnam compared with 20 years ago. As a result of *doi moi*, the scope for individual initiative has expanded considerably and the Party is less present in daily life; interest groups also are emerging (Ljunggren, 1996).

These developments do not yet constitute civil society, but they add up to a fundamental change in Vietnam's sociopolitical landscape. As autonomous organisations, private business and mass popular culture grow and ideology, public political indoctrination and the Party's ability to shape public values and opinions decline, Vietnam's civil society will develop, despite concerted efforts to redress the trend through measures such as the 'social evils' campaign of 1996 (McCormick, 1995). As the elements of civil society grow and develop, they gradually may coalesce to increase pressure on the Party and the State for more freedom and participation in political life.

CIVIL SOCIETY

Civil society may be defined as:

> the realm of organised social life that is voluntary, self-generating, self-supporting, autonomous from the state, and bound by a legal order or set of shared rules. It is distinct from society in general in that it involves citizens acting collectively or in a public sphere to express their interests, passions and ideas, exchange information, achieve mutual goals, make demands on the State, and hold state officials accountable. Actors in a civil society need the protection of an institutionalised legal order to guard their autonomy and freedom of action (Marr, 1994, p. 13).

CHALLENGES AND PROSPECTS

The Vietnam Communist Party seeks to apply the lessons it learned from the collapse of other socialist regimes in the late 1980s and early 1990s. It liberalises without democratising or risking stability and the Party's leading role (Ljunggren, 1996, p. 20). It manages change incrementally through relatively pragmatic policies, yet always maintaining cohesion. It is creating a framework for strong, centralised management of the State through streamlined government machinery and a growing body of laws, but continues to monopolise authority and to extend its influence and control throughout 'the system' and into the private sector as well.

....

30 The Constitution declares the Party is subject to the Constitution and the law.

The Party's political monopoly is not seriously challenged inside or outside Vietnam. Anti-government expatriate groups are an irritant and nothing more, although older party members and the Politburo may still see them as a direct threat. The Party tolerates a very small degree of confidential political debate and ideological difference within its own ranks, but is quick to snuff out serious dissidence when expressed in public.

However, the long term ascendancy of the Party is threatened by its diminishing relevance to the everyday lives of Vietnamese. Some analysts argue the Party lacks a positive and well articulated vision that can capture the imagination of the people, or even its own rank and file. Many ordinary people reject or ignore the Party's dogma and rhetoric. Marxism-Leninism, even when supplemented by vague Ho Chi Minh Thought, does not appeal to the postwar generation, which accounts for more than half the population (Marr, 1995). Generational change at the top has not altered the perception that the Party is a gerontocracy. The decline in membership has reversed, but the average age of members is rising steadily and the quality and motivation of new cadres seem poor.[31] Membership fails to attract Vietnamese youth, who prefer career paths in business. The Party is also a victim of falling ethical standards and rising corruption under *doi moi*.

The Party's decline was put in sharp focus by the collapse of the Soviet bloc. The leadership responded in 1992 by adopting the principles of party 'renewal' (*doi moi*), 'rectification' (*chinh don*) and 'rejuvenation' (*tre hoa*). It launched a drive to recruit new members (more than 9 per cent of current members joined after 1992), improve existing party organisations and create new ones in the state system and the private sector (Vasavakul, 1997, p. 16). The 1996 Eighth Party Congress confirmed the importance of party reform and endorsed the program of state administrative reform. Strengthening these two pillars consolidates Vietnam's one party state.

However, the Party's ability to respond to popular aspirations and make itself relevant to and lead a modern Vietnam, is a matter of debate. It could find itself increasingly ignored, or, over time, even challenged by gradually expanding civil society.

The State's capacity to deliver effective management at the Party's direction also is in doubt. Ministries and provinces act as independent fiefdoms. Strong vested interests firmly resist the centralising thrust of administrative and legal reforms. The system of laws is sketchy; the rule of law remains weak or non-existent; corruption is rife.

Increased influence of the military and the security authorities, representing a generally conservative, strongly nationalist tradition, should tighten the party leadership's focus on the negative by-products of *doi moi*, particularly growing wealth disparities, 'social evils'[32] and anti-socialist foreign influences. However, party leaders recognise their hold on power depends on raising living standards and ensuring the benefits of economic growth are widely distributed. Ideology is unlikely to prevail over these imperatives, although nationalism might if Vietnam's security is threatened seriously. *Doi moi* is unlikely to be substantially reversed, although

....

31 People aged under 30 - the vast majority of Vietnam's population - account for just 11 per cent of members, falling from 15 per cent five years ago.

32 In Vietnamese, *te nan xa hoi*, which include gambling, prostitution, drug addiction and smuggling.

changing circumstances and continuing differences between Vietnamese leaders will produce twists and turns, occasional backsliding, and often interminable delays.

Tension between central control and local autonomy, and the divide between north and south, continue to challenge the party leadership. Provinces frequently ignore or baulk at Hanoi's directives, and the two often differ over investment priorities. Political power is concentrated in the north, but the economic centre of gravity is firmly in the south, enabling Ho Chi Minh City to resist Hanoi's control. The 1996 Foreign Investment Law, giving local people's committees authority to issue investment licences, shows some loosening by Hanoi, but the practical effect of the new legislation remains to be seen.

OUTLOOK

Vietnam's political stability and the leading role of the Party are unlikely to change in the medium term. The strategy to strengthen and expand party organisations should give the Party greater control over the state sector and greater influence in the private sector. Whether this will benefit or impair either sector, or indeed the Party in the long term, remains to be seen.

The Party will continue to deal firmly with direct attacks on its political monopoly. With the close Party-army nexus, it has the means to do so.[33] A Vietnamese Tiananmen is difficult to imagine but cannot be ruled out. Although the army has deep roots in Vietnamese society and enjoys the respect of the people, it has taken up arms against them on at least one occasion in the past.[34] Moreover, 1989 was not without its share of grassroots restiveness in Vietnam, some of it involving clashes between students and police. Large scale violence was avoided, but this may have been more the result of popular restraint than leadership wisdom.

The Party can take some comfort from the strong precedent for single party rule in East Asia. The impression drawn from the collapse of socialism in Eastern Europe and the Soviet Union, that Leninist party-states must give way to some form of democracy before market economies can flourish, is not supported in East Asia (Turley, 1993b, p. 271). China and other East Asian regimes indicate that an authoritarian political style is compatible with rapid economic growth. However, it is not clear how long this can be sustained.

Marxism-Leninism-Ho Chi Minh Thought will require continuing ritual obeisance, but the Party's ideological orientation is likely to become increasingly irrelevant. Military and other strongly nationalist elements, whose hold on the party leadership is strong, may resist this trend and render uneven the path of continuing reform. However, the Party will focus on promoting growth and prosperity through economic practices that have little to do with socialism. It will accord the state sector a central role largely as a control measure, leaving the private sector somewhat handicapped (Fforde and Goldstone, 1995).

....

33 The army currently numbers around half a million men. There is a strategic reserve of some 3 million or 4 million and local paramilitary forces of another 4 million or 5 million.

34 In October-December 1956, the army was used to suppress peasant unrest in Quynh Luu District, Nghe An Province, during the infamous land redistribution campaigns in the then communist north (Thayer, 1989, p. 94).

Reform increasingly will test the Party's pragmatism and flexibility. The current extended period of growth and stability provides a breathing space for the Party to try to renew itself if it can, and to strengthen the resilience and effectiveness of the state management structure over which it presides. The success of this dual endeavour, and the Party's ability to reconcile conflicts between different sections of Vietnamese society, and between society and the State, will determine the Party's longevity. Vietnam's early transformation to a modern and prosperous nation, will depend substantially on the outcome.

REFERENCES

Dick, J., and Do, L., 1997, 'Foreign investment in Vietnam', Freehill, Hollingdale and Page (Solicitors), Ho Chi Minh City.

Fforde, A., and Goldstone, A., 1995, *Vietnam to 2005-Advancing on All Fronts*, The Economist Intelligence Unit, London.

Gillespie, D.G., 1993, 'The Evolution of Private Commercial Freedoms in Vietnam', Thayer and Marr, (eds), *Vietnam and the Rule of Law*, Department of Political and Social Change, Research School of Pacific Studies, The Australian National University, Canberra.

Irvin, G., 1995, 'Vietnam: Assessing the Achievements of *Doi Moi*', *The Journal of Development Studies*, Vol. 31, No. 5, June.

Le, Dang Doanh, 1996, personal communication with East Asia Analytical Unit.

Lichtenstein, Natalie G., 1994, 'A Survey of Viet Nam's Legal Framework in Transition', Policy Research Working Paper 1291, Legal Department, East Asia and Pacific Division, The World Bank, Washington DC.

Ljunggren, B., 1996, *Vietnam's Second Decade Under Doi Moi-Emerging Contradictions in the Reform Process?*, Stockholm University, Stockholm.

Marr, D.G, 1997, personal communication with East Asia Analytical Unit.

____ 1995, *Vietnam Strives to Catch Up*, The Asia Society, New York.

____ 1994, 'The Vietnam Communist Party and civil society', paper presented at the Vietnam Update 1994 Conference, Doi Moi, the State and Civil Society, The Australian National University, November.

____ 1991, 'Where is Vietnam Coming From?', in Forbes, D.K., Hull, T.H., Marr, D. and Brogan, B. (eds), *Doi Moi-Vietnam's Renovation Policy and Performance*, Department of Political and Social Change, Research School of Pacific and Asian Studies, The Australian National University, Canberra.

McCormick, B.L. 1995, 'Society and the State in Vietnam and China: the political consequences of economic reform', draft paper presented to the Vietnam-China Workshop, The Australian National University, August.

Peregrine, 1996, *Vietnam: Transition Under Threat*, Peregrine, Hong Kong.

Russell, N., 1997, 'A Summary of the new law and implementing regulations on foreign investment in Vietnam', Phillips Fox (Solicitors), Ho Chi Minh City.

Sidel, Mark, 1993, 'Law Reform in Vietnam: The Complex Transition from Socialism and Soviet Models in Legal Scholarship and Training', *Pacific Basin Law Journal*,Vol. 11, No. 221.

Thayer, Carlyle A., 1997 'The regularisation of politics revisited: continuity and change in the Party's Central Committee 1976-1996', paper to panel on Vietnamese Politics Transformed: Broad Conceptions and Fresh Approaches, Association for Asian Studies, Chicago, March.

____ 1989, *War by Other Means-National Liberation and Revolution in Viet-Nam 1954-60*, Allen and Unwin, North Sydney.

Tran, Khanh, 1996, 'Vietnam Tries to Rejuvenate Its Civil Service', *Trends*, No. 73, 28-29 September.

Turley, W.S., 1993a, 'Introduction', in Turley, W. S. and Selden, M. (eds.), *Reinventing Vietnamese Socialism-Doi Moi in Comparative Perspective*, Westview Press, Boulder, Colorado.

Turley, W.S., 1993b, 'Party, State, People: Political Structure and Economic Prospects', in Turley, W.S. and Selden, M. (eds.), *Reinventing Vietnamese Socialism-Doi Moi in Comparative Perspective*, Westview Press, Boulder, Colorado.

Vasavakul, T., 1997, 'Reforming the one party political system in post-central planning Vietnam: developments and trends' (draft paper).

____ 1996, 'Politics of the Reform of State Institutions in the Post-Socialist Era', in Leung, S. (ed.), *Vietnam Assessment-Creating a Sound Investment Climate*, Institute of Southeast Asian Studies, Singapore.

World Bank, 1996a, *Legal Institutions and the Rule of Law,* World Bank, Oxford University Press, London.

Wurfel, D., 1993, '*Doi Moi* in Comparative Perspective', in Turley, W.S. and Selden, M. (eds), *Reinventing Vietnamese Socialism-Doi Moi in Comparative Perspective*, Westview Press, Boulder, Colorado.

FURTHER READING

Political Report of the Central Committee (Seventh Tenure) to the Eighth National Congress of the Communist Party of Vietnam, Part II.

Thayer, Carlyle A, 1995, *Beyond Indochina*, Adelphi Paper 297, Oxford University Press, London.

____ 1993, 'Recent Political Development: Constitutional Change and the 1992 Elections', in Thayer, C. and Marr, D. G. (eds), *Vietnam and the Rule of Law*, Department of Political and Social Change, Research School of Pacific and Asian Studies, The Australian National University, Canberra.

____ 1992, 'Political Developments in Vietnam from the Sixth to Seventh National Party Congress', Discussion Paper No. 5, Department of Political and Social Change, Research School of Pacific and Asian Studies, The Australian National University, Canberra.

____ 1991, 'Renovation and Vietnamese Society: The Changing Roles of Government and Administration', in Forbes, D.K., Hull, T.H., Marr, D.G. and Brogan, B. (eds), *Doi Moi-Vietnam's Renovation Policy and Performance*, Department of Political and Social Change, Research School of Pacific and Asian Studies, The Australian National University, Canberra.

Chapter 2

ECONOMIC RENEWAL

Vietnam has made significant progress towards developing a market economy since it began comprehensive economic reforms in 1986 under the Government's *doi moi* reform program.[1] At first, measures were piecemeal, then in 1989, bolder, more comprehensive economic restructuring occurred. Changes include substantially reforming agriculture and land use, comprehensively liberalising prices, reforming taxes, restructuring state-owned enterprises, modernising the financial system, unifying the exchange rate, and moving towards freer trade. Since the 1990s, Vietnam's economy has grown strongly and inflation has been curbed through tight controls on bank credit and fiscal constraint.

As a result, Vietnam is attracting keen interest from international investors. Its market potential is huge; at current trends, its current population of 75 million is projected to reach 100 million in 15 years; its people are entrepreneurial; and economic growth should be sustained if reforms continue.

OVERVIEW OF ECONOMIC DEVELOPMENT

Vietnam remains one of the world's least developed economies, with a per capita income in 1996 of US$260 in exchange rate terms (Appendix Table 2.1) or $1 100 using international purchasing power parity (PPP)[2] (Centre for International Economics, 1996, p. 33). This compares with China's PPP per capita income of $2 000, and Burma's of approximately $1 000. (See Chapter 5 - *Burma: Economy*.) With a large and still fast growing population and relatively small land area, Vietnam's population density is one of the highest in the East Asia at 223 people per square kilometre. More than 90 per cent of the population live in less than 20 per cent of the country's land area.

Natural Resources

Vietnam's natural resources, though not rich on a per capita basis, are relatively rich compared with those of Vietnam's South East Asian neighbours. It has significant potential in coal, oil, natural gas, and hydro-electric power and is thought to be rich in bauxite, iron ore, copper, and gold. Vietnam's marine resources, tropical forests and agricultural potential also are significant. However, much of the environment is under stress, a result of war damage and overpopulation.

....

1 *Doi moi* usually translates as 'renewal' or 'renovation'.

2 The purchasing power parity method of measuring national incomes in internationally comparable terms uses converters to adjust money incomes to better reflect the ability of a unit of local currency to purchase goods and services in its country of issue. PPP income estimates measure actual production levels and living standards better than official exchange rate estimates because they adjust for the undervaluation - essentially because wages are low - of goods and services that are not traded internationally, like land and services. Incomes are expressed in internationally comparable dollars.

Early Postwar Period

After unifying north and south as the Socialist Republic of Vietnam in 1976, the communist Government introduced the north's Stalinist style central planning system in the south to rapidly industrialise the economy and transform Vietnamese society. However, within a decade, postwar socialist construction had brought Vietnam's economy to the brink of collapse. While official statistics showed impressive GDP growth in the early 1980s (Figure 2.1),[3] by 1985, per capita production of many consumer items was lower than in 1976 (General Statistical Office, 1996, p. 33). By then, Vietnam's traditionally self-sufficient and even surplus agricultural economy was relying on imported food and industrial inputs, paid for by aid and growing foreign debt. In 1986, inflation peaked at almost 900 per cent.

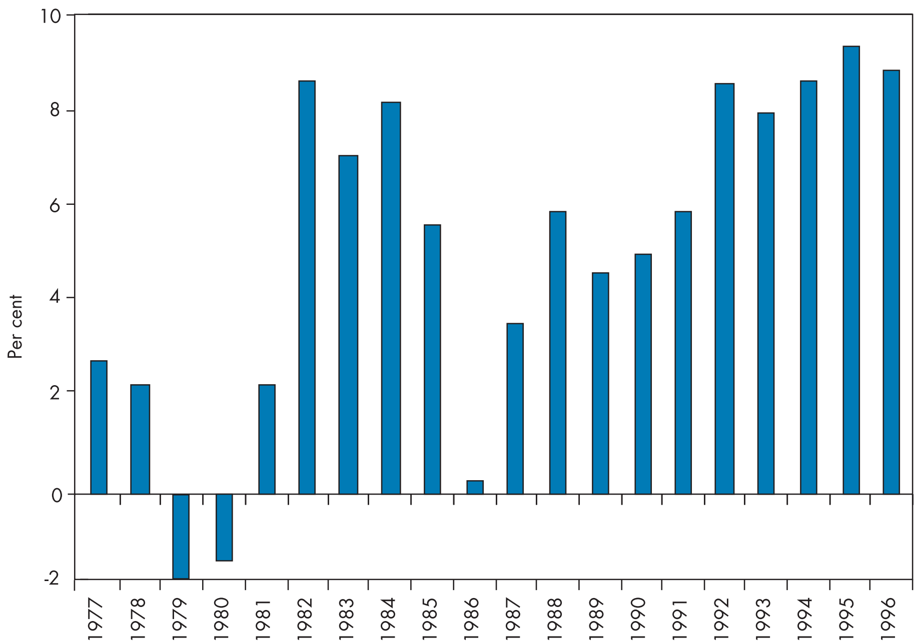
Doi Moi Economic Reforms

Market-oriented economic reforms implemented under *doi moi* contributed to high and relatively sustained growth between 1988 and 1996, rising incomes and improved living standards (Figure 2.1).

Figure 2.1

Strong Growth since Doi Moi

Annual Growth of GDP (at Constant Prices), 1977 to 1996



Note: 1996 figure is an annual estimate based on data for the first eight months only.

Source: Ministry of Planning and Investment, 1996.

....

[3] This growth largely reflected the expansion of heavy industries, but data for this period are unreliable.

The economy grew at an average annual rate of over 5 per cent from 1988 to 1990, increasing to over 8 per cent from 1991 to 1996. In the past five years, annual growth rates of over 10 per cent in industry and services, and 4 per cent in agriculture have underpinned strong economic performance and stabilised food prices.

Structural Change

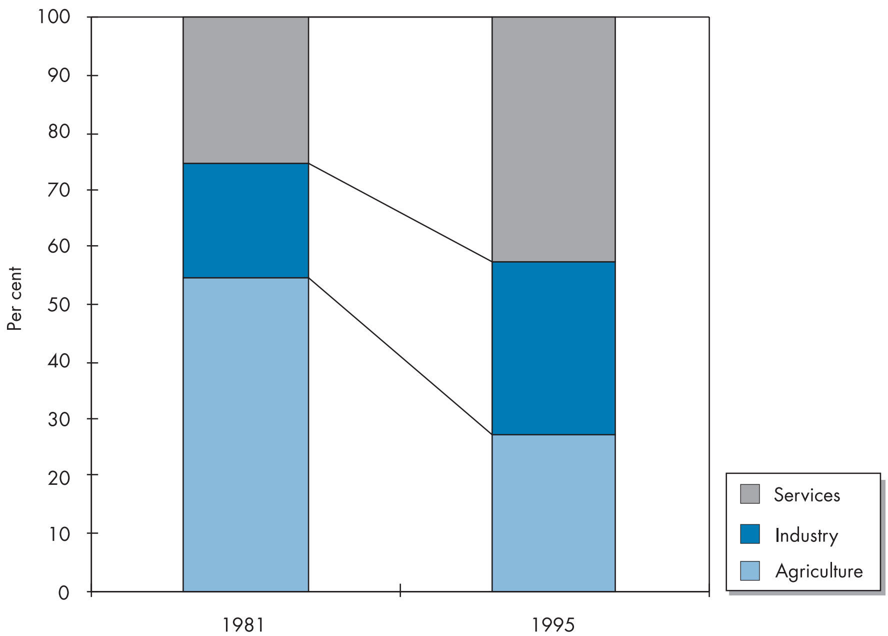
Shifting resources from agriculture to industry and services has generated high economic growth. This is reflected in the changing composition of GDP (Figure 2.2). Furthermore, since *doi moi*, market forces have played a major role in restructuring the industrial sector towards Vietnam's comparative advantage. During central planning, heavy industries dominated industrial output. Since *doi moi*, light manufacturing, particularly of garments and textiles for export, have expanded their production share.[4] Tourism, retailing and trade services initially spurred service sector growth but now transport, marketing, advertising and professional services are growing rapidly.

Figure 2.2

Resources Shift Away from Agriculture

Changing Structure of the Economy, 1981 and 1995

Share of GDP



Source: General Statistics Office, 1996.

However, economic restructuring is far from complete. Distortions from central planning still prevent Vietnam from exploiting fully its comparative advantage in the integrated world economy.

....

4 According to official statistics, the share of light industry in the industrial sector increased from 37 per cent in 1985 to 47 per cent in 1995 (General Statistical Office, 1996, p. 290).

Private Sector

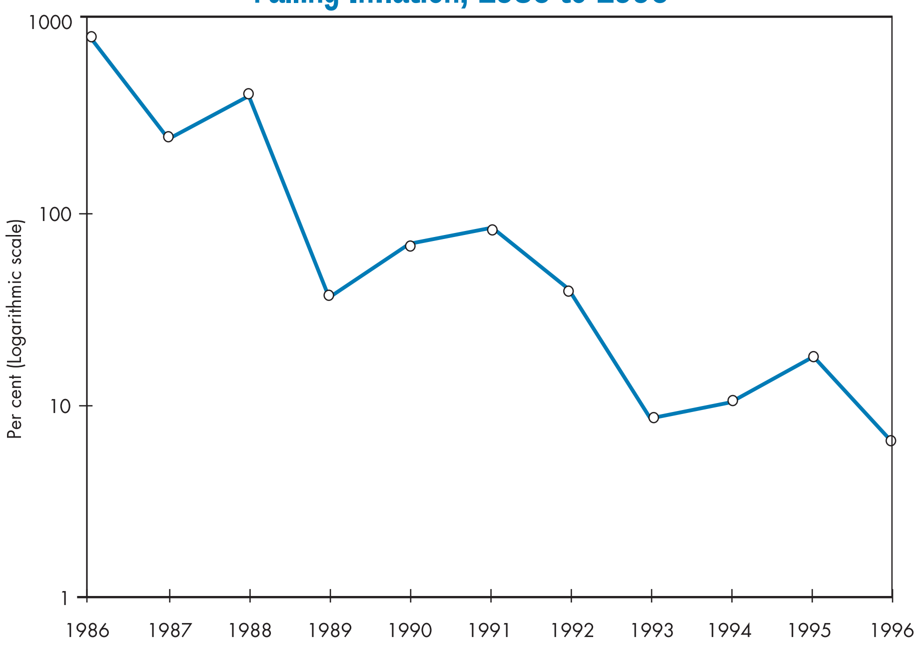
From 1985 to 1995, the private sector expanded rapidly despite constraints, including a lack of access to bank credit. Non-state sector employment increased by 3.4 per cent per year while state sector employment decreased by 2.5 per cent per year (General Statistical Office, 1996, p. 67). By 1990, the non-state sector contributed 66 per cent of Vietnam's GDP. This trend has continued although official statistics do not fully reflect the importance of the non-state sector due to data problems.[5]

Macroeconomic Stability

In addition to high economic growth and rapid industrialisation, *doi moi* has achieved macroeconomic stability. Restrictions on domestic credit expansion and financing of the budget deficit by bond issues have successfully controlled inflation. The inflation rate dropped sharply from its 1986 peak to only 5 per cent in 1993. Although it rose again to 13 per cent in 1995, due mainly to a poor harvest pushing up rice prices, it moderated to 4.5 per cent in 1996 (Figure 2.3).[6] Low inflation is likely to continue if macroeconomic stability can be sustained.[7]

Figure 2.3

Falling Inflation, 1986 to 1996



Note: The 1996 figure is for the first nine months only.

Source: International Monetary Fund, 1996.

....

5 For example, a large and growing proportion of foreign direct investment is in joint ventures with state-owned enterprises (SOEs); however, all this output is included in state sector data.

6 Inflation in 1996 was lowered by extremely tight credit ceilings, reduced government capital expenditures and increased imports due to a rationalisation of the licensing arrangements. As the rate is probably below the long term trend, the Government's target of 8 per cent for 1997 is probably realistic.

7 The year-to-year inflation rate in April 1997 is only 1.6 per cent (AusAID / NCDS, 1997).

The Government's budget has been consolidated, another major achievement since the 1990s, although much still needs to be done. Diversifying taxes and improving tax collection expanded the revenue base, and public expenditures are managed more carefully. As a result, the budget deficit dropped from over 8 per cent of GDP in 1990 to less than 2 per cent in 1995 (International Monetary Fund, 1996).

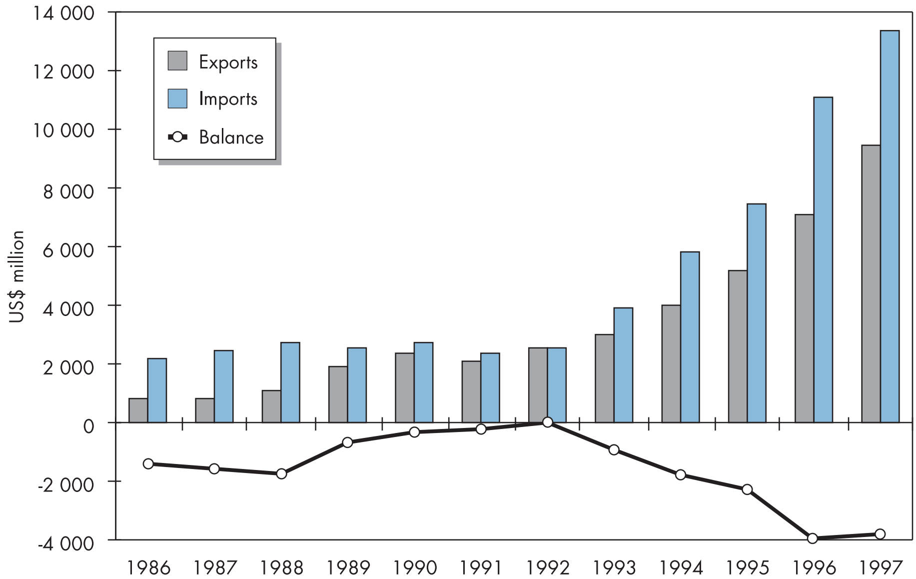
Trade

While foreign trade has expanded rapidly since *doi moi*, and initially improved the balance of payments position, the trade deficit expanded significantly in 1996 and is expected to remain high in 1997 (Figure 2.4). This causes concern. However, a high proportion of imports are capital and intermediate goods financed by foreign direct investment and other capital inflows and should expand exports.[8] Unprocessed primary products and raw materials dominate exports, but light manufactured products are increasing.

Figure 2.4

Trade Deficit Remains Large

Exports and Imports, 1986 to 1996



Source: General Statistics Office, 1996; AusAID/NCDS Vietnam Economic Research Project (Dec 14-20, 1996; Jan 18-24, 1997)

....

8 From 1990 to 1995, imported capital goods (machinery and parts and steel) increased from about 40 to 70 per cent of total imports (Figure 2.6).

Foreign Investment

Foreign direct investment surged into Vietnam between 1988 and 1996, with approvals reaching about US$27 billion, covering 1 800 projects. Vietnam's East Asian neighbours are the largest investors, accounting for nearly two thirds of total foreign direct investment approvals.

Living Standards Rise

Living standards have improved with market reforms. Measured by constant (1989) dong,[9] per capita income rose by 6 per cent per year from 1990 to 1996, compared with 3.4 per cent from 1986 to 1990. Growth is concentrated in Hanoi in the north and Ho Chi Minh City in the south where per capita incomes are respectively US$700 and US$800 to $1 000 (official exchange rate based), compared with less than US$100 in rural areas, where 80 per cent of the population live (Asia Pacific Economics Group, 1996).

Constraints

Despite impressive progress, Vietnam still faces many challenges, including a legal system that is not yet able to support a market economy, inefficient state-owned enterprises (SOEs), underdeveloped physical infrastructure and lack of managerial and skilled human resources, particularly in public administration.

THE PRE-REFORM ECONOMY

After the 1954 Geneva Conference divided Vietnam into two separate independent states at the 17th parallel, North Vietnam's[10] communist government promoted Soviet style heavy industrialisation, at the expense of agriculture, services and light industry. To achieve this, the Government allocated resources via a central plan which set quantitative targets. As prices of industrial inputs and basic consumer goods were held artificially low, shortages were endemic and resources were misallocated.

Post-1976 Socialist Transformation

The Government sought to extend central planning to the formerly capitalist south when it reunified the country under the socialist banner in 1976.[11] During the second five-year central plan (1976 to 1980), the Government sought to nationalise private industry and commerce, collectivise household agriculture, and create a state monopoly in foreign trade.

However, the central plan rarely was followed closely. Despite efforts to centralise the means of production in the State's hands, private markets continued to operate. In

9 The *dong* is the Vietnamese currency.

10 North Vietnam's official name was the Democratic Republic of Vietnam.

11 The Vietnam War ended in 1975 with the fall of Saigon to communist forces. However, formal reunification did not occur until a year later.

the south, attempts to collectivise agriculture, especially in the fertile Mekong Delta were largely unsuccessful, mainly because of farmer resistance, and initial attempts to fully nationalise industry also were unsuccessful. Furthermore, the heavy cost of invading Cambodia in 1978, the subsequent Chinese reprisals, and the West's trade and investment embargoes on Vietnam hampered economic development.

In the late 1970s, the Government redoubled efforts to implement central planning and eliminate private industry and commerce in the south. This had disastrous effects on industrial output. By the end of 1980, the economy faced collapse: real per capita incomes dropped from already low levels and sectoral growth rates fell well short of plan targets.[12]

Early Reforms

Economic performance had deteriorated so sharply during the second five-year plan, the Government had to moderate the pace of 'socialist transformation' of the economy and implement some reforms in the early 1980s, modelled partly on economic reforms recently begun in China.

Many agricultural cooperatives and SOEs had established economic activities outside state plans. Some early reforms in agriculture and industry followed what has since become a common pattern: locals have resisted central plan edicts; eventually, the central Government has tolerated spontaneous local activities; and finally, government policy is formally revised to reflect reality (Probert and Young, 1995, p. 506).[13] Both farmers and SOEs were allowed to sell their above plan surpluses in the free market.

Macroeconomic Mismanagement

However, macroeconomic management changed little, particularly the relationship between the state budget, the Central Bank and SOEs. The Central Bank financed (essentially by printing money) the budget's substantial deficit and the SOEs' deficits. As a result, domestic credit expanded rapidly; severe macroeconomic instability emerged by the mid 1980s; annual inflation accelerated to nearly 900 per cent; output declined; and foreign debt grew rapidly.

The perceived failure of reforms to improve economic performance strengthened the influence of conservatives in the party leadership. They undermined reform, reinstated collectivisation of agriculture as a national goal and reintroduced restraints on private sector activity. By 1986, after five years of piecemeal economic reforms and a gradualist approach to socialist transformation, Vietnam again faced economic crisis.

12 For example, the 1976 to 1980 five-year plan aimed for a national income growth rate of 13 to 14 per cent; whereas, the actual growth rate was only 0.4 per cent.

13 This is sometimes termed reform by 'fence breaking', in Vietnamese '*vuot dau*', a realistic adjustment to existing circumstances, rather than a top down directive process.

ADOPTION OF DOI MOI

After considerable debate, in December 1986, the Sixth Congress of the Vietnam Communist Party adopted the principle of *doi moi* as national policy to transform Vietnam into a market economy. This was a bold political step but an obvious economic one, given the failure of previous reforms and the successes of neighbouring market-oriented economies and rapidly reforming China (Reidel and Comer, 1995, p. 7).

While *doi moi* signified a cautious acceptance of the market to allocate resources and achieve growth, it also preserved the Party's political monopoly. (See Chapter 1 - *Vietnam: Politics*.) Even though the economy is more market-oriented, the Government still expects to dominate broad economic management and exercise control.

Major macroeconomic stabilisation measures and other economic reforms were not introduced until 1989. These aimed to reduce inflation, remove inefficient administrative controls, enhance freedom of choice for economic units and introduce competition to change fundamentally the economic management system (Leung and Vo, 1996, p. 188).

Vietnam's economy responded well to these reforms; inflation fell sharply and output increased. Industrial output growth rose from an average of 1 per cent in the second five-year plan to 7 per cent in the third plan (1991 to 1995). Initial favourable conditions helped: the dominance of agriculture and the small industrial base allowed a quick supply response; the legacy of a market economy was revived quickly in the south; economic integration with communist countries in the former Council for Mutual Economic Assistance was relatively low and the reform process began before this trade collapsed; and neighbouring countries provided buoyant markets for Vietnam's exports and a major source of investment (Dodsworth et al, 1996). The principal reforms and their impact on Vietnam's internal economic performance are discussed in the following sections.

AGRICULTURAL REFORMS

As in China, the first major reforms were in agriculture (East Asia Analytical Unit, 1997). Agricultural reforms implemented after 1986 confirmed the household as the basic production unit and limited the role of cooperatives. Farmers no longer were forced to sell contracted amounts of produce to the State; instead, they sold their produce to the market and determined the composition of their crops. As in China, households were given land tenure for at least 15 years and although the concept of private ownership of land was rejected, land use rights became transferable.[14] Farmers could make production and investment decisions as if they were private land owners. In 1989, agricultural prices were liberalised and the State's procurement of rice was abolished, greatly benefiting the agricultural sector.[15] Before then, the official price of rice had been only 10 per cent of the free market price. Other

....

[14] The legal right to transfer land use rights was formalised in the 1993 Land Law.

[15] Rice exports still are restricted to state trading companies.

important reforms stimulating agricultural growth were to introduce competition among agricultural trading companies and remove internal barriers to trade.

These reforms boosted agricultural output growth to 4 per cent per year between 1990 and 1995. Private, family based production units account for over 90 per cent of total production. Vietnam progressed from importing over 500 000 tonnes of rice per year between 1986 and 1988 to being the world's third largest rice exporter in 1989. It has maintained this role since.

In 1995, cultivation of crops, particularly rice, accounted for nearly 80 per cent of agricultural production. The Mekong and Red River deltas produce the bulk of output; in many other areas, mountainous country or extreme fluctuations in weather severely limit production. The area of agricultural land per person is small and labour productivity still is low, indicating the potential for productivity growth as labour moves out of agriculture.

INDUSTRIAL EXPANSION

Before 1986, industrial sector growth depended on large scale Soviet aid, which went mainly into heavy industries producing capital goods. These industries still make up about 40 per cent of industrial production. Vietnam's Government remains predisposed to big, capital intensive projects; some of which may be of limited commercial viability at this stage of Vietnam's development.[16] The Foreign Investment Law and the government investment plan also are biased towards heavy industry, especially petroleum and oil.[17]

Even before *doi moi*, in the mid 1980s, the business activities of SOEs that did not come within government plans were legalised and enterprises sold part of their output on the free market (Leung and Vo, 1996). Most industrial prices were liberalised by the end of 1988; prices that now are controlled, such as for cement and steel, generally are set at close to market prices. In addition, the official exchange rate was devalued and aligned closely to the rate applying in the parallel market. Export subsidies were eliminated; firms were permitted to retain foreign currency earnings; and trade was liberalised. The Government also legally recognised private firms and rationalised SOEs.

These reforms opened the industrial sector to domestic and foreign competition and promoted significant restructuring. A sizeable non-state sector developed and investment in new plant and equipment rapidly increased. After five years of over 10 per cent annual industrial growth, this sector's share of GDP has increased steadily (Figure 2.2). In the year to April 1997, industrial output grew a further 14 per cent. The construction sector performed particularly strongly; output of consumer goods and other light industries increased at a slower rate.

16 For example, the Government is considering building an oil refinery worth more than US$1 billion in the central provinces.

17 While domestic investment available for this sector is limited and the oil sector is strongly export oriented, it is also highly capital intensive, creating little employment compared to labour intensive manufacturing exports.

Vietnam's industrial sector still depends on the natural resource base, with food processing and oil and gas production dominating. However, the sector is diversifying gradually as textiles, chemicals, including fertilisers and rubber processing, and building materials become more important. Industrial production still focuses mainly on import substitution and the Government aims for self-sufficiency in some sectors.

SERVICES SECTOR REFORMS

Before *doi moi*, services sector development was constrained, as priority was given to heavy industry. Furthermore, many services were considered unproductive and went uncounted under the Marxist national accounts system. Correcting for years of under-investment, the services sector has expanded strongly since 1986, recording average annual growth of 14 per cent in 1988 and 1989 and 10 per cent between 1990 and 1995.[18]

The main reforms assisting the services sector were liberalising trade, promoting foreign investment, and legally recognising private ownership. The main areas contributing to growth were private transport, which benefited from eliminating internal trade barriers, and the private retail sector. As restrictions on private enterprises were removed, the number of markets, shops, restaurants, and other small and medium sized enterprises grew rapidly. Financial services recorded strong growth, but as they constitute only a small part of the services sector, their contribution to total growth was small. Tourism also strengthened after the opening up of the economy, and increased trade and foreign investment promoted the development of supporting businesses such as marketing, legal and accounting services.

REFORM OF STATE-OWNED ENTERPRISES

Doi moi reforms imposed hard budget constraints on SOEs, cutting most subsidies and denying automatic access to bank credit. SOEs' share of commercial credit fell from 90 per cent in 1990 to 60 per cent in 1995. Planning controls relaxed, allowing SOE managers to make more autonomous decisions. Measures to increase competition were introduced, SOEs and private firms were subject to the same legal requirements, and SOEs had to buy inputs and sell outputs at market prices. Preferential interest rates, tax treatment and debt rollovers were discontinued.

A large number of SOEs merged or closed in the early 1990s. From 1990 to 1996, while SOE numbers halved from 12 000 to 6 000[19] and their workforces declined from about 2.5 million to about 1.7 million, their production rose. Although SOEs were rationalised considerably, analysts estimate SOEs could readily shed a further 30 per cent of their workforces with no drop in output. However, the strong trade unions are effectively resisting this. Providing incentives to SOE workers has dramatically increased efficiency in sectors like transport, where some workers own 50 per cent of their trucks and buses, retailing, where workers buy shares to increase

....

18 Some of this growth reflects improved recording of services sector activity.

19 Of these, the central Government controls about 2 000 and provincial or district level authorities control the remainder. Most are very small, employing fewer than 500 people and with capitalisation of less than US$100 000.

enterprises' capital base, and agriculture, where workers buy coffee bushes on large plantations while land remains state owned (Le Dang Doanh, 1996).

Productivity of SOEs continues to vary greatly: performance of some has improved but most are not internationally competitive. Assessing the performance and profitability of SOEs is difficult because they do not employ uniform or accurate accounting systems. Efforts to remedy this include adopting new accounting procedures for SOEs in 1996. As in China, ownership rights over SOEs have been transferred from line ministries to an asset management bureau within the Ministry of Finance, to separate regulatory and ownership functions. However, provincial authorities are resisting this move.

Reform of SOE ownership also has started slowly. The SOE 'equitisation' policy envisages eventual partial privatisation of SOEs, limiting the private share to 50 per cent. However, this process is progressing very slowly with only five companies equitised in the past five years and less than US$10 million raised from share sales. Prospects for future equitisation of SOEs are uncertain. During 1996, the Prime Minister and others tried to accelerate the equitisation process, announcing that as an experiment, 200 mainly small and medium sized SOEs, representing 2 per cent of industrial output, would be equitised (Le Dang Doanh, 1996).

In 1995, the new State-Owned Enterprise Law aimed to consolidate a leading role for state business in the economy. During 1995 and 1996, the Government merged a number of SOEs into approximately 18 large state corporations, in industries such as steel, coal, power and textiles. This suggests that the Government now is consolidating rather than equitising SOEs. The Government hopes that by combining several SOEs in the same field, these conglomerates will be able to compete more effectively internationally. However, without competition and anti-monopoly legislation, the newly created corporations stand to benefit from increased market power, without having to become more efficient or innovative (Gates, 1996).

Due to the lack of political consensus, comprehensive equitisation of the SOEs sector is unlikely to occur in the foreseeable future. In any case, Vietnam's financial markets are insufficiently developed to support this process. The Government's financial dependence on this sector also will slow the pace of the reform. Technical problems, such as increasing accountability, valuing shares and determining numbers of shares to be sold, escalating social problems from redundant workers, and increasing union and party resistance also retard the process.

SOEs in priority sectors still receive substantial government support through land, credit and regulatory protection, because the 'socialist orientation' of Vietnam's economy requires industry to remain substantially state owned. Rapidly growing military involvement in business since the 1990s has strengthened the SOE sector. (See box.) SOEs benefit from tax breaks, as taxes are routinely negotiated with state collectors; have privileged access to foreign trade licences and quotas; and have easier access to credit from state banks which tolerate lingering bad debts as a result of their historically close relations with SOEs (Peregrine, 1996). Foreign investors also report difficulty in gaining approval to establish businesses that directly compete with SOEs.

SOEs also have greater access to foreign technology because the Government steers foreign investors into joint ventures with SOEs. Compared to private sector companies, SOEs are larger and receive preferential access to land and more favourable treatment from government agencies, making them more attractive partners for foreign investors.

Furthermore, many important sectors such as real estate development, telecommunications, minerals and energy, banking, construction, and large scale manufacturing, including auto assembly, steel and chemicals, are effectively reserved for SOEs. Foreign investors wanting to participate in these sectors must enter into joint ventures with SOEs. Many of these sectors also are heavily protected from import competition: continued high levels of protection may help explain the recent strong profit performance of SOEs relative to the non-state sector.

THE PEOPLE'S ARMY IN BUSINESS

The military started its involvement in business activities in the mid 1980s, when the Government, no longer able to afford Vietnam's huge and unproductive army, gave military units permission to set up companies and make profits from business.

The army's business activities developed rapidly during the 1990s, following the cessation of Soviet military aid and cuts to the Government's substantial military budget. The army's close link to the Party and strong representation in the leadership gives it important business advantages, particularly ready access to limited resources, quotas and business licences. (See Chapter 1 - *Vietnam: Politics*.)

Between 1990 and 1994, the turnover of military enterprises increased almost 60 per cent per year, from about US$40 million to US$250 million. By 1993, about 65 000 military personnel worked full time for more than 100 military-run companies in mining, electric power generation, infrastructure and building construction, spare parts for oil and gas production, textiles, electric appliances, fishing, rubber production and tourism. Military companies established a joint stock bank. Not only the army, but the navy, the air force and local militia units are all involved in business.

Miliary enterprises are divided into three groups: those run purely for profit, national defence enterprises run primarily to produce weapons and economic activities by defence forces which also are assigned a defence task. Examples of the last include surveillance activities by the fishing fleet and bridge construction teams which double as fighting units when necessary. Military companies are reasonably autonomous; most are run by the military regions though larger enterprises are operated directly by the Ministry of Defence. The military-run enterprises appear to be subject to the same tax and dividend regime as other SOEs. A proportion of profits goes to the defence budget.

Large military-run companies and company groups are emerging. Among them is Hanoi's Garment Factory No. 10 with a large share of Vietnam's European Union textiles quota. In 1994, the factory announced it would diversify into telecommunications. Large military enterprises also are involved in joint ventures with foreign companies.

THE EMERGING PRIVATE SECTOR

Currently 25 000 privately owned enterprises are registered under the Companies Law and a further 1.3 million are unregistered household businesses (Vietnam Chamber of Commerce and Industry, 1996). Private businesses are mainly small labour intensive operations.[20] Over 70 per cent use equipment that is more than 30 years old. Very few large private enterprises exist: less than 500 private enterprises have capital exceeding US$500 000 (World Bank, 1996). While 65 per cent of light industry output is from non-state firms, they have little presence in heavy industry sectors (Vietnam Chamber of Commerce and Industry, 1996). Although official data suggest private sector growth lags behind state sector growth, private sector activity is under-reported. (See box.)

While in theory, banks should not discriminate against private sector firms, in practice they do, partly because these firms are perceived as less creditworthy. While the formal company tax rate on private sector firms (35 per cent) is lower than on SOEs (up to 45 per cent), the taxation system is very ambiguous. Many firms pay different tax rates and local authorities impose many ad hoc taxes. Although recent tax reforms have eased personal tax rates somewhat, personal income tax rates can be as high as 80 per cent for only moderately high income earners, like many of the local professional staff employed by foreign companies.

Private sector development remains politically contentious. Although the 1991 Constitution recognises the sector, in practice it is not encouraged. Consequently, many private companies are reluctant to invest and expand their activities. Instead, they hoard US dollars and gold or make speculative property investments while waiting for more stable policies and clearer government signals.

PRIVATE SECTOR ACTIVITY UNDERESTIMATED

Strong evidence indicates that official statistics underestimate private sector activity in Vietnam. Households, which conduct most private sector activity, do not file statistics or lodge tax information. Many private firms probably underestimate output and profit to reduce taxation obligations and to maintain a low profile with the local authorities. In addition, SOEs, particularly in the south, are highly commercialised and many are financed by private capital. Foreign-funded joint ventures with the state sector are not included in private sector data. Finally, statistical collection methods are designed principally to measure SOE output; consequently, current data do not accurately measure the split between private and public sector activity.

A number of factors point to rapid growth in the private sector. For example, the sector created 4.7 million new jobs between 1989 and 1993, but private sector output data do not reflect this growth. The transition from collective agriculture to household (private) agriculture is not included in statistics. Furthermore, the unofficial (or black market) economy in Vietnam is very large; it may comprise 60 per cent of the economy. Statistics on credit allocation discussed below also confirm the private sector is growing rapidly.

....

[20] Small enterprises are defined as having between 100 and 300 million dong in capital and five to 50 employees; medium-sized enterprises have 50 to 300 employees and between 300 million and 1 billion dong in capital.

FINANCIAL SECTOR DEVELOPMENT

Before reforms, Vietnam, like most socialist economies, had a single state bank that functioned as both a deposit taking bank and a central bank. In 1988, these responsibilities were separated between the Central Bank and four state-owned commercial banks that specialise in different sectors of the economy.[21] Since then, joint venture banks also have started operations in Vietnam.

The number of banking institutions has expanded to over 60, but the four state-owned commercial banks still dominate deposits and extend about 75 per cent of bank loans. Credit cooperatives and credit circles (in Vietnamese, *hui)* operating outside the formal financial system also have expanded rapidly and are the main, and often the only source of funds for private sector businesses and individuals.

Despite growing numbers of domestic and foreign banking institutions, true competition with the big state banks still is minimal. The current combination of reserve requirements, turnover taxes and profit taxes make financial intermediations very unprofitable for foreign banks, which mainly are restricted to lending in US dollars, rather than Vietnamese dong. Financial sector infrastructure is rudimentary; financial instruments and payments systems are underdeveloped. The regulatory framework and measures to make the banking system more transparent need improving. Many people have little faith in the domestic banking system, mainly because of the problem of bad debts,[22] poor rates of return, poor service provision and fear of expropriation. The bulk of private sector savings still goes into the 'shadow' economy: the traditional use of informal money markets remains strong; fewer than 10 per cent of Vietnamese have bank accounts. As a consequence, penetration of the formal banking system remains very low compared to ASEAN countries and China.

Reforms in the financial sector have improved savings and investment rates in Vietnam. However, high interest rates and a lack of confidence in the domestic currency, which makes businesses wary of medium and long term borrowing, constrain domestic investment. Land cannot be used as collateral due to restricted land use rights, so this also constrains domestic investment and the ability of banks to lend. Foreign banks lend on the basis of borrowers' estimated future cash flows, which will usually be in foreign exchange. Nevertheless, between 1990 and 1995, investment increased dramatically, from 12 to 27 per cent of GDP. While foreign investment accounted for about one third of this investment, private domestic investment also has increased rapidly since the early 1990s.[23]

The domestic savings rate, although still low by regional standards, rose to about 19 per cent of GDP by 1996, compared with only 7 per cent of GDP in 1990. Government savings contributed substantially to this increase, increasing from

....

21 These are the Vietnam Industrial and Commercial Bank, Agricultural Bank of Vietnam, Vietnam Bank of Foreign Trade, and the Vietnam Bank of Investment and Development.

22 The Vietnamese Government does not recognise the concept of bad debts, although a 1996 Central Bank report estimated that 'overdue loans' (which include bad debts) amounted to about 5 per cent of the total loans advanced by the banks. Economists say privately that this understates the true situation and that the four state-owned banks are burdened with huge non-performing loans (mainly to SOEs) and 'are probably bankrupt several times over' (Grant, 1996).

23 However, this is difficult to measure accurately because much domestic private investment is in small scale businesses and family farms, which often are not recorded by official statistics.

negative 3 per cent of GDP in 1990 to over 5 per cent of GDP in 1995. Private sector savings only account for about 30 per cent of total savings, as most private savings go into the shadow economy. However, this share is increasing slowly. A new banking law scheduled for implementation in 1997 will allow new financial instruments which should encourage domestic savings.

INFLATION

Tight monetary and fiscal policies have been remarkably successful in controlling inflation, despite rapid growth and potential overheating of the economy. The main policy instruments used in the late 1980s were high real interest rates and credit tightening. Discontinuing cash-financed budget deficits and largely eliminating the deficits of SOEs contributed to lower inflation rates after 1992.

Inflation fell from almost 900 per cent in 1986 to 5 per cent in 1993. It rose again to nearly 13 per cent in 1995, mainly because of a poor rice harvest.[24] Nevertheless, the rise prompted concern at the potential for another inflationary spiral and the Government responded quickly by implementing tighter monetary and credit policies. These controlled inflation: the annual inflation rate to April 1997 was only 1.6 per cent, and was actually negative for the months of March and April 1997.

BUDGET MANAGEMENT

Before 1986, Vietnam's public finances were poorly controlled. Spending was often higher than projected as the Government attempted to meet plan targets. The resulting persistent deficits were financed by central bank credit creation; this fuelled inflation. Revenue consisted mainly of transfers from SOEs levied on the basis of ability to pay. Total revenue generally could not cover expenditure, so capital spending was very low.

Since 1988, the Government has progressed towards ensuring fiscal discipline and has improved its overall fiscal management, particularly monitoring public expenditures and allocating public funds. The Government's current expenditure budget moved from a deficit in 1990 to a large surplus in 1994 (Appendix Table 2.1).

Government revenues increased from 15 per cent of GDP in 1990 to 24 per cent in 1995. The structure of the revenues also changed. The revenue base has expanded through reforms diversifying taxes, improving tax collection and rationalising the taxation regime. For example, in April 1997, the Government replaced three complex turnover taxes by a new value added tax (VAT) starting in 1999. Business tax legislation also is being reformed.

The largest revenue items are tax revenue and transfers from SOEs, mainly from oil, cigarette and beer production. The fastest growth in revenue is in foreign trade taxes, which increased as imports rose and now account for over one quarter of government revenue (Figure 2.5). However, inefficient customs procedures and corruption continue to hamper import and export tax collections.

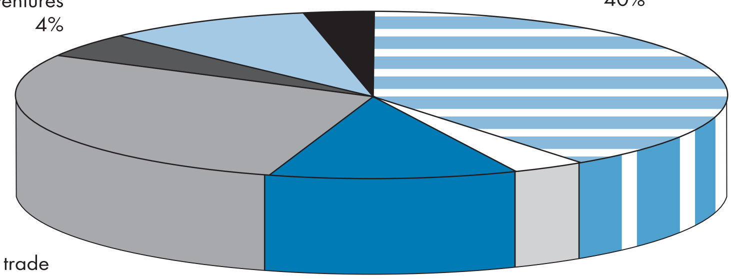
....

24 International Monetary Fund analyses suggest inflation in Vietnam mainly is caused by increases in the money supply and rises in food prices, especially rice, due to poor harvests.

Figure 2.5

SOE Earnings and Trade Taxes Dominate Revenue

Government Revenue Sources, 1995

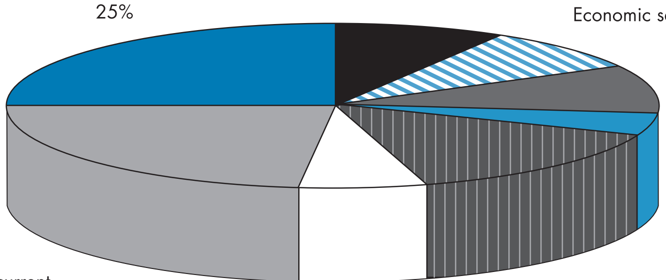


Source: World Bank, 1996.

Current expenditure on public service wages, health and education has increased while expenditure on national defence has fallen. Capital expenditure, mostly on infrastructure projects, has increased, accounting for about 7 per cent of GDP (Figure 2.6.) The Government recently reviewed public expenditure and aims to reduce industry and construction investment, and increase public infrastructure investment.

Figure 2.6

Government Expenditure Distribution, 1995



Source: Based on World Bank, 1996, Tables 5.3 and 5.5.

Interest payments on the public debt burden the Government's budget. In 1990, scheduled interest payments accounted for over 20 per cent of government revenue. Combined with weak government finances in the early 1990s, this resulted in large interest arrears. Recent budget consolidation and foreign debt relief have seen interest payments fall to about 5 per cent of revenue and have reduced the likelihood of accumulating more arrears (Kokko and Zejan, 1996).

EXCHANGE RATE REFORM

Until March 1989, Vietnam had multiple and grossly overvalued exchange rates, causing large distortions in the economy. In 1988 and 1989, the Government unified the two remaining official exchange rates and sharply devalued the new single official rate, aligning it closely to the parallel (free) market rate.[25] Since then, the Government has adopted a flexible and pragmatic approach to the official exchange rate, which now closely follows the exchange rate prevailing in the parallel market through a 'managed float' technique. This has helped to stop the dong becoming overvalued.

Many administrative controls on possessing and using foreign exchange were removed; this moved foreign exchange from the parallel market to the official market and made foreign exchange regulations consistent with new laws liberalising trade and foreign investment. To introduce a market for official foreign exchange transactions, in 1991 the Government established a foreign exchange trading floor at the Vietnam State Bank's branch in Ho Chi Minh City. Early in 1996, an Inter-Bank Foreign Currency Market Transaction Division opened at the same branch, allowing commercial banks to open foreign currency accounts. These reforms and high foreign direct investment and foreign loan inflows stabilised the exchange rate at close to dong 11 000:US$1, resulting in a real effective appreciation of about 10 per cent in 1995.

The Government wishes to maintain local currency stability to reduce the 'dollarisation' of the economy.[26] However, this effective appreciation of the exchange rate contributed to slower export growth in the first half of 1996. The Government has been reluctant to depreciate the exchange rate to the level in the parallel market because many imports are debt financed, but the depreciation pressure remains high. Following further deregulation of the banking sector in early 1997, financial institutions now can trade foreign currencies at rates 5 per cent above or below the official rate. Meanwhile the black market rate is about dong 11 600:US$1.

....

25 Before 1989, the official exchange rate was fixed at dong 900:US$1 but the unofficial, or black market rate, was much higher. The 1989 unification of the exchange rate at dong 4500:US$1 represented an effective depreciation of over 500 per cent of the official value of the dong.

26 The circulation of the US dollar alongside the dong (usually illegally) has characterised Vietnam's economy since the early 1970s, making it difficult for the Government to manage the exchange rate. In the past, use of foreign currencies and gold was encouraged by the large economic and financial imbalances, chronic shortages of basic goods, high and variable inflation, and poor and often arbitrary policy implementation. Another reason is that in 1981, and again in 1985, the Government depreciated the dong about 10 fold, creating considerable instability and severely undermining confidence in the currency. Low inflation and a stable exchange rate are slowly increasing confidence in the dong.

TRADE REFORMS AND THEIR IMPACT

Before the reforms, foreign trade in Vietnam was subject to central planning decisions and monopolised by a few state trading companies. Complex multiple exchange rates and trade subsidies put an air-lock between domestic and international prices. The overvalued exchange rate and quantitative controls discouraged exports, and a complicated system of licences and quotas impeded imports. The focus was on domestic self-sufficiency, so imports were limited to essential items Vietnam could not produce. Most of the limited international trade was with the Soviet bloc under the auspices of the Council for Mutual Economic Assistance.

Since 1986, the Vietnamese Government has repeatedly declared that trade liberalisation is central to its economic strategy. It has implemented some important reforms to simplify and improve trade procedures. For example, the state's monopoly on foreign trade was eliminated in 1988, permitting new foreign trade organisations to be established. Since 1991, private enterprises have engaged directly in trade, although SOEs still account for about 60 per cent of total trade. Many tariff and non-tariff barriers were reduced and many quantitative restrictions were removed. Fewer imported goods require permits and the process to obtain permits now is simpler.

Despite these reforms, the trade regime remains restrictive. The import regime is complex and non-transparent, making it difficult to determine how protected Vietnam's market is. In addition, the formal rules and their practical interpretation change often (Kokko and Zejan, 1996). For example, imports still are subject to formal tariffs, reference prices, excise taxes, quotas and other quantitative restrictions and import licences. Increased excise duties accompanied some recently reduced tariffs, leaving protection unchanged but much less transparent.[27] Also, formal import quotas and other quantitative restrictions that are adjusted to reflect short term developments in the economy are administered through the import licensing system. Export taxes are levied on 11 groups of commodities.

Despite mixed progress in trade reforms, since the late 1980s, Vietnam's trade has been restructured and expanded dramatically, increasingly integrating with the world economy. The ratio of total trade to GDP rose from 41 per cent in 1990 to 52 per cent in 1995. In 1996, imports grew by 48 per cent, to US$11.1 billion, and exports increased by 37 per cent, to US$7.1 billion (Figure 2.7).

Vietnam's current stage of development requires large volumes of imported machinery and intermediate goods to build up its productive capacity (Figure 2.7). Imports of these more than tripled between 1990 and 1995 as industrialisation gained momentum. Unprocessed primary products, particularly rice, raw materials, oil and minerals, dominate Vietnam's exports (Figure 2.8), but they are diversifying into textiles, garments and other light manufactured products, seafood products and coffee.[28] Large foreign investment inflows should further diversify exports and improve quality and export marketing, so long as the trade regime continues to open up, encouraging exports and imports.

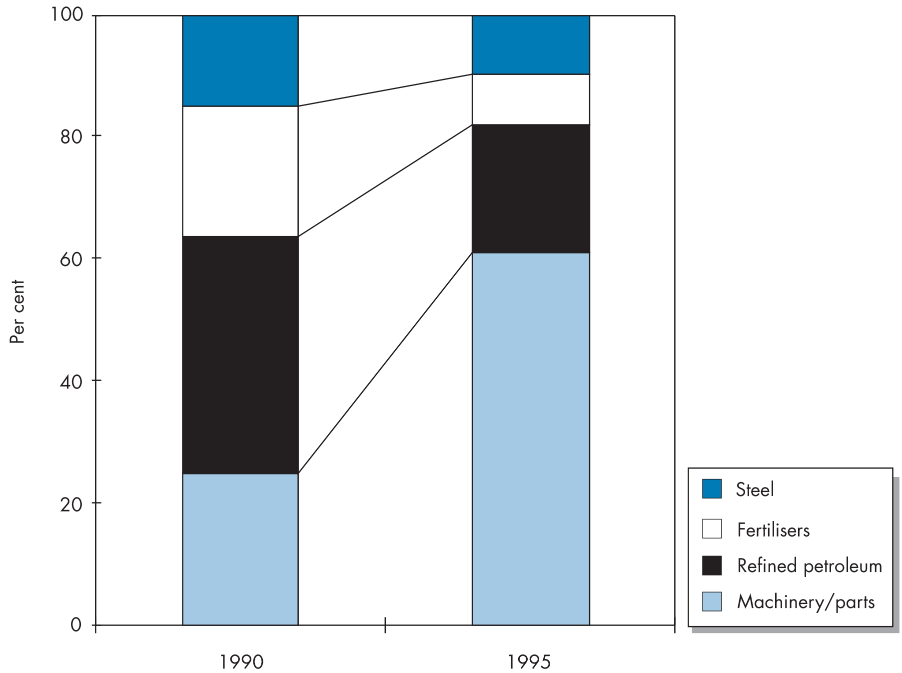
27 These excise taxes are usually justified by 'infant industry' arguments but it is not known when or if they will be phased out.

28 Textile and garment exports are constrained by Vietnam's lack of most favoured nation (MFN) status with the USA, which is potentially the largest market for these goods.

Figure 2.7

Demand Strong for Capital Goods Imports

Composition of Vietnam's Major Imports, 1990 and 1995



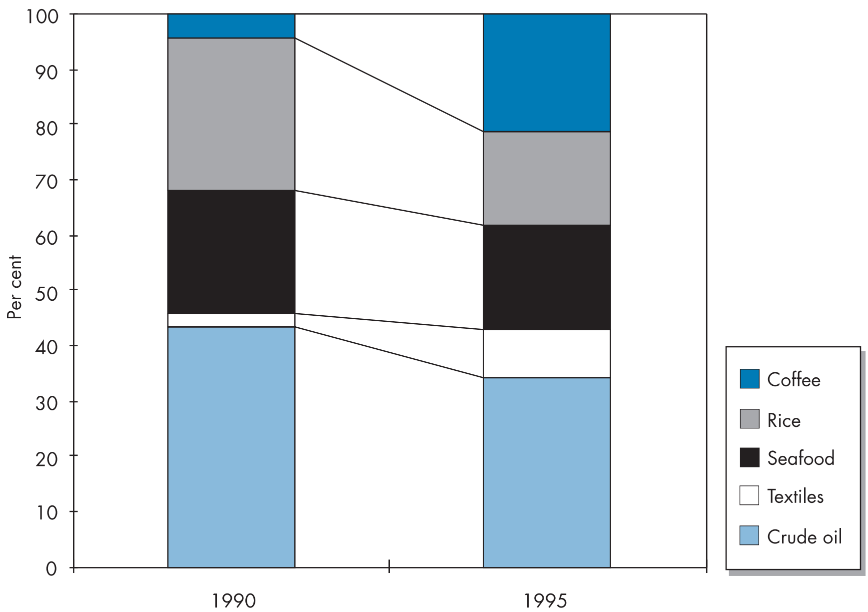
Source: Department of Foreign Affairs and Trade, 1996.

The direction of Vietnam's trade has changed dramatically (Figures 2.9 and 2.10). In the 1980s, trade with other communist countries accounted for most of Vietnam's total trade. The dissolution of the Council for Mutual Economic Assistance in the early 1990s necessitated a dramatic shift in trade partners, and former communist countries now account for less than 10 per cent of Vietnam's total trade (Dodsworth et al, 1996). The collapse of the former Soviet Union in the late 1980s led Vietnam to turn to its neighbours: East Asia now accounts for 72 per cent of exports and 67 per cent of imports. In 1995, Japan was the major export market while ASEAN countries and the Republic of Korea supplied respectively about 30 per cent and 13 per cent of imports (Figure 2.10).

Figure 2.8

Primary Commodities Still Dominate Exports

Composition of Vietnam's Major Exports, 1990 and 1995



Source: Department of Foreign Affairs and Trade, 1996.

FOREIGN DIRECT INVESTMENT

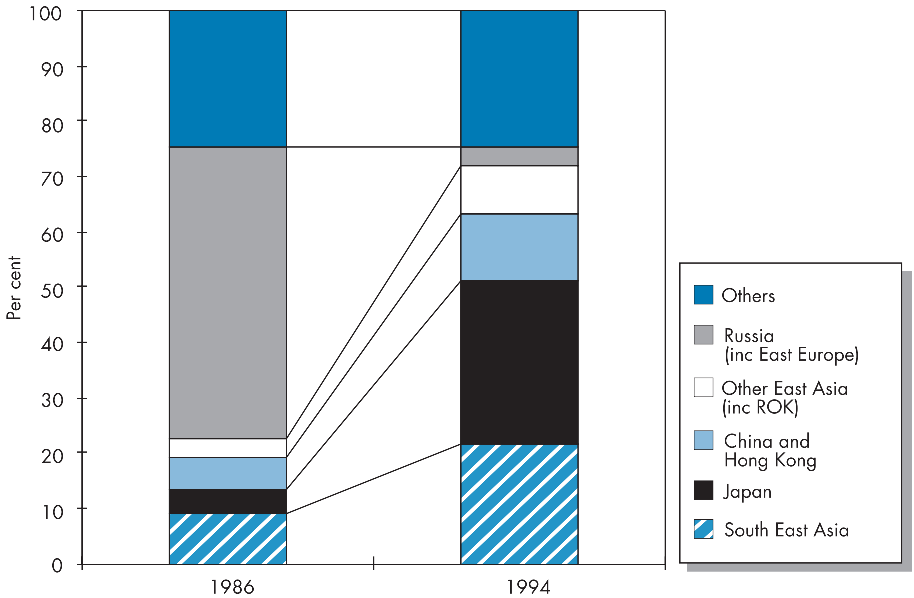
In 1987 under *doi moi*, the Government introduced a new law permitting and encouraging foreign direct investment. The new law offered tax incentives, import privileges, and permission to establish wholly foreign-owned enterprises or joint ventures with Vietnamese partners, either SOEs or, since 1990, private companies. (See Chapter 1 - *Vietnam: Politics*.)

In 1992, foreign direct investment was guaranteed against nationalisation, project duration extended and build-operate-transfer (BOT) projects allowed. In 1994, economic courts were established to deal with disputes involving foreign investors and measures to simplify the investment approval process and shorten delays were introduced in 1994 and 1996. In 1995, the State Planning Committee and the State Committee for Cooperation and Investment merged to form the Ministry of Planning and Investment, responsible for all aspects of foreign direct investment in Vietnam, in an attempt to reduce red tape and delays. (See Chapter 1 - *Vietnam: Politics*.)

Figure 2.9

Shift to Asian Trading Partners

Composition of Vietnam's Major Export Markets, 1986 and 1994

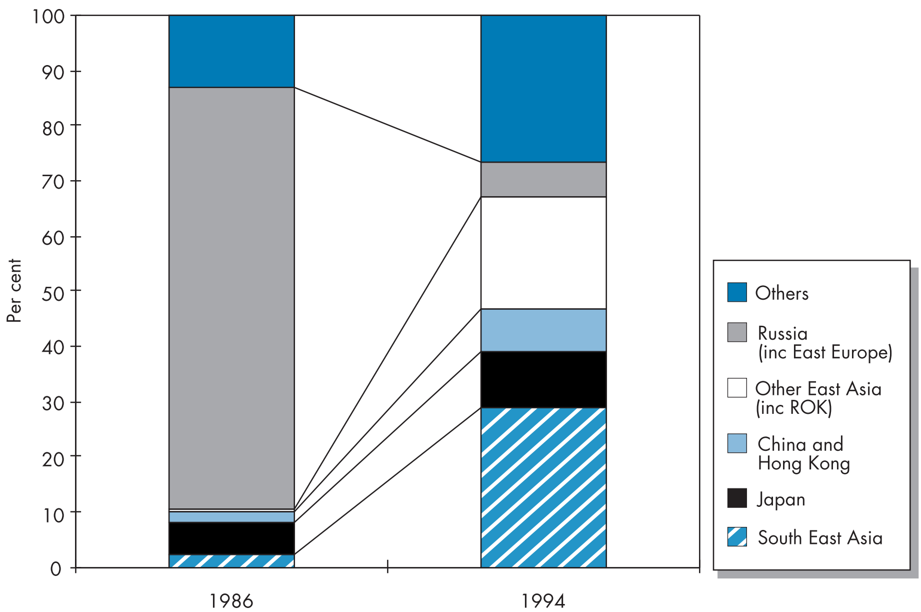


Source: General Statistics Office, 1996.

Figure 2.10

Shift to Asian Trading Partners

Composition of Vietnam's Major Import Suppliers, 1986 and 1994



Source: General Statistics Office, 1996.

While foreign investment provisions aim to encourage foreign direct investment with favourable legal treatment, implementation has not been smooth. Most national, provincial and local government institutions are adapting slowly to the market system. This results in long delays in the investment-approvals process because many government ministries continue to assess proposed foreign direct investment projects. Not only do bureaucrats assess the appropriateness of a potential foreign investment, but also its commercial viability, capital requirements and capital adequacy, matters which the investor is left to determine in most countries. Amendments to the Foreign Investment Law introduced in November 1996 sent mixed signals to investors. Despite the shortened approval process and lengthened tax breaks, the new measures appear to protect Vietnamese industry from foreign competition by no longer encouraging foreign direct investment in some import substitution enterprises.

The total value of foreign direct investment approvals from 1988 to 1996 was about US$27 billion, covering about 1 800 projects (Table 2.1). In 1995 alone, the value of new foreign direct investment approvals rose by 73 per cent, to US$6.5 billion. In 1996, although the number of new foreign direct investment approvals declined, the value of new approvals still increased by 35 per cent. In the short term, despite a spate of last minute approvals of some large real estate projects, the underlying trend in foreign direct investment may be down mainly due to:

- a market correction from the extremely high growth rate in 1995
- the Government's increasing selectivity about foreign direct investment projects
- growing foreign investor caution and disillusionment with the investment environment. (See Chapter 3 - *Vietnam: Business.*)

Data on foreign direct investment approvals probably overstate the actual figures by 20 to 25 per cent because most foreign investment is in joint ventures with SOEs which contribute a minimum of 30 per cent of the value of a given project, usually as land. The highly inflated value of land is usually counted in foreign direct investment totals. In addition, stalled projects with low actual committed capital, also are counted at their full project value (Peregrine, 1996).

On the other hand, figures are depressed by the unofficial entry of large amounts of foreign capital, often from smaller investors who have close personal contacts in Vietnam, particularly overseas Vietnamese, or *Viet kieu*.[29] Certainly, overseas Vietnamese, like overseas Chinese (East Asia Analytical Unit, 1995), will play an increasing role in the Vietnamese economy.

Foreign investment disbursements have not been satisfactory. Only 30 per cent of approved investment, or US$7 billion in capital, was realised by the end of 1995.[30] The disbursement of funds in 1996 was US$2.5 billion, a year-to-year increase of 25 per cent (AusAID/NCDS, 4-10 January 1997). This is partly the result of delays in the project cycle. However, data for 1988 to 1993 suggest foreign investments in

....

29 Rough estimates suggest that from 1975 to 1990, Vietnam received foreign direct investment of between US$6 billion and $8 billion from overseas Vietnamese (International Monetary Fund, 1996).

30 Detailed information on project implementation is not available in Vietnam's official statistics. Estimates of foreign investment realisations are based on limited surveys and reports by the Vietnamese authorities.

Vietnam often fail. During this period, foreign direct investment projects worth about US$660 million were withdrawn, and almost half of approved foreign direct investment projects between 1988 and 1990 were withdrawn by 1995.[31] Australian projects had one of the highest failure rates.[32] The level of disbursements is increasing, but slowly.

Table 2.1

Approved Foreign Direct Investment, 1988 to 1996

	Number of projects approved	Registered capital (US$ million)	Average value of approved projects (US$ million)
1988	37	372	10
1989	68	583	9
1990	108	839	8
1991	151	1 322	9
1992	197	2 165	11
1993	268	2 861	11
1994	343	3 766	11
1995	370	6 531	18
1996	326	8 815	27
Total	1 868	27 254	15

Source: Ministry of Planning and Investment, 1997; AusAID/NCDS, 1997.

The distribution of foreign direct investment approvals in Vietnam by region, economic sector and country of origin also has changed. Foreign investment initially was concentrated almost exclusively in the south, particularly in Ho Chi Minh City. More recently, it has spread to Hanoi and Haiphong in the north. Only about 20 per cent of investment commitments have gone to rural areas, where 80 per cent of the population live. This has intensified income and regional development disparities. Consequently, recent foreign investment guidelines favour projects destined for places other than Ho Chi Minh City and Hanoi.

The Government initially sought foreign investment mainly to develop the energy sector and key import substituting areas. However, foreign investment diversified into the construction of hotels and tourism facilities,[33] and since the early 1990s, into export oriented manufacturing as Vietnam established itself as a low cost location for manufacturing low technology goods (Figure 2.11). Recent large investments will establish production facilities in export processing and industrial

[31] Because it takes some time for Vietnamese authorities to realise that foreign investment projects cannot be implemented, estimates of failure rates for more recent years are much lower. Also failure rates should decline as more recent investors learn about possible problems from the first generation of investors.

[32] Possible reasons for the high failure rate of Australian investments are in Chapter 3 - *Vietnam: Business.*

[33] New foreign direct investment in hotel projects declined significantly in 1996.

zones. The Government also seeks higher technology projects to modernise and industrialise the economy.

Although a breakdown of realised foreign investment by sector is not available, property development, financial services and raw materials expansion are preferred to manufacturing and export oriented industries, which Vietnam needs most to sustain its economic development (Peregrine, 1996).

VIET KIEU ROLE IN THE ECONOMY

Overseas Vietnamese (*Viet kieu*) are an important source of foreign currency for relatives and friends in Vietnam. There are 2 million worldwide: 1.4 million live in the USA; 250 000 live in France; 160 000 live in Australia; and the balance are mainly in Germany and Russia. About 250 000 *Viet kieu* visit Vietnam each year: in 1995, they accounted for much of the US$900 million in private transfers to Vietnam (Schwarz, 1996, p. 29).

Many *Viet kieu* have invested in small service related businesses such as hotels and restaurants, often employing family members who remained in Vietnam. However, only a handful have made significant investments and fewer still have done so officially (Schwarz, 1996, p. 29).

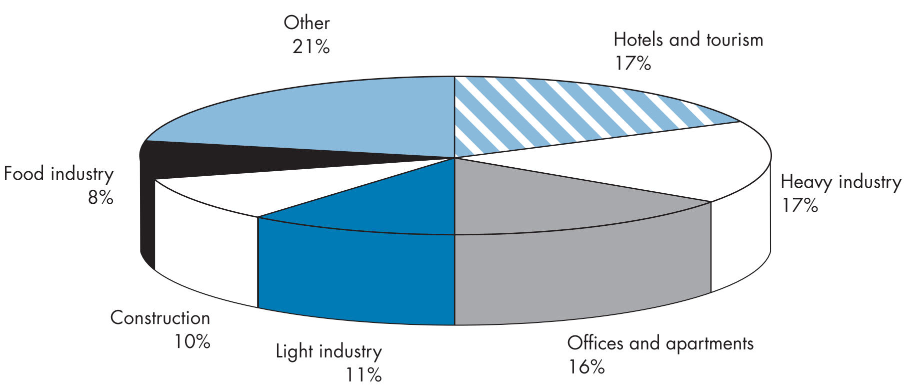
The Government recognises the *Viet kieu* as an important source of foreign capital and expertise and encourages them to return to invest in Vietnam. It offers them special incentives such as tax reductions under the 1996 Foreign Investment Law.

Overseas Vietnamese are natural partners or employees for foreign companies wanting to establish a presence in Vietnam, because of their language and cultural skills, local knowledge and contacts. They can bridge Western and Vietnamese business practices. (See Chapter 3 - *Vietnam: Business*.)

Figure 2.11

Approvals Diversified

Foreign Direct Investment Approvals by Sector, 1988 to 1995



Source: Ministry of Planning and Investment, 1996.

EXPORT PROCESSING ZONES AND INDUSTRIAL ZONES

Since 1992, the Government has approved construction of export processing zones and since 1994, development of industrial zones. By 1996, three export processing zones and 14 industrial zones had been developed. These zones should create more favourable conditions for domestic and foreign companies seeking to invest in Vietnam. In seven zones, Vietnamese companies developed infrastructure; nine are joint ventures with foreign investors (including from Singapore, Republic of Korea, Japan and Taiwan) and one in Hanoi is wholly foreign-owned.

For investors locating in these zones, the Government provides various incentives including tax breaks, tax holidays, duty free imports and exports (for export processing zones), and preferential dividend remittances. Licensing procedures also are simplified and often handled by the owner of the zone; all necessary utilities are provided; and 100 per cent foreign investment is encouraged. By mid 1996, about 220 companies were located in these zones, investing US$1.4 billion. Most are small and medium sized companies, with US$4 million to $5 million in invested capital and with 300 to 400 employees.

East Asian Investors Dominate

Vietnam's East Asian neighbours are the largest investors, accounting for nearly two thirds of the value of foreign investment approvals (Table 2.2). Vietnam is increasingly part of the global sourcing, production and distribution strategies of many East Asian transnational corporations. Taiwan is the major investor, mainly in footwear, textiles and clothing production, followed by Hong Kong, mainly in hotel, office and residential construction. Investment from Japan has increased since the US embargo was lifted. Japanese investment is mainly in electronics, cars, gas, oil and steel, for the Vietnamese market and neighbouring countries, not for re-export to Japan. Investment from Singapore, the Republic of Korea and Malaysia also is rising. The relative importance of Australia and France, which pioneered foreign investment when Vietnam first opened up, has declined. (See Chapter 3 - *Vietnam: Business*.)

The recent dominance of East Asian investors reflects rising costs of production and labour shortages in those economies and access to growing markets, relatively abundant natural resources and inexpensive labour in Vietnam.

Table 2.2

East Asian Investors Dominate

Foreign Investors by Country, 31 August 1996

Country[a]	Number of projects	Per cent share	Capital (US$ million)	Per cent share
Taiwan	232	16.0	3 945.6	18.0
Singapore	135	9.3	2 417.0	11.0
Republic of Korea	159	11.0	2 169.6	9.9
Japan	133	9.2	2 118.3	9.7
Hong Kong	171	11.8	2 025.6	9.3
British Virgin Islands	51	3.5	1 352.1	6.2
Malaysia	47	3.2	942.7	4.3
USA	51	3.5	755.0	3.5
Australia	53	3.7	683.7	3.1
Thailand	63	4.3	653.2	3.0
Others	354	24.4	4 812.0	22.0
Total	1 449	100.0	21 874.8	100.0

Note: a. Ranked by capital value.

Source: Ministry of Planning and Investment, 1996.

AID

In July 1993, the USA lifted its veto on a proposal by an international consortium known as the 'Friends of Vietnam', of whom Australia was a prominent member, to help Vietnam clear its arrears with the International Monetary Fund. This paved the way for bilateral and multilateral lending to resume, and overseas development assistance since has built up rapidly. At the international donors' meeting in November 1995, multilateral agencies and bilateral donors pledged US$2 billion in grant and loan assistance. The main donors are Japan, the World Bank and the Asian Development Bank. Australia is also an important donor, pledging A$63.6 million in 1996-97 and A$71 million in 1997-98, making Vietnam Australia's third largest aid recipient after PNG and Indonesia. Most aid goes to improving physical and social infrastructure.

However, Vietnam does not have the capacity to absorb much of this aid, causing low disbursement levels. Foreign aid disbursements in 1995 were about US$440 million, slightly higher than in 1994 because some major infrastructure projects reached the implementation stage. While Vietnam urgently needs external assistance, it lacks many elements needed to get aid projects underway, including counterpart budget funds, infrastructure, construction and other materials, and appropriate administrative skills and legal procedures.

EXTERNAL DEBT

Vietnam's external debt is divided into two distinct components: the hard currency debt of around US$8 billion and the rouble debt of from US$4 billion to $10 billion. The rapid devaluation of the rouble makes the size of this debt uncertain and the two sides still are negotiating an exchange rate at which payment can be scheduled. By 1993, when the USA lifted the embargo on international development lending to Vietnam, two thirds of the debt was in arrears.

Following the clearance of arrears to the International Monetary Fund and the Government's adoption of a Fund endorsed economic adjustment program in October 1993, Vietnam became eligible for a Paris Club debt rescheduling arrangement. At the end of 1993, Vietnam's bilateral hard currency debtors agreed to reschedule and write off US$791 million of the debt. In May 1996, after four rounds of negotiations with the London Club creditors (a group of mainly Japanese banks), Vietnam achieved restructuring of another major commercial debt of US$900 million and had half of it written off.

Debt rescheduling and write-offs and easy terms on new loans have helped lighten Vietnam's debt service burden; by 1995, the cost of servicing the debt as a proportion of exports dropped to less than 10 per cent from over 77 per cent in 1986. Also, export growth has outpaced debt growth.

However, concern is growing about the management of Vietnam's commercial debt. For example, in the first half of 1996, trade credits for SOEs' imports, probably sourced from foreign bank branches by their foreign joint venture partners, built up rapidly. The Government responded by imposing foreign borrowing limits on SOEs. Accumulated commercial debt combined with the lack of accurate data and difficulty of measuring Vietnam's debt to the former Soviet Union, make it difficult to assess Vietnam's external debt situation.

BALANCE OF PAYMENTS

In addition to its large and expanding trade deficit, Vietnam also has a significant deficit in net factor services including interest payments, profit repatriation and payment of dividends on foreign capital invested in Vietnam. This deficit probably will continue to increase as profit repatriation by foreign investors grows. Vietnam has a positive balance for non-factor services as tourism is growing, although payments for technical and insurance services also have increased. The private transfer of funds, mainly inward remittances by overseas Vietnamese, also increased substantially.

Vietnam's economic stability and growth depend on a sustainable current account position. However, Vietnam's current account has recorded large deficits in recent years: nearly US$1.9 billion or about 10 per cent of GDP in 1995, up from US$1.2 billion in 1994 (Table 2.3). The preliminary estimate of the current account deficit for 1996 is approximately US$4 billion, or about 18 per cent of GDP. This high and expanding current account deficit is not considered sustainable in the medium term (World Bank, 1996).

Table 2.3

Rising Current Account Deficits, 1990 to 1995

(US$ million)

	1990	1991	1992	1993	1994	1995
Merchandise exports	1 731	2 042	2 475	2 985	4 054	5 198
Merchandise imports	1 772	2 105	2 535	3 532	5 245	7 543
Trade balance	-41	-63	-60	-547	-1 192	-2 346
Services (net)	-357	-160	-72	-482	-318	-151
Transfers (net)	138	91	123	264	305	627
Current account balance	-262	-133	-9	-763	-1 205	-1 870
As a percentage of GDP	-4.2	-1.9	-0.7	-7.5	-8.6	-10.0
Foreign direct investment	120	220	260	832	1 048	1 781
Medium and long term loans	-46	-192	52	-597	-275	-284
Capital account	122	-60	271	352	897	1 807
Overall balance (Including official transfers)	-142	-50	-268	-1 056	-409	-177

Source: World Bank, 1996.

The current account deficit mirrors the difference between domestic savings and investment. Domestic savings in Vietnam are insufficient to finance investment requirements, so foreign resources are needed. The net inflow of foreign direct investment and overseas development assistance is measured in the capital account, which in 1995 showed a large surplus of US$1.8 billion, almost covering the current account deficit.

Increasingly imports, particularly of consumer goods, are financed by deferred letters of credit and about 70 per cent of foreign direct investment projects are debt financed. As much foreign investment is going into import substituting industries or hotel and real estate development, Vietnam may be building up its future debt servicing obligations while not significantly increasing its export capacity.

CHALLENGES

Vietnam's economic development in the past ten years has turned around dramatically. In starting its transition from central planning to market economy, Vietnam has borrowed from the experience of other countries, both its former Eastern European allies and its East Asian neighbours, including China. Although it still has a long way to go to achieve an efficient market-oriented economy, the political consensus in favour of *doi moi* is unlikely to be reversed. While the rhetoric of the leadership will continue to be socialist, in practice, policy decisions probably will be increasingly market oriented. Economic events continue to overtake the Party and many microeconomic reforms merely catch up with reality rather than directing development. At the same time, central economic institutions like the People's Bank of Vietnam are increasingly driving successful macroeconomic reforms and adopting International Monetary Fund advice.

Many current reforms lay the foundations for economic growth and development for the next 15 to 20 years. The focus increasingly is on methods of efficiently achieving reforms rather than policy directions more generally. Bureaucratic and legal institutions need time to adapt to the demands of these types of reform and progress in implementing reforms will continue to be uneven.

Despite its natural resources, Vietnam's medium term comparative advantage lies in export oriented, labour intensive manufacturing. This will require macroeconomic stability, relatively high rates of saving and investment, and a more open trade and investment environment. Vietnam already has progressed significantly in each of these areas, but much remains to be done, particularly in trade liberalisation and the removal of bias in foreign direct investment applications against labour intensive manufacturing. The latter are much more vital for Vietnam at its current level of development than large, capital intensive, import substituting projects, some of which are of marginal viability.

Long Term Economic Goals

The Government aims to double per capita GDP to US$400 by 2000 and make Vietnam a newly industrialising economy by 2020 (Le Dang Doanh, 1996). The first objective looks achievable in nominal terms but difficult in real terms, after inflation. If Vietnam can maintain the per capita GDP growth of 7 per cent achieved from 1994 to 1996, by 2000, its per capita GDP in 1996 dollar terms would only be US$340. As population growth has averaged about 2 per cent in the past few years, real GDP growth has to be maintained at above 9 per cent per year. Vietnam will remain a relatively low income country for some time, even if it maintains high GDP growth rates.[34]

MEDIUM TERM ECONOMIC TARGETS

The following economic targets for the next five years were approved by the Eighth Party Congress in June-July 1996:

- GDP growth of 9 to 10 per cent per year, with growth in agriculture of about 4 to 5 per cent, in industry about 14 to 15 per cent, and in services about 12 to 13 per cent
- export growth of 24 to 28 per cent per year
- state budget revenue to reach 22 to 24 per cent of GDP and budget deficits not to exceed 4.5 per cent of GDP
- inflation to be kept at about 10 per cent with the domestic savings rate to reach 31 per cent of GDP in the next five years
- foreign capital of about US$20 billion, comprising US$7 billion in overseas development assistance and US$13 billion in foreign investment, to be mobilised.

[34] For example, even if Vietnam could maintain per capita GDP growth of 9 per cent per year, in a quarter of century, with a further decline of population growth, its per capita GDP in real terms (around US$2 100) would still be below the current level of Thailand (US$2 400), even if all other conditions, including the exchange rate, remain stable.

Future Reform Agenda

These economic targets are ambitious but largely achievable. The political will to enter the next stage of economic reform will be crucial to achieving Vietnam's development goals. Major potential impediments to the further reform of Vietnam's economy include:

- lack of a comprehensive reform plan, creating uncertainty about possible policy directions and the Government's attitude towards the private sector and foreign investment
- inadequate development of capital markets, holding back improved savings performance and efficient private sector growth because of the difficulty and high cost of raising capital
- inadequate legal infrastructure, frustrating the corporate private sector which requires business activities to be regulated consistently and private property rights to be defended
- rivalry among government and party authorities as a consequence of independent local government agendas, frustrating management by policy makers in Hanoi and complicating the overall economic environment, including for foreign investors
- widespread corruption, causing a lack of transparency in the business environment and the uneven application of government regulations, and creating uncertainty about how effectively reforms will be implemented
- inadequate physical infrastructure resulting from war damage, poor maintenance and lack of access to capital
- inadequate skills and experience of many officials in central and local government agencies in regulating a market economy.

Maintaining Reform Momentum

Continuing the reform process is critical to ensuring sustainable growth, but the pace of reforms has started to slow. In the past, economic crisis prompted economic reform rather than any fundamental preference by policy makers for a market economy. Economic reforms successfully promoted economic growth and development, reducing the sense of crisis and hence, reform momentum: 'Vietnam's reforms began with a bang but are turning into a whimper' (Scown, 1996). In addition, gaps between policy and implementation, and the unclear delineation of responsibilities between central and provincial agencies, lead to delayed and confused decision making. 'Over-confidence or apathy on the part of the country's reformers could threaten the momentum of the current development drive and ultimately sabotage the progress achieved' (Peregrine, 1996, p. 2).

Reform reversal appears less likely, following the Eighth Party Congress's decision in June-July 1996 to confirm the policy of continuing *doi moi*. However, the increasing complexity and scale of the economy and future reforms mean that reforms probably will be more extensively debated and more gradually introduced.

DEBATE ABOUT ECONOMIC REFORMS

Although the direction of economic reforms is clear, their pace and scope are divisive issues. Some Vietnamese leaders wish to accelerate reforms to support the development of a stronger private sector, reduce the size of the largely inefficient state sector, and promote Vietnam's economic integration into the world economy. They believe the 'open door' policy is necessary to strengthen the Party and keep it alive.

However, more conservative leaders worry that faster economic reform could damage Vietnamese society and undermine the Party's monopoly on power through popular demands for political reform. They also are concerned about increasing outside pressure on the Party as openness increases. (See Chapter 1 - *Vietnam: Politics*.)

The internal contradiction of a 'controlled free market economy' reflects the Party leadership's divided views about the private sector's role. Vietnam remains an avowedly socialist state, and its government is not embracing capitalist orthodoxy. Each step on the reform path must be debated and justified, and must secure leadership consensus before it can proceed.

The Eighth Party Congress in June-July 1996 failed to overcome this divide. The Congress endorsed the ten-year-old program of economic reforms under *doi moi* but it also strongly emphasised state management, confirming continued state sector dominance of the economy. This suggests that reforms, particularly state-owned enterprise privatisation and land ownership, while unlikely to be reversed, probably will not move rapidly ahead.

Mobilising Capital

An important challenge will be to increase Vietnam's investment rate. Vietnam grew rapidly after *doi moi* despite a relatively low investment rate because it mobilised existing industrial and infrastructure capacity that was under-used during central planning. However, most of such capacity now is used fully, so the investment rate needs to be increased sharply (Leung and Vo, 1996).[35] To achieve a GDP growth rate of 10 per cent per year and to reach an average per capita income of US$400 by 2000, Vietnam must now invest about 30 per cent of GDP per year, no easy task.

Vietnam's savings rate will need to double if it is to finance this investment from internal sources. Financial sector reforms therefore will be crucial in mobilising domestic capital. To meet domestic savings targets, Vietnam must better use the considerable private savings, estimated at many billions of US dollars, that are outside the formal banking system (Freeman, 1996).

....

35 Vietnam's physical infrastructure is extremely poor. Very basic transport infrastructure - roads, railways, ports and airports - is inadequate due to war damage and lack of recent investment. In the north, such infrastructure is largely underdeveloped; in the south, a once adequate infrastructure base has not been well maintained. The Government encourages foreign direct investment in telecommunications and transport; international aid programs also assist in developing infrastructure but little so far has been approved and invested.

Promoting Foreign Investment

Competition for foreign direct investment is intensifying, and Vietnam needs to provide an environment to attract international capital. Realised foreign direct investment in Vietnam between 1988 and mid 1996 was only about US$7 billion, so the target of attracting US$5 billion per year in the next five years looks very ambitious. Policy measures need to overcome current bottlenecks, particularly in infrastructure, and respond to business concerns to improve the realisation rates of approved foreign investment projects. (See Chapter 3 - *Vietnam: Business*.)

Complex bureaucratic requirements, however, pose barriers to foreign investment, since the Government's philosophy of central control of the economy still permeates foreign investment policy. In addition, foreign investors may be deterred by the views of some conservatives, who publicly condemn perceived negative consequences of foreign investment.[36] For example, party and military newspapers routinely warn of the dangers of foreigners encouraging corruption, stirring up support for political pluralism, exploiting natural resources and workers, and avoiding taxes. The increasingly competitive international environment for foreign capital provides little scope for complacency about Vietnam's ability to attract and retain foreign investment.

Reducing Trade Barriers

Further reform of the trade regime is crucial to sustainable growth. The Government maintains control over trade licences and the trade regime in general. This allows many SOEs to collect monopoly rents on trade, hampering trade development and rationalisation of SOEs.

Importing is complex and closely regulated. Vietnam's emphasis on import substitution may distort the allocation of resources. Instead of using its comparative advantages, Vietnam may channel human and physical resources into producing goods that would normally have been imported, that is into its comparative disadvantages (Kokko and Zejan, 1996, p. 22).

Trade liberalisation, with a firm commitment to a pre-announced program of reducing tariffs and removing non-tariff barriers will be important in exposing Vietnam's economy to international competition and improving allocative and productive efficiency. Trade reforms also would facilitate adjustments in the SOE sector, by subjecting it to greater competition.

Clarifying the Role of the SOE Sector

In the coming decade, Vietnam must determine the role of the state versus the private sector. How it resolves this question will crucially affect the transition process and economic upgrading, and development more generally. Successful SOE reform would help to create a level playing field where private enterprises could compete equally with state enterprises, increasing the dynamism of both sectors.

[36] Some Vietnamese leaders have charged foreigners with deliberately undermining socialism through a campaign of 'peaceful evolution' (in Vietnamese, '*dien bien hoa binh*'). (See Chapter 1 - *Vietnam: Politics.)*

The Government continues to emphasise the role of SOEs in virtually all sectors of the economy; it believes state ownership of enterprises remains at the heart of socialism, despite the conflict of interest from the Government being both producer and regulator. This emphasis on state involvement in the economy concerns international financial institutions and others who favour accelerating reform: the SOE sector is a priority area for further reform, particularly to promote industrial efficiency (World Bank, 1995). Recent evidence suggests that SOEs have slowed their market orientation, reflecting either adjustment fatigue or their response to government policy changes that emphasise state managed industrialisation and modernisation (Mallon, 1996; Gates, 1996).

Promoting the Private Sector

Further development of the private sector will strongly influence Vietnam's economic prospects. The private sector is the only sector creating employment, and Vietnam has over 1 million people joining the labour force each year. In addition, the private sector responds well to changing market conditions, and this will be important if Vietnam is to compete effectively in international markets. However, the private sector's small size, limited capital and confusing official treatment raise questions about the sector's capacity to grow and respond to emerging opportunities, both domestically and internationally.[37]

To succeed with an export oriented industrialisation strategy, many analysts agree Vietnam will need to develop a dynamic, small to medium sized private enterprise sector, particularly in labour intensive manufacturing (Reidel and Comer, 1995). They argue that it is through the private sector that Vietnam's most important asset, its large, educated and enterprising human resource base, will best be used. The entrepreneurial success of overseas Vietnamese gives cause for optimism about the potential dynamism of the domestic private sector, provided impediments are removed.

PROSPECTS

Vietnam has some strong advantages that should support further growth in its economy. It has many resources, especially human resources but also energy, mineral and other natural resources. Its location in the dynamic South East Asian region also confers advantages. There is strong demand for its exports and ample capital and entrepreneurial skill in search of a good return, ready to develop Vietnam's economy in line with its comparative advantage, particularly in low cost, relatively skilled labour. 'Provided sound and pragmatic policies are followed with the resolution that Vietnam has shown throughout the transition, there are good prospects for sustained high growth' (Dodsworth et al, 1996, p. 10).

External forces also can encourage reform. For example, Vietnam's recent membership of ASEAN, and its application to become a member of the World Trade Organisation and APEC should keep the country moving towards a more market-oriented economy. Membership of ASEAN will help further trade liberalisation.

37 According to Gates (1996), in recent interviews the investment sentiment of private entrepreneurs is increasingly pessimistic primarily because of the changing and uncertain business environment.

(See Chapter 14 - *Expanded ASEAN*.) In addition, preconditions for loans from the International Monetary Fund and the World Bank impose useful support for reformers to continue the reform process and provide technical assistance to help implementation.

Vietnam's ability to overcome economic difficulties in the past provides grounds for optimism that with sound, pragmatic, forward looking leadership, it should overcome its many challenges to consolidate growth at reasonably high levels. Continuing economic reforms, increasing foreign investment and aid, and developing infrastructure should sustain balanced growth of 8 to 9 per cent per year in the next 10 to 20 years.[38] In the second and third decades of next century, Vietnam should be at the stage of development that some of its South East Asian neighbours, such as Thailand and Malaysia, are at today, and should be moving towards realising its potential as an Asian 'tiger' economy of the twenty first century.

....

38 Continued ideological divisions between party leaders suggest, however, that the reform process will not be smooth. Some analysts believe the two steps forward and one step back approach will continue, with the state sector continuing to play a large role and small entrepreneurs continuing to operate from a somewhat handicapped position (Ahearn, 1996).

Appendix Table 2.1

Selected Economic Indicators, 1992 to 1996

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Population (million)	61.1	62.5	63.7	64.8	66.2	67.8	69.4	71.0	72.5	74.0	75.4
Population growth (% p.a.)	2.1	2.2	2.0	1.6	2.3	2.3	2.4	2.3	2.1	2.0	1.9
GDP (billion dong)	590	2 836	15 362	27 345	40 518	74 304	108 944	134 723	167 835	222 370	245 770
GDP deflator (1989 =100)	2	12	59	100	141	244	329	377	431	522	529
Real GDP growth (% p.a.)	0.3	3.6	6.0	4.7	5.1	6.0	8.6	8.1	8.8	9.5	9.0
GDP per capita (current US$)	na	na	62	98	119	118	141	178	211	274	296
Exchange rate (dong:US$)	na	na	3 900	4 300	5 133	9 274	11 150	10 640	10 955	10 970	11 000
Sectoral structure of GDP (%)											
Agriculture	38.1	40.6	46.3	42.1	38.7	40.5	33.9	29.9	28.7	27.5	na
Industry	28.9	28.3	24.0	22.9	22.7	23.8	27.3	28.9	29.6	30.1	na
Services	33.0	31.1	29.7	35.0	38.6	35.7	38.8	41.2	41.7	42.4	na
CPI (1989=100)	5	15	74	100	168	282	333	350	399	450	478
Broad money growth (% p.a.)	na	na	na	na	32.4	78.7	33.7	19.0	33.2	22.6	20.0
Savings-investment (% of GDP):											
Gross capital formation	na	na	na	na	na	na	17.0	24.9	25.5	27.1	30.4
Gross national savings	na	na	na	na	na	na	16.3	17.4	16.9	17.1	21.5
Government budget (% of GDP):											
Revenue and grants	na	15.4	13.1	16.0	16.1	14.8	19.0	22.5	24.3	23.9	23.4
Expenditure	na	20.8	21.2	24.9	21.7	15.6	19.8	25.8	24.2	23.0	20.7
Fiscal balance	na	-5.5	-8.3	-9.1	-6.4	-1.3	-3.7	-6.0	-2.5	-1.1	-0.8
Foreign debt (US$ million)	na	na	na	19 516	22 268	22 450	23 840	24 360	25 115	na	na
External trade (US$ million):											
Exports	789.0	854.2	1 038.4	1 946.0	2 404.0	2 087.1	2 580.7	2 985.2	4 045.3	5 200.0	7 100.0
Imports	2 155.1	2 455.1	2 756.7	2 565.7	2 752.4	2 338.1	2 540.7	3 924.0	5 825.8	7 500.0	11 100.0
Trade balance	-1 366.1	-1 600.9	-1 718.3	-619.7	-348.4	-251.0	40.0	-938.8	-1 780.5	-2 300.0	-4 000.0
Current account deficit (% of GDP)	na	na	na	na	na	na	-0.7	-7.5	-8.6	-10.0	-16.0
Debt service / exports (per cent)	na	na	na	na	na	na	22.1	25.8	13.9	13.5	9.8

Note: na. Not available.

Source: International Monetary Fund, 1996; AusAID / NCDS, 1996 and 1997.

REFERENCES

Ahearn, R. J., 1996, *Vietnam's Transition to a Market Economy*, CRS, Washington DC.

Asia Pacific Economics Group, 1996, 'Vietnam', *Asia Pacific Profiles 1996*, Canberra.

AusAID/NCDS (National Center for Development Studies), 1997, 1996, various issues, *Summary of Recent Developments in the Vietnamese Economy*, NCDS, Canberra.

Department of Foreign Affairs and Trade, Australia, 1996, *Country Economic Brief, Vietnam*, Department of Foreign Affairs and Trade, Canberra.

Dodsworth, J.R., Spitaller, E., Braulke M., Lee, K.H., Miranda, K., Mulder C., Shishido, H. and Srinivasan, K., 1996, 'Vietnam: Transition to a Market Economy', Occasional Paper 135, IMF, Washington DC.

East Asia Analytical Unit, 1997, *China Embraces the Market: Achievements, Constraints and Opportunities*, Department of Foreign Affairs and Trade, Canberra.

____ 1995, *Overseas Chinese Business Networks in Asia*, Department of Foreign Affairs and Trade, Canberra.

Freeman, N., 1996, 'Saving for a rainy day, Vietnamese style', *Business Times, Weekend* edition, 24-25 February.

Gates, C.L., 1996, 'Enterprise Reform and Openness in Vietnam: Microeconomic Response and Transformation', *ASEAN Economic Bulletin*, Vol. 13, No. 2, pp. 212-28.

General Statistical Office (GSO), 1996, *Impetus and Present Situation of Vietnam Society and Economy after Ten Years of Doi Moi*, Statistical Publishing House, Hanoi.

Grant, J., 1996, 'Doubts raised over health of Vietnamese banking', *Financial Times*, August.

Kokko, A. and Zejan, M., 1996, *Vietnam at the Next Stage of Reforms*, Stockholm School of Economics, Sweden.

International Monetary Fund, 1996, 'Macroeconomic Experiences of the Transition Economies in Indochina', Working Paper No. 112/96.

Le Dang Doanh, 1996, interview with Professor Doanh, President of Central Institute for Economic Management, Hanoi, by East Asia Analytical Unit.

Leung, S. and Vo, T., 1996, 'Vietnam in the 1980s: Price Reforms and Stabilisation', *Banca Nazionale del Lavoro Quarterly Review*, No. 197, June.

Mallon, R., 1996, 'State Enterprise Reform in Vietnam', report prepared for the Asian Development Bank, Hanoi.

Ministry of Planning and Investment, 1996 and 1997, periodic data releases on foreign investment.

Peregrine, 1996, *Vietnam: Transition under Threat*, Peregrine, Hong Kong.

Probert, J. and Young, S.D., 1995, ‘The Vietnamese Road to Capitalism’, *Communist Economies and Economic Transformation*, Vol. 7, No. 4, pp. 499-525.

Reidel, J. and Comer, B., 1995, ‘Transition to Market in Vietnam’, in Woo, W.T., Sachs, J. and Parker, S. (eds), *Economies in Transition: Comparing Asia and Eastern Europe*, MIT Press, Cambridge.

Schwarz, A., 1996, ‘You Can’t Go Home Again’, *Far Eastern Economic Review*, 17 October.

Scown, M. J., 1996, ‘Second thoughts in Vietnam’, *Asian Wall Street Journal*, 25 October, p. 6.

Vietnam Chamber of Commerce and Industry, 1996, interview with Madam Pham Chi Lan, Secretary General VCCI by East Asia Analytical Unit.

World Bank, 1996, *Vietnam: Fiscal Decentralisation and the Delivery of Rural Services*, World Bank, Washington DC.

1995, *Viet Nam Economic Report on Industrialisation and Industrial Policy*, World Bank, Washington DC.

FURTHER READING

Fforde, A. and Goldstone, A., 1995, *Vietnam to 2005: Advancing on all Fronts*, Economist Intelligence Unit Research Report, Economist Intelligence Unit, Hong Kong.

Freeman, N., 1996, ‘Vietnam must rally to the cry for more capital’, *Business Times*, 28 February.

Gates, C.L., 1995, ‘Enterprise Reform and Vietnam’s Transformation to a Market-Oriented Economy’, *ASEAN Economic Bulletin*, Vol. 12, No. 1, pp. 29-52.

Grant, J. 1996, ‘Vietnam diaspore ponders links with home’, *Financial Times*, 22 July.

Le, Van Toan, 1992, *Vietnam Economy 1986-1991, Based on the System of National Accounts*, Statistical Publishing House, Hanoi.

Leung, S. (ed.), *Vietnam Asessment: Creating a Sound Investment Climate*, Institute of Southeast Asian Studies, Singapore.

Lipworth, G. and Spitaller, E., 1993, ‘Vietnam - Reform and Stabilisation, 1986-92’, IMF Working Paper, WP/93/46.

Schwarz, A., 1996a, ‘Getting Off Debt Row’, *Far Eastern Economic Review*, 30 May.

____ 1996b, ‘Vietnam-Safety First’, *Far Eastern Economic Review*, 11 July, pp. 14-18.

Tran, Hoang Kim, 1994, *Economy of Vietnam - Reviews and Statistics*, Statistical Publishing House, Hanoi.

Chapter 3

COMPLEX COMMERCE

Beginning in the late 1980s, Vietnam's abundant natural resources, large potential market, low cost, well educated and industrious labour force, stable government and strategic location attracted a surge of foreign traders and investors through the country's newly opened door. The initial rush has stabilised; in 1996, except for a spate of late approvals, foreign investment tapered, although trade growth remained strong. (See Chapter 2 - *Vietnam: Economy*.) Based on recent experiences of Australian and other foreign companies, this chapter examines the current environment for business in the context of Vietnam's transition to a market economy.

AUSTRALIAN BUSINESS PROFILE

Australia was one of the first Western nations to recognise the Socialist Republic of Vietnam more than 20 years ago. The relationship between the two nations is strong, and in 1996, over 100 Australian companies were engaged in business in Vietnam.

Trade

Australia's trade with Vietnam expanded rapidly in the 1990s, albeit from a low base. Between 1990 and 1996, Australia's merchandise exports to Vietnam increased at an annual trend rate of almost 45 per cent, approximately 5 times faster than Australia's overall export growth (Figure 3.1).

In 1996, Australia's exports to Vietnam totalled US$158 million. The main items were machinery and transport equipment (35 per cent of total), gold, telecommunications equipment, wheat, steel products, medicines and electricity distribution equipment (Figure 3.2).

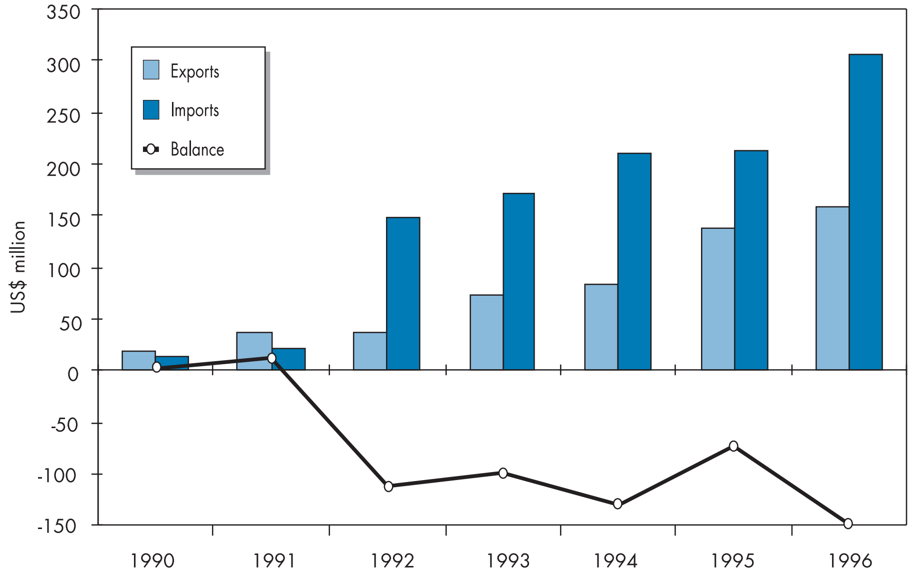
Australia's merchandise imports from Vietnam have grown at an even faster rate, also from a low base, at a trend rate of 65 per cent between 1990 and 1996. In 1996, Australia's imports totalled US$306 million. The main item was crude petroleum (72 per cent of total), most of which was shipped to Geelong in Victoria for refining. Food imports, principally coffee and seafood, also increased rapidly, as did imports of light manufactures such as clothing and travel goods (Figure 3.3).

Trade in services between Australia and Vietnam also is growing. Australian companies are established in Vietnam in a number of service industries, among them telecommunications and financial, legal and business services.

Figure 3.1

Trade Growing Strongly

Australia's Merchandise Trade with Vietnam, 1990 to 1996

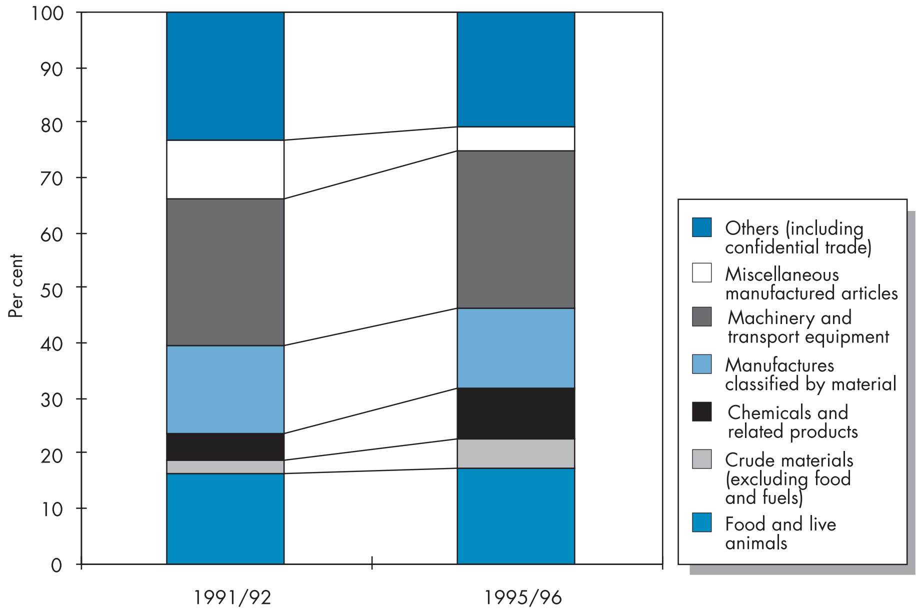


Source: Department of Foreign Affairs and Trade, 1996.

Figure 3.2

Machinery and Transport Equipment Dominate Exports

Composition of Australian Exports to Vietnam, 1991-92 to 1995-96

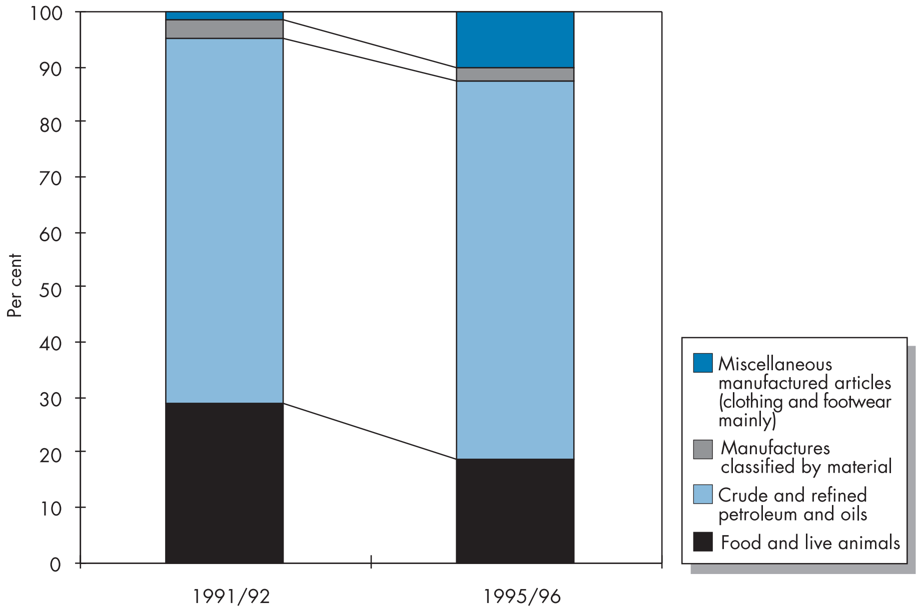


Source: Department of Foreign Affairs and Trade, 1996.

Figure 3.3

Crude Petroleum Dominates Imports

Composition of Australian Imports from Vietnam, 1991-92 to 1995-96



Source: Department of Foreign Affairs and Trade, 1996.

Investment

As a result of developing early investment links with Vietnam in 1988, Australia has been a prominent investor, ranking third for much of the last decade. However, with the rapid increase in international investor interest, by the end of August 1996 it had fallen to ninth place,[1] with 53 approved projects involving a capital commitment of nearly US$700 million. Among the companies investing are some of Australia's largest and most experienced, including Telstra and the ANZ Bank, a range of legal, accounting and other professional service providers, and some smaller, innovative businesses. The main concentrations of Australian investment capital are in infrastructure (civil engineering and construction), natural resources and manufacturing. Many investments are by small and medium sized companies, and valued at less than US$5 million each.

When surveyed, Australian companies' reasons for investing in Vietnam differed quite markedly from commonly held views on what makes Vietnam attractive to foreign investors (Maitland, 1996, p. 96). Low wage costs, access to raw materials, and establishing export bases to China and other Asian countries were not important; whereas, establishing a long term presence, the strong growth prospects

....

1 Australia's fall in the ranking of Vietnam's foreign investors partly reflects the lifting of the US economic embargo in 1994, which resulted in catch up US investment and rapidly rising investment by other countries such as Japan, whose business activities in Vietnam had been constrained by the US embargo.

for the economy, and the size of the Vietnamese market were major attractions. However, many Australian investors are making only minor sales to the Vietnamese. Australian investment in infrastructure, services and manufacturing focuses on servicing other foreign investors: up to 80 per cent of Australian companies sell services or products to other foreigners inside or outside Vietnam.[2] This probably partly reflects the priority Vietnamese joint venture partners attach to earning hard currency through exports. Foreign service providers also face restrictions. For example, licences granted to foreign banks limit the services they can provide to domestic clients and Vietnamese companies need state bank approval before accepting loans from foreign banks.

The focus on foreign customers leaves Australian and other similarly oriented, foreign companies vulnerable to significant downturns in foreign direct investment. Moreover, foreign companies frequently compete with each other to supply a relatively narrow, specialised section of the market. The current focus also may limit companies' exposure to the domestic market and hence their development of local knowledge and networks. This would affect wholly foreign-owned enterprises more than joint ventures. However, as the local market matures, Australian companies may diversify their customer base and supply more Vietnamese customers.

Most Australian investment in Vietnam is in joint ventures. They are politically acceptable and the Vietnamese Government promotes joint ventures with state-owned enterprises (SOEs). Joint ventures with local non-state enterprises are rare, but increasing.

The Vietnamese joint venture partner can perform a number of roles:

- provide access to the local market
- deal with the bureaucracy
- provide political weight and access to important decision makers.

Some, but not all, of these roles can also be performed by in-house Vietnamese staff or consultants. Foreign investors often prefer wholly foreign-owned investment structures, partly because of perceived problems with joint ventures. Anecdotal evidence suggests establishing viable, long term relations with local partners is difficult.

Although Australian investors enjoy a reputation as reliable partners and good employers, the extent to which this translates into a commercial advantage is unclear. Vietnamese statistics indicate Australian investment projects in Vietnam have one of the highest failure rates. This finding reflects:

- early entry of Australian companies to the market, exposing them to the Vietnamese Government's steep learning curve in dealing with foreign investors and forcing them to learn about the realities of doing business in Vietnam without the benefit of others' experience
- early dominance of entrepreneurs, as opposed to project owners, whose proposals sometimes were not well considered or were speculative
- the relatively large number of early projects in property development, some of which were not 'bankable' and foundered for lack of finance

2 On the other hand, Australia's two largest investors focus on the domestic market.

- increased competition from Asian investors, who are more adept at operating in a less formal, relatively opaque, commercial environment.

However, the 1996 East Asia Analytical Unit survey results suggest Australian companies cope with Vietnam's business environment as well as most other foreign businesses.

Aid

Australia was among the first countries to resume aid to Vietnam after the 1991 Cambodian peace settlement. It was also active in supporting renewed lending to Vietnam by international financial institutions and development assistance agencies. In November 1995, at the international donors' group meeting, Australia pledged US$160 million in development assistance funding to Vietnam over four years, making Vietnam Australia's third largest aid recipient in 1996-97, after Papua New Guinea and Indonesia. Total annual Australian aid to Vietnam grew from US$8 million in 1990-91 to about US$55 million in 1995-96.

The aid program covers education and training, health and infrastructure development, including water supply projects. Education and training efforts focus on providing tertiary level education and English language tuition. In infrastructure development, the biggest project is the My Thuan bridge to be built across the lower Mekong. Aid projects, both multilateral and bilateral, provide opportunities for Australian companies to enter the Vietnamese market.

CHARACTERISTICS OF THE BUSINESS ENVIRONMENT

Vietnam is one of the most complex and difficult places in Asia for foreigners to do business. However, the business environment in Vietnam remains fluid as the economy continues its transition from central planning to a uniquely Vietnamese market-oriented system. Foreign investors need to be cautious about overly optimistic expectations and overly pessimistic forecasts for the country. Overall, Vietnam is a high risk market, with reasonable profit potential as economic growth and development generate commercial opportunities.

Some of the main themes to emerge from discussions with foreign businesses in Vietnam are that foreign investors need to be in Vietnam for the long term, have deep pockets, be flexible, have good local knowledge and contacts, and be committed. It is 'no place for the fainthearted' (Spencer and Heij, 1995, p. 1).

Analysts point out that frequent policy changes, vague and contradictory regulations, an underdeveloped legal system, an unclear and largely untested adjudication process for economic disputes, a lack of accounting standards and constant shifts in property ownership cause investors uncertainty (Peregrine, 1996, p. 29).

The remainder of this section discusses the main challenges foreign investors in Vietnam experience. Many are a consequence of the nation's early stage of economic development or the inevitable by-products of the transition from central planning. Moreover, they are not unique, and their significance should decrease over time. For the present, foreign companies operating in Vietnam stress the importance of a thorough understanding of the local commercial environment and the full cost of doing business.

Business Contracts

Vietnamese and foreign[3] business people regularly differ in their interpretations and expectations of business contracts. While foreign companies often adopt a legalistic approach, regarding contracts as more or less binding obligations, their Vietnamese partners tend to view them more as statements of intent. This contributes to the view that Vietnamese partners cannot be relied upon to adhere to the terms of joint venture contracts. Foreign companies also sometimes complain of the ground rules changing after contracts are signed.

This is not only an issue of cultural misunderstanding or a by-product of economic transition. Foreign companies often fail to appreciate that their Vietnamese partners only can fulfil contractual obligations they are legally entitled to fulfil. They cannot necessarily observe terms and conditions that are subject to decision making by a higher authority, possibly at ministerial or even prime ministerial level.[4]

Recent moves to tighten the lengthy investment approvals process are having some success, but have little bearing on negotiating a joint venture agreement. Many companies already in Vietnam describe the negotiation process as 'protracted' and 'frustrating'. Often, this is a consequence of their inexperience in operating in Vietnam and Vietnamese inexperience in dealing with foreign private companies (Maitland, 1996, p. 98).

Legal Infrastructure Underdeveloped

Vietnamese commercial law is underdeveloped, although, considering that ten years ago Vietnam had no commercial laws at all, much has been achieved in a short time. In the early 1990s, foreign investors called for more laws and regulations, and large Western multinationals and resource developers continue to do so. In general, larger companies are more concerned than smaller ones about the risks associated with the rudimentary legal system (Maitland, 1996, p. 103).

Many foreign investors would prefer the Government to focus on implementing better the existing laws and regulations. However, this will take time as implementation depends on many factors outside the legal system (Heij, 1997). The profusion of sometimes contradictory decrees, circulars and other legal instruments, without coordination between the different ministries, creates much uncertainty.

Most investors are confident greater legal and regulatory certainty and transparency will emerge eventually to provide greater security for long term, high value investments. The increased government commitment to move to a law based, appeal supported bureaucratic system is improving the business situation.

Asian investors are more comfortable operating in a flexible, administratively based system than their Western counterparts.

....

3 These comments apply mainly, but not solely, to Western business people. Asian business people, even those used to operating in a common law system, are often better attuned to the Vietnamese outlook than their Western counterparts.

4 Foreign investors therefore should conduct a due diligence assessment of ministerial, higher or other approvals governing decisions made by a particular state-owned enterprise before entering into a joint venture with it.

Dispute Resolution

For foreign investors, two distinct dispute resolution processes exist: the Vietnam International Arbitration Centre affiliated with the Vietnam Chamber of Commerce and Industry (VCCI); and the People's Court comprising a civil court, economic court, administrative court, labour court and criminal court. Most foreign investors prefer not to test either process because they are underdeveloped and politics, relationships, reputations and long term objectives are important in Vietnam.

Many foreign companies consider Vietnam's dispute resolution processes favour locals. A common view is that if a foreign company cannot avoid a dispute with its Vietnamese business partner, it should walk away altogether, despite losing financially, rather than fight the issue legally (Spencer and Heij, 1995, p. 4).

If the system is biased, it partly reflects SOEs being the joint venture partners of most foreign companies. As a result, foreign partners should try to secure as much leverage as possible in joint venture arrangements to ensure the management structure does not give the Vietnamese side too much control. An inappropriate management structure was thought to contribute substantially to at least one spectacular foreign joint venture collapse in Vietnam.

If a dispute cannot be resolved through negotiation, then nominating a foreign arbitration centre (such as in Singapore) is an option. The People's Court in Vietnam theoretically can enforce international rulings. Where legal and factual issues are relatively straightforward, the People's Court is prepared to decide in a foreign investor's favour, even where the other party is a Vietnamese SOE. However, enforcement is problematic so, rather than push things to the limit if they obtain a favourable court decision, foreign companies should compromise.

Dealing with the Bureaucracy

Complex bureaucratic requirements create problems for foreign companies in Vietnam, as in other parts of Asia. A survey conducted by Indochina Project Management in 1994 found that 44 per cent of the foreign investors interviewed said coping with the bureaucracy was their biggest challenge (Dung, 1996, p. 82).[5] This is because the Government's philosophy of central control still permeates many areas of Vietnam's economy. Licences and permits are needed for everything.

Many bureaucrats do not understand free market mechanisms or modern management and financial practices. Some companies complain of the 'whimsical bureaucracy of communists who are used to setting the rules' (O'Flahertie, 1996, p. 24). Some bureaucrats also appear to mistrust foreign business: 'having spent 2 000 years fighting colonisation by the French, the Chinese, the Japanese and the Americans, some bureaucrats are now caught up in a battle to keep Vietnam from being colonised by corporations' (O'Flahertie, 1996, p. 24). In addition, government officials do not always understand the need for returns on investments to compensate for the risks foreign investors take in Vietnam. This may reflect a cavalier attitude on the part of some Vietnamese decision makers: they believe that if individual foreign companies find the operating environment too difficult, others will take their place.

5 Other surveys show that foreign investors find coping with the bureaucracy their biggest challenge in Thailand, China and Indonesia.

Problems with the exchange of information between the various elements of the Vietnamese bureaucracy are considerable. A written assurance from one government agency can mean little to another and rules can be negotiated. However, foreign companies say transparency and certainty in regulating foreign investment are improving.

At least eight central government agencies, including the Ministries of Industry, Finance, Trade, Construction, and Science, Technology and the Environment, and numerous local government agencies, such as the Ho Chi Minh City People's Committee, participate in approving foreign investment proposals. They consider whether the foreign company offers appropriate (state-of-the-art) technology; whether existing supply and demand in the industry demonstrates a need for the investment; whether the investment will threaten domestic firms; and whether the project will generate sufficient export income to at least cover its foreign currency needs (imports and remittances).

This leads to long delays. Licensing joint ventures averages about one year and wholly foreign-owned enterprises averages twice as long (*Saigon Times*, 1994). The new 1996 Law on Foreign Investment confronted the problem by making the Ministry of Planning and Investment a 'one-stop shop' to deal with foreign investment applications within 60 days from lodgement. The Ministry is not really a one-stop shop,[6] since foreign investors must obtain certain key approvals (notably land use) before lodging an investment application. However, post-licensing approvals and registration procedures are completed more quickly and easily than before.

Some companies suggest when dealing with the bureaucracy that it is best to assume paperwork will take a long time to get through the system, and to use patience, tact and persistence to ensure it does not get bogged down completely (Spencer and Heij, 1995, p. 4). Many companies now employ Vietnamese consultants to help them complete, lodge and ensure prompt processing of applications. One successful company, even after licence approval, retained the consultant on a small monthly retainer with a success fee component for reaching certain objectives.

In many cases, provincial, district or village officials have more day-to-day influence over foreign investment projects than do central government agencies in Hanoi. Changes in provincial authorities can affect foreign investors, especially in terms of political patronage and the degree of official interest in their projects. For example, in southern Vietnam, the Ho Chi Minh City People's Committee and other provincial authorities have a major role in implementing Vietnamese government policy on foreign investment and are far more influential in practical terms than central government agencies such as the Ministry of Planning and Investment. However the central Government approves licences to establish businesses. Companies therefore should interact closely with both provincial and central governments.

The 1996 Law on Foreign Investment explicitly recognised the role of provincial people's committees in foreign investment. Under the law, people's committees of provinces and cities under central authority now can be delegated authority to issue

....

[6] A Vietnamese joke was that before the new Foreign Investment Law was introduced, it was necessary to knock on many doors. Now, there is one door, but with many locks.

foreign investment licences for projects that are not nationally important.[7] The decision to approve or refuse an investment application must be made within 30 days from lodgement.[8] (See Chapter 1 - *Vietnam: Politics*.)

Despite the Government's intention to reduce bureaucratic hurdles foreign investors face, improvement has been minimal. Once a licence is issued, any amendments must be negotiated with and re-approved by the Ministry of Planning and Investment or other issuing authority; this procedure can be protracted. Foreign investors also experience difficulties and delays in obtaining visas and land use rights and in employing labour.

Honouring Investment Undertakings

Fulfilling undertakings given in feasibility studies and investment licence documentation is important. These include technology upgrades and transfers, exports, and staff training and development. Regular consultation and communication to demonstrate compliance and progressive sign offs at different stages of an investment project can be useful. While there appears to be no way to enforce formally a company's licence conditions, the Vietnamese authorities rightly expect foreign investors to meet the commitments made in their licence applications.

GOOD FAITH IN WORD AND DEED

A foreign company in Vietnam spent almost two years in feasibility studies, identifying a partner and obtaining an investment licence. The licence incorporated the main features of the feasibility study, including commitments on the part of the foreign company to export products, transfer technology and train Vietnamese staff.

The business at first prospered, but after about a year the expatriate manager noticed it had become increasingly difficult to operate. For example, import quotas became harder to obtain and were often for less than the requested amount, customs delays grew longer, and tax inspections increased and involved protracted negotiations. After a further six months, the company began to struggle under a barrage of small irritations with a large cumulative effect. The company contacted the Ministry of Planning and Investment to explore whether the problems could be resolved. The Ministry undertook to examine the matters raised and noted in passing the conditions on which the licence had originally been granted. Following this, the company emphasised exports, technology development and training, and the irritations eased.

Corruption

Corruption is tolerated to a degree in Vietnam as it is accepted that individuals have a duty to fulfil family and other personal obligations. However, corruption has

....

7 Nationally important projects include those dealing with oil and gas, energy, ports and cement.

8 The Government implemented the new law by issuing Decree 12/CP on 18 February 1997 and Circular No. 3 of the Ministry of Planning and Investment on 15 March 1997.

become a ‘national plague’ (Kerkvliet, 1996). It is widespread and adds substantially to the cost of doing business. In 1995, Vietnamese Prime Minister Vo Van Kiet acknowledged that corruption directly endangered the national economy.

Vietnam’s transition from central planning to market economy has created new opportunities for corrupt practices, including extensive face-to-face contact with foreign business people seeking licences and concessions. (See Chapter 1 - *Vietnam: Politics*.) Officials from all levels and parts of the bureaucracy exact ‘facilitation payments’. Some bureaucrats assume that foreign companies make spectacular profits in Vietnam; others are opportunistically ‘making hay while the sun shines’. Bureaucrats are poorly paid compared with their colleagues in the private sector and particularly with expatriates working in Vietnam.

Recently, high profile corrupt senior officials were tried and sentenced to death or lengthy prison terms. However, so far the fairly regular public exposure and prosecution of corrupt officials has done little to reduce the problem. The Government says it plans to define more precisely crimes of corruption and increase penalties for some offences.

Foreign Exchange Restrictions

Generally, foreign investors need to meet or generate their own foreign currency needs. Companies that cannot do so face problems securing access to foreign currency. These problems may grow if Vietnam’s trade gap continues to widen and the Government imposes further restrictions. The Foreign Investment Law guarantees the right to ‘repatriate’ profits, but it does not guarantee the right to ‘convert’ local currency profits into foreign exchange. To convert currency, joint ventures or wholly foreign-owned enterprises must apply to the State Bank of Vietnam for a special permit. Approval is automatic for projects classified as either infrastructure or import replacement projects. The State Bank issues ad hoc one-year permits, although the security and legal status of the permits is uncertain.

For enterprises selling mainly to domestic consumers, the inability to generate foreign exchange can create particular difficulties. New investors should be aware of this before deciding to enter the market.

MANAGING FOREIGN EXCHANGE

A foreign company provides business consultancy services to foreign and local businesses, including SOEs, on developing business plans and improving publicity material and other matters. Foreign companies pay for these services in foreign currency, either offshore through their headquarters or in Vietnam through the consultant’s foreign exchange account with a local branch of a foreign bank. Vietnamese companies generally pay in local currency (dong), which the consultant uses to pay local operational costs. This gives the consultancy company sufficient flexibility to manage its separate foreign and local currency needs, although if a large part of the company’s earnings in any particular year were in local currency, this would create problems.

Source: Spencer and Heij, 1995, p. 22.

Unpredictable Tax Regime

For foreign investors, Vietnam's tax system is unpredictable and haphazard. The tax system is still evolving and is not yet fully supported by legislation. Interpretations of tax laws can vary widely. As a result, tax regulations change constantly and taxes often are applied retrospectively. Tax arrangements are negotiated continuously and can be imposed arbitrarily. These increase frustration and opportunities for corruption. Some analysts believe some Vietnamese officials fear being cheated and treat foreign businesses unfairly as a pre-emptive measure. It also appears to be easier to make foreign companies pay taxes than Vietnamese ones, especially state-owned enterprises. The increasingly unpredictable tax regime makes long term planning very difficult.

In theory, foreign companies have access to a wide range of tax reductions and exemptions. In practice, these are not guaranteed and generally have to be negotiated case by case. Foreign companies also face higher charges than local firms for many services such as rent, airline tickets, local staff salaries, electricity and water supplies. These steadily reduce profits.

RECENT TRENDS IN THE BUSINESS ENVIRONMENT

Increasing Foreign and Local Competition

Competition among foreign investors is accelerating and domestic companies also are becoming more competitive as Vietnam's industrial capacity expands. The Government actively encourages the development of specific industrial and service sectors. Vietnamese banks now fund local businesses to enter these markets. Rising local competition may shorten the life of some foreign-funded projects, invalidating the traditional view of foreign investment in Vietnam being long term with profits gradually increasing over time.

The window of opportunity for new small and medium sized investors to enter the market in some industries may be closing. The Vietnamese Government has little enthusiasm for small foreign companies unless it sees a need for their technology, products or export capability. In one company's experience, despite its original investment being strongly welcomed, support from the people's committee fell with the rise of local capabilities and the company was pressured to relocate its investment. Before, Vietnam accepted all projects; now, it gives priority only to big projects (Schwarz, 1996b, p. 49).

Increasing Difficulties for Small and Medium Sized Companies

Some small and medium sized businesses already in Vietnam find it increasingly difficult to operate. Small investors can experience considerable problems in obtaining investment licences; their lack of negotiating strength makes it difficult for them to deal with Vietnamese authorities. High business costs and risks also affect small companies disproportionately. Individuals often risk their personal financial resources. Larger companies normally can go without profits for longer than can smaller companies.

On the other hand, despite the very real problems that smaller companies face, their size enables flexibility and motivates them to find 'creative' solutions. Smaller companies may also find an easier fit with Vietnamese partners than larger ones and be more adept at handling crucial relationship issues. Furthermore, the success of Dong Nai and Binh Duoc (Song Be) as industrial centres is based on the Government's willingness to facilitate smaller projects in the US$1 million to $20 million range.

Slow Microeconomic Reform

In ten years, Vietnam has progressed considerably in implementing important economic reforms to make the economy more market oriented. (See Chapter 2 - *Vietnam: Economy*.) Some challenges facing foreign companies are a consequence of Vietnamese institutions being unable to cope with the rapid change. In 1996, particularly before the Eighth Party Congress in June-July, the pace of reform slowed considerably. This is partly because of the more difficult nature of the reforms required but also because of the vigorous debate about the costs and benefits of reforms. The direction of reform is uncertain, particularly the role of the State in the economy; emphasising this role causes disquiet among private sector investors.

COMPANY STRATEGIES

Foreign companies adopt a range of strategies to meet the challenges of operating in Vietnam's complex business environment. Using government-to-government relations, employing on-the-ground representation, building relationships with Vietnamese partners and bureaucrats based on mutual benefit, staying at arm's length in dealing with the bureaucracy through local partners or consultants or Vietnamese returnees (*Viet kieu*), and applying patience and persistence seem to work. However, there is no guaranteed approach; each circumstance needs to be treated individually.

Government-to-Government Relations

Vietnamese give priority to high level contacts with other governments. Foreign companies benefit if senior members of their home governments demonstrate a close interest in the commercial relationship. When countries have good government-to-government relations with Vietnam, their companies can benefit from seeking assistance from their diplomatic representatives to promote their case to senior officials, arrange introductions, and lobby for changes in government practices that affect business operations. Companies also can benefit from participating in government trade missions to Vietnam. Similarly, government-owned enterprises from investor countries may have an advantage of greater credibility with Vietnamese officials.

Local Representation

To be able to communicate effectively with the Vietnamese bureaucracy and local partners, companies need to establish a presence on the ground. Foreign firms need to convince the Vietnamese that they are committed for the long term and to the good of Vietnam, not just for quick profits (Turner, 1996, p. 24). A company representative needs to be on the ground to follow through project implementation, develop personal relations with business partners and relevant ministries, and monitor the rapid changes in the business environment that may affect the company's activities.

Establishing a physical presence in Vietnam however, is very expensive. If a company is unable to do so, it is important that the company's representative travels to Vietnam regularly. This should be the same person each time. Continuity is important in building relationships with Vietnamese officials and partners.

Business Relationships

Networks of family and social obligations based on patronage substantially drive the Party, government, society and business in Vietnam. This is unlikely to change in the foreseeable future, even as laws and regulations impinge increasingly on Vietnamese life. Accordingly, building effective relationships (Vietnamese *quan he*, Chinese *guanxi*) is both the key and an important touchstone for successful business dealings. Anecdotal evidence suggests that Australians do not always perform well in this crucial area.

Companies can benefit greatly from developing a genuine personal relationship with their business partners, important government officials, and local staff. Knowing the right people can be critical to getting things done. Good relationships help achieve compromise solutions to commercial disputes. Personal relationships are even more important with the move towards a more flexible administrative system. As administrative discretion increases, personal agendas assume greater importance. In some cases, this is synonymous with a 'greed is good' mentality.

As the state sector still dominates Vietnam's economy, government regulates almost every aspect of business operations, and as most foreign investors form joint ventures with SOEs, relationships with government officials are particularly important. A Vietnamese SOE naturally turns to the State for support if it encounters difficulties with its foreign partner. This tendency can transform a commercial dispute between partners into a criminal one involving the State against the foreign investor, usually with serious consequences for the latter. Foreign investors need to spend at least 30 per cent of their time working on their relationships with their Vietnamese partners.

Relationship and communication problems between foreign and Vietnamese joint venture partners often lead to a mutual loss of trust and commonly lead to investment failure. They have a number of causes, including:

- the parties' fundamentally different, indeed conflicting, reasons for entering the joint venture
- management transfers in a joint venture from the foreign company's 'relationship oriented' personnel to its 'bottom line driven technocrats'
- the parties' inability to achieve expected profits
- fundamental differences and misunderstandings over managing the enterprise according to Vietnamese or foreign practice
- poor corporate strategies for dealing with the Vietnamese partner, the Government and the media.

What are the characteristics of effective business relationships? In Vietnam, these should not be confused with 'mateship'; a clear perception of long term mutual benefit is important; honesty, openness, mutual respect and acceptance of differences also are important. If a relationship is effective, the two sides can disagree, even argue, but still respect each other's position.

The Media

Some companies surveyed noted that an effective media strategy is often a crucial element of doing business in Vietnam and that building relations with the press and creating an image of openness and transparency is important. This is because pressure groups and joint venture partners often use the media to air grievances. However, foreign companies should avoid publicly airing project difficulties or embarrassing Vietnamese joint partners or authorities, as this is usually counter productive.

GOOD COMMUNICATION

The media in Vietnam, especially the print media, are strategically important. Recognising this, a foreign company appointed a spokesperson to establish links with key journalists, respond to enquiries from the media and brief them on the company's operations. The spokesperson comments only on matters directly related to the company's activities and takes particular care to be accessible, positive, courteous and respectful.

A similar approach to communicating with government officials also works well. One person approves all communications after consulting with executives involved in the company's Vietnam activities. This not only ensures continuity of the company's corporate policy and strategy; it also protects and develops the company's relationships with its Vietnamese counterparts.

Transparency and Openness

Most companies seek to operate transparently and honestly to gain the respect of the Vietnamese as partners: transparency allays suspicions.

Within the bounds of normal commercial practice, foreign investors also should be reasonably frank when negotiating with their Vietnamese partners. Withholding important information could leave a Vietnamese partner feeling cheated and therefore, not obliged to observe the terms of the contract. Rather than trying to achieve some sort of victory over the Vietnamese side in negotiations, consciously seeking a 'win win' outcome is better. In Vietnam, foreign companies that try to outsmart their Vietnamese partners risk retribution (Folkmanis, 1997, p. 36).

Arm's Length Dealing with the Bureaucracy

Rather than dealing directly, a number of foreign companies use consultants and agents, either foreign, local or *Viet kieu* (overseas Vietnamese), to handle their relations with the authorities. This keeps the companies at arm's length from officials, diminishing the potential for conflict and loss of face arising out of cultural misunderstandings and avoiding direct discussion of 'facilitation payments'. Lobbyists and consultants can help change investment licence conditions, negotiate with taxation and customs officials, lobby for projects, and even negotiate with a foreign company's joint venture partner.

However, the arm's length approach does limit the development of cooperative relationships with key people. Also finding the 'right' consultants or agents can be difficult and they can increase the risk of mis-communication or add another layer to the corruption chain. Accordingly, some foreign companies prefer the traditional direct approach to communication in which foreign and Vietnamese partners meet to discuss matters and resolve problems, normally with the help of an interpreter.

A case-by-case approach or one that uses a mixture of direct and arm's length dealings probably is a safe way to develop relationships with the Vietnamese bureaucracy and joint venture partners. Over-reliance on a single strategy, particularly the use of Vietnamese intermediaries, is risky.

THE ARM'S LENGTH APPROACH

A foreign company involved itself directly in the early stages of a joint venture. Using an interpreter, it met regularly with its Vietnamese partner, the bureaucracy and sought to develop links with Vietnamese clients. Over time, the company concluded that the direct approach caused more problems than it solved. Meetings had become increasingly unsatisfactory and prone to conflict. Consequently, the company gradually changed its approach. Dealings with the bureaucracy were handled by intermediaries. For example, the company's accountants dealt with taxation officials. The company's direct dealings with the bureaucracy largely became formalities to confirm pre-agreed arrangements. Intermediaries also took over negotiations with the joint venture partner.

The company found the new strategy reduced conflict and tension and made decision making more efficient.

Viet Kieu

The Vietnamese Government recognises *Viet kieu* (overseas Vietnamese) promote trade and investment and offers special incentives, such as tax reductions under the 1996 Law on Foreign Investment, to attract them back to Vietnam. (See Chapter 2 - *Vietnam: Economy*.) The cultural, linguistic, business and technical skills, and local connections *Viet kieu* possess also make them potentially valuable assets for Australian and other foreign companies. A number employ *Viet kieu* as facilitators to help start ventures and to handle continuing interaction with the Vietnamese bureaucracy. The quality, number and range of contacts, as opposed to other skills ,appear to determine their success in many cases.

Despite the official welcome, *Viet kieu*, collectively, are sometimes regarded with suspicion, disdain and, occasionally, outright hostility by ordinary Vietnamese (Schwarz, 1996c, p. 30). The reasons for this attitude are complex, but jealousy can be a factor. Some *Viet kieu* have connections with the former South Vietnamese regime or other 'negatives' in their background that can make them unsuitable as business facilitators.

Accordingly, foreign companies need to be careful in selecting *Viet kieu* to further their business interests in Vietnam. Ultimately, most Vietnamese will judge *Viet kieu* as individuals. Foreign companies should do likewise.

VIETNAMESE STAFF AND CONSULTANTS

Many foreign companies develop special relationships with local Vietnamese employees or consultants, who play a prominent role in the company, combining the skills of interpreter/translator, cultural adviser, liaison officer and lobbyist. Their employment often results from the foreign company's initial market research or licensing activities. In many cases, the person was originally employed by a Vietnamese company that became important to the foreign company's Vietnam operations (as a joint venture partner, major supplier or major customer). These people are vital to the efficient operations of many companies, but may experience problems of divided loyalty.

Patience and Persistence

'For companies willing to make the long term commitment, this is a great place to be ... but it will take time, money and lots of investment for companies to become profitable here' (Schwarz, 1996a, p. 50).

Obtaining access to essential utilities such as telephones and electricity, employing staff and obtaining basic office equipment may be arranged quickly and easily elsewhere but can be very slow to arrange in Vietnam. These difficulties are additional to coping with the complexities of getting investment licences approved.

As a result of increasing pressure on foreign companies to demonstrate the value of their investment to Vietnam, many companies specify a phased development program for their investments, indicating how technology transfer will proceed. It is important to be willing to compromise and work within the system, adopting the attitude that foreign investors are guests in Vietnam.

It also is important that home-based boards of companies operating in Vietnam demonstrate patience and persistence. They need to understand how business is done and the difficulties involved, and have realistic expectations. Taking senior management on field trips and communicating frequently with head office help management to appreciate the problems.

INCREMENTAL DECISION MAKING

As the volume of laws and regulations increases, thousands of middle and upper level bureaucrats responsible for making incremental decisions find it harder to understand and implement consistently these rules. This can increase inconsistency and non-transparency, despite the rising number of rules. In addition, the Vietnamese system emphasises the apportioning of credit or blame to outcomes. As a result, poorly trained and supervised Vietnamese officials try to avoid individual responsibility by making consensus decisions or delaying decisions.

One strategy to deal with this problem is to divide big decisions into a series of incremental ones. Project management then focuses on monitoring a series of performance and contractual benchmarks. Before each discrete section of the project begins, technical, performance and time benchmarks must be agreed. When each benchmark is reached, it is signed off as satisfactory. In this way, the final signing off for a project is no longer a formal, highly responsible decision but a process of smaller decisions encompassing cumulative agreements.

CONCLUSIONS

Although in recent years, some of the gloss has gone from Vietnam as an investment destination, most Australian and foreign companies are confident about Vietnam's medium to longer term prospects. Of the Australian companies surveyed by one analyst, most 'would still invest in Vietnam, and none would elect to delay their entry into the country' (Maitland, 1996, p. 104). The main attraction for Australian companies is not quick profits or cheap inputs for export production; rather, it is in establishing a long term presence in an economy with strong growth prospects. This is consistent with the view that 'negative corporate stories from Vietnam represent about 3 per cent of the real picture of Australia's investment in Vietnam' (O'Flahertie, 1996, p. 24).[9]

Vietnam is a very difficult market, but foreign companies can be successful. Moreover, the sources of Vietnam's initial attractiveness to foreign investors remain, and continuing strong economic growth and the Government's commitment to reforming the bureaucracy, making more and better laws, and implementing them, should see conditions for foreign companies gradually improve. Vietnam's membership of ASEAN will support this process. However, while the general direction is positive, progress is unlikely to be smooth or rapid: change will take time.

Overall, there is a need for balanced and realistic assessments of business opportunities in Vietnam. Both foreign companies and local officials are on a steep learning curve: Vietnam needs to learn more about the complexities of a market economy; foreign companies need to learn more about the complexities of operating in Vietnam.

9 Some of the blame for the 'hard luck' business stories in Vietnam is due to unrealistic expectations by some foreign business people.

REFERENCES

Department of Foreign Affairs and Trade, 1996, *Country Economic Brief: Vietnam*, Department of Foreign Affairs and Trade, Canberra.

Dung, N.T., 1996, 'Foreign Direct Investment in Vietnam' in Leung, S. (ed.), *Vietnam Assessment: Creating a Sound Investment Climate*, Institute of Southeast Asian Studies, Singapore.

Folkmanis, J., 1997, 'Honeymoon over on Vietnam investment', *Australian Financial Review*, 9 April.

Heij, G., 1997, personal communication with East Asian Analytical Unit.

Kerkvliet, B. 1996, 'Partial Impressions of Vietnamese Society' (abstract), The Australian National University, Canberra.

Maitland, E., 1996, 'Foreign Investors in Vietnam: An Australian Case Study', in Leung, S. (ed.), *Vietnam Assessment: Creating a Sound Investment Climate*, Institute of Southeast Asian Studies, Singapore.

O'Flahertie, S., 1996, 'Is Vietnam Worth the Risk', *Asian Business Review*, June.

Peregrine, 1996, *Vietnam: Transition Under Threat*, Peregrine, Hong Kong.

Saigon Times, 1994, various issues.

Schwarz, A., 1996a, 'Vietnam Syndrome', *Far Eastern Economic Review*, 28 March.

____ 1996b, 'Promises, Promises-Vietnam's Leaders Come under Pressure to Speed up Reforms', *Far Eastern Economic Review*, 24 October.

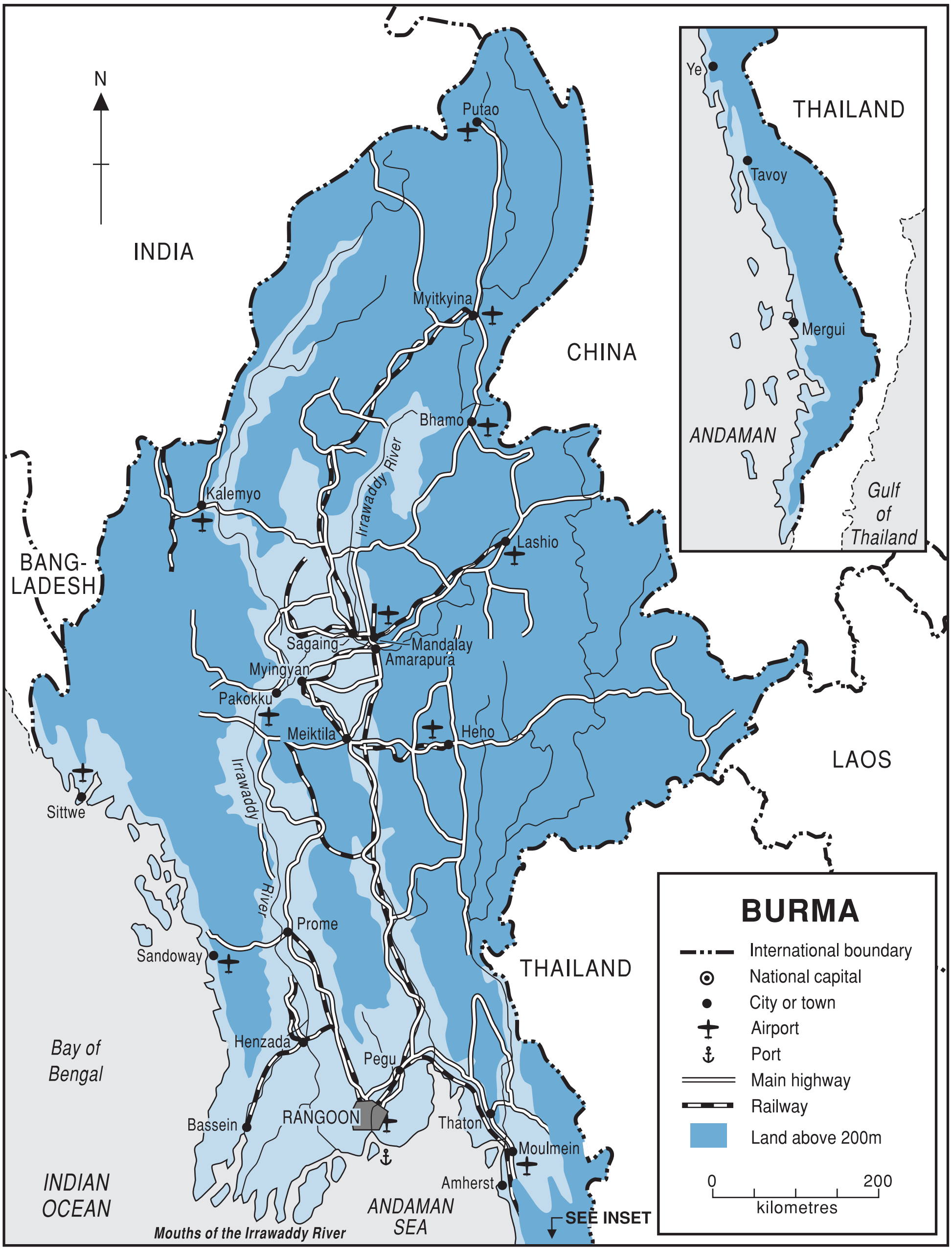
____ 1996c, 'You Can't Go Home Again-*Viet Kieu* Face Tough Going in Their Native Land', *Far Eastern Economic Review*, 17 October.

Spencer, C. and Heij, G., 1995, *A Guide to Doing Business in Vietnam*, Asia Research Centre, Murdoch University, Perth.

Turner, D., 1996, 'Vietnam-A Special Feature', *International Business Asia*, 22 July.

P A R T T W O

BURMA


BURMA
International boundary
National capital
City or town
Airport
Port
Main highway
Railway
Land above 200m
0
200
kilometres
N
INDIA
CHINA
BANG-
LADESH
LAOS
THAILAND
Putao
Myitkyina
Bhamo
Irrawaddy River
Kalemyo
Lashio
Sagaing
Mandalay
Amarapura
Myingyan
Pakokku
Meiktila
Heho
Sittwe
Irrawaddy
River
Prome
Sandoway
Henzada
Pegu
Bassein
RANGOON
Thaton
Moulmein
Amherst
Bay of
Bengal
INDIAN
OCEAN
ANDAMAN
SEA
Mouths of the Irrawaddy River
SEE INSET
Ye
Tavoy
Mergui
ANDAMAN
Gulf
of
Thailand

Chapter 4

PERPETUATING THE MILITARY STATE

Burma's socialist one party state collapsed in the face of mass popular demonstrations in 1988. The military, which previously ruled indirectly through the civilian government it controlled, resumed direct political control.[1]

The new military regime, the State Law and Order Restoration Council (SLORC), formally abandoned the Burmese Way to Socialism that had been pursued haphazardly for 26 years following General Ne Win's 1962 coup. In its place, the SLORC declared 'the open door market economy of Myanmar', in essence a Burmese way to capitalism (Maung, 1995, p. 649).

This chapter examines the military regime's political agenda, the current administrative and legal structures through which it seeks to achieve its goals, and the outlook for Burma.

THE ARMY IN POLITICS

For over three decades, the military has dominated Burmese public life and eliminated or stultified potential challengers. The military remains unwilling to concede autonomous political power to civilians, or to the ethnic minorities who surround the Burman dominated heartland.[2] Rather, its aim is to restore Burma to an outwardly civilian form of government that still will leave the military firmly entrenched in power.

Vanguard Army

Preserving the military's elite status and protecting its political and economic interests are central to the SLORC's calculations for Burma's future. The military leadership's political outlook has been shaped substantially by its interpretation of modern Burmese history and the part played by the military in it.

Since its formation as a nationalist armed force under Japanese patronage during World War II, the Burma Army always has been a political and military institution. The army's founders, the Thirty Comrades led by Aung San,[3] were mostly young

....

1 The expressions military, armed forces and army are used interchangeably in this chapter. Burma's armed forces include a navy and an air force, but these services are very small compared with the army and have little political influence.

2 Burmans are Burma's ethnic majority. Under ceasefire arrangements the SLORC concluded after 1988, several former ethnic insurgent groups enjoy a high degree of de facto autonomy in the territories they control. This is, however, a temporary measure; the SLORC is resisting granting de jure autonomy to these groups under Burma's new constitution, which is being prepared.

3 Aung San was the father of Burma's democracy leader and Nobel laureate, Aung San Suu Kyi.

nationalist politicians, and the army's central role in securing Burmese independence in 1948 was essentially political.

Since independence, the army has been either at the centre of Burmese politics or close to it. Military leaders were politically active in the first ten years of Burmese civilian democracy; their meddling contributed to a political crisis in 1958. The civilian Prime Minister, U Nu, then handed over power temporarily to the armed forces commander-in-chief, General Ne Win, as head of a so-called Caretaker Government. Ne Win returned power to the newly elected civilian government in 1960, but seized it in 1962 when political stability and national unity appeared threatened[4] by ethnic minority demands for greater autonomy (Lintner, 1990, p. 36). The military has ruled Burma ever since: first as the Revolutionary Council with Ne Win as Chairman; then indirectly from 1974 as the Burma Socialist Program Party (BSPP) with Ne Win as party Chairman and State President for most of this period;[5] and finally from 1988 as the SLORC.

The army also has developed its military capability, becoming South East Asia's second largest fighting force,[6] and one of its most battle hardened. For almost 50 years, the army has defended Burma against a succession of enemies, real and perceived: communist, ethnic and narco-insurgents; Kuomintang forces; and rebellious students and other civilians. Since 1988, the SLORC has expanded and modernised the army, almost doubling its size and acquiring a wide range of new, mostly Chinese weaponry.[7]

The military sees itself as the founder and central institution of the State, dedicated to safeguarding the unity and integrity of the nation. This self appointed role as national saviour is enshrined in the army's three main national causes:

- non-disintegration of the union
- non-disintegration of national solidarity
- consolidation of national sovereignty.

The military also regards itself as the guardian of Burmese cultural purity, maintaining a tight hold on social, religious and economic affairs. The military generally has little faith in non-military institutions or individuals, with some notable exceptions; civilian politicians, as a class, are viewed with distrust.

....

4 It is unclear whether Ne Win's seizure of power was opportunistic, or based on a misplaced concern to preserve national unity, or a combination of the two.

5 In 1974, a new constitution providing for a one party (the Burma Socialist Program Party) socialist state was adopted. This meant little change, however, as the military controlled the BSPP and most senior party and state office-bearers were either serving or retired military officers. The military also controlled, both directly and through the BSPP, the state administrative apparatus throughout the country at all levels.

6 The armed forces had between 300 000 and 400 000 personnel in 1995. Although the latter figure seems very high, the SLORC makes no secret of its final goal: 'a 500 000-strong, well-equipped military machine' (Selth, 1996, p. 19).

7 Military purchases between 1988 and 1995 cost over US$1 billion (Selth, 1996, p. 22).

TRANSITION TO CIVILIAN GOVERNMENT

The SLORC imitates in important respects the political activities and approaches of its military forerunners. As did the Revolutionary Council, the SLORC aims to remake the Burmese State, this time as a 'multi-party democratic system' with the armed forces in the central role. As did the military in the 1950s, the SLORC also plays a substantial economic role. It has set up a military controlled holding company, Union of Myanmar Economic Holdings Limited (UMEH), which is Burma's largest enterprise and plays a significant role as a joint venture partner in many foreign investment projects (Lintner, 1996, p. 25).

As soon as it took power, the SLORC abandoned the concept of a one party socialist state and agreed to proceed with the multi-party democratic elections that the BSPP Government had offered in its dying days. Despite the SLORC's repressive tactics, which included placing Aung San Suu Kyi, the charismatic spokesperson for Burma's democratic opposition, under house arrest in mid 1989, the elections on 27 May 1990 were remarkably free and fair. This was evident in the landslide victory of the National League for Democracy (NLD), the party perceived by the SLORC as the one most inimical to its interests.[8]

The elections, however, proved to be an aberration. Two months later, the SLORC rejected any transfer of power until a new constitution had been drafted according to guidelines to be laid down by a National Convention. A constituent assembly[9] of representatives elected on 27 May 1990 was to draft the new constitution,[10] which would need to be adopted by popular referendum and approved by all 135 national races. The military would also need to accept the new constitution. The SLORC set no timetable for this process.

The SLORC's repudiation of the election results forced the NLD to a showdown; large numbers of NLD leaders, elected representatives, members and supporters were arrested and imprisoned. Some elected representatives fled to the Thai border, where they formed the National Coalition Government of the Union of Burma under the auspices of the ethnic insurgent Democratic Alliance of Burma.

There was virtually no advance towards drafting a new constitution until April 1992, when General (now Senior General) Than Shwe took over as SLORC Chairman from the ailing Saw Maung.[11] Than Shwe released large numbers of political prisoners, including in 1995 Aung San Suu Kyi, and started the SLORC's transition process.

....

8 The NLD won 392 or 80 per cent of the seats and 60 per cent of the popular vote. The former governing BSPP, reincarnated as the National Unity Party, won just 10 seats and slightly over 21 per cent of the popular vote. Voter turn-out on the day was 73 per cent, the highest participation rate of any election in Burma's history (Taylor, 1991, p. 201).

9 Although SLORC Chairman Senior General Saw Maung had confused the issue by suggesting before the elections that power would be handed over to the winning party, other SLORC leaders, notably Secretary Major-General (now Lieutenant-General) Khin Nyunt, indicated before the elections that elected representatives would form a constituent assembly, not a full legislature.

10 Even the minor constitution writing role accorded to elected representatives has been eroded. The task of drafting the new constitution has fallen largely to a SLORC appointed team of 'legal experts'.

11 Senior General Saw Maung was stood down on the grounds of ill-health, reputedly nervous exhaustion.

New Constitution

Since January 1993, the SLORC has stage managed a National Convention comprising mainly hand picked delegates to prepare a framework for a new constitution that borrows from Indonesia's *dwifungsi* (dual function) model. The new constitution will formalise the army's dual political and military functions and consolidate its hold on power.

It has taken the National Convention three years to set 'guiding principles' for six of the new constitution's 15 chapters. (See box.)

A military head of state with extensive executive powers will preside over a highly centralised government structure. The military will have a major stake in both houses of parliament; ethnic minority representation will be token. The military, its budget, appointments and recruitment will be independent and quarantined from civilian scrutiny. The army commander-in-chief will have a reserved right to intervene in politics and take power in cases of national emergency, without even nominal oversight by the President or parliament. In addition, the military's powers will be extended through much wider distribution of military units around the countryside, and more direct participation in local political, economic and social affairs (Selth, 1996, p. 155). These constitutional provisions will make the military all powerful. The post-SLORC judiciary should be as compliant, or at least as controllable, as at present.

Union Solidarity and Development Association

Through this new constitutional structure, the SLORC hopes to replicate the success of the Soeharto regime in Indonesia by securing military led government that the broader population tolerates and the regional and international community accepts (Sundhaussen, 1995, p. 768). As a further step in this direction, in September 1993 the SLORC created the Union Solidarity and Development Association (USDA), which resembles GOLKAR, the military controlled 'government party' that has won every election in New Order Indonesia (Sundhaussen, 1995, p. 770).

GOLKAR is an instructive parallel, although not necessarily the model for USDA. Like GOLKAR, USDA is not strictly speaking a political party but a 'social organisation'. In three years, USDA has attracted more than 6 million members.[12] It is represented at all administrative levels, with branches in every state and division, district, township and in 90 per cent of Burma's 16 104 wards and villages. Membership of USDA is open to all Burmese citizens older than 10, but the 11 to 25 year age group, representing roughly one third of the population is the focus of recruitment efforts. Secondary schools are a fertile recruiting ground. Military personnel and public servants and their families, for whom membership of political parties or political activism is proscribed, are 'encouraged' to join. Recruitment of ethnic minorities, particularly in geographic areas where they predominate, has been minimal. Like the army, USDA is a Burman dominated organisation.

12 By contrast, the NLD, Burma's largest opposition political party, claimed a membership of 2 million in 1990, but because of the SLORC's depredations this had shrunk to between 400 000 and 500 000 by early 1997 (National League for Democracy, 1997).

DISCIPLINED DEMOCRACY[13]

The National Convention's 'guiding principles' indicate the SLORC's political vision for the Republic of the Union of Myanmar.

Administrative Structure

The new republic will consist of seven ethnic based states, matched by seven divisions covering the ethnic Burman dominated heartland. Each state and division will have its own legislature with limited autonomy from Rangoon, but one quarter of the seats will be reserved for the military.

The President

An 'electoral college', one third of whom will be military nominees, will select the President. Selection pre-requisites include a substantial military background.

The President's extensive powers will include the power to appoint:

- ministers from inside or outside parliament, with the defence, security-home affairs and border affairs portfolios appointed by the military. The President will also have the power to remove ministers
- the Chief Justice and the other supreme court justices, as well as chief justices of state and regional high courts
- chief ministers of states and divisions
- the public service board charged with selecting and training public servants responsible for district and township administration, even in so-called self administered areas. The latter is a contentious point with the ethnic minorities.

The Legislature

The two houses of parliament will be:

- a 440-seat lower house (House of Representatives) with 330 or three quarters of the seats to be filled by popularly elected representatives; the remaining 110 or one quarter of the seats to be reserved for the military
- a 224-seat upper house (House of Nationalities) with 12 members from each state and region, one representative from each self administered zone or division, and 56 or one quarter of the seats to be reserved for the military.

State Legislatures

The 14 state and division legislatures will comprise two elected representatives from each township and one from each ethnic group (subject to certain qualifications). One quarter of all representatives will be nominated by the military.

....

13 SLORC Chairman Senior General Than Shwe used this expression to refer to the military's vision for Burma.

The military controls USDA: its chief patron is the SLORC Chairman, and the SLORC, military and non-military members of the cabinet dominate the top structure of USDA. All new USDA members are carefully vetted by Military Intelligence,[14] and training and indoctrination are important aspects of membership. According to SLORC Chairman, Senior General Than Shwe, USDA's main aim is 'to implement the social objectives of the State'. Its five objectives are the same as those of the SLORC.[15] In addition, USDA members are obliged to give 'all round assistance' to the armed forces.

In practice, the SLORC encourages USDA members to inform on dissidents. It also deploys the organisation to rally support for SLORC policies and plans, notably the new constitution, and to counterbalance the popular support for the NLD. At times, USDA takes on a 'brown shirt' role, such as on 9 November 1996, when it mobilised several thousand demonstrators against the NLD: cars carrying Aung San Suu Kyi and other party leaders were attacked and damaged.[16]

Since 1995, USDA has also been building an economic base to provide benefits to members. Its company, Myan Gone Myint Company, with an investment of around US$500 000, earned US$2.7 million from selling or renting shops in Rangoon markets. On the SLORC's orders, the Rangoon City Development Committee had turned these shops over to USDA. USDA also controls bus lines and other businesses. Myan Gone Myint Company is likely to become a target of foreign investors seeking a well connected local joint venture partner.

The SLORC has invested significant energy and resources in developing USDA. In the broadest sense, USDA is the SLORC's vehicle for creating and fostering a civilian constituency, particularly among Burmese youth, whose volatility has often catalysed anti-government protests. Otherwise, the SLORC has made little progress in gaining popular support and has developed no alliances with sections of the civilian population.

The SLORC is likely to use USDA to legitimise the transition process and to project the military's interests once the 'new order' is established. USDA already has publicly acclaimed the provisions of the new constitution. In his opening address to USDA's 1995 annual meeting, SLORC Chairman Senior General Than Shwe said, 'you constitute … a national force reliable to the State which will serve the interest of the State … hand in hand with the armed forces'. This suggests that USDA may complement the military's leading political role under the new constitution.

For USDA to perpetuate military rule rather than merely to rally support, it must transform itself into a political organisation and, presumably, field candidates in elections under the new constitution. Such a development, however, is still some way off.

14 Military Intelligence or MI is the popular name of Burma's highly effective, if not necessarily efficient, 'secret police' network, the Directorate of Defence Services Intelligence.

15 The SLORC's five objectives are the armed forces' 'three main national causes' plus 'revitalisation of patriotism with a view to enhancing national pride and prestige' and 'emergence of a modern and peaceful nation.'

16 Those who carried out the attack may have been USDA recruits or others.

MILITARISING THE ADMINISTRATION

All executive, legislative and judicial authority is currently vested in the SLORC; the SLORC Chairman is concurrently head of the armed forces, head of state and head of government. Furthermore, in the cabinet that rules Burma, almost all 36 ministers and 24 deputies are serving or retired army officers. Local Law and Order Restoration Councils (LORCs) extend military rule down to the lowest level of state administration.

Although the SLORC made some early, tentative moves towards privatising a handful of the numerous inefficient state-owned enterprises (SOEs) that virtually ran the economy in BSPP times, it has left the creaky administrative machinery relatively untouched. (See Chapter 5 - *Burma: Economy.*) While the objective of socialism has been abandoned, socialist thinking and the tools and methods of the BSPP era remain. The Burmese bureaucracy continues to stifle rather than encourage initiative, and lacks the capacity to make decisions.[17]

Military officers during the Ne Win period followed a predictable career path, from active service in the armed forces to influential positions in politics, public administration and the management of various SOEs. This pattern continues under the SLORC. Military personnel either in uniform or in mufti are in senior and middle levels in all ministries. In Burma's current circumstances as a military state, this streamlines decision making and approval processes in some cases, although few of the military personnel have relevant expertise. However, the main effect is to extend the military's reach and control, and to ensure that policies and directives are not stymied by civilian bureaucratic inertia or deliberate subversion.[18]

The SLORC has sought to engender bureaucratic loyalty to itself and support for its objectives by submitting public servants to regular sessions at the public service training centre at Phaungyi on the outskirts of Rangoon. USDA is supposed to perform a similar function.

LEGAL REFORM

Immediately on taking power, the SLORC suspended the 1974 Constitution providing the legal basis for the socialist one party state. It revoked laws protecting the socialist system, abolished some state monopolies and either reinstituted relevant laws from the pre-socialist period or created new ones to support Burma's changed economic orientation.

....

17 This reflects a continuing adherence to the 'motto' of BSPP era bureaucrats: *m'lo, m'sho, m'pyo* (literally, 'don't do, don't interfere, don't get sacked'), the result of centralised power in military hands and the fear and conservatism this breeds among bureaucrats.

18 Although most public servants were compulsorily aligned with the BSPP, they formed a prominent phalanx in the demonstrations that ultimately brought down the BSPP Government in 1988. The SLORC responded by sacking large numbers of them immediately it assumed power.

Origins

Burma's legal system combines family customary law, codified British common law and more recent Burmese laws.

The principles of British common law and statutory law were implanted in Burma by the British law codes of the pre-independence India Statutes.[19] The Union of Burma (Adaptation of Laws) Order 1948 ensured the continuation of these laws after independence, until they were either repealed or amended.[20] Many old laws, however, were not used during the socialist period. Consequently, the lack of recent precedents makes it difficult to interpret and enforce many laws in the contemporary context.

From 1962 to 1974, the Revolutionary Council issued laws in the form of decrees. From 1974 to 1988, the BSPP People's Assembly enacted laws. Then, from 1988 to the present, the SLORC has issued laws, decrees and orders.

BURMESE LAWS

Burmese laws take the following forms:

- acts introduced from the time of the British annexation of Burma up to the 1962 military coup as passed by the colonial and/or local legislature
- laws issued or enacted from 1962 to the present. These have the same legal effect as acts and are statutes in the common law sense
- decrees and orders issued by the SLORC exercising its executive authority
- rules and procedures, which are usually administrative, such as those specifying the forms and procedures to apply under the 1988 Foreign Investment Law
- regulations made under powers given to a ministry or other authority by an act or law
- notifications, normally issued by a ministry and relating to administrative matters of that ministry, such as forming a SOE.

Legal Framework for a Market Economy

The SLORC has revived Burma's pre-independence commercial, corporate, and economic laws to provide the fundamental legal framework for a market economy, based mainly on British common law principles. These laws govern companies, contracts, partnerships, trusts and succession, the sale of goods, negotiable instruments, insolvency and basic types of intellectual property. This is a substantial legal inheritance, giving Burma a considerable head start on the other three new ASEAN economies, all of which are at an early stage in developing their legal infrastructure from the ground up.

19 Burma was administered by the British as part of India until 1937, when it was granted separate status.

20 All these laws, most of them British in origin, can be found in the 13 volumes of the 1954 Burma Code.

Onto this base, the SLORC has grafted a number of modernising new laws. As a result, Burma's legal framework generally is adequate but needs further refining and updating to serve the needs of a modern market economy.

Foreign Investment

The 1988 Foreign Investment Law provides incentives for foreign investment in wholly foreign-owned enterprises or joint ventures with Burmese individuals, companies or SOEs, with at least 35 per cent foreign equity. Where the joint venture is with a SOE, the State's interest is typically 50 or 51 per cent. Most hotel projects are wholly foreign-owned investments constructed on a Build-Operate-Transfer (BOT) basis.

Because the Foreign Investment Law prescribes a rigorous set of criteria and conditions, some foreign investors, particularly smaller ones, prefer to operate under the 1913 Companies Act and Regulations. Larger investors, however, are normally keen to avail themselves of the specific guarantees and incentives offered by the Foreign Investment Law. Investors operating under the Foreign Investment Law also appear to encounter fewer restrictions when remitting monies offshore from local foreign currency accounts.

All sectors of the economy are open to foreign investment except the 12 prescribed by the 1989 State-Owned Enterprises Law. These still are reserved for state monopolies, although foreign investment may be specifically authorised, case-by-case, by the Foreign Investment Commission. The Government is especially keen to encourage foreign investment projects that are either export-oriented with a positive effect on national balance of payments, or capital intensive, for example, natural resource-based industries; introduce new technologies; create employment; or support regional development.

To attract foreign investors the Government offers:

- a guarantee against nationalisation
- guaranteed repatriation of profits and capital after the termination of the business
- tax holidays and other tax and customs duty exemptions or relief.

The Government issued the 1994 Citizens Investment Law to accord Burmese nationals the same exemptions and privileges and encourage domestic investment.

In addition, the Government has adopted in a fairly ad hoc manner a range of new laws to support economic reforms in specific sectors, for example banking and finance. (See Chapter 5 - *Burma: Economy*.)

Land Law

Burma recognises private freehold and leasehold interests in land; both need to be registered under a system that approximates Old System title in Australia.

The 1882 Transfer of Property Act embodies common law principles dealing with land sales and purchases, leases and mortgages and moveable property. This law is supplemented by the 1987 Transfer of Immovable Property (Restrictions) Law which prohibits transfers of land between foreigners and Burmese citizens in either direction. The prohibition extends to mortgages of land or 'immovable property' and leases longer than one year (or assignments of such leasehold interests). This precludes foreign lenders taking any security interest in land or immovable property unless specifically approved or exempted.

Specific exemptions have been granted, for example for BOT hotel projects, and the 1987 law is not applied in practice to entities formed under the Foreign Investment Law. In these cases, the SLORC or an SOE that holds land may provide a foreign entity with a long term 'right to use' specific land as part of its foreign investment permit conditions.

Although the SLORC soon may replace the 1987 law or amend it to make it more liberal, it seems unlikely that foreigners will be allowed to own land in Burma.

Dispute Settlement

Common law principles underpin Burma's court system and civil procedures, and decisions are recorded in law reports. There are few recent case reports, however, covering court or arbitration proceedings involving foreign investors.

Arbitration is the preferred and often the required method of resolving disputes involving foreign investors. Except in foreign trade contracts, there is no legal requirement that foreign investors' contracts be governed by Burmese law or Burmese courts. However, the Foreign Investment Commission, other government agencies and SOEs invariably require contracts to be made specifically subject to Burmese law and any disputes arising under those contracts to be resolved by arbitration in Burma under the provisions of the Arbitration Act.

In at least one case involving a large investment, however, arbitration was permitted in Singapore under United Nations Commission on International Trade Law (UNCITRAL) rules. While this is not yet the norm, the Government is said to be seriously considering accepting international arbitration under the provisions of UNCITRAL, the International Chamber of Commerce and/or the International Centre for Settlement of Investment Disputes (Christie, 1996, p. 14). The enforcement of foreign awards in Burma is covered by the 1939 Arbitration (Protocol and Convention) Act.

THE RULE OF LAW AND CIVIL SOCIETY

The SLORC is careful that its actions have a legal basis. For example, it argues that Burma has no political prisoners, only criminals who have been punished under due process of Burmese law. In the SLORC's hands, however, law is very much an instrument of state control and, often, repression. Laws are applied selectively and arbitrarily[21] by the military regime to enforce its will (Steinberg, 1995, p. 7). The judiciary is established as independent under the Judiciary Law, but there are concerns about its independence in practice. The SLORC's rule is inconsistent with

[21] An example of the SLORC's selective and arbitrary application of laws is the case of James Leander Nichols, a wealthy supporter of Aung San Suu Kyi, who died in prison in 1996 while serving a three-year sentence for possessing an unregistered fax machine.

the concept of the rule of law, under which individuals and institutions are equal before the law.

Similarly, Burma has only the rudiments of civil society.[22] The lack of civil society is not a new development under the SLORC, but may be traced directly to the 1962 coup and the role of the BSPP. The Revolutionary Council abolished independent political parties, newspapers, schools, hospitals, banks and other major economic institutions.

During the 1988 uprising, a nascent civil society, comprising an ephemeral press and a number of spontaneous local organisations, emerged, but was crushed by the SLORC takeover. Today, few groups in Burma are not under direct or indirect government control or supervision. Even so-called non-government organisations like the Myanmar Red Cross, are government administered. The Buddhist *sangha* (the monkhood) is under state guidance and registration. The Myanmar Women's Entrepreneurial Association operated independently for a time, but was later forced to place itself under the umbrella of USDA, the SLORC's alternative to civil society.[23] The exceptions are a handful of purely religious bodies, the private business sector, opposition political parties like the NLD, and the ethnic and narco-insurgent groups.

CHALLENGES AND PROSPECTS

The military has ruled Burma since 1962; even during the preceding short period of democratic government after independence, it was never far from power. On the basis of historical precedent, the military considers it has a right and a duty to take a central political role. It is determined to press ahead with a new constitution that formalises its protector's role in perpetuity. The military considers this will be in the best long term interests of the nation; it will brook no interference with the process.

The military must meet several important challenges, however, both to its short term plan to establish a new civilian order under its control, and to its long-term ascendancy in Burma. Unlike other new ASEAN governments, the SLORC faces widespread domestic disapproval, resentment and non-acceptance, both within the mainstream Burman majority population and from ethnic minorities. It also has to manage an economic development process without substantial outside assistance-indeed, in the context of international economic sanctions. (See Chapter 5 - *Burma: Economy*.) Furthermore, it must ensure that these manifold pressures do not endanger military unity and cohesion.

Civilian Opposition

The SLORC knows from the 1988 uprising, the 1990 elections and the pervasive activities of Military Intelligence that it lacks popular support and legitimacy. Public disapprobation extends to the armed forces as an institution. For too long, the military has been associated with economic failure and political repression: in particular, the large scale killing of civilians during the 1988 uprising and the

22 For a working definition of 'civil society' see Chapter 1 - *Vietnam: Politics.*

23 In this function, USDA resembles to some extent, the Vietnam Fatherland Front, which rallies a wide range of quasi non-governmental organisations in Vietnam behind the Communist Party's banner.

SLORC's repudiation of the 1990 election results are still fresh in the popular consciousness. The SLORC is trying to gain popular support for the military, or at least acceptance, in two ways: by installing a stable elected government under a new constitution and delivering economic prosperity.

The SLORC will continue to do what it considers necessary to maintain stability and steadily implement its plans. The military learnt from 1988 how easily matters can escalate and will attempt to pre-empt further outbreaks of dissidence or quickly quell them. The civilian population, although resentful, remains cowed by the army's use of force in 1988 and by its manifest preparedness to do so again. The populace also is increasingly convinced of the futility of opposing the SLORC.

The National League for Democracy

The NLD, personified by its General Secretary, Aung San Suu Kyi, is the main rallying point inside Burma for overt civilian opposition to military rule. Other political parties have grown quiescent under constant SLORC harassment. Somewhat protected by her connection to independence hero Aung San and her international status, Aung San Suu Kyi has voiced often blunt criticism of the military regime-a 'freedom' that no other Burmese is permitted.

The SLORC refuses to negotiate with Aung San Suu Kyi or to concede her party more than a minute role in the current polity, despite (or more likely because of) her widespread popular and international support and the NLD's sweeping election victory in 1990. Rather, the SLORC has seen Aung San Suu Kyi sidelined in the political processes currently in train and she can do little about it. The SLORC will continue to try to marginalise her and whittle down the NLD and its support base so that in elections under the new constitution, neither Aung San Suu Kyi nor her party will affect significantly the outcome.

However, it is difficult to see at this stage, how, short of banning Aung San Suu Kyi and the NLD, the SLORC will achieve this. Popular support for both the party and its leader probably peaked at the time of the 1990 elections but is still widespread, although it has undoubtedly diminished through the inability of either to extract significant political concessions from the SLORC. Aung San Suu Kyi appears no less determined than the SLORC to shape Burma's future. She will remain a popular figure while she provides a forward looking, democratic counterpoint to the stale authoritarianism of the military.

Real dialogue between the two sides is unlikely, as it would involve the SLORC according Aung San Suu Kyi the status of a serious player, something it is reluctant to do, particularly as her bottom line is an end to the military's reserved central status in Burmese politics. In the SLORC's eyes, Aung San Suu Kyi poses a serious threat to the military, a charge she regularly and strongly denies, and to its political vision for Burma. In particular, her strong support in the West only deepens the conviction that she is a tool of Western interests and lacks a proper appreciation of Burmese culture. The SLORC is also a prisoner of the vitriolic anti-Aung San Suu Kyi rhetoric it regularly disseminates through the official media: in the SLORC's eyes, dialogue and compromise would amount to capitulation.

The NLD's relations with the SLORC are made even more difficult as a number of former senior military officers are in the NLD's leadership. They and the SLORC generals were all subordinates of Ne Win, who, while not necessarily playing an active role in the SLORC-NLD contest, has left a conflicting legacy of loyalty and distrust. Two senior ex-military NLD leaders, Tin Oo and Kyi Maung, were imprisoned by Ne Win.[25] Against this background and a possibility that NLD leaders could still command loyalty and respect within the armed forces, the SLORC will not allow them a political role.[26] Aung San Suu Kyi's problems with the SLORC may go back even further to the existence of two rival factions within the Thirty Comrades, one led by her father and a smaller faction which included Ne Win. As former Prime Minister U Nu (1989) said, 'in Burma, all politics are personal politics'.

THE NATIONAL LEAGUE FOR DEMOCRACY

The NLD originated in the 1988 mass demonstrations when students and other opposition groups coalesced around a number of prominent personalities. Three of these-Aung San Suu Kyi, ex-general Tin Oo and ex-brigadier Aung Gyi-united to form the NLD on 27 September 1988. The original party leadership brought together ex-military followers of Tin Oo and Aung Gyi with a group of intellectuals-lawyers, writers and artists-under Aung San Suu Kyi.

Since then, the NLD and its leadership have undergone many changes, mainly as a result of unrelenting repression by the SLORC. Many party leaders, elected members of parliament and other members have been imprisoned, forced to resign, fled or died.[24] In 1990, the NLD claimed approximately 2 million members, but in early 1997, the party had shrunk to between 400 000 and 500 000 members.

The current leadership is drawn almost entirely from the ex-military and other followers of Tin Oo. (One ex-military follower of Aung Gyi-Kyi Maung-survives in the leadership. The rest quit with Aung Gyi to form a separate party in December 1988.) The group of intellectuals surrounding Aung San Suu Kyi has been thoroughly crushed by the SLORC. Aung San Suu Kyi herself is the only remaining member of her faction in the NLD leadership.

Ethnic Minorities - A Major Problem

Burma's ethnic minorities-the 135 national races-pose an even more complex and difficult problem for the SLORC. It is not a problem of the SLORC's own making but one inherited from the British at independence, although exacerbated until very

....

24 According to the National League for Democracy (1997), the SLORC has either detained, disqualified or forced to resign half of the party's 392 elected representatives.

25 Both Tin Oo and Kyi Maung also have served prison sentences under the SLORC. Tin Oo was placed under house arrest at the same time as Aung San Suu Kyi on 20 July 1989 and was later imprisoned, but he was released shortly before her, in early 1995. Kyi Maung was sentenced to 20 years imprisonment in 1990 but was released in early 1995.

26 The NLD performed well in some military cantonment areas in the 1990 elections, suggesting the party had supporters in the armed forces and among armed forces families.

recently by military intransigence. Unlike the mainstream civilian opposition represented by the NLD, the ethnic minorities not only complicate Burma's long term outlook but could upset the SLORC's constitutional plans.

Burma's ethnic minorities account for approximately one third of the current population of some 45 million. Since independence, almost every minority has at some stage taken up arms against the central government. Often, the army was deployed on several fronts at once. As late as 1989, more than 25 separate organisations were in armed revolt, of which ten controlled 'liberated areas'.

Since 1989, the SLORC has brokered separate ceasefire agreements with 15 to 18 insurgent groups; only three groups remain in the field against the army today. However, these are fragile cease-fires, interim accords which need to be converted into permanent peace settlements if 50 years of ethnic insurgencies are to end. The SLORC also has brought a few minority groups into its constitutional process, although most insurgent groups retain their arms and de facto autonomy in the geographical areas they control.

Ethnic minorities' support is the key to achieving a workable constitution and, in the long term, a viable Burmese state. Minority leaders want sufficient autonomy and control to preserve their cultural independence. The SLORC, on the other hand, is bent on strong central control and national unity, the preservation of which underlies at least the first two of its three main national causes.

Although the SLORC allows former insurgents autonomy now, it firmly opposes federalism. The new constitution envisages limited autonomy in a few geographical areas much smaller than those former insurgent groups currently control. The larger areas populated by ethnic minorities will have state legislatures, but the military will dominate these and in any case, they will exercise only minimal power. The national legislature will have an upper House of Nationalities, but ethnic Burmans and the army will dominate it too. Secession from the Union, a right theoretically accorded to two of the largest ethnic minorities in Burma's first constitution, will not be an option.

Until recently, Aung San Suu Kyi, also a Burman, and the Burman dominated NLD, showed strongly ethnic-centrist tendencies, and made little apparent effort either to develop the potential for alliance with the ethnic minorities or to address their concerns. In her 1996 Union Day (12 February) speech, Aung San Suu Kyi implied that ethnic concerns were secondary to the struggle for democracy. A year later, however, in her 1997 Union Day speech, Aung San Suu Kyi took pains to place the two agendas on an equal footing. This followed the declaration of support accorded Aung San Suu Kyi on 15 January 1997 by the National Democratic Front, a coalition of 15 ethnic insurgent groups including several that have negotiated ceasefires with the SLORC (Ethnic Nationalities Seminar Statement, 1997, cl. 6).

Whether these separate announcements of NLD-ethnic solidarity are largely tactical, aiming to extract important political and constitutional concessions from the SLORC, or substantial, remains to be seen. It is still an open question, therefore, whether any future government of Burma - military or civilian - will concede significant regional autonomy to the ethnic minorities.

Military Unity under Pressure

Anecdotal evidence suggests that eight years of military rule have generated tensions within the leadership and the armed forces. Indications persist of leadership factionalism based on personal rivalry (Lintner, 1997, p. 17) or policy differences. Military leaders' public behaviour and statements confirm the political outlook of some is relatively hard line while some others are more pragmatic.

Below the leadership, younger officers are believed to be increasingly frustrated by their slow advancement and lack of access to associated privileges. For Burma's young, intelligent elite, the military is no longer a popular career choice. New officer recruits are said to come increasingly from the families of existing officers. The average intellectual level is falling; corruption is rife; morale is weakening (Selth, 1997).

There remains, however, a strong imperative for self-preservation that binds the armed forces, and particularly its leadership together to safeguard their highly privileged position as Burma's central institution. A major split within the military leadership or the armed forces therefore seems unlikely.

A more serious challenge to the continued ascendancy of the military is the intellectual calibre of its current leadership. Promoted largely for loyalty rather than ability,[27] most generals have limited formal education and their outlook is parochial; most, moreover, fail to recognise the strict limits of their skills and abilities. The many who have a background in regional tactical command lack a sense of overall strategy and seem convinced that every problem, for example the challenge presented by Aung San Suu Kyi, has a tactical military, as opposed to a strategic political, solution. As a result, policies are often poorly conceived and executed and lack inputs from experts (Sundhaussen, 1995, p. 780). There is little evidence of coherent, coordinated, long term planning in either the political or the economic spheres. The generals seem to work from day to day: decisions are often knee jerk and short sighted.

OUTLOOK

The military is, for the time being, strong, united, determined and firmly in control of practically every facet of Burmese life. This is unlikely to change in the short to medium term. The SLORC also has consolidated Rangoon's hold over the territorial extent of Burma in a manner unprecedented since independence. The SLORC will press ahead with its new constitution and will not tolerate any opposition to its plans.

The civilian opposition has been decimated; the overwhelming but tacit popular support it can muster and the moral authority this provides mean little to the SLORC; they are no match for the military's armed strength. Against a determined and ruthless military regime, any attempt to convert popular support into a campaign of mass civil disobedience has little chance of success.

....

[27] This was a deliberate and avowed policy of Ne Win.

The SLORC is well aware of the capacity of students to catalyse mass popular unrest and is careful to quarantine student problems within campuses. Despite these precautions, inevitably, sporadic protests, probably sparked by student groups, will occur from time to time, but will be kept under tight control and the ringleaders punished with long prison terms.

So far, the SLORC has not shown any interest in genuinely addressing the aspirations of the ethnic minorities for autonomy and participation in central government; instead, it has done the minimum necessary to keep the powerful former insurgents happy. It has sought to substitute economic development for political autonomy in the economically backward ethnic minority areas-the same tactic, incidentally, that it is employing in relation to the Burman majority. (See Chapter 5 - *Burma: Economy*.)

However, the SLORC knows that the ethnic minorities are the key to its constitutional plans and are also central to its endeavours to re-establish the popular legitimacy of the armed forces. It will proceed slowly, therefore, in negotiating one by one with the minorities on the future shape of Burma, rather than pushing ahead quickly, with the attendant risk that the minorities will abandon the process. Besides, the SLORC is in no hurry; as the incumbent it has time on its side. It has already been in power for more than eight years without a constitution and would prefer lengthy negotiations with the former insurgents under a ceasefire than a resumption of fighting.

International pressure will have only limited success in speeding up the transition process. The SLORC will complete its constitutional process, call elections and ‘transfer’ power to an elected government only when the elements it requires are substantially in place: a constitution in the desired form; the ethnic minorities on board; and elections guaranteed to deliver continued government to the military, albeit with some limited civilian involvement. USDA can be expected to play an important part in the process, but it remains to be seen how the SLORC will prevent a re-run of the 1990 elections. There can be little doubt, however, that the lessons of that debacle have been learned well.

The SLORC hopes to establish an elected government under a new constitution and end Burma’s international isolation and prompt a resumption of bilateral and multilateral lending and aid. The new government will exercise administrative functions but real power will be with the military, who will provide a strong degree of policy continuity.

The military’s refusal to allow autonomous political and social institutions, however, duplicates one of the main causes of the BSPP collapse in 1988. The SLORC’s strategy bottles up dissent, maintains a situation of inherent instability and builds up longer term pressures. In these circumstances, a serious miscalculation by the SLORC could precipitate another crisis along the lines of 1988 and a return to large scale insurgency can never be ruled out.

Moreover, the ability of the military regime to deliver durable growth and long term prosperity is open to serious doubt. The SLORC generally overvalues the capabilities of the military and has little faith in civilians as a class. It is reluctant, therefore, to seek or accept expert economic advice. In contrast, Indonesia’s Soeharto regime recognised the limits of the military’s skills. Soeharto saw that the rehabilitation of the economy was basic to his legitimacy but, unlike the SLORC, he hired indigenous and foreign economists - prominent among them an American-trained corps dubbed 'the Berkeley Mafia' - to run the economy for him. The absence of a Burmese equivalent undermines the SLORC's efforts to replicate Soeharto's economic achievements and his success in establishing a relatively stable polity in Indonesia. The refusal of the major international financial institutions, notably the World Bank and the International Monetary Fund, to assist Burma's military regime until there is meaningful dialogue with Aung San Suu Kyi weakens further Burma's economic reforms and its growth prospects.

The military's longer term position is therefore far from assured. Military leaders may permit the gradual erosion of the military's central political role, as has occurred in Thailand and the Republic of Korea, and may be occurring in Indonesia. The military may have already begun to provide against the day when it relinquishes absolute political control: it has sought to quarantine its budget through a provision in the constitution and is developing a substantial, independent economic base through UMEH.

On the other hand, the handing out of a death sentence and life imprisonment to two former military leaders in the Republic of Korea in 1996 will have given the SLORC generals pause to consider how they might fare, individually, under a future civilian government.

None of this is to suggest that long-term military rule in Burma should be accepted as a fait accompli. On the contrary, important sections of the international community are implacably opposed to the regime's continued oppression of the Burmese people, and its frustration of the popular will. That opposition will continue to express itself through intense international scrutiny - and criticism - of the regime's human rights performance, and other bilateral and multilateral pressure to secure meaningful, positive change in Burma. Burma's development as a mature and prosperous nation will continue to be hampered while the bulk of the civilian population is effectively sidelined in the political and economic life of the country. Politically and in other important respects, Burma has made little progress since independence in 1948.

REFERENCES

Christie, A., 1996, 'Introduction to Doing Business in Myanmar', LWA Consultants Limited, Rangoon.

Ethnic Nationalities Seminar Statement, 1997, January, Maetharawhta, Karen State, Burma.

Lintner, B., 1997, 'Spot the Strongman: Signs of a Power Struggle within the Ruling Junta', *Far Eastern Economic Review*, 20 March.

____ 1996, 'Absolute Power: Burma's Army Controls Economy and Government', *Far Eastern Economic Review*, 18 January.

____ 1990, *Outrage: Burma's Struggle for Democracy*, White Lotus, Bangkok.

Maung, M., 1995, 'Facts versus Fiction: Socio-Political and Economic Development of Burma under Military Management since 1988', *The Pacific Review*, Vol. 8, No. 4.

National League for Democracy, 1997, personal communication with East Asia Analytical Unit.

Selth, A., 1997, personal communication with East Asia Analytical Unit.

____ 1996, *Transforming the Tatmadaw: the Burmese Armed Forces Since 1988*, Strategic and Defence Studies Centre, Research School of Pacific and Asian Studies, The Australian National University, Canberra.

Steinberg, J., 1995, 'Civil Society in Burma', *The FDL Quarterly*, Winter.

Sundhaussen, U. 1995, 'Indonesia's New Order: A Model for Myanmar?', *Asian Survey*, Vol. 35, No. 8.

Taylor, R., 1991, 'Myanmar 1990: New Era or Old', *Southeast Asian Affairs*, Institute of Southeast Asian Studies, Singapore.

U Nu, 1989, personal communication with East Asia Analytical Unit.

Chapter 5

ARRESTED ECONOMIC DEVELOPMENT

Burma has a population of 46 million and is the largest country on the South East Asian mainland, covering 679 000 square kilometres. It shares borders with five nations-China, Thailand, Laos, India and Bangladesh-and has over 2 800 kilometres of coastline. Its large area of arable land, its natural gas and mineral deposits, and its fisheries and forestry represent enormous resource potential. Such potential remains largely unexploited, however, because of a long period of rigid, centralised economic planning.

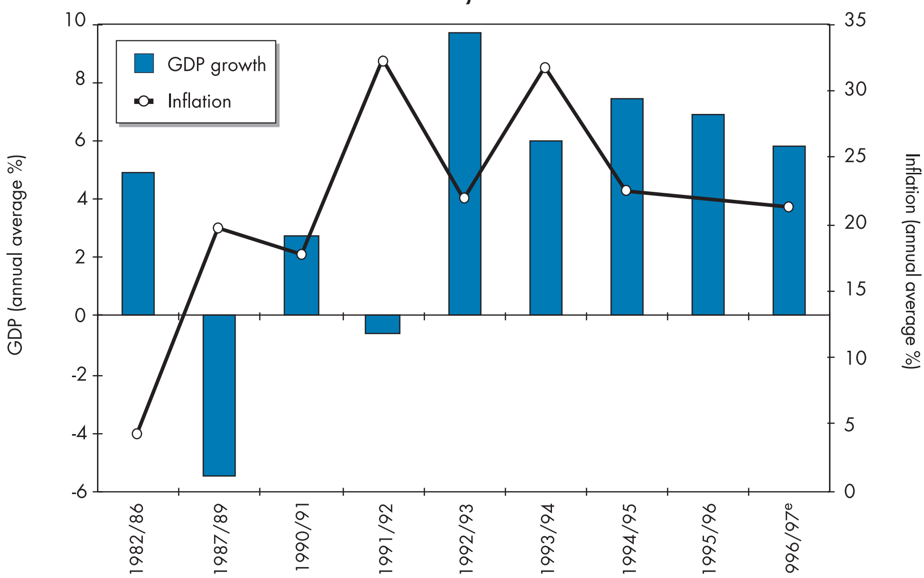
OVERVIEW OF ECONOMIC DEVELOPMENT

Official data suggest that the 'open-door' initiatives introduced since 1988 have enabled the economy to grow more robustly than previously, at an estimated average of 7 per cent per year over the period 1992 to 1996, in real terms (Figure 5.1).[1]

Figure 5.1

Growth Recovers, Post 1991

Real GDP Growth Rate, 1982-86 to 1996-97



Note: e. Estimated.

Source: World Bank, 1995a, p. 5.

....

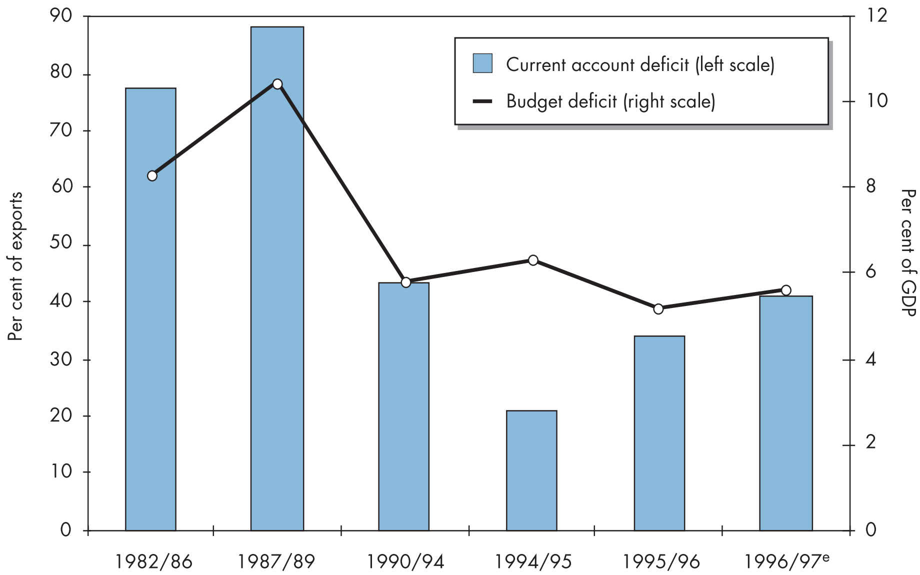
1 Burma's financial year runs from 1 April to 31 March. Unofficial estimates of Burmese economic data are as unreliable as official estimates; as a result, unless otherwise stated, all figures in this chapter are based on official estimates.

Officially, inflation has remained above 20 per cent since 1990, except for a sharp fall to 12.5 per cent in early 1996 (Figure 5.1) Although the budget and current account deficits have been reduced, they remain very high and are rising again (Figure 5.2). Financing the budget deficit essentially through printing money has contributed to Burma's high rate of inflation.

Figure 5.2

Deficits Lower but Still Too High, 1982-86 to 1996-97

Current Account and Budget Deficits



Note: e. Estimated.

Source: World Bank, 1995a.

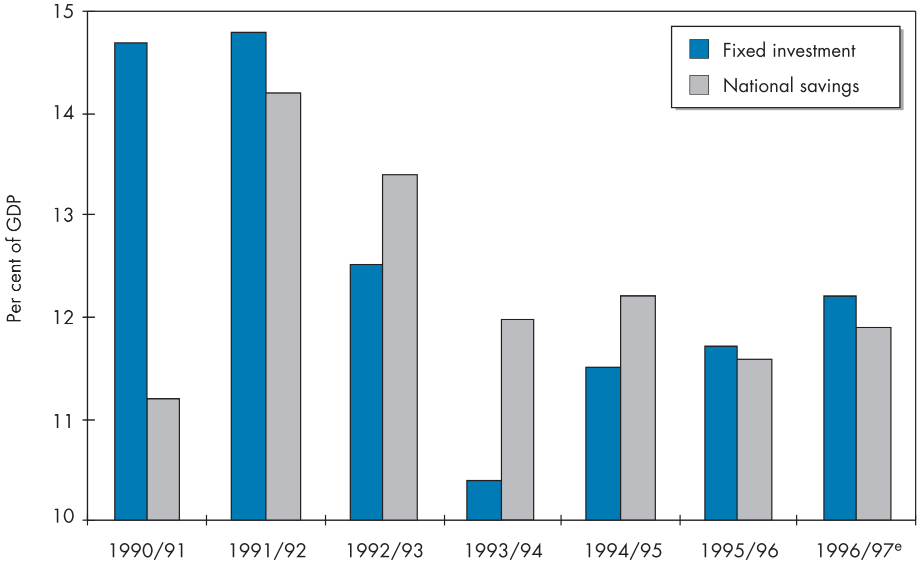
The gap between national savings and investment only narrowed in the 1990s because much needed investment has fallen even faster than savings since the early 1980s (World Bank, 1995a). Both investment and savings were only about 12 per cent of GDP in 1996-97 (Figure 5.3).

Burma's balance of payment's position is precarious with the trade deficit and arrears increasing, while foreign aid remains suspended (Figure 5.4).

Inward capital flows are insufficient to cover the remaining current account deficit. The Government has attempted to maintain its foreign exchange reserves by reneging on bilateral foreign debt repayments, causing arrears to rise to US$1.5 billion by the end of 1996. However, reserves still fell from three and a half months of imports at the end of 1995 to only three weeks in August 1996. The Economist Intelligence Unit (1996a) estimates total foreign debt is over US$5.5 billion, of which around 55 per cent is owed to Japan. Burma's weak trade position makes debt servicing difficult, despite most of the debt attracting little or no interest.

Figure 5.3

Savings and Investment Fall, 1990-91 to 1996-97



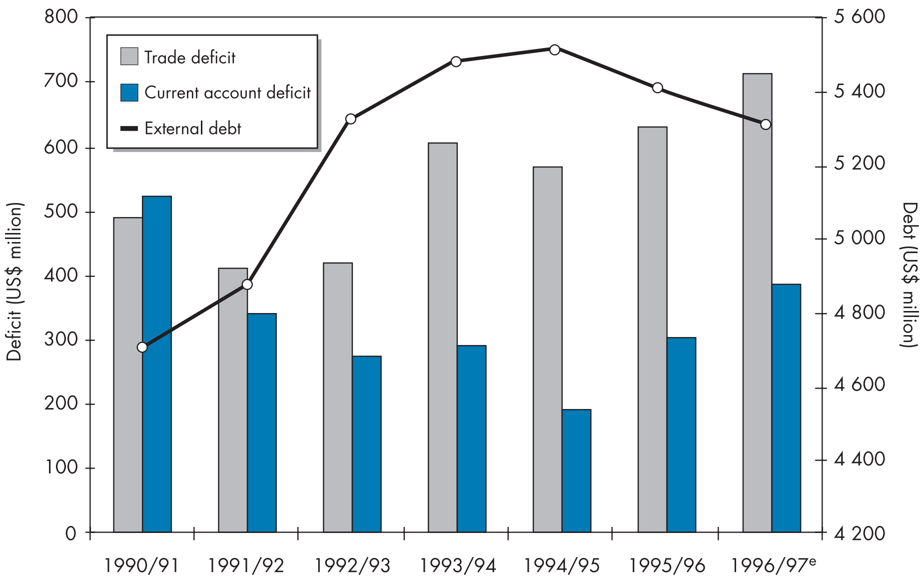
Note: e. Estimated.

Source: World Bank, 1995a.

Figure 5.4

Trade and Current Account Deficits Rising, Debt High

Deterioration of External Accounts, 1990-91 to 1996-97

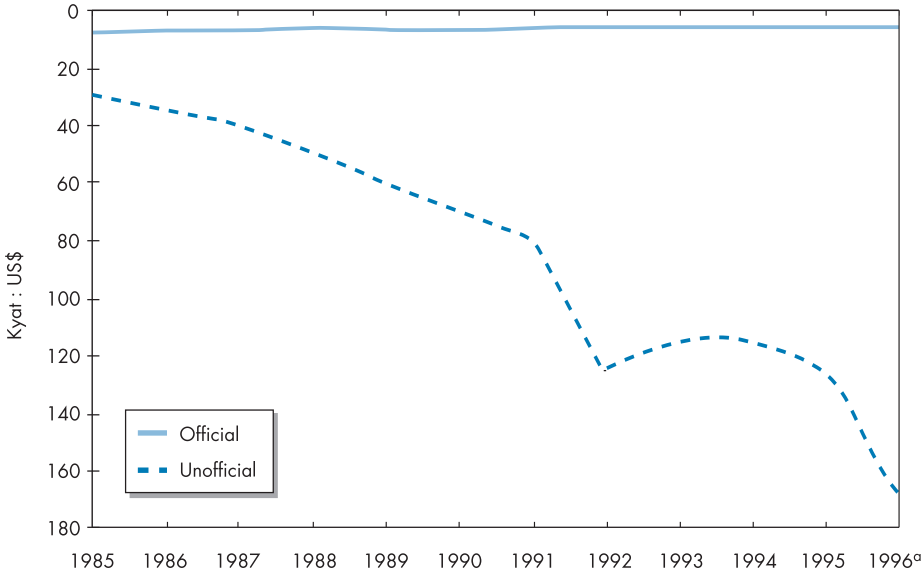


Source: World Bank, 1995a.

The official exchange rate highly overvalues Burma's currency, the kyat, pronounced *chat* (Figure 5.5).

Figure 5.5

Official and Unofficial Exchange Rates Diverge, 1985 to 1996



Note: a. As of October 1996.

RELIABILITY OF ECONOMIC DATA

Economic statistics for Burma are unreliable. Official statistics use the extraordinarily overvalued official exchange rate, which is almost 30 times the unofficial parallel exchange rates. Using the official exchange rate makes per capita GDP data appear unreasonably high (US$2 407) compared to observed living standards. On the other hand, using the parallel exchange rate makes per capita GDP rates appear excessively low (US$114). In addition, official statistics underestimate the rate of inflation, by between 10 and 15 per cent and ignore the large black market, which may be as large as the legal economy and includes unregulated border trade, drug-related commerce and informal economic activity.

Sectoral Performance

Agriculture accounts for 46 per cent of GDP (Figure 5.6), 64 per cent of the workforce, and 50 per cent of total exports. In the 1990s, liberalisation of agricultural prices and improved performance of the sector raised agriculture's share of GDP and underpinned stronger GDP growth.

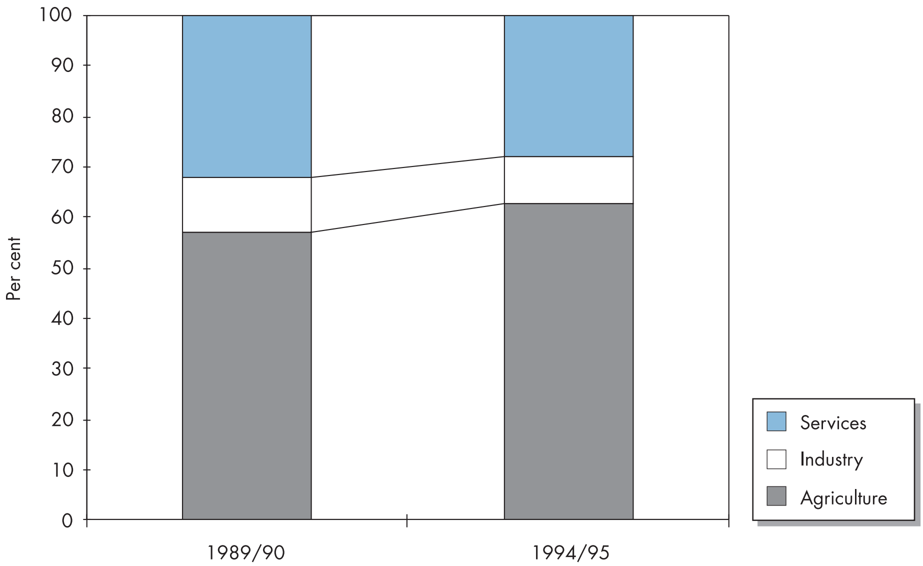
Industry accounted for only 15 per cent of estimated GDP in 1995, 8 per cent of the workforce, and 12 per cent of total exports. Burma's low level of industrial activity is virtually unchanged since the 1960s. Industrial output fell in the late 1980s but since 1989 it has grown strongly at just over 8 per cent per year. Large state-owned enterprises (SOEs) and small scale private manufacturing activities dominate the manufacturing and processing sector, which is based largely on agriculture.

The services sector contributes 39 per cent of GDP. Since 1990, the sector has grown more slowly than the economy overall.

Figure 5.6

Agriculture's Share of GDP Grows

Structural Change of GDP, 1989-90 to 1994-95



Source: World Bank, 1995a.

State and Private Sectors

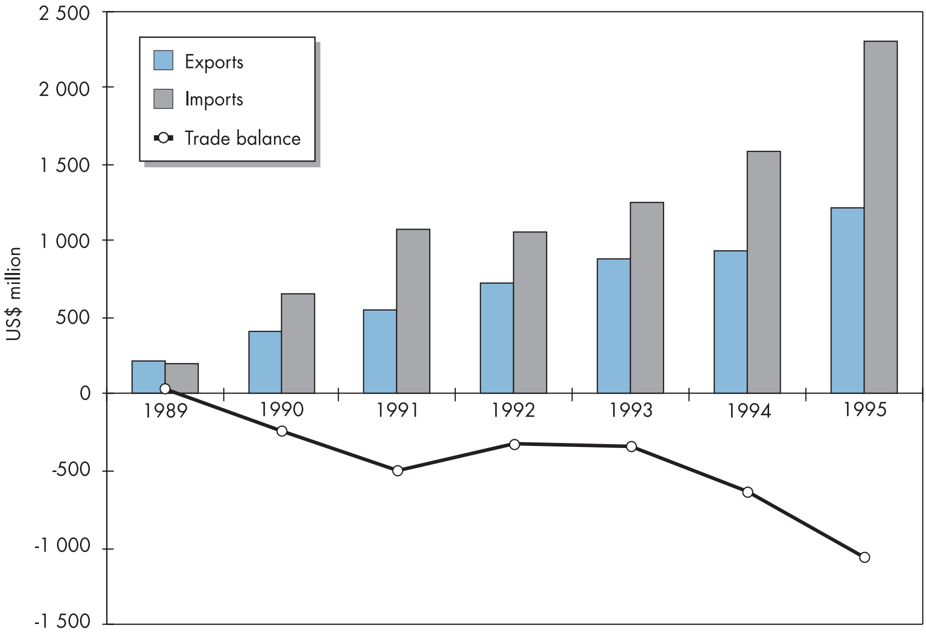
The Government estimates that the private sector accounts for just over three quarters of the economy, even excluding the sizeable black market. While SOEs accounted for only 24 per cent of GDP in 1995-96, they monopolised important resource sectors and dominated large scale manufacturing. Of the 42 607 factories and establishments operating in 1993-94, 94 per cent were privately owned, but of those employing 100 or more people, 91 per cent were state-owned (Economist Intelligence Unit, 1995). SOEs contribute 40 per cent of tax revenues, just over 50 per cent of exports and 40 per cent of imports.

Trade Performance

Exports and imports have rebounded since 1989, albeit from a very low base. Imports have grown faster than exports, increasing the trade deficit (Figure 5.7). Burma's export and import shares of GDP are estimated to be just 2.2 per cent and 1.2 per cent respectively. However, as border trade is grossly underestimated, the trade share of GDP could be double this.

Figure 5.7

Recovery in Exports and Imports, 1989 to 1995



Source: International Monetary Fund, 1996a.

Poverty and Aid

Burma's recent economic progress is only one indicator of Burma's economic potential. Despite its inadequate economic performance, Burma's crude human development indicators have improved in recent decades. Life expectancy increased from 44 to 58 years between 1960 and 1994; infant mortality fell from 158 per 1 000 live births in 1970 to 84 in 1992; and the proportion of literate people aged more than 15 years increased from 71 per cent in 1970 to 82 per cent in 1992. Primary school enrolments are also very high.

Although in 1987 the United Nations classified Burma as a least developed country, absolute poverty is uncommon because favourable agricultural conditions keep food prices low and unrecorded black market activity is extensive. Burma's per capita GDP measured in terms of purchasing power parity (PPP) has followed overall growth, falling in 1988 and 1989 before recovering to its mid 1980s level in 1992 (Figure 5.8).[2] However, at about $1 000 per capita in PPP terms, Burma's 1996 per capita income still is approximately one half of China's ($2 000 to $2 500) in comparable, international dollars.

....

[2] The purchasing power parity (PPP) method of measuring national incomes in internationally comparable terms uses converters to adjust money items to better reflect the ability of a unit of local currency to purchase goods and services in its country of issue. PPP income estimates measure actual production levels and living standards better than official exchange rate estimates because they adjust for the undervaluation-essentially because wages are low-of goods and services that are not traded internationally, like land and services.

Table 5.1

Social and Demographic Indicators, 1994[a]

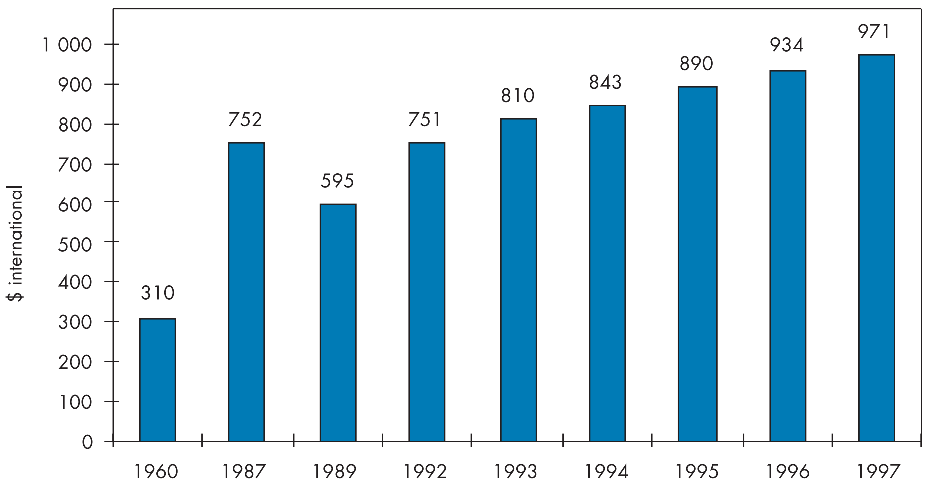
Social and demographic indicators	Burma	Same income group in Asia[b]
Population growth rate	1.9	2.2
Life expectancy at birth (years)	58	61
Access to safe water (per cent of population) (1993)	33	55
Urban population (per cent)	26	23
Population per physician (people)	3 170	6 160
Daily calorie supply (calories per person) (1990)	2 454	2 320
Primary school enrolment (per cent of school age population) (1992)	102[c]	98

Note: a. 1994 unless otherwise indicated. b. Nearest available year for the comparison countries comprising Bangladesh, Cambodia, China, India, Indonesia, Laos, Nepal, Pakistan, Sri Lanka and Vietnam. c. A result of more than 100 per cent here reflects primary school enrolment including people other than primary school age children.

Figure 5.8

Living Standards Recovering

Per Capita GDP in Terms of Purchasing Power Parity



Note: Measuring per capita GDP in purchasing power parity terms is preferred because Burmese official GDP data are unreliable.

Source: United Nations, 1995 and previous years; Department of Foreign Affairs and Trade estimates.

Most nations, including Australia, suspended their government-to-government aid programs to Burma in 1988. The Organisation of Petroleum Exporting Countries (OPEC), and the Republic of Korea provide modest loans for light rail and power generation projects and China makes, possibly considerable, loans for military acquisitions and infrastructure projects. Japan is resuming its aid program on a case-by-case basis, particularly to ethnic minority regions where ceasefires exist. Since 1990, Japan has provided about US$450 million in aid, mainly as debt forgiveness.

Burma is seeking a stand-by loan from the International Monetary Fund of around US$2 billion, which it claims is necessary to enable it to undertake exchange rate reform. So far multilateral assistance has been limited because of US opposition and the Burmese Government's lack of serious fiscal and monetary adjustment. The International Monetary Fund provides technical assistance through annual Article IV consultations. World Bank aid for pre-1988 projects will soon be completed and the Asian Development Bank is lending Burma US$100 million to develop transport links between Mekong subregion countries. (See Chapter 15 - *Mekong Subregion*.) The Food and Agricultural Organisation, World Health Organisation and the United Nations Development Program have modest programs in Burma.

PRE-REFORM ECONOMY

In the 1940s, Burma was a leading regional economy, a major grain exporter and 'rice bowl' of Asia. Immediately following World War II, Burma provided 28 per cent of the world's rice trade. However, economic mismanagement and increasing government interference[3] caused productivity to fall, agriculture to stagnate, and the national economy to decline.

After seizing power in 1962, Burma's military leaders pursued the 'Burmese Way to Socialism': economic management based, essentially, on self-sufficiency and state ownership. Businesses were nationalised and many Chinese and South Asian (mainly Indian) entrepreneurs, who had played a key role in the pre-1962 economy, left. Twenty three military-run state corporations dominated the economy. By the early 1970s, the State monopolised the economy, economic performance was extremely poor and living standards stagnated or declined.

In 1972, the Government introduced reforms to expand the agricultural sector and increase private sector activity. Although the reforms were only partially implemented, economic performance improved for a time, and agricultural and GDP output and exports rose. However, these initial improvements were not sustained due to continued central planning, the lack of fundamental economic reform and macroeconomic mismanagement. The official exchange rate became increasingly overvalued and the budget and current account deficits grew unsustainably.

In the early 1980s, the Government tried to rectify the situation by tightening import controls, cutting public investment and printing money to finance the budget deficit. The first two measures slowed growth; the third caused inflation to escalate rapidly. In 1985 and again in 1987, the Government de-monetised the currency,[4] causing a loss of confidence in the economy and the kyat, and reducing the incentive to save. Rather than checking the economy's downward spiral, these measures hastened its demise. By the late 1980s, the economy was in crisis (Figure 5.9).[5]

3 By the early 1950s, the State Agricultural Marketing Board handled 80 per cent of rice exports and 98 per cent of internal trade.

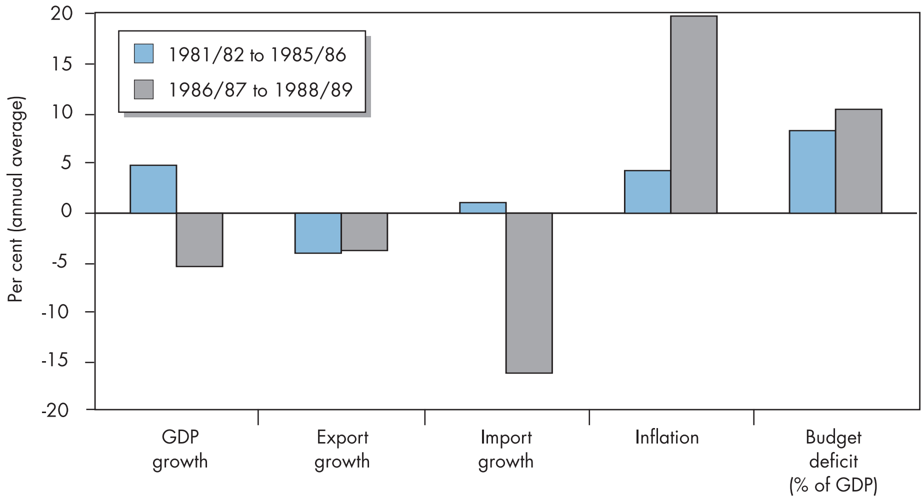
4 In both cases, more than half the currency in circulation was declared worthless.

5 In late 1987, the United Nations reclassified Burma as a 'least developed country'; this allowed Burma access to debt relief.

Figure 5.9

Economy Deteriorated Sharply in 1980s

Key Economic Indicators, 1981-82 to 1985-86 and 1986-87 to 1988-89



Source: World Bank, 1995a.

In July 1988, the Government proposed introducing economic reforms to stimulate the stagnant economy but was overtaken by mass demonstrations that paralysed the civilian government, prompting the military in September to take back direct political control as the State Law and Order Restoration Council (SLORC). (See Chapter 4 - *Burma: Politics*.) Building on the July reforms, the new military regime abandoned socialism and initiated the open door program of economic reforms. It took over an economy that, except for a few short bursts of growth, had stagnated or declined for a quarter of a century.

ECONOMIC REFORMS AND THEIR IMPACT

Burma is still a severely indebted, low income nation whose main exports are non-fuel primary products (World Bank, 1995b). The economy now is in the early stages of transition. This and the partial nature of reforms inhibit stronger economic growth and contribute to rent seeking behaviour (including the illegal appropriation of underpriced resources) and corruption.

The Government's original four-year target for 1992-93 to 1995-96 of annual GDP growth of 5.1 per cent was exceeded, with the economy growing at an average rate of 7 per cent. Despite the improved economic activity and the strong recovery, by 1992 per capita GDP and agricultural output only had recovered to mid 1980 levels. Moreover, in 1996, the economy was showing signs of strain and the immediate outlook is for GDP growth to fall to around 5 per cent in the next few years. In May 1997, the Government estimated GDP growth in 1996-97 had slowed to a five-year low of 5.8 per cent.

THE MACROECONOMY

The Government has attempted to stabilise the macroeconomy by reducing the budget deficit which is one of the main causes of inflation, the growing trade and current account deficits and accumulating foreign debt.

Although the Government has raised the interest rate ceiling, interest rates remain heavily negative in real terms. While the Government issued a small volume of treasury bonds to finance 5 per cent of the budget deficit (in 1996-97), the latter still is largely financed by printing money, stimulating inflation. Ad hoc measures introduced to tackle macroeconomic problems include the temporary ban on essential food exports to prevent shortages and price rises, and the misguided attempt, in 1996, to curtail the use of foreign exchange by delaying import approvals. The latter threatened production in industries dependent on imported inputs, increasing inflationary pressures.

Unbalanced Budget

In 1996, the macroeconomic situation deteriorated: foreign exchange reserves fell sharply leading to a reduction in imports; the unofficial exchange rate fell by 40 per cent in six months; inflation increased and export growth weakened. The increase in the budget deficit contributed to this deterioration (Table 5.2).

Two factors are responsible for the rise in the budget deficit:

- the Government's revenue base is too narrow and shrinking: the average ratio of government revenues to GDP fell from 18 per cent between 1960 and 1986 to 6 per cent in 1996-97 (Table 5.2). The World Bank (1995a) believes overvaluation of the kyat contributed to the fall in revenue as it forces economic activity into the black market
- the Government's heavy military expenditure is undermining its efforts to reduce the budget deficit.[6] Budget expenditure in almost all categories except military expenditure has declined as a percentage of GDP, due to the reduction of social sector expenditures, the Government's withdrawal from commercial activities and public service salary restraint. The 1996-97 budget allocated more funding to capital spending, targeting mainly agriculture, health and education. This increased the deficit (Economist Intelligence Unit, 1996b). Some analysts believe that the Government is unwilling to increase taxes because of its fundamental unpopularity and fear of civilian unrest.

....

6 Military expenditure is forecast to fall from 3.2 per cent of GDP in 1995-96 to 2.9 per cent in 1996-97, but this will be difficult to achieve given that the Government also plans to increase the size of the military and upgrade its hardware.

Table 5.2

Revenue Low and Falling

The Budget, 1992-93 to 1996-97
(Per Cent of GDP)

	1992-93	1993-94	1994-95	1995-96	1996-97
Total revenue	7.9	7.4	6.8	6.4	6.0
Total expenditure	12.9	11.9	13.1	11.6	11.6
Overall balance	-5.0	-4.4	-6.3	-5.2	-5.6
Domestic loan financing	4.9	4.4	5.8	4.7	5.3

Lax Monetary Policy

Accelerating growth of money supply also exacerbates the macroeconomic situation. Because the Central Bank lacks autonomy, it finances the public sector deficit by purchasing treasury bills at only 4 per cent interest. (See section, 'Failure to reform state-owned enterprises'.) Overall credit creation also increased sharply due the licensing of many new banks which improved the private sector's access to credit.

Priorities

Macroeconomic stabilisation, a precondition for sustained growth, has not been achieved. The Government has made tentative steps in the right direction but large unsustainable budget deficits, lax monetary control and failure to undertake comprehensive exchange rate reform remain serious problems. Lack of transparency and uncoordinated macroeconomic decision making contribute to instability.

Reducing the budget deficit remains the most pressing task facing the Burmese Government and failure to do so risks economic crisis.[7] The target level for the public sector deficit is too high to contain inflation, which was unofficially estimated to be between 35 and 40 per cent in the latter half of 1996, compared with the official estimate of around 20 per cent (Figure 5.1).

The recent experience of other transition economies in the region indicates that an economic reform program based on a flexible foreign exchange regime, positive real interest rates, and tight fiscal and monetary policies, together with structural reform measures, can be highly effective in achieving stability and sustaining growth.

Lack of exchange rate reform threatens economic stability, encourages corruption and undermines the quality of government:

> Most often, dual currency rates were closely related to repressive regimes, who used the fixed exchange rate to enrich themselves and buy favours they could not otherwise afford with the state employees they depended on for their survival.(*Asia Money*, 1995, p. 5).

....

7 Perhaps as a harbinger of a possible crisis, in September 1996, Burma's foreign exchange reserves fell so low that it was unable to pay Mitsui & Co. US$30 million for fuel already delivered.

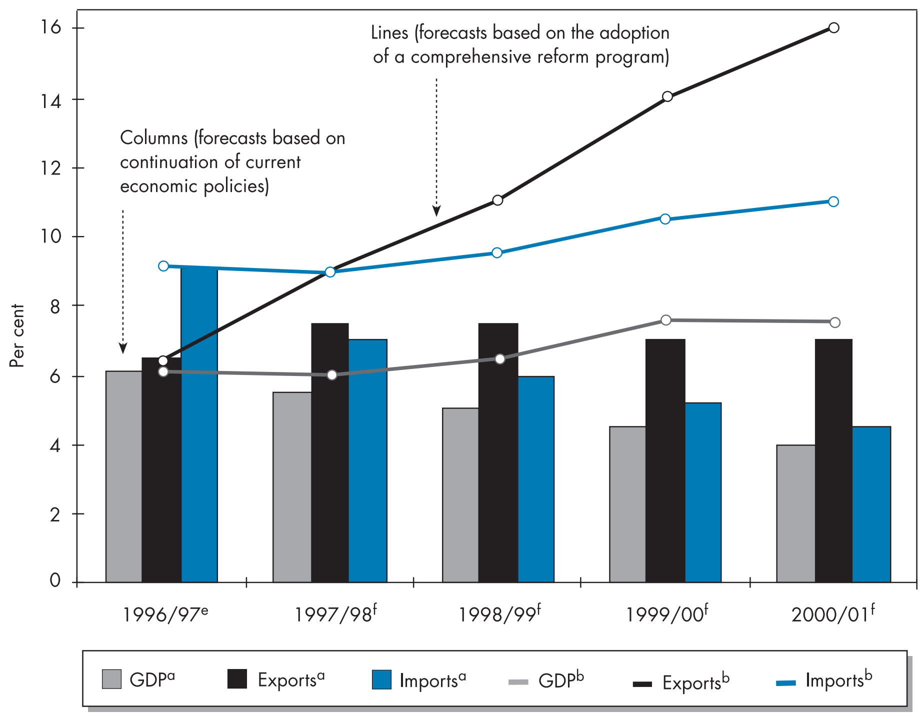
Burma probably will have to restructure its economy and unify its exchange rate with little international assistance. The shortfall in assistance is only partially offset by the strong growth in foreign investment and private remittances. The Burmese Government maintains that support from the International Monetary Fund and the World Bank is essential if economic growth is to be propelled by more than deficit spending, resource extraction and hotel construction (*Financial Times*, 24 May 1996, p. 7). However, the Government has little to gain from waiting for international assistance and much to lose if comprehensive economic reform is further delayed.[8]

GDP, exports and imports would grow much more strongly by 2001 if comprehensive economic reforms were adopted (Figure 5.10). Benefits also would accrue in terms of foreign direct investment and official reserves (Figure 5.11).

Figure 5.10

Exports Would Rise Strongly with Reform

Alternative Scenarios for GDP, Export and Import Growth, 1996-97 to 2000-01



Note: e. Estimate; f. Forecast; a. Scenario based on a continuation of current economic policies; b. Scenario based on the adoption of a comprehensive program of economic reform.

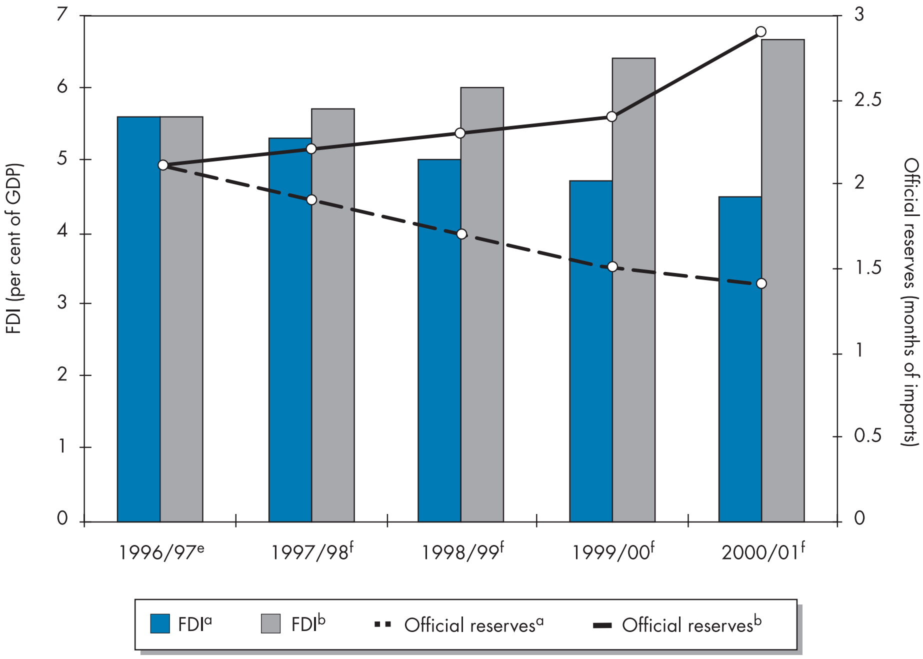
....

8 Unless appropriate economic policies are put in place, the anticipated oil and gas revenues could simply cause exchange rate appreciation, increased consumption and a disincentive to invest and export in other sectors. Moreover, the recent strategy of raising expensive foreign loans by mortgaging future oil and gas proceeds is risky.

Figure 5.11

FDI and Official Reserves Would Accelerate with Reform

Alternative Scenarios for FDI and Official Reserves, 1996-97 to 2000-01



Note: e. Estimate; f. Forecast; a. Scenario based on a continuation of current economic policies; b. Scenario based on the adoption of a comprehensive program of economic reform.

PARTIAL EXCHANGE RATE REFORM

While the Government has failed to introduce comprehensive exchange rate reform, it has effectively allowed a de facto legalisation of the unofficial exchange rate. Analysts estimate that about 75 per cent of the economy operates at the unofficial exchange rate, including virtually all the private sector. However, one third of external transactions, all related to the public sector and the military, are valued at the official rate, providing a significant subsidy to public sector importers. As only public sector exporters receive the depressed official exchange rate for their exports, presumably this subsidy could be replaced by fiscal transfers between different public sector activities.

The Government has introduced foreign exchange certificates (FECs) pegged to the US dollar. More than 20 exchange dealers in Rangoon and regional centres are licensed to exchange kyat or US dollars for these certificates at the unofficial exchange rate, and US dollars to kyats at the unofficial exchange rate, but not kyats to US dollars. Market trading of FECs was legalised in December 1995, allowing the parallel exchange market to work more smoothly. Foreign exchange account operations also have been liberalised and foreign investors without a local source of kyat can pay local expenses in kyat legally converted at the market exchange rate.

Although in theory, importers must show that funds used to import goods derive from foreign capital inflows or export earnings, in practice kyat profits, legally changed into foreign exchange certificates, can be used to pay for imports. However, repatriation of kyat profits from local foreign currency accounts is restricted, especially when foreign investors do not operate under the Foreign Investment Law. The tax implications of the two exchange rates, by creating artificial 'book' profits, also forces importers to export commodities if they wish to repatriate profits (LWA Consultants, 1996). [9]

In June 1996, the Government changed the exchange rate used to value imports, for the purpose of levying tariffs and sales taxes from kyat 6:US$1 to kyat 100:US$1. Simultaneously, it lowered customs and commercial tax rates. In effect, Burma now has three exchange rates.

Partial De Facto Devaluation Is Insufficient

Burma's exchange rate has therefore undergone a partial, de facto devaluation which is useful for traders and foreign investors. However, maintaining a grossly overvalued currency and a multiple exchange system has many negative consequences:

- reducing the earnings of exporters still receiving the official exchange rate, reducing their incentives to expand export production
- encouraging imports by those who can purchase foreign exchange at the official exchange rate, necessitating administrative allocations of foreign exchange to SOEs to curb their excess demand for imports
- undermining reform of SOEs and inflating their true net output value
- discouraging investment in the non-export sector because of the difficulty of repatriating profits from this sector
- undermining fiscal reform and obscuring the nature and level of subsidies
- encouraging the use of foreign currencies because of the lack of a credible domestic currency
- encouraging corruption and rent seeking behaviour.

Likely Timing and Impact of Comprehensive Exchange Rate Reform

Due to the impact of partial *de-facto* devaluation, comprehensive exchange rate reform would only raise overall consumer prices about 10 to 15 per cent, although public sector prices would rise more.[10]

Exchange rate reform would also increase budget outlays by about 6 per cent of GDP. Public sector workers would need to be compensated for the substantial reduction in

9 A number of specialised local firms now purchase goods for export (often pulses and seafood) on behalf of firms or individuals wishing to repatriate profits or other earnings, and credit them with the income earned in their overseas account. They typically charge a fee of 5 per cent.

10 Calculations based on 1995-96 financial data on 29 SOEs and 1994-95 data on 39 SOEs suggest that realigning the official exchange rate would cause official prices to rise by 50 per cent. This would vary with individual enterprises. The petroleum sector and heavy industry would need to increase their output prices three or four fold.

their income due to reduced access to commodities at official prices based in part on the overvalued exchange rate. To meet the anticipated revenue shortfall, the Government could increase taxes on SOEs currently exporting at the official exchange rate that would receive windfall gains from devaluation.

The Government claims the private sector is not large enough and foreign exchange reserves not strong enough to support comprehensive exchange rate reform before mid 1998. By then, the Government expects to have built a reserve cushion from oil and gas revenues of US$300 million to $400 million a year.[11] However, in the meantime macroeconomic deterioration may become more rapid, especially severe foreign exchange shortages, sharply rising inflation and rising budget deficits.

FINANCIAL SECTOR STRUCTURE AND REFORMS

Four public sector banks dominate the banking sector and hold around 90 per cent of kyat deposits and almost all foreign exchange deposits. Myanmar Economic Bank, responsible for almost all public sector domestic transactions, holds about 75 per cent of private sector bank deposits. However, the bank is believed to be making considerable losses, due in part to its quasi-fiscal functions and probably has a negative net worth.

Under the 1990 Financial Institutions Law, the Government liberalised banking services and relaxed some regulations, allowing private local banks and representative offices of foreign banks, and inviting joint ventures between the two. Five joint ventures have been approved: Mayflower Bank-Siam City Bank; Maybank-Tun Foundation Bank; Thai Farmers Bank-Asia Wealth Bank; Yoma Bank-Fuji Bank and Myanmar Livestock and Fisheries Development Bank and Global Commercial Bank.

By May 1997, there were 21 domestic private banks, 11 of them were semi-government or state-private joint venture banks or had some government or military involvement. In addition, 44 foreign banks, mostly from South East Asia, have been granted licences to open representative offices. All but two banks are located in Rangoon. Only seven private banks can deal in foreign exchange. Foreign banks cannot offer banking services but provide their clients with financial services from overseas branches.

In June 1996, the new stock exchange, the Myanmar Securities Exchange Centre Co. Ltd, opened in Rangoon. A 50-50 joint venture between the state-owned Myanmar Economic Bank and Japan's Daiwa Securities Co. Ltd, it has an initial investment of US$6.7 million. It will conduct its own securities business, provide an investment advisory service and act as a stock exchange. However, many analysts are concerned that Burma may not be ready for a stock market; among other reasons, accounting standards are inadequate.

Myanmar Insurance Corporation dominates the insurance sector. Under the 1996 Insurance Business Law, foreign insurance companies can open representative offices and arrange insurance policies from their overseas branches.

....

11 However, Burma may not accrue a positive revenue flow from gas until 2000, as much of its foreign exchange earnings from gas exports during the first three years of production will form its equity contribution to the joint venture with US, French and Thai partners.

Banking Sector Growth Stunted

Despite the reforms, banking sector growth remains stunted, saving is discouraged by negative real interest rates,[12] and private borrowers face tight credit and harsh lending conditions. Total bank saving deposits rose gradually from 7.5 per cent of GDP in 1991-92 to 9 per cent in 1995-96.[13] While reforms have increased the private sector's share of total domestic credit, from less than 2 per cent in 1990-91 to 27 per cent by September 1996, this is still far below the private sector's share of GDP of around 75 per cent. Liberalising financial services has not increased the range of services private banks provide because they can only offer short term lending.

The net effect of financial sector reforms is that many legitimate banks do illegal business (particularly money laundering) while illegal money lenders do the bulk of legitimate money lending. Negative real interest rates and credit restrictions make legal banking unprofitable. As a consequence, most private banks have found creative ways to conduct business, including using growth in bank equity values to provide depositors with a return and providing hire purchase and illegal services such as conduits for illegal foreign equity inflows.

REFORMING THE TRADE REGIME

Most reforms to the trade sector were introduced between 1988 and 1995 in response to a sharp decline in exports and imports during the 1980s and the need to generate foreign exchange (Myat and Mya, 1995). Compared with the ASEAN average, Burma's tariffs are reasonably low.

In 1988, the Government allowed private traders to engage in external trade for the first time. In addition, private companies now can retain 100 per cent of their export earnings. Export taxes were removed; although low, they had compounded the exchange rate's bias against exports. Except for rice, teak, petroleum, natural gas and most minerals, most quantitative restrictions on private sector exports also were removed.

As Burma's external payments position weakened in the 1990s, imports were restricted. Now exporters must export more than they import, unless they are engaged in barter, and must dedicate 25 per cent of their export earnings to purchasing imports deemed to be of high priority to the economy.[14] This and import licensing restrictions seriously impede the free flow of goods. For example, private

....

[12] In October 1996, the interest on savings bank account deposits was a minimum of 12 per cent and for loans the rate was a maximum of 21 per cent. As the official and unofficial rates of inflation were much higher, an estimated 21 per cent and about 38 per cent respectively, most interest rates on deposits and loans were negative. However, savings are higher than the negative interest rates would suggest. Many believe this is because banks provide many 'laundering' services for illegal drug and black market activities.

[13] This compares with the increase in China's ratio of household bank deposits to GDP of 42 per cent in 1991 to 57 per cent in 1996 (East Asia Analytical Unit, 1997, p. 106).

[14] In mid May 1997, Commerce Minister Lieutenant-General Tun Kyi told Burmese importers 100 per cent of goods imported on credit and 50 per cent imported on letters of credit needed to be of high priority to the economy.

firms can import only if they can generate their own foreign exchange earnings: they have no access to the foreign exchange available to the Government.

To develop and strengthen bilateral trade relations with its five neighbours, the Burmese Government has formalised and expanded border trade using the unofficial exchange rate.

TRADE PERFORMANCE

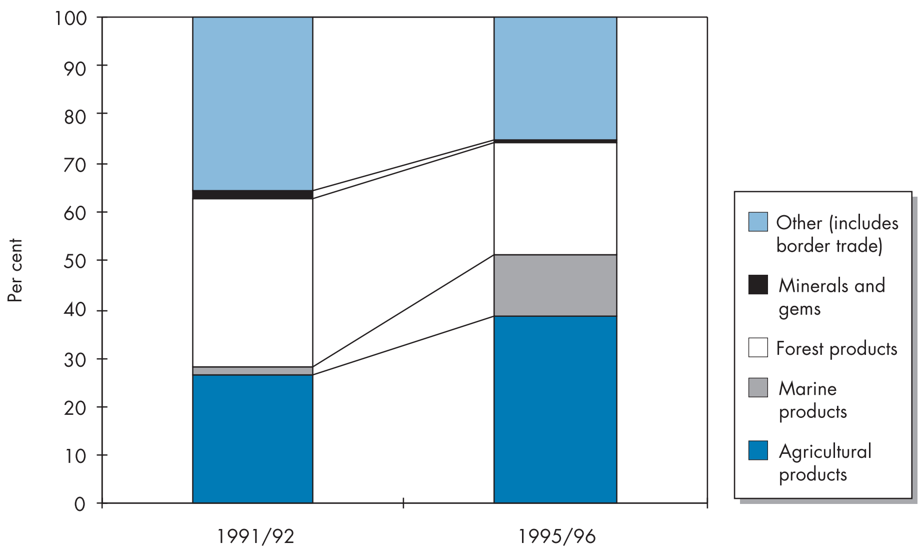
Burma's trade statistics are unreliable and difficult to interpret given exchange rate distortions. The Government also understates private exports to offset the exclusion of military imports from the balance of payments data. Nevertheless, Burma appears to have enjoyed strong trade growth since 1990 (Figure 5.4).[15]

The composition and destination of trade have changed considerably since 1990. Agricultural products have increased their share of exports from 27 per cent in 1991-92 to 38 per cent in 1995-96, in response to agricultural reforms (Figure 5.12). This pattern is not observed elsewhere in South East Asia, where agricultural exports are typically a falling share, but it is a consequence of the previous suppression of agricultural output and exports under central planning controls.

Figure 5.12

Agricultural Export Share Growing

Changing Composition of Exports, 1991-92 and 1995-96



Source: Government of Myanmar, 1996.

....

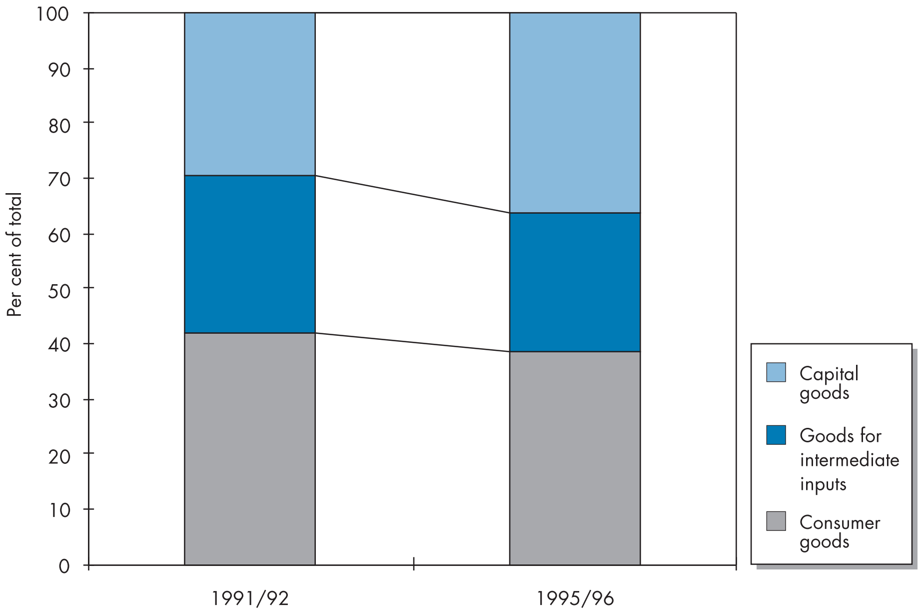
15 However, figures for the first half of 1996 suggest both imports and exports stagnated in 1996, although this will not be clear until partner country figures for the full year are available.

Government directives on the use of foreign exchange have led to legal imports being dominated by capital equipment and raw materials (Figure 5.13). However, the huge illegal border trade is largely in consumer goods.

Figure 5.13

Capital Goods Dominate Imports

Changing Composition of Imports: 1991-92 and 1995-96



Note: 'Other' includes recorded border trade. The value of military imports, believed to be substantial, is not publicly available.

Source: Government of Myanmar, 1996.

In 1995, 82 per cent of exports were to Asia, with just over 25 per cent of all Burma's exports going to ASEAN members (Figure 5.14).[16] Singapore, India and China accounted for 16, 12 and 11 per cent of exports respectively.

The most noteworthy trend in the source of imports is the declining importance of Japan and the increasing importance of ASEAN and China, which together accounted for around 75 per cent of Burma's imports in 1995 (Figure 5.15).

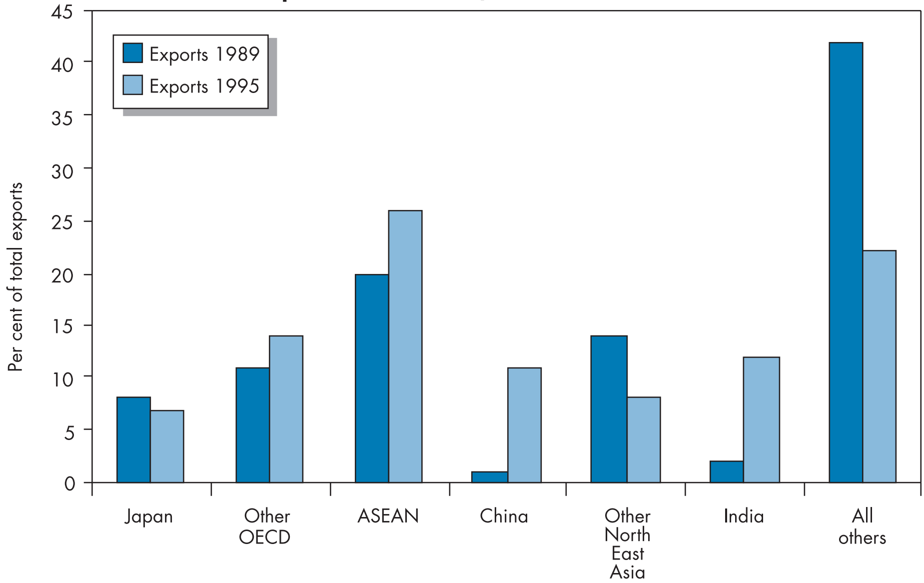
....

16 Trade figures are based on partner country estimates and refer to calendar years.

Figure 5.14

ASEAN Takes Growing Share of Exports

Export Destinations, 1989 and 1995

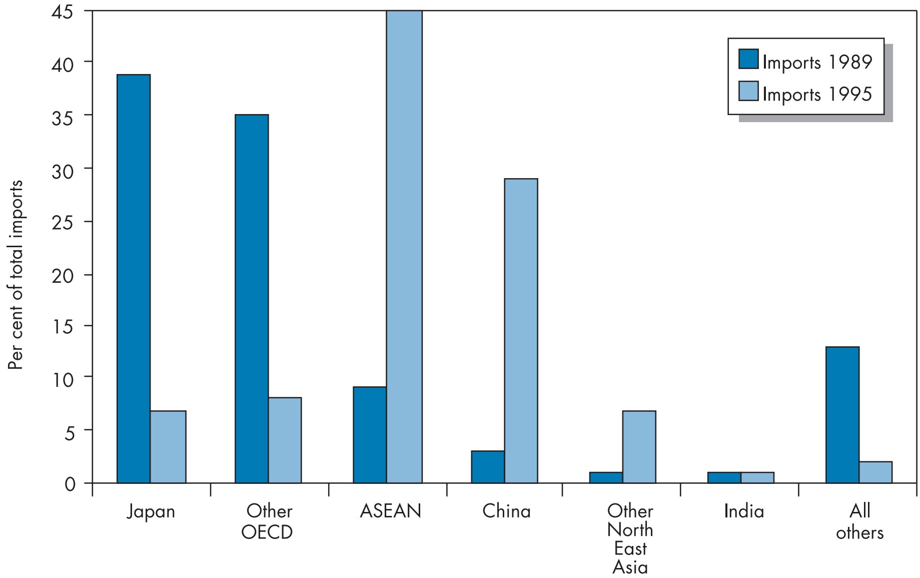


Note: Other North East Asia means Hong Kong, Republic of Korea and Taiwan. Other OECD includes Australia, whose imports from Burma in 1995 accounted for less than 0.5 per cent share of Burma's total exports.

Source: International Monetary Fund, 1996a.

Figure 5.15

Sources of Imports, 1989 and 1995



Note: Other North East Asia means Hong Kong, Republic of Korea and Taiwan. Other OECD includes Australia, whose exports to Burma in 1995 accounted for less than 0.3 per cent of Burma's total imports.

Source: International Monetary Fund, 1996a.

Burma's economy is poorly integrated into regional and global economies, though fundamental economic reforms and ASEAN membership should improve its integration. The World Bank (1995a) estimates Burma's ratio of trade to GDP is only 10 per cent of that for any ASEAN member, including Vietnam.[17]

Burma's export competitiveness continues to be undermined by the overvalued official exchange rate, complex foreign exchange and trade controls, high inflation, and the poor quality of infrastructure, particularly in areas such as cargo handling and transport. Foreign exchange and trade controls disproportionately hamper the private sector and threaten the Government's objective of emulating the East Asian export-led model of economic development.

Border Trade

Border trade, particularly in the areas adjoining China and Thailand, is growing strongly. It is, however, grossly understated by Burmese official figures. Border trade in 1994-95 was officially valued at US$232 million (U Aung Kyi, 1996) but it was probably 15 times that amount in 1995 (Table 5.3).

Table 5.3

Border Trade 1995

(US$ million)

Estimates	China	India	Thailand	Total border trade[a]	Total trade with neighbours	Total (all countries)
IMF estimates of total trade[b]	816	169	100		1 091	3 507
Unofficial estimates of border trade	1 000	150-200	2 250	3 450[c]		

Note: a. Does not include Laos; b. Derived from partner country figures; c. China, India and Thailand only.

Sources: International Monetary Fund, 1996a, Mya Maung, 1996; Vatikiotis, 1995; Economist Intelligence Unit, 1996a, p. 16.

Burma's official trade with its neighbours at US$1 091 million in 1995 was worth a little over 30 per cent of Burma's total trade. Yet, unofficial estimates valued border trade at three times that, making it roughly equivalent to the value of total official trade (Mya Maung, 1996; Vatikiotis, 1995; Economist Intelligence Unit, 1996a).

Links with China

Liberalised border trade since 1992 has led to China's Yunnan province[18] having an increasingly important impact on the economy of northern Burma. The Chinese

....

17 However, as export, import and GDP figures use official Burmese data and are based on the official exchange rate, this ratio is certainly a significant understatement.

18 China's Yunnan province, with a population of 38 million, has a reasonably extensive industrial base, complementing Burma's natural resource base.

yuan is the currency of choice[19] and Yunnanese operations dominate the Mandalay Commodity Exchange. The exchange, the largest in Burma, has doubled its turnover since 1988 and handles roughly 70 per cent of total border trade in non-rice produce.

Local businesses in northern Burma find it difficult to compete with Chinese networks and business practices. Yunnanese entrepreneurs tend to be wealthier and have better access to funds, allowing them to have better warehousing facilities than their Burmese counterparts. Burmese entrepreneurs also claim Yunnanese 'donations' to the Government and private bribes result in favourable treatment from the authorities.

CHINESE IN MANDALAY

In Mandalay, the principal city in northern Burma, the mostly Yunnanese Chinese community is estimated to make up 20 per cent of the population of almost 1 million people. Chinese entrepreneurs dominate Mandalay's central business district, raising concerns among some local Burmese about their role and the extent of Chinese immigration, much of it illegal.

Private banks meet the borrowing needs of the Yunnanese business community. While most Yunnanese businesses and narcotic traffickers probably are not linked, the Yunnanese community benefits indirectly from the narcotics trade and the Burmese Government's political largesse to narco-insurgent ceasefire groups. On the other side of the border, increased economic interchange is creating tensions in China, with drug-related problems escalating in Yunnan province.

While the mainstay of Yunnanese involvement in Burma is high risk, high return border trade, there are also some Yunnanese manufacturing and real estate investments in Mandalay and increasingly, in Rangoon.

Mandalay's location as a natural hub for northern Burma should ensure its continuing economic importance over the medium to longer term. However, the growth in international trade through Rangoon, its nascent financial sector, the centralising tendency of the Government,[20] Rangoon's new industrial parks and improved road links between Mandalay and Rangoon are likely to reinforce Rangoon's ascendancy in the national economy.

LIBERALISING FOREIGN INVESTMENT

To overcome a severe shortage of capital through the economy and particularly for infrastructure, the Government passed the 1988 Foreign Investment Law. (See Chapter 4 - *Burma: Politics*.)

....

19 A similar 'baht zone' is in Shan state.

20 For example, all export and import permits must be approved personally by the Commerce Minister.

Strong Foreign Investment Growth

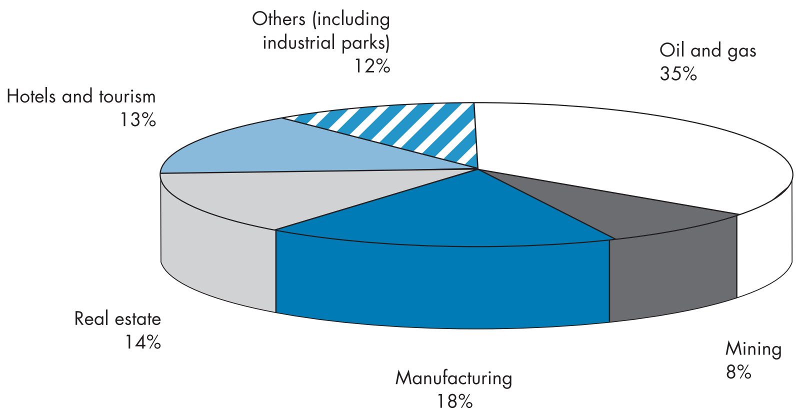
Foreign investment has grown strongly. From 1988 until the end of March 1997,[21] the Government had approved 247 projects worth US$6.05 billion. The value of approvals increased by 87 per cent in 1996-97 over the previous year. The disbursement rate is about US$200 million per year or 36 per cent which is fairly standard for the region.

Most approved foreign direct investment is in oil and gas exploration, real estate, hotels and tourism, and increasingly manufacturing (Figure 5.16). A year ago, the resources and hotels and tourism sectors attracted three quarters of approved foreign investment, mainly through quick-return projects such as hotels. Approved foreign investment has diversified over the past year, with foreign investment in manufacturing increasing five fold to US$1.1 billion. Both Japan and Singapore recently gained approval to build multi-million dollar industrial parks in Burma.

Figure 5.16

Export Oriented Projects Dominate

Approved Foreign Direct Investment since 1989, by Sector, at 31 March 1997



Source: Myanmar Investment Commission, 7 January 1997.

As of November 1995, of the dollar value of approved investments, 30 per cent were wholly foreign-owned; 51 per cent were under production sharing arrangements, mostly in oil and gas exploration; and the rest were joint ventures, 12 per cent with SOEs and 7 per cent with private firms.

....

[21] That is the end of Burma's financial year, which runs from April to March.

Regional Interest

The main holders of foreign investment approvals are (in order) the United Kingdom, Singapore, Thailand, the USA, France and Malaysia (Table 5.4). Asian investors predominate but the disbursement level is higher for Western investors. Singapore and Malaysia were the most active new investors in 1995-96 accounting for two thirds of new approvals. Thailand more than doubled the level of its approved investment in 1996.

Table 5.4

Wide Dispersion of Foreign Investors but Asia Dominates

Foreign Direct Investment Approvals, by Selected Countries, at 31 March 1997

Nation	Number of approvals	Approved amount (US$ million)	Percentage of total approvals
United Kingdom[a]	27	1 304	21.6
Singapore	55	1 215	20.1
Thailand	39	1 027	17.0
USA	16	652	9.6
France	3	470	7.8
Malaysia	19	462	7.6
The Netherlands	5	238	3.9
Indonesia	4	211	3.5
Japan	13	192	3.2
Austria	2	73	1.2
Republic of Korea	12	70	1.2
Hong Kong	17	64	1.1
Australia	11	40	0.7
Total Asian	172	3 283	54.3
Total Western	75	2 469	45.7
Total	247	6 052	100.0

Note: a. Inclusive of enterprises incorporated in British Virgin Islands and Bermuda Islands which have been registered as UK investments.

Source: Myanmar Investment Commission, 3 April 1997.

Priorities for Foreign Investors

Strong foreign investment benefits the Government's development strategy, but Burma may be losing its aura as the last frontier among the emerging markets (Takeoka and Murata, 1995). Executives in ten Asian countries and Australia were surveyed and only a majority of those from Singapore and Thailand thought Burma a better country to invest in than Vietnam, despite the latter's complex business environment (Economist Intelligence Unit, 1996a, p. 17). There is only one listed mutual fund specialising in Burma; its shares are rarely traded (*The Economist*, 1997, p. 83).

Foreign investors face several investment barriers. In particular, as discussed previously, foreign investors need to export commodities, such as beans, pulses or prawns, to obtain hard currency (or pay a 5 per cent commission to have this done for them) because kyat profits still cannot be exchanged freely for foreign exchange and repatriated despite the introduction of foreign exchange certificates. This distorts the pattern of foreign investment in favour of foreign exchange earning sectors (resources) and against manufacturing, except for export.

Also large investment projects, such as pipelines to the offshore gas fields, are vulnerable to attack from ethnic insurgents. Burma's poor human record on human rights also discourages foreign investors. (See Chapter 6 - *Burma: Business*.)

Human Rights, Aid and Investment

Aung San Suu Kyi, leader of Burma's main opposition party, the National League for Democracy, has called on foreign governments to discourage commercial links with Burma while the military remains in power. Despite this, Western nations remain among the biggest investors.[22]

The USA blocks any World Bank or International Monetary Fund lending to Burma and has not had an ambassador in Burma since 1990, although 110 US companies are there. In April 1997, the US Government banned new US investment to Burma. Several US cities and the state of Massachusetts ban official purchases of products or services from US companies operating in Burma.[23] Although US investment in Burma, except for Unocal's large natural gas investment, is minuscule and shrinking, US investment sanctions could affect Burma.

However, US trade sanctions, should they eventuate, are likely to have little impact. Despite lack of MFN trade treatment, Burmese exports (mostly garments) to the USA are growing steadily, reaching about US$80 million or roughly 10 per cent of Burma's total legal merchandise exports in 1995. However, even with sanctions, Burmese exports would most likely reach the USA via third countries. Furthermore, any US moves to economically isolate Burma could be complicated by Burma's membership of ASEAN.

European Union governments do not generally assist their companies operating in Burma. Indeed, several US and European companies recently severed commercial ties with Burma,[24] with Asian firms often replacing them. For instance, Singapore's Fraser & Neave took up Danish brewer Heineken's share of a proposed new brewery. However, Western firms dominate high technology natural resource extraction, and Asian firms may not be able to replace them (Fairclough, 1996). So far, natural resource projects have been less susceptible to Western consumer pressure.

Japanese companies, particularly the big trading houses, are keen to invest in Burma following a Keidanren mission in mid 1994, but the Japanese Government is attempting to delay a major build up of investment because of Burma's lack of

....

22 The United Kingdom, for example, accounted for almost one quarter of new investments in 1995-96 and the British Department of Trade and Industry led a trade mission to Burma in February 1996.

23 In October 1996, a Massachusetts law forced Apple Computer Inc. to end its contracts in Burma.

24 In January 1997, PepsiCo totally withdrew from Burma. Others to do so are Levi-Strauss, Liz Claibourne, Macy's, Amoco, Heineken and Oshkosh.

progress towards democracy. Japanese business sources suggest that a full resumption of their nation's aid to Burma, including export credits and risk insurance, would generate a flood of Japanese investment into Burma.

OVERCOMING INFRASTRUCTURE SHORTFALLS

Burma's infrastructure is very weak as a result of decades of neglect, long internal wars of attrition and a shortage of capital. Regional investors have begun major infrastructure projects to overcome development obstacles such as inadequate port facilities.

Most large infrastructure projects are in and around Rangoon. However, both the private sector (including Yunnanese Chinese) and government sectors are investing millions of dollars on infrastructure in Mandalay. For example, the Mandalay City Development Committee has spent about US$255 million on hydro-electric power plants and other infrastructure; and Thailand's Ital-Thai Group, with a US$150 million highly concessionary loan from Thailand's ExIm Bank, has contracted to build an international airport in Mandalay.

MAJOR INFRASTRUCTURE PROJECTS

- In April 1996, Japan's Mitsui gained approval to build a US$14 million industrial park, with electricity supply and other infrastructure support, near Rangoon airport.
- In mid 1996, Singapore's C & P Holdings with Chinese partners won a BOT contract to construct a US$50 million container port at Thilawa, 10 kilometres south of Rangoon.[25]
- In June 1996, China's Yunnan Machinery and Equipment Import-Export Corp., with US$28 million in foreign investment, entered a joint venture with the Myanmar Port Authority to expand Rangoon's container wharf.
- The Industrial Estates Authority of Thailand has signed a MOU to invest US$80 million in building Dawei deep sea port.
- Sinmardev International Pte Ltd of Singapore has signed a contract to invest US$166 million in constructing the Thanlyin-Kyauktan industrial zone near Rangoon.
- Japan's Mitsui & Co. has signed a MOU for a US$750 million project to build a pipeline from Total's gas field in the Gulf of Martaban, with estimated reserves of 9.6 trillion cubic feet, and a power station and urea plant in Rangoon.
- Four Burmese entrepreneurial groups with foreign backers (three possibly Malaysian, the fourth possibly US) have permits to construct a new 600 kilometre BOT expressway linking Rangoon and Mandalay, which is expected to cost US$1.3 billion.

....

25 The project's backers expect that the container port will serve Burma and China's south western provinces (Economist Intelligence Unit, 1996a, p. 16).

AGRICULTURAL REFORMS

After 1988, the Government dismantled most controls on agriculture, including those on crop selection, private domestic and international trade, prices and distribution (World Bank, 1995a, p. 33). The private sector now can supply agricultural inputs such as fertiliser and seed.[26] However, the Government still has a monopoly on rice exports and farmers must sell from 15 to 20 per cent of rice production at below market prices. As farmers generally pay no other taxes, this is in effect a tax in kind.

Agricultural Performance

Removing price controls and freeing up domestic and international trade significantly raised producer prices for most crops, including rice and raised agricultural output. However, output only now is returning to the levels of a decade ago; despite being Burma's most important crop, rice surpassed its 1984-85 production level only in 1992-93. Crop production increases are partly due to expanding the cultivated area from 10 per cent of total land area in 1989 to 13 per cent in 1994, practising multiple cropping and using more fertiliser. Since 1992, fertiliser use has tripled.[27]

However, farmers do not consider their long term leases provide sufficiently secure and clear tenure rights; this reduces their incentive to invest. Furthermore, leased land cannot be used as collateral for long term credit. Access to domestic credit is very restricted because of the virtual absence of rural banks and credit cooperatives. Consequently, Burma's agricultural borrowings amount to a very low US$2 per hectare of cultivated land, compared with Vietnam's US$40 (Dapice, 1996). The agricultural sector attracts less than 0.1 per cent of total foreign direct investment.

UNPAID LABOUR

Rural infrastructure is receiving government attention. However, many projects such as road building use so-called 'voluntary' unpaid labour, often described as forced labour. The Government argues that using corvee village labour without payment is a form of tax and accords with the Villages Act and Towns Act enacted during British rule. Labour for large scale infrastructure projects is generally unpaid; in June 1995, the Government ordered officials to pay workers. However, it either failed to provide resources, or administrators pocketed the money.

Dapice (1996) argues that human rights considerations aside, it may be time to increase infrastructure investment by paying market wages to labourers. Foreign aid and a township rural infrastructure program could increase necessary investment in local irrigation, rural roads, land reclamation and reforestation.

....

26 According to the World Bank (1995a, p. 42) continued use of subsidies inhibits private sector provision of inputs.

27 This amounted to 24 kilograms per acre for paddy in 1994-95, which is still very low by regional standards (Dapice, 1996).

Government Priorities

The Government's five-year development plan (1996-97 to 2000-01) focuses on developing agriculture, agribusiness, industries producing agricultural inputs, such as fertilisers, and industries processing agricultural raw materials, such as food processing. The aim is to double agricultural yield. The plan builds on Burma's comparative advantage in agriculture and should raise living standards in an equitable way, enhancing Burma's fragile national cohesion.[28]

Much more needs to be done to realise Burma's agricultural potential, especially as large areas of land are underused. Apart from remaining controls discussed previously, arbitrary unofficial tax collection is widespread (Dapice, 1996) further reducing rice farmers' incomes.[29] Transport problems and the inferior quality of Burmese milled rice frustrate efforts to increase exports. With better varieties and improved drying and milling techniques, price parity could approach Thai export rice prices; this would generate over US$100 million per year in extra foreign exchange earnings (Dapice, 1996).

FISHERIES

Burma's long and relatively unpolluted coastline, its 3-mile Exclusive Economic Zone and lack of heavy commercial exploitation mean it has abundant marine resources. In 1995-96, the offshore catch was 607 000 tonnes while the freshwater catch was 226 200 tonnes.

Fisheries potential remains underdeveloped, despite the privatisation of the state-owned Fisheries Enterprise. As fisheries is a restricted economic activity, foreign investors require a local partner to operate in the Exclusive Economic Zone. Consequently, the number of joint ventures has grown steadily since 1994. The Government offers long leases on previously state-owned vessels and cold storage facilities.

Onshore and offshore prawn fishing attracts foreign investment and acquaculture is an increasingly important source of exports. The Government encourages the development of onshore 'semi intensive' prawn farms using 2 to 20 hectare natural ponds flushed with tidal water (Irrawaddy Advisors Limited, 1996). Although aquaculture accounts for only around 10 per cent of the total catch, the area of fish and prawn ponds (now 34 403 hectares) has increased by 50 per cent since 1992-93.

....

28 As with most developing economies, 80 per cent of Burma's population live outside urban centres. A number of studies suggest that in such economies, the trickle-down effect of economic development from urban to rural communities is very slow and that income gaps remain large and even grow for a long time.

29 According to the World Bank (1995a, p. 38) the government monopoly on rice exports leads to farmers receiving a domestic price 17 per cent less than the export parity price.

FORESTRY

Burma's forestry resources are substantial: half the total land area is forested with about 6 million hectares of closed-canopy cover. Despite restrictions, deforestation continues, particularly in areas outside the central Government's control. In areas controlled by the Government, forestry conservation practices generally are better than elsewhere in South East Asia. Burma has 75 per cent of the world's teak reserves and supplies 90 per cent of the world teak market. The harvest and export of teak logs remain a government monopoly; exports were just over US$200 million in 1995-96.

The Government has terminated all foreign concessions and banned the private export of non-teak logs, because of over-exploitation and breaches of concession terms. Private firms from the Republic of Korea, Hong Kong, Singapore and Malaysia have joint ventures in some value adding projects, in particular furniture production.

Forestry production has declined because of tighter restrictions and the chronic neglect of forestry infrastructure. In 1995, the Government launched a three-year reafforestation program. However, following the rebel ceasefires, groups such as the Kachin Independence Army have established timber companies and now illegally export wood to China. Experts are concerned that massive deforestation could affect the crucial watersheds feeding the Irrawaddy River, which waters Burma's central plains (Lintner, 1995).

MINING SECTOR

Burma's extensive mineral resources are largely underdeveloped and large tracts of potentially mineral rich land have not been thoroughly surveyed. In 1995-96, copper and gold were the most important minerals (Table 5.5). Three quarters of Burma's mineral resources will be mapped by 2000.

Table 5.5

Estimated Production of Selected Minerals, 1995-96

Mineral	Estimated production
Zinc concentrate (metric tonnes)	6 070
Refined lead (metric tonnes)	4 250
Tin concentrate (metric tonnes)	1 191
Copper concentrate (metric tonnes)	42 500
Refined silver ('000 ounces)	260
Gold (troy ounces)	22 496

Note: Burma also produces gems, including 8 000 carats of gem-quality diamonds per year, most of which are illegally exported.

Source: Irrawaddy Advisors Limited, 1996.

In principle, mining and energy sector activity is the preserve of the State, but due to capital and technical expertise shortages, the Government has entered many production sharing arrangements with foreign investors on a joint venture or BOT basis.

In 1994, the Government promulgated its new Mining Law, although companies are still waiting for implementing regulations. While in 1995-96 the mining sector contributed only 1.3 per cent of GDP after years of stagnation, the mining sector, particularly copper and gold mining, is now growing at double digit rates. The Government's five-year plan (1996-97 to 2000-01) anticipates that mining will grow by 18.5 per cent per year, focusing on exploration for and production of crude oil, natural gas, gems and jade.

ENERGY SECTOR

Burma's substantial reserves of natural gas and coal attract foreign investment. Coal production in 1995-96 was estimated at 48 million long tons. The extent of crude oil reserves is unclear, but could be depleted. Crude oil production was estimated to be about 4 million barrels in 1995-96 and natural gas production about 9 million barrels (in crude oil equivalent).

The Myanmar Oil and Gas Enterprise (MOGE) operates all 17 onshore oil and gas fields, as well as 1 550 kilometres of pipeline. However, since 1989 it has invited investors to become involved in production sharing projects.[30] The most noteworthy of these projects are:

- the natural gas pipeline being built from Burma to Thailand by Total and Unocal, costing US$1.08 billion. When completed in mid 1998, the pipeline should generate US$300 million per year in foreign exchange for Burma
- the natural gas pipeline project involving Texaco, Nippon Oil and Premier Oil (a British firm). When completed, this project should generate approximately US$140 million per year in foreign exchange for Burma.

Burma's hydro-electricity potential is also underdeveloped with only 0.75 per cent of available potential generated and just under 50 kilowatt hours per person per year consumed. This is considerably lower than in Thailand and China, which in 1992 consumed 655 and 479 kilowatt hours per person respectively (Irrawaddy Advisors Limited, 1996). Domestic consumer tariffs, held down by the Government, are insufficient to cover generating costs; this discourages private sector investment.

IMPEDED INDUSTRIAL DEVELOPMENT

Chronic input shortages, particularly of energy and imported commodities, and low use of capacity, just 42 per cent in 1994-95, inhibit Burma's industrial development. Lack of foreign exchange means non-exporting firms, both domestic and foreign, have difficulty obtaining hard currency to buy inputs and spare parts to maintain

....

30 Fourteen foreign companies participated in oil exploration projects since 1992. At least five remain active; the rest (including BHP) pulled out after finding no oil.

plants. Foreign exchange reform and the associated freeing-up of exchange controls would enhance significantly Burma's comparative advantage in this sector, which is based on low wages and a reasonably well educated workforce.

Planned new industrial parks should strengthen industrial growth. Additional infrastructure could consolidate recent growth in labour intensive, export oriented manufacturing, particularly garment manufacturing.

SERVICES SECTOR DEVELOPMENT

The Burmese Government believes the services sector, especially tourism, has significant potential to earn foreign currency. Hotel construction projects for tourists and business visitors constitute the second largest area of foreign investment. By the end of 1998, 9 000 rooms should be available.

Although services attract more investment than previously, resources to rapidly expand the sector are inadequate. Services like tourism, accountancy, communications, and banking, all lack infrastructure, capital, and human resource development. These deficiencies need to be overcome so that the services sector can support economic expansion.

FAILURE TO REFORM STATE-OWNED ENTERPRISES

Except for the state-owned Fisheries Enterprise, the Government has failed to reform SOEs. In 1995, 69 mainly small scale enterprises were scheduled for privatisation through the Privatisation Commission, but sale prices were excessive. By September 1996, only four listed, smaller enterprises had been sold to private sector bidders. Two thirds of the listed enterprises subsequently were withdrawn by ministers safeguarding institutional and pecuniary interests, including their foreign exchange requirements. This was a serious blow to the Government's privatisation program.

However, even if the program had been successful, it did not go far enough: SOEs would continue to dominate key economic sectors; the largest, and probably least efficient enterprises were not offered for privatisation and the State intended to retain those enterprises with the greatest capacity to earn foreign exchange (Economist Intelligence Unit, 1995, p. 67).

The Government also has been unsuccessful in its efforts to improve the management of SOEs. Compared with 1989, the operational and financial autonomy of SOE managers has diminished, and control and oversight have become more centralised in their parent ministries (World Bank, 1995a).

Most SOEs remain inefficient and heavily subsidised, with the budget covering their deficits. If the exchange rate were unified and devalued, most SOEs would make serious losses: even now, many only break even. The retention by SOEs of their privileged position, has led three quarters of foreign investors to choose SOEs, rather than private sector firms, as partners in joint venture or production sharing arrangements. This link also gives foreign investors access to government decision makers.

EXCHANGE RATE REFORM AND STATE-OWNED ENTERPRISES

Only SOEs still can import at the official rate and transactions between such enterprises still occur at controlled prices. The official exchange rate gives these enterprises a non-transparent subsidy: they buy foreign inputs more cheaply than private enterprises, so they can sell outputs more cheaply. Furthermore, exchange rate subsidies and price controls on domestic inputs and sales ensure that the current appearance of profitability provides no guide to the long term viability of SOEs. Accurate data on costs, prices and profits would be valuable to the reform process; it also might allow more viable enterprises to attract private and foreign investment.

However, comprehensive exchange rate reform or privatisation of SOEs would cause influential groups, especially those on government payrolls in the public service, the military and the enterprises to lose their privileges. For this reason, progress has been minimal.

Privatisation Outlook

The withdrawal of enterprises listed for privatisation largely reflects the Government's difficulty in coordinating economic reform policies. Given the resistance to privatisation, it may be easier and more rewarding to encourage the private sector and reduce the privileged status of the state sector. The trend to lease state assets to private operators and joint venture activities, with either domestic or foreign investors, should accelerate.

The 1996 opening of the stock exchange may help the Government to partly privatise SOEs by selling some of their equity. While ministerial involvement in the stock exchange may increase acceptance of state enterprise privatisation, the risk is that profitable privatised assets could go to military personnel.

UNEQUAL TREATMENT FOR THE PRIVATE SECTOR

The Government has taken steps to remove obstacles and bias so that the private sector can compete on a more equal footing with SOEs. The Government now allows the private sector to participate fully in the financial sector, improving the private sector's access to credit. It also encourages foreign investment, allows exporters to retain and trade in foreign exchange, and gives the private sector access to the lower unofficial exchange rate.

While these reform measures have boosted private sector activity, much more needs to be done. The private sector's demand for credit continues to be crowded out by the public sector: the budget directly finances SOEs with working and fixed capital, and loss making enterprises receive interest free credit. The private sector has limited access to the inadequate infrastructure that does exist: private entrepreneurs can experience delays and difficulties in obtaining a telephone connection, securing a water connection for an industrial site and connecting new electricity. Goods can take months to clear the congested ports (World Bank, 1995b, p. 46). SOEs also have privileged access to prime locations.

Removing Incentives for Black Market Activities

Black markets generally thrive where exchange rate or other distortions disrupt the free flow of price information, capital, goods and services (Economist Intelligence Unit, 1996a). In Burma, the overvalued currency combined with widespread commodity shortages has created a thriving black market, estimated to be at least as large as the legal economy. Burma's business environment encourages corruption; some foreign investors are forced to participate in corrupt practices to do business. For large projects of over US$10 million, decision makers can expect a 'donation' of between 3 and 5 per cent of the project cost.

ROLE OF NARCOTICS IN THE ECONOMY

A US State Department report issued in March 1996 estimated heroin production in Burma was 191 tonnes in 1995, nearly double its estimated 1988 level and nearly 10 times its estimated 1970s level. This amounts to just over 90 per cent of heroin produced in the Golden Triangle (of Burma, Thailand and Laos). Drug proceeds do not appear in the balance of payments figures; it is not known how much drug proceeds contribute to the economy nor the extent to which the Government benefits. An unofficial US Embassy report (1996) suggests that the at-border value of opiate exports alone may equal all Burma's legal merchandise and services exports. As drug dealers do not accept payment in kyat, narcotics remain a good source of hard currency and probably contribute to the relative stability of Burma's unofficial exchange rate.

Ceasefires with narco-insurgent groups, in particular the ethnic Chinese Kokang and the Wa, have allowed these groups to mobilise and deploy their capital, largely derived from narcotics trafficking. The Burmese Government allegedly accepts 'drug dollars' to finance infrastructure projects. For example, in 1996, Asia World Co. Ltd, controlled by a convicted drug trafficker was awarded a road upgrading contract worth US$27 million. It is widely believed that the United Wa State Army, one of South East Asia's largest drug-trafficking organisations, and the Kokang Chinese are investing drug money in highway building contracts and land sites in central Rangoon.

GOVERNMENT AND OPPOSITION POLICY PRIORITIES

In April 1996, the Government outlined a five-year plan for 1996-97 to 2000-01 to achieve an overall GDP growth target of 6 per cent per year. However, this is well below the take off growth rate associated with Asian tigers, so even if the target is met Burma will fall further behind its ASEAN neighbours. Manifold economic policy failings and the political situation constrain growth below potential levels.

Policy Objectives of the 1996-97 to 2000-01 Plan

The five-year plan promotes value added agricultural production. It gives high priority to trade: exports are targeted to grow at over 21 per cent per year and imports at over 13 per cent per year.

The economic objectives of the plan include:

- encouraging agricultural production to grow at an annual rate of 5.4 per cent, livestock and fisheries at 5.8 per cent, forestry at 2.8 per cent, the mining sector at 18 per cent, and processing and manufacturing at 7.4 per cent
- allocating US$70 billion for total investment, about 43 per cent of the total coming from the state sector
- achieving exports of around US$2.5 billion and imports of just over US$3 billion, in the last year of the plan.

The Government plans to employ various measures to achieve its objectives: increasing foreign exchange earnings; balancing the budget to stabilise the kyat; promoting health and human resource development; striving for balanced regional development; promoting value added production; improving the supply of energy and other industry inputs; improving economic infrastructure; promoting more effective use of natural and financial resources; increasing the inflow of investment for long term development projects; and emphasising protection of the environment.

Macroeconomic Stability and Lack of Aid

While the Government appears likely to continue its ad hoc program of gradual exchange rate reform, failure to reduce the budget deficit and undertake comprehensive exchange rate reform risks increasing macroeconomic volatility, slowing growth, rising inflation and worsening external imbalances.

Reducing the Role of the Military in Business

Burma's private sector does not compete equally with SOEs. Also, the private sector often lacks connections with Burma's most important decision makers, the military.

ECONOMIC ROLE OF THE MILITARY

The Union of Myanmar Economic Holdings Ltd, Burma's largest enterprise, is a public company whose shares are only available to military personnel. Its shareholders are the Directorate of Defence Procurement (40 per cent), the Ministry of Defence, Regimental Defence Institutes and defence personnel. The Union of Myanmar Economic Holdings is prominent in foreign investment, controlling joint ventures ranging from garment manufacturing to real estate. It manages the army's pension funds and owns Myawaddy Bank, a ready source of finance (Lintner, 1996). Its registered capital was almost 10 per cent of Burma's estimated GDP in 1990 (Mya Maung, 1995).

The company paid a 30 per cent dividend for 1995-96, up from 15 per cent in 1994-95. Its long term plans include setting up heavy industries, such as cement and iron and steel. The company receives special treatment from the Government, including exemption from commercial and income taxes.[31]

....

[31] Under the Myanmar Citizens Investment Law, the tax exemptions are also available to other domestic investors. (See Chapter 4 - *Burma: Politics*.)

NLD ECONOMIC POLICIES AND PRIORITIES

The NLD's economic priorities[32] are to: reduce inflation; stabilise and gradually unify the currency (under the auspices of the International Monetary Fund); offer job security; provide fiscal responsibility; liberalise the trade and investment regime; reschedule external debt and resume overseas aid; liberalise the business regulatory environment, including reviewing the taxation requirements for private enterprise and encouraging the private sector; and in the short term only, continue export subsidies and a multiple exchange rate.

To achieve these objectives, the NLD initially will focus on privatising (or returning to their former owners) nationalised enterprises and making it constitutionally unlawful to nationalise private enterprises. It would permit private and joint ventures to develop gem and mining ventures; abolish all nationalised enterprises (except where unacceptable unemployment would be created); take full responsibility for all currencies officially circulating; and facilitate the introduction of technology into all aspects of the economy and the education system. In transport and communications, the NLD would give special attention to developing infrastructure.

In the rural sector, landlordism would be abolished, allowing the peasantry to own or transfer land. Farmers would be free to decide on cultivation, storing, milling, transport and sale of produce. The peasantry would receive a minimum bench price for produce, and domestic prices would be adjusted in line with international prices. Improved access to credit, high yield varieties, fertilisers and irrigation would promote agricultural production. A more systematic approach to forestry, based on modern techniques and expertise, would conserve forests.

PROSPECTS FOR THE ECONOMY

Burma has the potential to become a dynamic economy and attain far greater prosperity than it currently enjoys. The nation has huge resource potential; its population is relatively well educated and motivated; it is strategically located; and its neighbours are welcoming it into the regional fold of ASEAN. It also should benefit from emulating the successful economic models of its neighbours.

However, to achieve its potential Burma requires greater political commitment to reform its economic structures. Because Burma's current Government lacks domestic legitimacy, it has been cautious about implementing reforms that incur short term adjustment costs. Burma's reform difficulties are primarily political rather than economic. Burma also faces the threat of trade and investment sanctions. However, regional assistance in the form of limited aid, growing trade and investment links, and economic advice could help to offset the lack of wider international assistance.

....

32 This is an unofficial translation of a National League for Democracy paper on economic matters issued at the end of the NLD Congress held in Rangoon, 26-28 May 1996.

Integration into the wider region through membership of ASEAN will provide Burma with assistance, expanding trade and investment links and a framework for continuing with economic reform. The Burmese Government may consider that ASEAN's AFTA framework provides it with the political legitimacy to carry out economic reforms, if it wishes to do so. Without urgent steps to increase transparency, Burma's economic institutions are likely to be thoroughly corrupted, reducing any legitimacy bestowed by ASEAN.

Economic Challenges

To sustain moderate growth rates and complete the transition from a command to a market based economy, Burma must succeed in:

- stabilising the macroeconomy, probably without the assistance of multilateral financial institutions, in particular the International Monetary Fund
- developing a credible legal system and independent judiciary
- decontrolling prices and legalising all normal business activities to reduce black market activities and corruption
- reforming the SOE sector and promoting the private sector
- integrating the Burmese economy into the regional and world economies.

Economic Potential

Few doubt Burma's natural wealth and economic potential. If Burma is to follow the successful examples of the East Asian model, it will first promote agriculture, install basic infrastructure, and encourage labour intensive exports. It then will harness the generated surplus to support development in other sectors and invest in human resources. Many analysts expect that Burma will eventually follow the pattern of other East Asian economies; Japan, Taiwan, Republic of Korea and the ASEANs, but argue that for the late-comers like Burma, Vietnam, Laos and Cambodia, growth will be much faster as they can benefit from Asian investment.

Burma's human resource potential is considerable. The Burmese value education; although Burma is considerably poorer, its basic literacy levels compare with those of Malaysia, Indonesia and Brazil (World Bank, 1996).[33] Furthermore, the population has considerable entrepreneurial skills, as evidenced by the vast black market and pace with which it has taken up opportunities arising from recent economic reforms.

Burma has a favourable geographical location, with abundant arable land and water, and a variety of ecosystems. Coupled with its proximity to major markets in East Asia and India, this will allow agriculture and agribusiness to flourish.

On this basis, some foreign investors are keen to make an early entry into Burma. For example, some argue that Burma has the attributes of Thailand 20 years ago.

33 Student unrest and university closures have greatly reduced graduate numbers since the late 1980s.

Regional Integration

In July 1995, Burma took an important step toward regional integration by signing the ASEAN Treaty of Amity and Cooperation, a precursor to ASEAN membership. In addition, it showed its willingness to participate fully in such a regional body by signing the South East Asia Nuclear Weapons Free Zone Treaty along with other South East Asian countries. Burma was granted ASEAN observer status in July 1996 and becomes a full member of ASEAN in 1997.

In some respects, because of the widespread use of English and a common law based legal system, Burma is in the best position of the three new ASEANs to fulfil its technical membership obligations. An embryonic ASEAN Division has been formed in the Foreign Ministry. However, joining ASEAN is a big step because Burma has had little experience in international organisations,[34] especially at the regional level. Vietnam's recent experience in ASEAN raises doubts about whether Burma will be able to meet its obligations under the ASEAN Free Trade Area (AFTA) agreement. As a member of ASEAN, Burma, like Vietnam, Cambodia and Laos, probably will be given a ten-year period in which to meet its commitments.

Of the ASEAN members, Singapore has the strongest economic ties with Burma. It is the largest investor, with more than US$1 billion in approved investments. As part of a broader strategy of creating an external 'wing' for the Singaporean economy, the Singapore Trade Development Board has launched the Myanmar Business Group.[35] Thailand's bilateral relationship with Burma is complicated by historical tensions, a large refugee population along the Thai-Burma border, and insurgent groups. Nevertheless, Thailand has moved quickly into the Burmese market and has an active presence in the resources, financial and manufacturing sectors. However, Burmese military and business representatives complain about predatory Thai business practices.

Models for Development

The Burmese Government receives advice from ASEAN members, Japan, the Republic of Korea and perhaps even China on successful development strategies, but so far implementation has been very piecemeal and uncoordinated. Burmese ministers have spoken favourably of an Indonesian model, which they believe places a military government at the centre of successful economic development. Meanwhile, the Burmese Government is moving to develop a new constitution that directly draws on the Indonesian experience of giving the army a central political role. The military's hope is that a variant of the Indonesian model will allow it to gain domestic legitimacy on the basis of economic growth, rising per capita incomes, and relative prosperity. (See Chapter 4 - *Burma: Politics*.)

Burmese officials also need expert advice on detailed implementation of reforms and day-to-day management of the economy. The military must relinquish much of its current control over the economy to avoid economic crisis. In this respect, Indonesia

[34] Burma is a member of the World Trading Organisation (WTO).

[35] The group consists of 117 businesses, and within a few months of its formation in 1996, Singapore companies had won 17 projects in Burma. The Group hopes to shorten the 'learning curve' for Singaporean newcomers and enable them to penetrate the market more rapidly.

provides a useful lesson: the Indonesian military has long employed specialists and dedicated civilian technocrats to run the economy.

Political Will

Normally, authoritarian governments are at least credited with a capacity to embark on difficult reforms and make difficult decisions. In Burma, the Government judges that social stability and national sovereignty are still too fragile for the economy to undergo comprehensive reform. For example, the currency has been only partly floated and many other urgent reforms are proving difficult to achieve. Also some decisions suggest that the Government puts a higher priority on its own cohesion than on economic development; this results in a piecemeal approach to economic policy making. A question mark must therefore remain over the Government's will to continue reform, particularly when such reform is not perceived to be in its own, or its supporters' economic interests. Against this, significant progress has been made since 1988 in restructuring Burma's low growth, command economy.

CONCLUSION

The Government has made a start in its reforms encouraging economic growth. If it can continue to make sustained, although more rapid progress with its economic reform agenda, in particular budget and exchange rate reform, increased regional economic integration should ensure that the nation will start to realise its economic potential in the next two decades. By 2020, Burma could achieve Thailand's 1995 per capita income level (The Economist Intelligence Unit, 1994).

However, corruption and the influence of illegal economic interests are growing and the Government lacks the confidence of legitimacy and the necessary skills to make necessary reforms. The next couple of years will be critical; unless a more comprehensive and transparent approach to implementing the remaining reforms is adopted, growth may slow and the economy may stagnate.

REFERENCES

Asia Money, 1995, 'Making Markets', July/August.

Asian Development Bank, 1996, *Asian Development Outlook*, ADB, Manilla.

Aung Kyi (Deputy Director General of Directorate of Trade), 1996, 'Doing business in Myanmar', paper presented at Myanmar: Open for Business Conference, Rangoon, May.

Dapice, D.O., 1996, 'Policies to increase and sustain agricultural output in Myanmar', Harvard Institute of International Development, Cambridge, unpublished.

The Economist, 1997, 'Mutual Funds in Asia', 19 April.

Economist Intelligence Unit 1996a , *Myanmar*, 1st quarter, EIU, Hong Kong.

____ 1996b, *Myanmar*, 2nd quarter EIU, Hong Kong.

____ 1995, *Myanmar (Burma): EIU Country Profile*, EIU, Hong Kong.

____ 1994, *Asia to 2020*, Report for the Darwin Committee, EIU, Sydney.

East Asia Analytical Unit, 1997, *China Embraces the Market*, Department of Foreign Affairs and Trade, Canberra.

Fairclough, G., 1996, 'Worlds Apart: Asia and West at Odds over Approach to Burma', *Far Eastern Economic Review*, 25 July.

Financial Times, various issues.

Government of Myanmar, 1996, *Review of the Financial, Economic and Social Conditions for 1995-96*, Government of Myanmar, Rangoon.

International Monetary Fund (IMF),1996a, *Directions of Trade Statistics Yearbook*, IMF, Washington DC.

____ 1996b, *Directions of Trade Statistics Quarterly*, December, IMF, Washington DC.

Irrawaddy Advisors Limited, 1996, *Myanmar: Agro-Industry Sector Review*, Bangkok.

LWA consultants, 1996, communication with East Asia Analytical Unit.

Lintner, B., 1996, 'Absolute Power: Burma's Army Controls the Economy and Government', *Far Eastern Economic Review*, 18 January.

____ 1995, 'Cutting Edge', *Far Eastern Economic Review*, 22 December.

Mya Maung, 1996, 'The Burmese Approach to Development', *Journal of Asian Economics*, Vol. 7, No. 1.

____ 1995, 'Facts versus Fiction: Socio-Political and Economic Development of Burma under Military Management since 1988', *The Pacific Review*, Vol. 8, No. 4.

Myanmar Investment Commission, 7 January 1997, Periodic data releases on foreign investment.

Myat Thein and Mya Than, 1995, 'Transitional Economy of Myanmar: Performance, Issues and Problems', in Naya S.F. and Tan J.L.H. (eds), *Asian Transitional Economies*, Institute of South East Asian Studies, Singapore.

Takeoka, R. and Murata, F., 1995, 'Myanmar Emerging as Vietnam Rival', *The Nikkei Weekly*, 14 August, p. 21.

United Nations, 1995 and previous years, *Human Development Report*, Oxford University Press, New York.

Unofficial US Embassy Report, 1996, 'Country commercial guide: Burma', Rangoon.

Vatikiotis, M., 1995, 'Border Bushfires', *Far Eastern Economic Review*, 16 February.

World Bank, 1996, *From Plan to Market*, World Developing Report, Oxford University Press, New York.

____ 1995a, *Myanmar: Policies for Sustaining Economic Reform*, World Bank, Washington DC.

____ 1995b, *Global Economic Prospects and the Developing Economies*, World Bank, Washington DC.

FURTHER READING

Pritchard, C., 1996, 'Burma Still Winning a Trickle of Cash', *Business Review Weekly*, 3 June.

Chapter 6

POLITICISED BUSINESS

Burma is enjoying strong growth in trade and foreign investment as a result of new opportunities that have emerged with the dismantling of the socialist command economy. However, the military regime's suppression of democratic freedoms and other human rights casts a long shadow over Burma's commercial landscape.

Many risks and difficulties investors in Burma confront are common to other developing economies. The key difference in Burma is the high degree of political risk for foreign companies while the military remains in power. Foreign traders and investors face the prospect of shareholder revolts and consumer boycotts. International economic sanctions are already a reality. Political instability also remains possible, although both the Government and the Opposition say they are committed to avoiding disruptive confrontation.

AUSTRALIA-BURMA TRADE AND INVESTMENT

Australia's trade with and investment in Burma are negligible. This is partly a consequence of the Australian Government's explicit policy of neither encouraging nor discouraging commercial ties with Burma.

Trade

Australia's trade with Burma was worth US$16.4 million in 1996. Exports were valued at US$11.3 million; imports were US$5.1 million (Figures 6.1 and 6.2). Trends of both are volatile.

Investment

By the end of March 1997, Australia was thirteenth among foreign direct investors in Burma. Australian investment was worth US$40 million,[1] spread over 11 projects. This amount accounted for only 0.66 per cent of total approved foreign direct investment in Burma.

Australian investment is concentrated in mining and energy projects, reflecting Australia's comparative advantage in this area. Australian companies also have invested in construction and infrastructure, telecommunications, processed food (especially seafood) and beverages, and legal and investment consultancy services.

For Australian companies, investment in Burma often forms part of a regional strategy: most of those investing or seeking investment opportunities in Burma are active elsewhere in South East Asia, especially Indonesia and Vietnam.

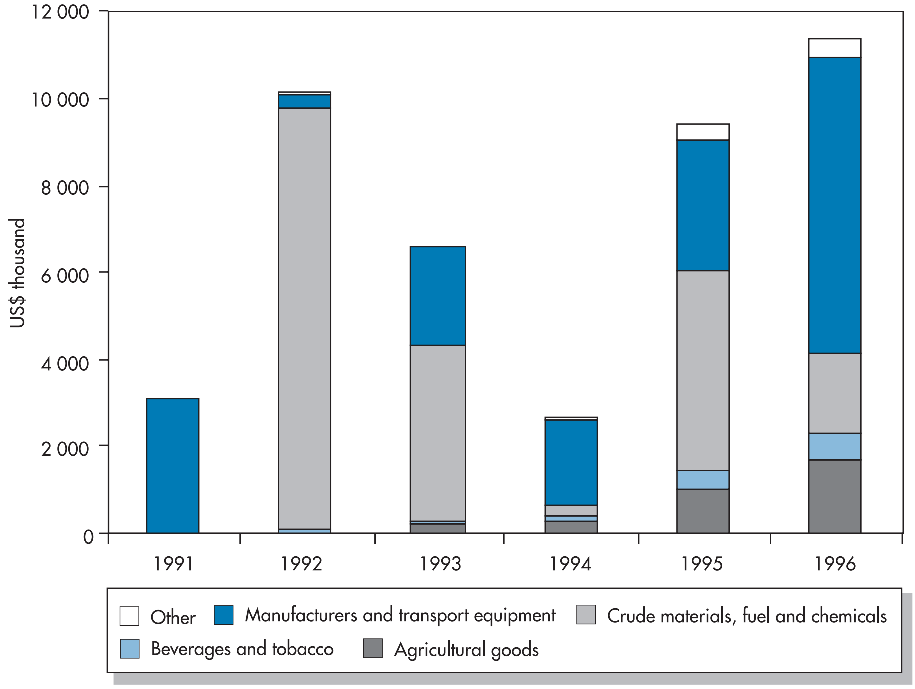
....

1 This figure is somewhat misleading as around US$25 million is attributable to BHP Petroleum's unsuccessful search for oil in Burma from 1989 until 1992, when the company withdrew.

Figure 6.1

Exports Volatile

Australia's Exports to Burma, 1991 to 1996



Source: Department of Foreign Affairs and Trade, STARS database, 1997.

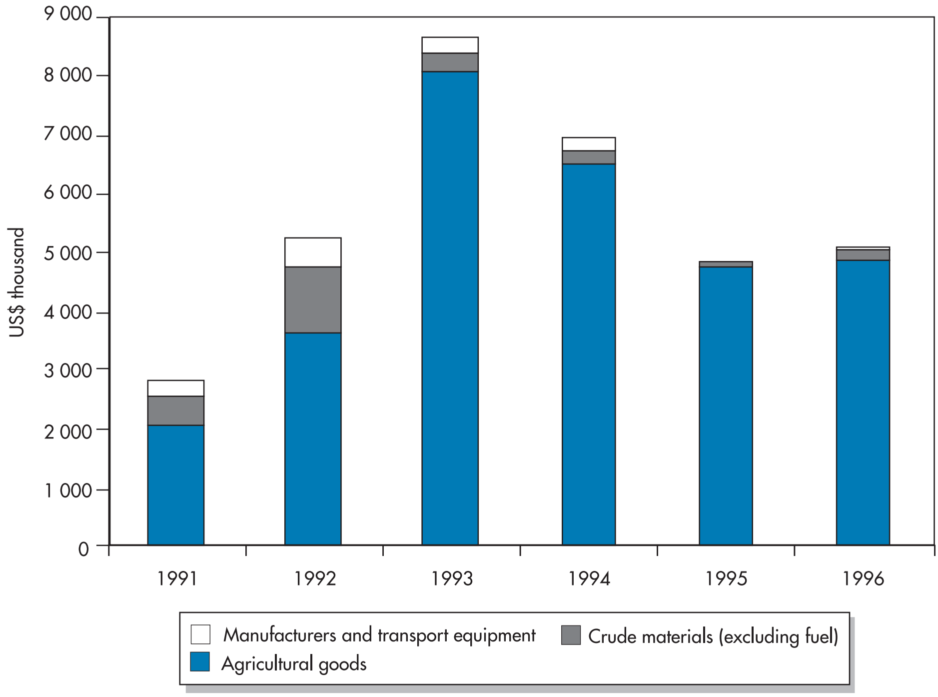
Aid

Australia and most other donor countries suspended bilateral aid to Burma during the 1988 violent political upheaval. However, Australia provides limited humanitarian assistance through non-government organisations and United Nations agencies.

Figure 6.2

Imports Fluctuating

Australia's Imports from Burma, 1991 to 1997



Source: Department of Foreign Affairs and Trade, STARS database, 1997.

ATTRACTIONS

Foreign companies operating in Burma speak positively about the country's business environment and its long term economic prospects; they point to Burma's abundant natural resources, its strategic location as a land bridge between China and South East Asia, and northern Burma's proximity to the rapidly growing Chinese province of Yunnan. Other attractions include:

- comprehensive, if somewhat outdated British based legal and accounting systems
- a high degree of English language competence, particularly among the older generation[2]
- a low cost, reasonably well educated labour force

....

[2] English is spoken fairly widely in Burma, often to a very high standard. Many Burmese in the 25 to 45 age bracket, however, speak little or poor English. They are the legatees of a government policy during the mid 1960s to the early 1970s that saw English as the medium of instruction discontinued in most secondary schools.

- a bureaucracy which is relatively efficient and less corrupt than some others in the region, though slow moving and (understandably) risk averse
- a rapidly growing demand for all goods and services
- a generally reliable cadre of local business people
- a paucity of competitors
- a liberal foreign investment regime that permits 100 per cent foreign ownership of companies and offers generous tax incentives, including a three-year tax holiday
- a relatively open tariff regime that compares favourably with that of regional competitors, for example Thailand and Vietnam.[3]

Companies identify Burma's British common law based legal system as a significant advantage. Burmese commercial concepts and laws are internationally recognisable and conform to those of other former British colonies in the region, Malaysia, Singapore and India. This gives Burma an edge over the other new ASEAN economies and will facilitate Burma's economic integration with ASEAN. (See Chapter 14 - *Expanded ASEAN*.)

On the other hand, there are few modern legal precedents for companies to follow. This undermines certainty in the business environment and the outmoded character of commercial laws impedes commercial decision making.

NEGATIVE FEATURES

Political Shadow

Burma's international pariah status complicates its foreign, trade and investment relations. Western countries including Australia have virtually quarantined Burma from bilateral and multilateral aid, and generally do little to encourage their nationals to trade or invest there. The usual government-to-government underpinnings for commercial dealings, including trade or investment promotion and protection agreements, are lacking and export insurance is usually not available. Opposition leader Aung San Suu Kyi called publicly on the US Government to impose its recently announced investment sanctions and urges foreign companies to withdraw from Burma.

Faced with the high degree of political risk, many foreign investors establish a small presence in the Burma market to build on later. The prospect of negative publicity and consumer boycotts or, in the case of Pepsi, a revolt by shareholders, caused a number of well-known foreign companies[4] to withdraw from Burma. (See Chapter 5 - *Burma: Economy*.) Consequently, foreign companies that continue to trade with or invest in Burma normally adopt a low profile. This is relatively easy for smaller

[3] Since Burma's tariffs were recalculated in June 1996 at the 'near market' exchange rate of kyat 100:$US1, Burma's overall tariff regime compares favourably with the ASEAN average.

[4] Apart from Pepsi, high profile foreign companies withdrawing from Burma include Foster's, Levi-Strauss, Heineken, Macys and Carlsberg.

companies or ones that do not have a consumer profile, but difficult for larger, high profile multinationals.

Exchange Rate Difficulties

The single most difficult economic problem confronting foreign business is Burma's vastly overvalued official exchange rate and complex multiple exchange rate system. A 1995 Keidanren survey of Japanese companies found 71 per cent of these companies considered the multiple exchange rate a major obstacle to investing in Burma.

The huge discrepancy of almost 30:1 between the unofficial and official exchange rates makes it difficult for foreign companies to assess whether investment projects are viable or profitable; it increases the cost of doing business in Burma; and adds an extra dimension to the problem of commercial risk. Associated foreign exchange controls on profit remittances and imported inputs have a similar effect.

Infrastructure Lacking

Transport, energy and communications infrastructure are inadequate. They impede Burma's economic performance, adding to the costs and frustrations of doing business.

Poor roads, bridges and railways leave much of Burma's rural hinterland relatively inaccessible and insecure, and inhibit trade with the country's five neighbours.[5] Shortcomings in Burma's sea freight services also limit export growth and make importing difficult and time consuming. Projects are underway to upgrade port facilities. Major road upgrades are also planned. (See Chapter 5 - *Burma: Economy*.) Serious shortages of electricity hamper industrial growth. Foreign investors normally install their own generators.

TRENDS

Foreign investors are most concerned by the rising tension between Burma's military regime and Western governments.

Political Risk Increasing

Early in 1997, the European Commission withdrew Burma's access to generalised system of preferences (GSP) advantages.[6] In April, the US Government banned new US investment in Burma. Although US investment in Burma, except for Unocal's large natural gas investment, is small, these sanctions increase pressure on the military regime. Possibly escalating hostility and increasing economic sanctions cause concern to current and prospective foreign investors.

....

[5] A number of Chinese-Burmese projects are underway to strengthen economic links between the Chinese province of Yunnan and northern Burma. (See Chapter 5 - *Burma: Economy*.)

[6] The GSP scheme is an autonomous development oriented trade policy instrument offering developing countries tariff preferences for their exports.

Military Keeping Tight Control

The Burmese Government has relatively quickly freed up Burma's trade and investment regime. However, the military is not willing to loosen control over key sectors of the economy or economic policy and decision making. Indeed, there are indications that its control over economic life in Burma is increasing. (See Chapter 5 - *Burma: Economy*.)

Asian Investment Growing

Investment in Burma from other parts of Asia is growing more strongly than investment from Western countries due to the Western policy of disengagement. Asian investors now predominate (Table 5.3). Asian governments, particularly those in ASEAN, pursue 'constructive engagement' with Burma. A number actively encourage and support investment there. Consequently, their investors face less risk in entering the Burma market than Western counterparts and generally are better informed about opportunities and the business environment.

The predominance of Asian investors replicates the pattern in the other three new ASEAN countries. This is despite Burma's investment environment appearing to offer Asian investors fewer relative advantages over their Western counterparts. Burma's British-based legal and accounting systems, for example, assist most Western investors. So does Burma's comparative advantage in natural resources, development of which usually requires advanced technology. The key difference is the much higher level of political risk Western investors face.[7]

MARKET REALITIES

As in the other new ASEAN business environments, the Burma market is neither easy nor quick to penetrate. Business has to adapt to the Burmese way of doing things, for example by setting realistic deadlines.

Cooperating Rather than Competing

The Western business presence in Burma is modest compared to that of Asian investors and traders. The level of homogeneity, mutual support and sharing of experiences among Western companies is high, with little evidence of competition among national interest groups or even between companies in the same industry.

Foreign Exchange Problems

Foreign investors adopt creative strategies to deal with the foreign exchange regime. For example, foreign companies are entitled to retain foreign exchange earnings from exports, which, if not required, can be on-sold to other foreign companies needing foreign exchange. A number of importers and exporters have created a discreet

7 Western and Asian investors share the risk that Western countries could institute embargoes against Burmese exports. Western investors also risk pressure from shareholders and the public at home, and consumer boycotts.

secondary market in foreign exchange rights. Similarly, some foreign banks operate a brokerage service in the rights.

Credit

Bank finance in Burma is generally unobtainable and the financial services industry is undeveloped. Foreign investors therefore have to secure access to external finance or fund any expansion of their business in Burma from retained earnings.

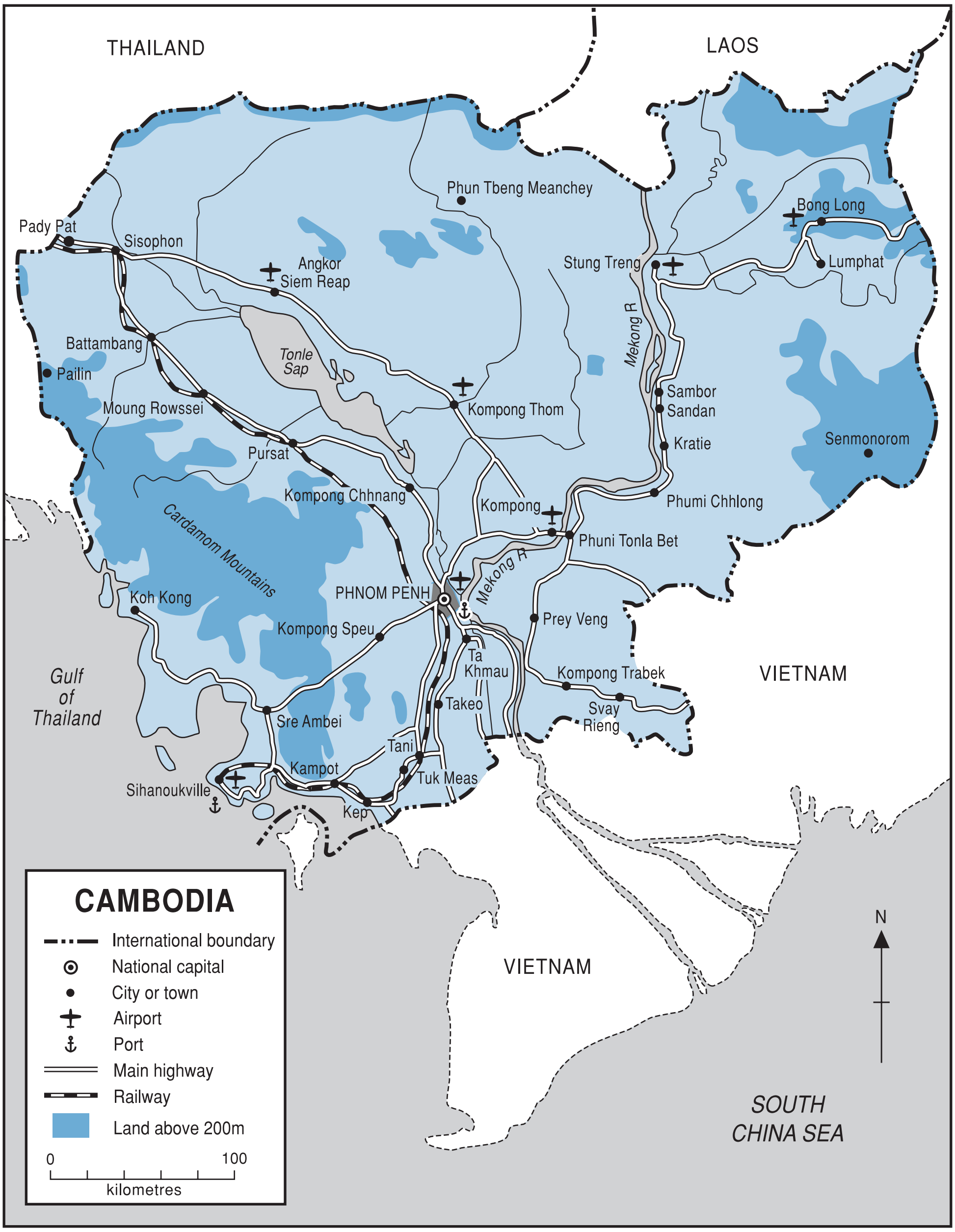
Investors normally limit their initial investment exposure in Burma to the bare minimum required to establish a viable business, although their approval from the Government may cover a much larger project. An approved project for a 600 room hotel, for example, might begin as a 200 room structure.

Key Business Relationships

As the exercise of power in Burma is highly personalised, successful foreign business dealings are most often linked to symbiotic relationships with influential members of the military establishment or senior government officials. These relationships, however, invite criticism from shareholders and consumer groups, among others. This is a serious dilemma all foreign companies face in Burma. Moreover, high level corruption, involving substantial sums for large projects, is said to occur, although foreign companies are rarely willing to talk about it.

PART THREE

CAMBODIA


THAILAND
LAOS
Phun Tbeng Meanchey
Bong Long
Pady Pat
Sisophon
Angkor
Siem Reap
Stung Treng
Lumphat
Mekong R
Battambang
Pailin
Tonle Sap
Sambor
Sandan
Moung Rowssei
Kompong Thom
Kratie
Senmonorom
Pursat
Kompong Chhnang
Kompong
Phumi Chhlong
Phuni Tonla Bet
Cardamom Mountains
Mekong R
Koh Kong
PHNOM PENH
Prey Veng
Kompong Speu
Ta Khmau
Gulf of Thailand
Kompong Trabek
VIETNAM
Takeo
Svay Rieng
Sre Ambei
Tani
Kampot
Tuk Meas
Sihanoukville
Kep
CAMBODIA
International boundary
National capital
City or town
Airport
Port
Main highway
Railway
Land above 200m
0
100
kilometres
VIETNAM
N
SOUTH CHINA SEA

Chapter 7

REBUILDING THE STATE

More than Vietnam, Laos or even Burma, Cambodia remains the captive of its recent turbulent past. Since United Nations sponsored elections re-established a framework for democratic rule in May 1993, Cambodia has sought to recover from over two decades of internal conflict that destroyed much of the country's educated elite, its economic base and its political and administrative institutions. Recreating a stable and durable civil order is proving a major challenge. Democratic government is in an early stage of development and remains subject to individual will. Power politics, closely intertwined with corruption and violence, are the order of the day. Political forecasting in these circumstances is very difficult.

This chapter examines the political forces in play, and the administrative and legal framework for domestic and foreign investors in Cambodia's freewheeling market economy.

HISTORY OF CONFLICT

As with Vietnam and indeed many other parts of South East Asia, Cambodia's history is one of struggle by the predominant ethnic group, the Khmer, to assert territorial independence. Historically, the Khmer fought fiercely to gain control of their territory, then defended it, not always successfully, against invading neighbours. 'Periods of triumph and conquest alternated with eras of defeat and vassalage' (Munson et al, 1968, p. 19).

At its peak in the late twelfth and early thirteenth centuries, the Khmer Empire extended from the Annamite Cordillera in southern Vietnam to the Gulf of Thailand. The great temples, palaces and other public buildings erected during that time at Angkor are national symbols; the Towers of Angkor form the central design on the national flag.

French Protectorate

The Khmer Empire declined from the early thirteenth century. In the next five centuries, Cambodia steadily contracted as neighbouring Siam (Thailand) and Annam (Vietnam) expanded; by the mid 1800s, Cambodia was a vassal state of both. To extricate his country, the Cambodian vassal king, Duang, aligned Cambodia with France against Annam.[1] Then in 1863, France and Siam signed a treaty under which Cambodia became a formal protectorate of France. A French *Resident Superieur* was installed in the capital. He became the de facto ruler of Cambodia, under the authority of the Governor-General in Hanoi. The Cambodian King remained only as a figurehead. After 1887, Cambodia, with Vietnam and Laos, formed the French Indochinese Union.

....

[1] Cambodia's current King, Norodom Sihanouk, is a direct descendant of Duang.

After World War II, Cambodia was granted partial independence and became an autonomous constitutional monarchy within the French Union, with the young Norodom Sihanouk as king.[2] Cambodia celebrated its independence in November 1953, shortly before the 1954 Geneva Conference at which Vietnam was divided in two and also gained independence from France.

Sihanouk and the Vietnam War

Cambodia withdrew from the French Union in 1955. In the same year, to retain power for himself as a civilian politician, Sihanouk abdicated the throne, making his father a figurehead king. Prince Sihanouk dominated Cambodian politics for the next 15 years, presiding over a period of relative prosperity.

Despite's Sihanouk's efforts to steer a neutral middle course between Hanoi and Washington, Cambodia was drawn inexorably into the Vietnam War. Sihanouk's own position became increasingly precarious, and in 1970, he was deposed in a right wing coup by General Lon Nol. Outright war ensued, involving at various times, the USA, South Vietnam, the Vietcong and North Vietnam, in addition to Cambodia's own national army and its leftist opponents. The result was a military victory to the communist Khmer Rouge[3] of Pol Pot on 17 April 1975, just two weeks before Saigon fell to Vietnamese communist forces.

Democratic Kampuchea

The Khmer Rouge renamed Cambodia, Democratic Kampuchea, proclaiming it a worker-peasant revolutionary State. Cities and towns were virtually emptied and their former occupants reorganised into large rural and industrial cooperatives, with economic self-sufficiency the goal. Many attributes of modern civilisation were abolished. More than a million people perished through illness, starvation, exhaustion, revenge killings, or the recurring purges of 'class enemies' (intelligentsia and professionals), ethnic minorities and others whose existence was considered inimical to the new State.

Vietnamese Invasion to Paris Peace Accords

In December 1978, after repeated clashes on the common border, Vietnam mounted a full scale invasion of Cambodia.[4] Vietnamese forces ousted the Khmer Rouge from Phnom Penh in January 1979 and installed a new Cambodian communist regime, the Khmer People's Revolutionary Party (KPRP),[5] in their place. The new regime renamed Cambodia the People's Republic of Kampuchea (PRK).[6]

....

[2] Sihanouk originally became king in 1941.

[3] Sihanouk gave the Khmer Rouge this name when he referred to them as *les Khmers rouges* (literally, ' the red Khmer').

[4] The clashes began soon after the April 1975 communist victories in Vietnam and Cambodia, with the Khmer Rouge seeing every territorial dispute with Vietnam as evidence that Hanoi was attempting to continue its centuries long domination of Cambodia.

[5] The Khmer People's Revolutionary Party changed its named to the Cambodian People's Party in 1991.

[6] The People's Republic of Kampuchea was renamed the State of Cambodia in 1989.

The ousted Khmer Rouge fled to the Thai border where they were joined by the forces of two non-communist groups, Prince Sihanouk's FUNCINPEC (a French acronym for National United Front for an Independent, Neutral, Peaceful and Cooperative Cambodia) and the Khmer People's National Liberation Front (KPNLF).[7] In June 1982, the three groups formed a government-in-exile, the Coalition Government of Democratic Kampuchea (CGDK), to fight against the KPRP regime in Phnom Penh and its Vietnamese backers.

Civil war, including sporadic infighting between the three CGDK factions, continued in Cambodia throughout the 1980s with external political and in some cases, military support provided to the antagonists along cold war lines. The end of the Cold War, however, opened the way for a negotiated settlement of the seemingly intractable 'Cambodian problem', with Australia playing a major facilitating role.[8] In 1989, Vietnam withdrew its remaining forces from Cambodia. In 1991, the three CGDK factions and the KPRP regime in Phnom Penh agreed to a ceasefire and signed the Paris Peace Accords that in 1992 placed Cambodia under the temporary administration of the United Nations Transitional Authority in Cambodia (UNTAC).

UNTAC AND DEMOCRATIC ELECTIONS

UNTAC prepared Cambodia for general elections, which were held in mid 1993. The Khmer Rouge did not participate; a year earlier, it had withdrawn from the peace process and returned to the jungle.

The elections were a historic exercise in democracy. Despite persistent threats of violence throughout the campaign period, most registered voters cast their ballots on election day in largely peaceful circumstances. Most voters were illiterate but because of UNTAC's successful voter-education drive, they understood the technical requirements of voting and that the poll was secret. The result, a win to FUNCINPEC rather than the incumbent Cambodian People's Party (CPP), surprised most observers, who had not anticipated the strength of popular support for Sihanouk or the desire for change.

Of all the parties contesting the election, only four won places in the 120 seat National Assembly: FUNCINPEC (58 seats); the CPP (51 seats); the Buddhist Liberal Democratic Party, BLDP, successor to the KPNLF, (10 seats) and Molinaka[9] (1 seat). FUNCINPEC, the CPP and elements of the BLDP formed a coalition government, heavily favouring the two major parties. The leaders of FUNCINPEC and the CPP, Prince Norodom Ranariddh (Sihanouk's eldest son) and Hun Sen,[10]

7 The KPNLF was led by Son Sann, who held various ministries during the 1950s and 1960s, eventually becoming Prime Minister under Sihanouk in 1967-68.

8 Australia's role in facilitating the peace settlement and in the subsequent administration of Cambodia under the United Nations Transitional Authority in Cambodia (UNTAC) is described in a forthcoming book by Ken Berry.

9 Molinaka (Movement for Cambodian National Liberation) is an offshoot of FUNCINPEC currently aligned with the CPP.

10 Hun Sen was Foreign Minister and later Prime Minister in the KPRP-CPP regime.

became respectively First and Second Prime Minister.[11] Government ministries were divided between their parties with the BLDP securing three junior portfolios; it currently holds just one - Information.

In September 1993, Cambodia adopted a new democratic Constitution, becoming a constitutional monarchy under King Sihanouk again.

THE GOVERNMENT: AN UNSTABLE MODUS VIVENDI

The unusual power sharing arrangement between FUNCINPEC and the CPP (the BLDP is largely irrelevant) is meant to be a transitional measure, but it has given Cambodia a functioning government of sorts. However, it is an unequal arrangement; the two parties share power in name only. FUNCINPEC, although the 1993 election victor, never gained control of policy or administration from the CPP after the elections. As the former incumbent regime and inheritor of a strongly centralised, communist party structure, the CPP is organisationally stronger than FUNCINPEC and retains a strong hold on the police, armed forces and much of the bureaucracy (Frost, 1996, p. ii). It also predominates in the provinces and at the local level.

After the Constitution was adopted, a short honeymoon period of apparent cooperation soon gave way to the deep divisions between the two parties that are the result of past conflicts and suspicions, and to increasing disquiet on the part of FUNCINPEC over its unequal share of power (Frost, 1996, p. 5). Tensions between the two rose inexorably and came to a head in the first half of 1996: Ranariddh's threat to dissolve the partnership drew a sharp warning from Hun Sen. However, in mid 1996, Ranariddh and Hun Sen appeared together in Tokyo to present a united front to the international donor community.

Yet the war of words between the two sides, amounting to a cold war, according to a senior government official (Lee, 1996, p. 16) recommenced soon afterwards. Jockeying between the two intensified as they began to focus on local elections scheduled for 1997 and, more importantly, national elections scheduled for November 1998 that are meant to end the current transitional arrangements and see one or other of the two main parties take government in its own right.[12] Then, a surprise split in the Khmer Rouge added a further volatile element to the mix.

11 The two prime ministers formula is a transitional provision written into the Constitution; it is intended to apply only until the next general elections, scheduled for November 1998.

12 It is open to FUNCINPEC and the CPP to form another coalition government after the 1998 national elections, but the deep divisions and tensions between the two parties would make such an outcome no more effective or satisfactory than the current arrangement. The CPP has said it will continue coalition government after 1998, but it clearly envisages that it will be the dominant party.

PARTIES AT A GLANCE

Cambodian People's Party

The CPP is the successor to the communist Khmer People's Revolutionary Party (KPRP) established in 1951 to fight for independence from France. At an extraordinary congress in 1989, the KPRP renamed itself the Cambodian People's Party and discarded communism in favour of a social democratic platform. Second Prime Minister Hun Sen is the Deputy President of the CPP; the party President is Chea Sim, current head of the National Assembly.

FUNCINPEC

FUNCINPEC was established by Sihanouk in 1981. In 1992, it became a political party with Prince Ranariddh as Chairman. It won the 1993 elections, so Prince Ranariddh is First Prime Minister.

Khmer Nation Party

The KNP was established in 1995 by Sam Rainsy, the former FUNCINPEC Finance Minister in the Coalition Government, who was sacked in 1994 for his strong criticism of the Government. He also was ousted from FUNCINPEC and expelled from the National Assembly in 1995. The KNP is yet to receive formal recognition from the Government. The KNP platform includes anti-corruption, the promotion of human rights and democracy, the defence of territorial integrity and settlement of the problem of illegal immigrants. (The last two planks are aimed respectively at Vietnam and Vietnamese settlers in Cambodia.)

Buddhist Liberal Democratic Party

The BLDP was formed from the KPNLF established by former Prime Minister Son Sann on 9 October 1979. In mid 1992, the political wing of the KPNLF was renamed the BLDP to contest the 1993 election. The party split in 1995 and now comprises two factions, one led by Son Sann (now part of the FUNCINPEC led National United Front), the other by Information Minister Ieng Mouly (now aligned with the CPP).

Khmer Rouge

After signing the Paris Peace Accords, the Khmer Rouge withdrew from the peace process, attempted unsuccessfully to sabotage the 1993 elections and continued a guerrilla war against the Government. The Khmer Rouge has been considerably weakened by mass defections since August 1996 when Ieng Sary, a Deputy Prime Minister in the Democratic Kampuchea regime, split from the hard liners in the Khmer Rouge under Pol Pot and Ta Mok.

The Khmer Rouge Split

Following their mid 1992 withdrawal from the UNTAC process, the Khmer Rouge were largely confined to sparsely populated areas in northern and western Cambodia. There they were isolated both from Phnom Penh politics and from external sources of materiel support. Under these conditions, their capability was eroded but they were still strong enough to repel concerted government attacks on their main bases.

In August 1996, Ieng Sary, 'Brother Number Four' in the Khmer Rouge hierarchy and a former brother-in-law of Pol Pot,[13] announced that he had broken with the Khmer Rouge hard liners led by Pol Pot and Ta Mok, taking with him two Khmer Rouge divisions of some 4 500 soldiers, around half of the Khmer Rouge's total fighting strength. Ieng Sary's defection also cut off the Khmer Rouge from its main source of revenue: the timber and gem rich, north western jungle region surrounding Pailin.[14] These losses have important implications for the Khmer Rouge's prospects.

While a significant coup for the Government, the split sharpened the divide between the coalition partners, with each seeking to enlist the political and military support and the economic assets of the Ieng Sary group and other Khmer Rouge defectors. The competition is earnest, as the result could bear on the political prospects of the two main parties. FUNCINPEC, much the weaker of the coalition partners, militarily, financially and organisationally, has the most to gain. An alliance between it and Ieng Sary's Democratic National Union Movement (DNUM), could help even up the strategic balance. A CPP-DNUM alliance, on the other hand, while less likely, would probably tip the balance irretrievably in the CPP's favour.

Pre-Election Postures

By early 1997, two distinct electoral alliances had begun to coalesce: an anti-CPP (and anti-Vietnamese) National United Front (NUF) led by FUNCINPEC and linking it with the Son Sann faction of the BLDP and Sam Rainsy's Khmer Nation Party (KNP); and a CPP led alliance including the Ieng Mouly faction of the BLDP, the Liberal Democratic Party (LDP), Molinaka and a number of smaller parties. As elections approach, more parties will join the two opposing alliances. At the NUF's founding congress on 27 February 1997, the DNUM declared its support for the policies and principles of the new front. In an interview, Ieng Sary insisted he had no further plans to seek political party status for the DNUM, to organise a separate party or to run in the national elections. The remaining Khmer Rouge hard liners, still in the jungle, also have publicly supported FUNCINPEC.

....

13 Ieng Sary is often described as number two in the Khmer Rouge hierarchy, but according to Thayer (1996, p. 24), he occupied the number four slot before the August 1996 split.

14 Ieng Sary's move was not really a defection, as he formed his own political organisation, the Democratic National Union Movement (DNUM), and retained administrative control of Pailin independently of the Government in Phnom Penh. The revenues from gem mining and logging have therefore continued to accrue to Ieng Sary's group rather than to the Government. Although the two divisions of soldiers loyal to Ieng Sary were nominally integrated into the Government's forces, they, too, continued to act independently in the areas under the control of Ieng Sary's group.

Current Position

From the second half of 1996 to mid 1997, tensions between the two main parties virtually paralysed government administration and sharpened the natural divisions in the armed forces.[15] The co-Prime Ministers openly rejected each other's legitimacy and authority.

DEMOCRACY UNDER PRESSURE

Apart from jockeying between and within mainstream political parties,[16] attempts since 1993 to transplant liberal democratic concepts to Cambodia also have generated tensions. Cambodia had little historical or social basis for democratic elections, human rights protection, free political expression and free press comment, so the goal of developing them, with severe damage remaining from the Khmer Rouge years and after two decades of internal war, was clearly ambitious (Frost, 1996, p. 5).

However, many ordinary Cambodians are strongly commited to nurturing liberal principles: citizens eagerly prepared for and participated in the UNTAC elections; a boisterous free press thrives in Phnom Penh; parties of all persuasions still find eager recruits; and a number of non-government organisations actively promote and protect human rights. Despite this, Cambodia's nascent democratic values and practices face an inhospitable reception from the country's top leaders, some of whom appear to reject political opposition as a legitimate activity. The ruling coalition dampens open political contests and co-opts, cowers, or marginalises centres of power (Heder in Frost, 1996, p. 6).

Several developments illustrate this illiberal trend:

- in 1995, Sam Rainsy was dismissed as Minister of Finance and expelled from the National Assembly, largely because of his zealous and outspoken opposition to official corruption
- Rainsy's subsequent founding of a new political party, the Khmer Nation Party (KNP), was opposed by the Government, which at first sought to ban all political parties apart from the four represented in the National Assembly. The Government does not legally recognise the KNP
- the passage by the National Assembly of a new press law in 1995 curtailing press freedom was followed by violent attacks on newspaper premises and journalists, and the separate killing of four editors. Journalists publishing articles criticising either of the two main parties are routinely threatened; a number have been imprisoned
- the Government continues to gain greater control over non-government organisations.

---

15 The Royal Cambodian Armed Forces (RCAF) is an amalgam of the formerly separate military forces of the CPP, FUNCINPEC, KPNLF (that is BLDP) and now Khmer Rouge defectors. The RCAF is therefore highly factionalised, and this has led to clashes, sometimes involving casualties.

16 FUNCINPEC, the CPP, the BLDP and the KNP all suffered internal ructions and leadership tensions.

Politics, crime, corruption and the high incidence of violence in Cambodia seem closely connected. Instances of apparently politically motivated killing are common, as are allegations of serious violations of human rights (killings, beatings, rape and torture of villagers and other civilians and extortion at road checkpoints) made against the armed forces, police, and Khmer Rouge. These legacies of past conflict and social upheaval will not easily be overcome.

ADMINISTRATION DIVIDED

Deficiencies in the government administration, much of which was destroyed during the Khmer Rouge period, hamper economic development. They discourage many serious investors while attracting the more exploitative ones.

The bureaucracy is bloated and functions poorly. Public service salaries are very low (on average, US$20 per month); moonlighting and absenteeism are common. Many officials lack the technical skills required to assess foreign investment applications and implement foreign aid programs (Frost, 1996, p. 13).

Administrative functions are duplicated and coordination between the centre and the local level is poor. A public service census in 1995 found that 4 000 positions drawing salaries were not actually occupied (Frost, 1996, p. 13). This situation is replicated in the Royal Cambodian Armed Forces with a ghost army echoing Lon Nol's 'phantom soldiers' of the early 1970s (Shawcross, 1980, p. 345).

The bureaucracy cleaves along party lines, although most public servants side with the CPP. The two main parties agreed to divide equally the top two to four positions in each ministry, but foreign investors need to be keenly aware of the party affiliations of government officials, although both parties will normally participate in government decisions affecting a foreign investor's interests. Therefore, investors must consult officials of both parties and resist the temptation to align themselves with either side.

In these circumstances, there is no neutral 'state' machinery to manage national affairs. Both Prime Ministers must sign circulars; otherwise, circulars risk being ignored by officials of the other party, who will merely side with their own patron (Hiebert, 1996, p. 25).

Bribery and corruption thrive in this environment. Projects often are won by paying off officials, then reselling at a profit. Furthermore, Cambodia's natural resources often are exploited more for the benefit of well placed individuals rather than the nation. Forestry reserves, in particular, are being depleted much faster than they can be replenished. (See Chapter 8 - *Cambodia: Economy*.)

Reform

The Government has stated it intends building a smaller and considerably streamlined, more skilled and efficient and better paid public service. To achieve this, the World Bank and the United Nations Development Program will assist with a program of retrenchments. Government ministries will be restructured. Given the highly politicised character of Cambodia's public service and the imminence of elections, progress in reducing numbers has been slow.

Public service reforms have been carried through to the military: the number of generals has been reduced from 1 876 to about 300 and demotions have occurred at other senior levels. However, recent mass Khmer Rouge defections have swelled the ranks of the armed forces, providing a further challenge to the Government's demobilisation plans.

THE LEGAL SYSTEM

One difficulty both Cambodians and foreigners face is identifying the law applying in a given situation. Under the 1993 Constitution, any past law (or regulation) may apply today unless or until it is displaced by a new, inconsistent law. A knowledge of Cambodian legal history is useful:

- before 1975, Cambodia's legal and judicial system consisted of laws and structures the French superimposed on the pre-existing indigenous system
- the Khmer Rouge however, abolished all existing laws and legal institutions; most judges and lawyers were killed, died or fled the country. The Khmer Rouge made no attempt to set up an alternative system but operated through arbitrary administrative decisions
- the KPRP regime rebuilt the legal system to a limited extent, with strong Vietnamese socialist influences.[17] When UNTAC took control in 1992, Cambodia had a functioning court system, with some judges trained in Vietnam, Russia and East Germany. The judiciary was not independent; courts were subject to direction and interference; and the legal profession was virtually non-existent
- during the period of economic liberalisation after 1989, several laws, including the current land and labour laws, were adopted
- the Supreme National Council[18] adopted a number of new laws, including a criminal and judiciary law, and a press law during the UNTAC period.

Current Situation and Reforms

Cambodia's 1993 Constitution provides for the separation of powers and an independent judiciary. It also enshrines Cambodia's adoption of a market economic system. The National Assembly enacts laws and the King promulgates them. Laws originate in proposals by members and committees of the National Assembly, the Prime Minister, and the Council of Ministers (acting on recommendations of the ministries).

The Government is rebuilding Cambodia's legal infrastructure with new laws that aim to combine the best of the the pre-1975 civil law and common law traditions. Since 1993, the National Assembly has adopted many new laws to support the

17 Cambodia's current contract law was drafted in this period.

18 The Supreme National Council was the interim governing authority composed of representatives of UNTAC and the four political factions that signed the Paris Peace Accords (that is the CPP, FUNCINPEC, the KPNLF and the Khmer Rouge).

development of a modern market economy. As in Laos, continuing legislative gaps are covered by issuing executive decrees.

As a new ASEAN, Cambodia is keen to ensure its legal system integrates with those of established ASEAN member countries (Dirksen, 1996, p. 8). Consequently, the company law presented to the National Assembly in 1995 was withdrawn because it was considered not to conform sufficiently with ASEAN standards. A new draft is being prepared (Dirksen, 1996, p. 15).

Foreign Investment

Both foreign and domestic investment are governed by the 1994 Investment Law. Most sectors of the economy are open to foreign investment; only a few activities, notably importing and exporting and certain areas of transport and construction, are restricted to Cambodian nationals.

Cambodia is yet to adopt a comprehensive company law, so the regulation of business enterprises in general is flexible. For example, the level of foreign equity permitted in Cambodian registered companies is not restricted. Wholly foreign-owned limited liability companies are popular; joint ventures and business cooperation contracts are less popular.

The Investment Law guarantees:

- no nationalisation of investors' property
- no price controls on products or services produced by licensed investors
- remittance of foreign currencies abroad
- decisions on foreign investment applications in most cases within 45 days. However, this stipulation is only rarely followed. Lengthy bureaucratic delays of up to six months, largely caused by official ineptitude and political infighting, are the norm (Hiebert and Lee, 1996, p. 57).

Investment projects also can attract a range of, by regional standards, generous incentives, for example tax holidays and exemptions although some of these may not yet operate in practice.[19] As a general rule, the larger and more important the project, the more favourable the incentives that may be granted.

The Cambodian Investment Board operates within the Council for the Development of Cambodia as the one stop service for approving foreign investment projects and granting incentives. Certain large scale development and investment projects require the approval of the Board. Otherwise, foreign investors need not normally place themselves under its jurisdiction unless they seek preferential treatment (incentives). Many investors by-pass the Board and deal directly with officials exercising decision making power in the ministries or the ministers themselves.[20] This practice has tended to undermine the Board's effectiveness.

....

19 This is because the relevant implementing regulations under the Investment Law have not yet been issued.

20 As in Laos, for example, where a similar one stop service is offered, the prudent foreign investor maintains relations with all government agencies, including provincial authorities, that have a role in approving a particular project.

Land Law

As most foreign investment projects involve the use of land, the legal position on land ownership and use is critical. Land can be owned only by Cambodian nationals or companies, and other legal entities with at least 51 per cent Cambodian equity. The 1993 Constitution expressly prohibits foreign ownership of land. Foreign investors may lease land for up to 70 years[21] and, in theory, can own buildings on land leased for this maximum period.[22]

Cambodia's recent tumultuous history complicates land ownership. The Khmer Rouge abolished all private interests in land. Today, establishing a clear title to land can be difficult.

Dispute Resolution

Like many other Asian countries, Cambodia has a tradition of dispute resolution favouring community based conciliation and mediation over adversarial 'win-lose' adjudication. Compromise solutions represent a balancing of interests. This tradition remains strong and influences how many disputes are resolved in the courts.

The court system is three tiered, consisting of provincial and municipal courts, a single Court of Appeals based in Phnom Penh and a Supreme Court. A separate Constitutional Council to rule on the constitutional validity of laws and regulations is still to be established.

In the provinces, conciliation offices staffed by justice representatives conduct conciliation in the first instance. The system is very informal and the justice representatives have only rudimentary legal training. The importance of conciliation in the Khmer justice system, however, gives these people an important role.

The courts are currently the only judicial or quasi-judicial forum available to deal with commercial disputes. Judges and magistrates normally lack expertise in commercial law. Certain ministries are prepared to mediate on a case-by-case basis, but their mediation has no legal effect unless the parties bind themselves contractually to accept the result.

In practice, foreign investors avoid using the Cambodian court system to resolve commercial disputes. They rely instead on clauses in their contracts requiring offshore arbitration of all disputes. This practice may change once the Government establishes a commercial tribunal with sole jurisdiction over commercial disputes. The Government also plans to set up an arbitration and mediation body (Dirksen, 1996, p. 39).

Enforcement of foreign arbitral awards in Cambodia will be difficult until the Government ratifies the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, which it already has signed. The Government is considering adopting the United Nations Commission on

21 The Government is considering increasing the maximum period to 99 years.

22 In practice, however, the Cambodian authorities seem not to recognise the separate ownership of buildings on land owned by someone else.

International Trade Law (UNCITRAL) Model Law on international commercial arbitration, the Convention Establishing the Multilateral Investment Guarantee Agency and the Convention on the Settlement of Investment Disputes between States and Nationals of Other States. It also is considering joining or using the services of either the Regional Centre for Arbitration in Kuala Lumpur or the Singapore International Arbitration Centre.

Legal Profession

A continuing effect of the Khmer Rouge period is the few private Cambodian lawyers and handful of foreign trained lawyers, including some overseas Cambodians who have returned.

Under the 1995 Bar Code, foreign lawyers can practice in Cambodia in association with a Cambodian lawyer, provided their home countries accord reciprocal rights to Cambodian lawyers. As such reciprocal rights are rarely if ever extended, foreign lawyers in Cambodia operate under certain restrictions as legal or business consultants. Only one Australian law firm has established a presence on the ground in Cambodia; others operate on a fly in-fly out basis.

Assessment

Legal reform is proceeding very slowly. Cambodia still lacks a number of laws needed to support a transparent business environment, notably separate company and bankruptcy laws and legislation to protect intellectual property. Foreign investors criticise the Investment Law as insufficiently detailed.

In-country dispute resolution is not yet a practical option for foreign investors. The legal system also is affected by the corruption that pervades most areas of Cambodian life. FUNCINPEC's lack of support among the judiciary has led it to block indefinitely the establishment of the Supreme Council of the Magistracy, which would oversee the independence of the judiciary.

More worrying than these deficiencies is the continuing low adherence to legal norms in Cambodia; the concept of an overarching rule of law is relatively alien and new. For example, no mechanism exists for citizens to enforce constitutional provisions guaranteeing individual rights. The continuing application of Article 51 of the Law on Civil Servants, which entrenches the problem of impunity from prosecution of public servants and members of the armed forces, is of serious concern.

PROSPECTS

The 1991 Paris Peace Accords brought significant gains to Cambodia. The country is no longer a military proving ground for international and regional rivalries. Democratic institutions and an elected government have replaced the one party state. The Khmer Rouge have suffered a substantial and rapid decline. Human rights conditions have improved and non-government organisations are active in monitoring them. The economy is growing steadily with continuing international donor support. Coming after many years of deadlock, the Paris Peace Accords and the subsequent, striking success of the elections may have created unrealistic expectations of rapid political stabilisation and economic recovery. Developments since the 1993 elections have demonstrated clearly that the damage and debilitation suffered by Cambodia and its society since the late 1960s left legacies of political and armed conflict, economic backwardness and inequality, and institutional weakness that are likely to take decades to overcome (Frost, 1996, p. 22).

There are serious obstacles to the re-creation of a stable political and civil order in Cambodia as a basis for durable economic development and eventual prosperity. For a start, the leading individuals and parties in Cambodian politics today, until recently, were at war with one another. For the Khmer Rouge hard liners, the war continues, albeit on a much reduced scale. Military engagement has given way to a different form of conflict, power politics, which are played out in every sphere of Cambodian life, from the economy to the military. The State in its current incarnation as the Kingdom of Cambodia is barely four years old and is still at a very early stage of development. Cambodian institutions are unable to restrain the often arbitrary actions of individuals seeking personal political and economic advantage.

Under the 1993 Constitution, the FUNCINPEC-CPP duumvirate has one more year before it faces national elections. Local elections scheduled for 1997 will give a clue to the likely national outcome in 1998. The sustainability of the current power sharing arrangement until then is questionable. Although tensions between the coalition partners have run high for most of their time in government, each recognised its own best interests and, incidentally, those of the country, were served if the two stayed together. Pressure from the international donor community, along with aid inflows and foreign investment, has probably played some part in this.

However, manoeuvring over the spoils from the Khmer Rouge split has sharpened the broader competition between the two contenders for government after 1998. The rivalry and manoeuvring and the tensions these generate will intensify as the elections draw nearer. FUNCINPEC could seek to highlight the differences between it and the CPP, thereby improving its electoral chances, by withdrawing from the coalition. Such a move would raise tensions, increasing the potential for political violence.

On the other hand, a combination of self interest, pressure from the international donor community and influence from ASEAN could keep the coalition together until the national elections. Even with the political stand-off between the two parties in early 1997, responsible leaders on both sides tried to contain their growing differences. Whatever the outcome, further crises of governance, along with escalating violence, appear inevitable.

The anti-CPP NUF alliance, which appears to have won the approval both of the DNUM and of the Khmer Rouge hard liners, could provide a fairly even election contest with the CPP and its allies. The NUF can be expected to handle the DNUM connection very carefully, particularly as Ieng Sary is widely regarded inside Cambodia and internationally as one of those centrally responsible for the bloody purges that characterised the Khmer Rouge period.[23]

....

23 Ieng Sary, along with Pol Pot and several other members of the Khmer Rouge leadership, were during the PRK period convicted *in absentia* of genocide. King Sihanouk's decision in September 1996, based on political expediency, to grant Ieng Sary an amnesty generated considerable controversy inside and outside Cambodia.

Inevitably, the NUF will strengthen its electoral prospects by tapping the rich vein of nationalist anti-Vietnamese sentiment that runs through Cambodian society. It will play on the role of the CPP in facilitating the Vietnamese invasion in 1978 and in collaborating with the Vietnamese as military occupiers for the ensuing decade. For many Cambodians, there is no contradiction between their fear and loathing of the Khmer Rouge and their dislike of Vietnam and Vietnamese settlers in Cambodia.

On the other hand, FUNCINPEC's close association with Sihanouk is no longer as persuasive a factor as it was in 1993. Also, the party's relatively ineffectual performance in government has disappointed many who voted for it.

The CPP still appears electorally the stronger of the two sides. Apart from the advantages it continues to enjoy as the former incumbent regime, the CPP's leadership appears more in control and determined, and less vacillating, than that of its rival. With its greater organisational strength and support base in the bureaucracy, police and armed forces, the CPP also is better placed than FUNCINPEC to mount an effective, nationwide election campaign and resort to strong-arm tactics if its aspirations appear likely to be thwarted. Above all, the CPP appears firmly determined to hold on to power. As the 1993 elections showed, the CPP would be likely to challenge an electoral defeat through a mix of legal, political and other measures.

Although the CPP and FUNCINPEC provide the main contest for power, the hard line Khmer Rouge and the monarchy as an institution are two peripheral factors that complicate Cambodia's political outlook and search for a stable polity.

The Khmer Rouge: Down but Not Out

The decision by the Khmer Rouge not to enter Cambodia's political mainstream in 1993 was short-sighted. Indeed, it proved disastrous for the once powerful organisation, increasingly marginalising it, politically, militarily and economically.[24]

Following the Ieng Sary split and associated and earlier Khmer Rouge defections, the hard line Khmer Rouge still loyal to the Pol Pot-Ta Mok political military leadership are a force probably of no more than 3 000 fighters. This represents a substantial decline from the 30 000 estimated before 1991.[25] The hard line group is centred on Anlong Veng in the country's north but retains some residual, although largely ineffectual, support in other parts of Cambodia. Along with most of their fighting strength, the hard line Khmer Rouge have seen their economic support base whittled down: China discontinued support after the Paris Peace Accords were signed; Thai interests no longer are engaged substantially; and Ieng Sary's departure has cost the Khmer Rouge crucial revenues from logging and gem mining around Pailin.

....

24 A possible alternative interpretation is that by refusing to open up areas under their control to UNTAC in 1992 to 1993, the Khmer Rouge in fact delayed the process of decline that is now well advanced in the organisation (Frost, 1997).

25 Pre-1991 estimates of the Khmer Rouge's fighting strength may have been exaggerated for political reasons to make the organisation seem more of threat to security than it was. Similarly, current estimates are educated guesses as the Khmer Rouge remains a highly secretive organisation.

The hard line Khmer Rouge now face several options, two of which are:

- to continue indefinitely as a small, weak insurgent group capable of defending Anlong Veng and irritating the Government in some other areas. The hard line group probably has sufficient economic resources at its disposal to sustain itself indefinitely at a relatively modest level
- to follow the lead of Ieng Sary and strike a deal, retaining control of territory around Anlong Veng.

While Pol Pot remains alive and in control, the first option is more likely. Any move to grant him an amnesty would not only be extremely difficult domestically, but also would be almost certainly unacceptable to a number of Cambodia's major donors. Pol Pot has no obvious successor and his eventual death will weaken the Khmer Rouge considerably. In the meantime, government amnesties, military campaigns and defections continue to make inroads into its fighting strength. In these circumstances, the Khmer Rouge could come to imitate Laos' insurgents, whose military activities now are almost indistinguishable from banditry. (See Chapter 10 - *Laos: Politics*.) Or, like the Burmese narco-insurgent groups, the hard line Khmer Rouge could focus increasingly on money making activities as their political and military prospects continue to diminish.

Alternatively, the Khmer Rouge hard core, minus Pol Pot and Ta Mok, could at some stage seek an accommodation with the Government. If granted, this would presumably give them a degree of territorial autonomy and a possible stake in Cambodia's political future.

The Khmer Rouge Defectors: An Emerging Third Force

The Ieng Sary group and substantial numbers of other Khmer Rouge defectors have joined the Royal Cambodian Armed Forces. More importantly, they rapidly are carving out a role for themselves as a minor third force in Cambodian politics, playing off the two main parties against each other in a quest for maximum advantage.

If the Khmer Rouge defectors can enter the political mainstream as a separate grouping, their pronounced anti-Vietnamese posture and broad appeal to the peasantry that make up 85 per cent of Cambodia's population could attract possibly significant electoral support, particularly if they are included in a NUF that adopts the strategy of supporting single candidates rather than splitting the vote between the parties.

Moreover, the characteristics that formed the background to the Khmer Rouge's original political appeal, the political self interestedness of mainstream politicians, widespread corruption and the growing urban-rural economic gap still are strong.

King Sihanouk's Role

The importance of King Sihanouk in the Cambodian political equation has diminished steadily since 1993. The King's declining health, which has seen him spend long periods undergoing medical treatment out of the country, has played a large part in this. The balancing role that Sihanouk played so cleverly for most of his political career, and particularly during the UNTAC period and shortly after, is now also largely absent.

The future of Sihanouk and the monarchy as an institution are in doubt. Under the 1993 Constitution, Sihanouk's successor is to be chosen by a council that has been nominated but will not function until it is needed. The choice will be difficult, as both major parties need to approve the successor.

Although Hun Sen has declared publicly that 'in Cambodia the monarchy is eternal' (Faulder, 1996, p. 41), his party's newspapers have voiced criticism both of Sihanouk and the institution of the monarchy. Hun Sen and the CPP view the position of the monarch under the 1993 Constitution as one of titular head of state only, without political functions. Only a candidate successor they consider unlikely to emulate Sihanouk's 'political interference' will be acceptable. This will narrow the field ruling out Prince Ranariddh succeeding his father on the throne.[26]

OUTLOOK

Although most or many of the forces that will determine Cambodia's political future and the development of its society already are known, it is extremely difficult to foretell how those forces will interact. Even the short term future for Cambodia is uncertain.

The CPP appears to be electorally the stronger of the two main parties but it is vulnerable to attacks by the anti-CPP NUF alliance focusing on its communist past, its strong links to Vietnam, and its failure to accept the outcome of the 1993 elections. If defeated in the next elections, the CPP still would not lightly surrender government to a coalition that bears a strong resemblance to the old Coalition Government of Democratic Kampuchea political-military alliance. The election is shaping up as a two-way contest between the pre-1991 military antagonists, only now without their international backers. This is potentially destabilising and does not help the cause of national reconciliation. An outright victory to the CPP would probably strengthen authoritarian tendencies already evident, although CPP leaders have committed themselves publicly to the principle of political pluralism.

The current power sharing arrangement, while unsatisfactory in many ways, creates a degree of equilibrium between the various forces in play. However, the high incidence of violence and corruption in Cambodia is unlikely to abate until the institutions of government are more strongly developed.

....

[26] A possible successor acceptable to all sides is Prince Norodom Sihamoni, a son of King Sihanouk, who is Cambodia's Ambassador to UNESCO in Paris.

REFERENCES

Dirksen, Flipse, Doran and Le, 1996, Mekong Law Report: Cambodia.

Faulder, D., 1996, 'I have to be firm', *Asiaweek*, 27 September.

Frost, F., 1997, personal communication with East Asia Analytical Unit.

____ 1996, *Cambodia's Troubled Path to Recovery*, Parliamentary Research Service, Commonwealth of Australia, Canberra.

Heder, S., 1995, 'Cambodia's Democratic Transition to Neoauthoritarianism', *Current History*, December.

Hiebert, M., 1996, 'Truce at the Top', *Far Eastern Economic Review*, 4 July.

Hiebert, M. and Lee, M., 1996, 'Hidden Costs', *Far Eastern Economic Review*, 11 July.

Lee, M., 1996, 'Fighting Words', *Far Eastern Economic Review*, 15 August.

Munson, F.P., Martindale, K.W., McMorris, D.S., Parachini, K.E., Raiford, W.N. and Townsend, C., 1968, *Area Handbook for Cambodia*, US Government Printing Office, Washington DC.

Shawcross, W., 1980, *Sideshow: Kissinger, Nixon and the Destruction of Cambodia*, Fontana Paperbacks, Great Britain.

Thayer, N., 1996, 'After Pol Pot, Who?', *Far Eastern Economic Review*, 29 August.

Chapter 8

ASSISTED ECONOMIC DEVELOPMENT

Cambodia has a population of just over 10 million and a land area of 181 040 square kilometres. It shares borders with Thailand, Vietnam and Laos. During the last 25 years, war and genocide have depleted the country's human and physical resources, causing living standards to fall significantly (Table 8.1).

With an estimated 4.5 million hectares of arable land, Cambodia has good agricultural potential. Extensive forests and a range of ecological zones suit a variety of crops and livestock. The climate is tropical monsoonal, with pronounced wet and dry seasons and much of the country lies within the catchment of the Mekong River. However, the soil outside the Mekong catchment area generally is poor and deforestation and gem mining have damaged the water table.

Over the past 25 years, Cambodia has been a victim of its geography and political underdevelopment (Shawcross, 1994). The challenge for Cambodia is to develop a sustainable market economy and to use its geography to advantage, profiting from its proximity to large, dynamic neighbouring economies while developing strong and stable political institutions. At present, Cambodia depends substantially on external assistance from bilateral donors and international financial institutions to rebuild the economy and integrate itself into the regional and global markets.

OVERVIEW OF ECONOMIC DEVELOPMENT

Despite recent improvements in economic performance, Cambodia is still one of the poorest countries in the world, with a per capita income of US$260. Its economic and social indicators are generally much lower than those of neighbouring economies (see Chapter 13 - *New ASEANS*) and sub-Saharan Africa; they are also lower than those achieved 25 years ago by East Asia's newly industrialised countries. Most economic indicators suggest Cambodia is yet to recover to the levels achieved in the late 1960s (Table 8.1).

The Khmer Rouge years, between 1975 and 1979, severely depleted Cambodia's human resources, particularly its skilled people. In 1979, only 43 physicians were left in Cambodia and life expectancy was around 31 years (Shawcross, 1994). By 1996, most of the population still lacked access to health and education services, drinking water, electricity and serviceable roads. Poverty is greater in rural areas: per capita incomes are much lower than in urban areas, and only 12 per cent of rural people have access to safe drinking water compared with 20 per cent of city dwellers.

Table 8.1

Economic and Social Indicators Low: A Historical Comparison

Indicator	1969	1989	1995
Economic indicators			
Per capita GDP (US$, 1995 prices)	455	208	260
Total GDP (US$ billion, 1995 prices)			2.9
Agriculture as a proportion of GDP	38	52	45
Rice production (million tons)	3.2	2.6	2.7
Social indicators			
Life expectancy (years)	42	46	52
Population per physician (people)	16 250	16 500	7 730
Infant mortality (per thousand live births)	181	160	110
Illiteracy (per cent of population age 15+)	36	71	35

Note: While data are extremely difficult to obtain, most commentators estimate that all social indicators declined sharply during the Khmer Rouge years from 1975 to 1979.

Source: World Bank, 1996, p. 3.

CURRENT ECONOMIC PERFORMANCE

Despite Cambodia's low level of development, a combination of economic liberalisation and generous external assistance has led to rapid economic recovery; GDP expanded at an annual rate of about 6 per cent from 1991 to 1996.[1] Inflation fell sharply from an average of 140 per cent in 1990 to 1992, to 3.5 per cent in 1995, before rising to 7.4 per cent in 1996 (Figure 8.1).

The budget deficit has increased because growth in government revenue has failed to keep pace with expenditure (Figure 8.2). Large amounts of aid, reaching 7.5 per cent of GDP in 1995 have replaced central bank financing of the budget, (printing money) markedly reducing inflationary pressures.

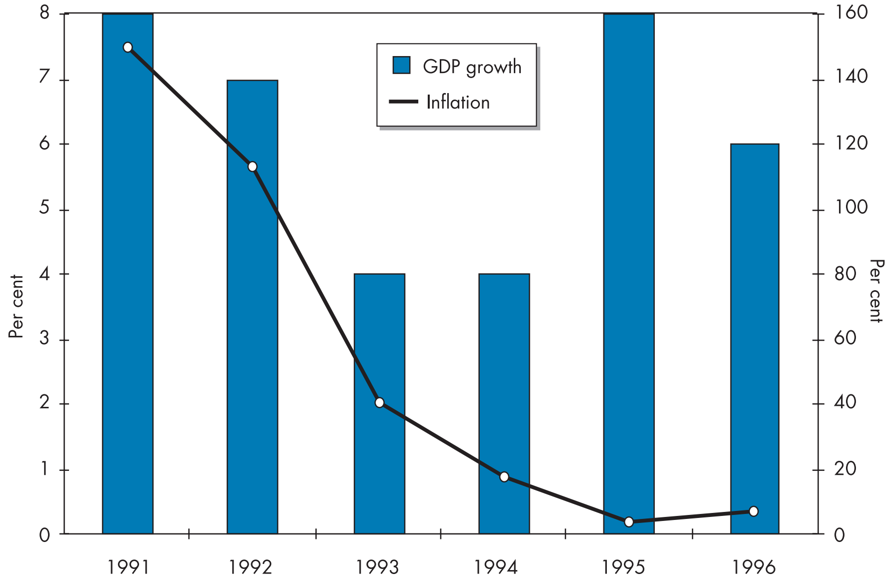
Since March 1994, the Cambodian National Bank has set the official exchange rate daily so as to keep the national currency, the riel, within 1 per cent of the informal market rate (Figure 8.3).

1 Cambodia's financial year is the calendar year.

Figure 8.1

Economic Recovery

Growth and Inflation

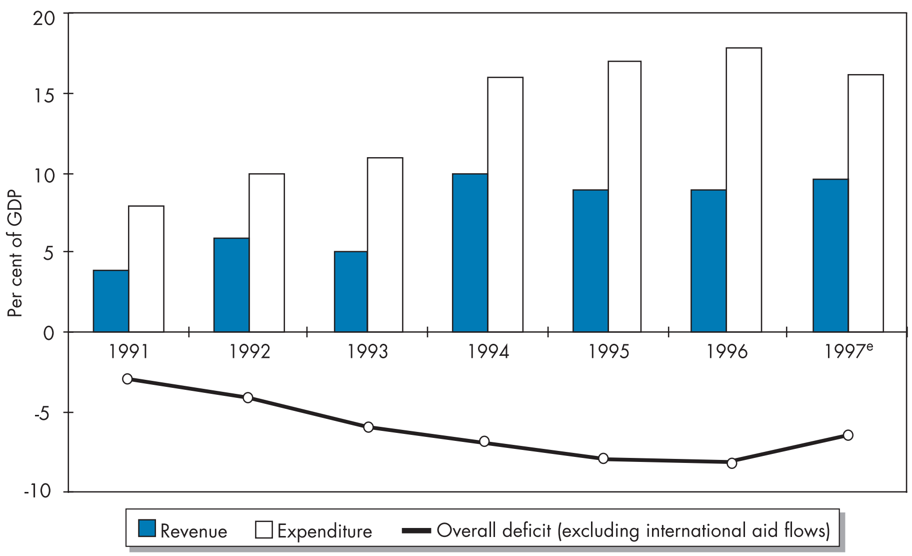


Source: World Bank, 1996, p. 4 and Cambodian Government estimates.

Figure 8.2

Government Expenditure Outstrips Revenue

Budget Deficit, 1991 to 1997

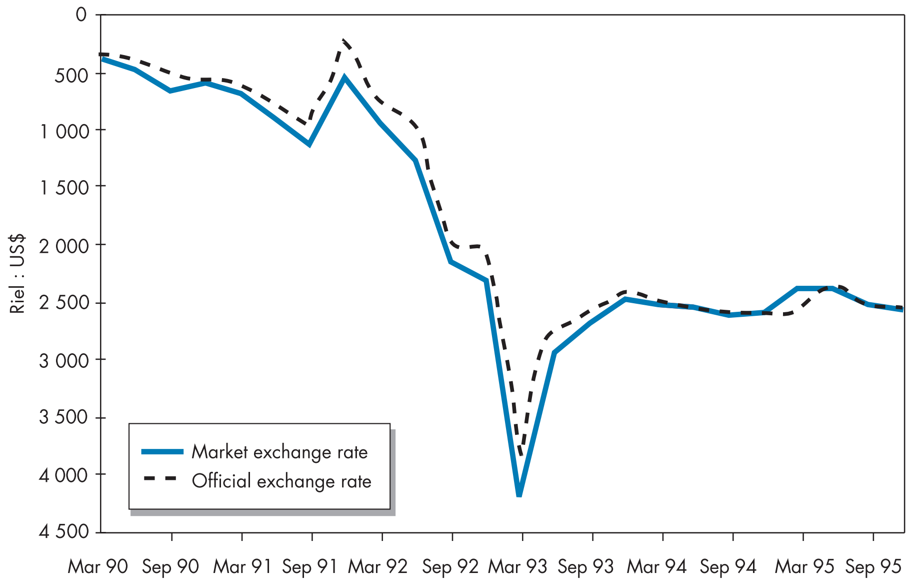


Note: e. Estimate.

Source: World Bank 1996, p. 4 and Cambodian Government estimates.

Figure 8.3

Similar Market and Official Rates of Exchange

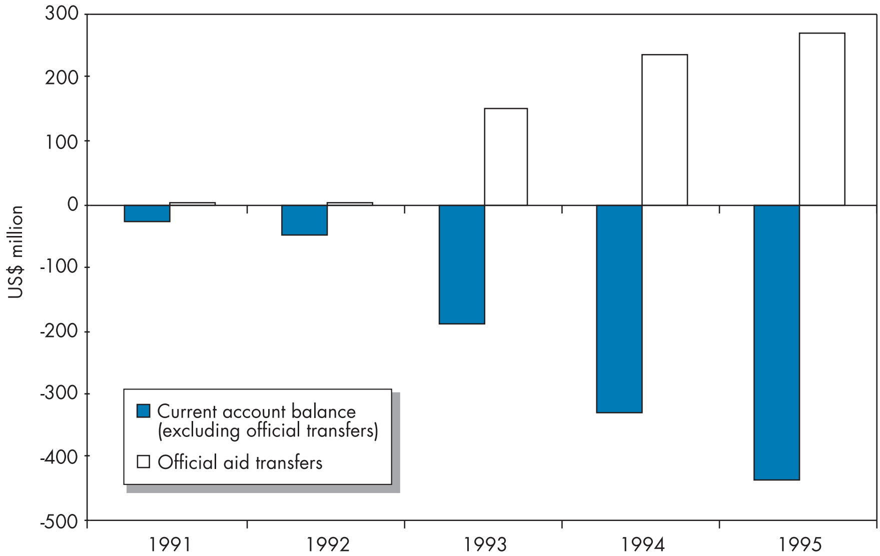


Source: World Bank, 1996, p. A-20.

Official transfers, a stable external environment, improved export performance and increased foreign investment have contributed to an improved balance of payments (Figure 8.4). By September 1996, official reserves had risen to US$218 million (or over 3 months of import cover). Realised foreign investment, mostly from ASEAN countries, rose sharply, from US$10 million per year in 1994 to US$171 million in 1996.

Figure 8.4

Official Transfers Largely Offset Current Account Imbalance, 1991 to 1995



Source: World Bank 1996, p. A-15.

SECTORAL PERFORMANCE

About three quarters of economic growth between 1991 and 1995 came from growth in the construction and services sectors, where most activity was aid related (Figure 8.5).

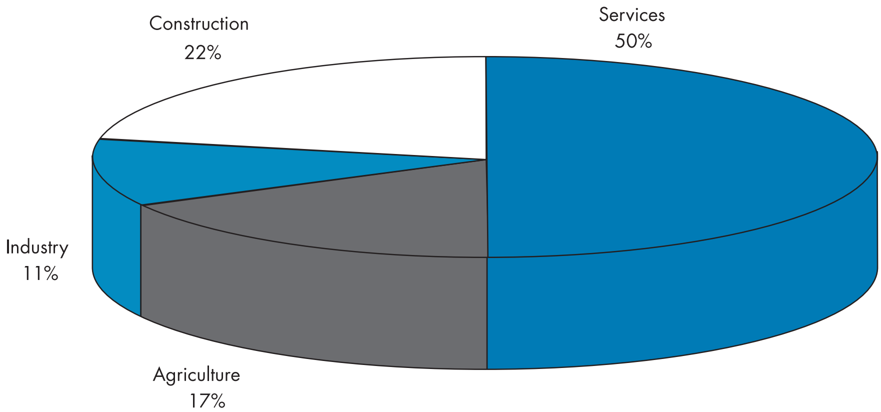
While agriculture plays a central role in Cambodia's economy, employing about 75 per cent of the workforce and in 1995, accounting for 44 per cent of GDP (Figure 8.6), the sector grew at a trend rate of less than 3 per cent between 1990 and 1995.

Industry grew at an average rate of 11 per cent from 1990 to 1995 and accounted for 19 per cent of GDP by 1995. Services (including construction) grew very rapidly at a trend rate of 49 per cent per year, in response to donor-sponsored rehabilitation activities, accounting for 37 per cent of GDP by 1995.

Figure 8.5

Construction and Services Expanding Rapidly

Sources of GDP Growth During 1991 to 1995

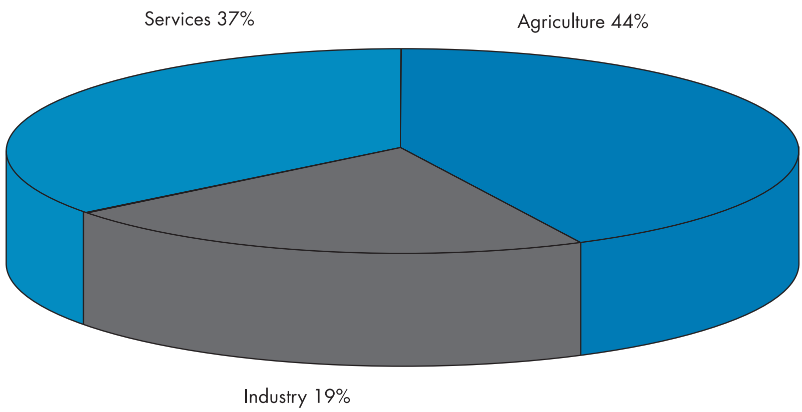


Source: World Bank, 1996, p. iv.

Figure 8.6

Industry and Services Now Exceed Agriculture

Sectoral Shares of GDP, 1995



Source: Economist Intelligence Unit, 1996.

ECONOMIC DATA AND THE BLACK MARKET

War and internal strife have made it almost impossible to collect economic data for Cambodia, particularly from 1979 until 1990. Moreover, a sizeable part of the nation's economic activity has always been unrecorded (Thion, 1994) because the large black market includes border trade, drug, illegal timber and gem-related commerce and informal activity.

The World Bank (1996) notes no reliable statistics indicate the size or composition of the private sector in Cambodia. It estimates about 1.6 million people are involved in informal market activities (unregistered businesses), mostly in micro-enterprises and small businesses, many of them part time.

Smuggling is rife across Cambodia's borders: government sources suggest that this costs the Government US$35 million to $50 million per year in lost revenue. The remoteness of many border areas, lack of resources, and corrupt behaviour of some Cambodian, Thai, Vietnamese and Lao officials and military personnel make it a very difficult problem. Smugglers are seldom tried or convicted through the judicial system, although some boats have been seized and crews fined.

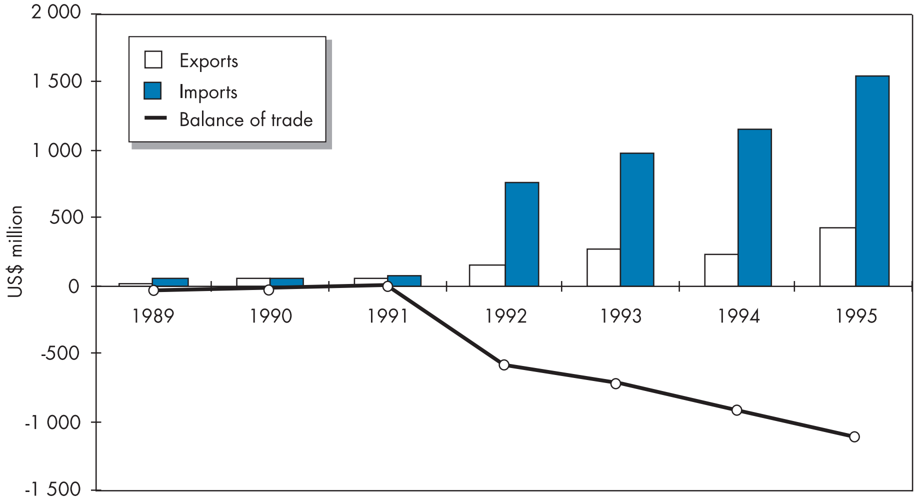
Most smuggling involves timber, rubber, gems, consumer goods and drugs. Lee (1995) argues Cambodia is emerging as a major money laundering centre because of its weak legal framework, ineffective border controls, lack of adequate supervision of banking and financial activity, overwhelming use of cash and popularity of dollars and gold as the means of exchange.

Trade Performance

While Cambodia's small export base has increased four fold since 1991, retained imports have risen six fold, widening the trade deficit (Figure 8.7). As discussed previously, the extent of trade is underestimated due to black market and smuggling activities.

Figure 8.7

Trade Recovering but Deficit Widening



Source: International Monetary Fund, 1996.

PRE-REFORM ECONOMY

The Cambodian economy progressed little from independence in 1953 until the late 1980s, when comprehensive economic reform began.[2] The structure of the economy and agricultural techniques have changed little since the Angkor period, which ended in the fifteenth century.

For a short while after independence, the economy grew at an average of 5 per cent per year, but growth slowed and by 1962, the economy was stagnating. Among the factors contributing to the economic malaise were the loss of the French market, the decline in foreign aid, a 20 per cent reduction in public spending, growing indebtedness, and excessive monetary expansion and inflation.

In the mid 1960s, the Government attempted to stimulate industrial development through nationalising urban industry, but this only exacerbated the situation; by 1968, the economy had ceased to grow at all. The nationalisation policy was curtailed and banks and industries were re-privatised. However, the repression and corruption that characterised the Lon Nol regime (1970 to 1975) caused the economy to fall into crisis once again. Production and exports declined, and the budget and trade deficits escalated, largely because Cambodia became enmeshed in the wider Indochina conflict.[3] Rubber exports, traditionally the second largest

2 Little economic information about Cambodia is available from 1954 to 1989, and more so particularly from 1970 to 1980. Most of the information in this section is from one source, Annear (1996).

3 See Chapter 7 - *Cambodia: Politics*.

export earner, ceased after 1970. By 1972, rice imports were needed for the first time since independence: the harvest that year was less than one third of normal levels.

A comprehensive stabilisation program was attempted in 1971; UN agencies, multilateral banks and foreign governments established an Economic Support Fund to restore monetary stability in the face of rising inflation, financial speculation and black marketeering. However, the introduced reforms did not go far enough and the economy could not insulate itself from the war throughout Indochina. By the time the Khmer Rouge seized power in April 1975, the economy had collapsed.[4]

The Khmer Rouge, calling itself the Government of Democratic Kampuchea, pursued a radical economic experiment designed to return Cambodia to a land of self-sufficient peasant farmers. The Khmer Rouge's four-year plan from 1977 to 1980 aimed to meet 60 to 80 per cent of the demand for basic consumer goods through planned local production. The plan concentrated overwhelmingly on unattainable targets for rice production. The forced resettlement of urban dwellers to the countryside, the persecution of the nation's educated middle class and political purges took a shattering human toll. Most estimates suggest that during this four-year period about 1 million Cambodians were killed or died from starvation. By the time the Vietnamese forces ousted the Khmer Rouge Government in early 1979 and installed a communist government loyal to Hanoi, Cambodia's physical infrastructure was in ruins and its human capital base decimated.

In the absence of functioning markets, formal economic structures and viable infrastructure, a socialist planned economy was adopted. The new Government's first five-year plan prioritised agriculture, trade and infrastructure development and reducing the budget deficit through increased exports and savings. In response, there was an upturn in domestic commerce, illicit crossborder trading, and in government controlled foreign trade (predominantly with the socialist bloc).[5] The Government assumed official title to all land, and money, which was replaced by barter under the Khmer Rouge, was reintroduced in 1980. Despite these measures, the Cambodian economy was characterised by an extreme degree of laissez faire, owing to the limited efficacy of governmental institutions.

While the Government was intent on moving to a centrally planned economy, the security situation and popular resistance to centralisation and agricultural collectivisation made it impossible to implement the 1986 to 1990 five-year plan. In 1986, the Government ceased promoting collectivisation and a year later, it more than doubled the procurement price for rice, bringing it into line with market prices.

Until 1987, the state monopolised external trade and most trade transactions took place under annual agreements with member countries of the communist bloc. In 1989, paralleling similar reforms in Vietnam, the Government moved towards establishing a mixed economy, although initial reforms were partial and ad hoc. Private enterprises were permitted, the private ownership of land for family plots was restored and farmers were able to sell their surplus on the free market, after meeting a small requirement for state procurement.

4 According to Annear (1996), at this time Cambodia was surviving mainly on imported food financed by the USA.

5 Until 1989, Cambodia also benefited from about US$100 million per year in Soviet aid.

RECENT ECONOMIC REFORMS AND THEIR IMPACT

In 1993, the newly elected Coalition Government introduced a comprehensive macroeconomic and structural reform program supported by the international donor community. The resumption of official aid through the International Committee on the Reconstruction of Cambodia has contributed greatly to the process of economic rehabilitation. With International Monetary Fund assistance, the Government also has achieved considerable success in stabilising the economy and implementing structural reforms. The economy has responded well and recent growth, particularly in the private sector in the capital Phnom Penh, has been robust.

The major structural reforms undertaken to date include:

- virtually eliminating the divergence between the official and parallel exchange rates
- decollectivising agriculture and reforming prices
- introducing a commercial banking system and a central bank
- eliminating most non-tariff barriers and streamlining tariffs
- adopting a liberal foreign investment law
- privatising most state-owned enterprises (SOEs).

MACROECONOMIC REFORMS AND PERFORMANCE

Fiscal Reforms and Performance

The 1994 Budget Law created, for the first time, a single national budget. In principle, all revenues and expenditures would now pass through the Ministry of Finance.

The 1996 budget reduced defence and security spending to 5 per cent of GDP and public service numbers by 10 per cent in 1996 and again in 1997. (See Chapter 7 - *Cambodia: Politics*.) However, in practice, the bureaucracy has little control over the military. (See box.) In 1996 the Government also increased the provinces' revenue-raising powers. However, this is incompatible with earlier attempts to centralise budgetary control and could result in wealthier provinces refusing to transfer wealth to poorer ones (Economist Intelligence Unit, 1996).[6]

The fiscal situation and macroeconomic stability remain fragile with foreign financing covering 30 per cent of total budgetary outlays (Table 8.2). The cessation in 1993 of the practice of printing money to finance the budget deficit, has reduced inflationary pressures, allowing inflation to fall sharply and the exchange rate to stabilise.[7]

6 This occurred in Vietnam, where a similar policy, reversed in 1990, was blamed for consolidating the province level fiefdoms that remain a feature of that country.

7 In late 1996, the National Bank Governor expressed concern that instability in the value of the riel was causing the level of official reserves to fall dangerously low. The Finance Minister announced in December 1996 that official reserves had again risen to the equivalent of over 2 months of imports.

The tax revenue base is small and depends largely on imports destined for re-export.[8] To reverse its heavy dependence on trade taxes before Cambodia joined ASEAN, and began to dismantle its tariff regime in line with the requirements of the ASEAN Free Trade Area (see Chapter 14 - *Expanded ASEAN*), the Finance Ministry sought other sources of revenue. In January 1997, the Finance Minister announced a new value added tax and a land tax; both will become effective in 1998 after the scheduled national elections. Penalties for corruption and tax evasion also were announced. Other taxes are being discussed and the Government may need to tighten its policy on investment incentives.[9]

Table 8.2

Government Revenue and Expenditure Risks

The Budget

	(Per cent of GDP)						
	1991	1992	1993	1994	1995	1996	1997[e]
Revenue	4.4	6.2	5.2	9.6	8.9	9.0	9.6
Expenditure	7.8	9.8	11.0	16.1	17.0	17.9	16.2
of which defence	3.5	4.7	4.0	5.3	5.9	5.3	4.9
Overall deficit	-3.4	-3.6	-5.7	-7.0	-8.0	-8.1	-6.5
Foreign financing	0.5	0.1	1.4	7.0	7.5	6.6	4.8
Domestic bank financing	1.1	4.5	0.1	-0.2	0.1	-0.2	0

Note: e. Estimates contained in the 1997 budget.

Source: World Bank, 1996, and Cambodian Government estimates.

On the expenditure side, defence and security expenditures continue to absorb one third of budget expenditures, despite the reduced threat from the Khmer Rouge. As a result of this, health and education expenditures are constrained; the 1997 budget estimates that they will account for 10 per cent and 8 per cent respectively of total outlays in 1997.

Priorities

The Government's target is to double the tax ratio from the current low 6 per cent of GDP to 13 per cent in the next decade and to cover current expenditure entirely from domestic sources by 1997 (Economist Intelligence Unit, 1996). The Finance Ministry has been instructed to oversee the rationalisation of the taxation system and with International Monetary Fund assistance, has prepared a comprehensive strategy to achieve this objective. However, tax reform could be delayed in the lead-up to the 1998 elections. Apparently, revenue collection already has increased, a

8 Import duties represent more than half of total tax revenue, of which about one third come from the taxation of re-exports to other countries, mainly Vietnam. Many of these re-exports are illegal in their country of destination. (See section entitled 'The trade regime'.)

9 The World Bank (1996) argues that these incentives should be strictly limited to protect the tax base and be aligned with treatment provided by ASEAN.

result of improved collection mechanisms and separating tax collectors from the revenue collected, which now goes directly to the Ministry of Finance (Finance Minister Keat Chhon, 1996).

In the medium to longer term, as the level of foreign aid falls, the budgetary situation will be sustainable only if revenues are increased and military expenditures decrease dramatically. Although the Government has moved tentatively in this direction, its political will to exercise fiscal discipline on outlays or significantly improve tax collection remains in doubt. In particular, the decision to allow provinces greater budgetary control means the Finance Ministry must now enforce budgetary discipline not only over such powerful central institutions as the Defence Ministry but also over individual provinces (Economist Intelligence Unit, 1996).

ECONOMIC IMPACT OF THE MILITARY

Decades of war have ensured the military's large role in Cambodian political and economic affairs. Military demobilisation is an essential element of rationalising budgetary expenditures. Now that some measure of stability and security has returned to Cambodia, the Government intends to reduce military personnel from around 125 000 at the beginning of 1996 to 85 000 by the end of 1997. Despite a public commitment to demobilisation, the army continues to expand due to the integration of recent Khmer Rouge defectors. In 1997, military expenditure was down 5.5 per cent to US$104 million, from US$110 million in 1996.

At present, the Minister for Finance has little power to question the army's demands for funds and is obliged to sign any military invoice presented (World Bank, 1996). World Bank officials believe that unless this practice ends soon, and overall military costs are heavily pruned, the Cambodian economy will never recover.

The military also wields considerable indirect economic power through, for example, its large vested interest in Cambodia's logging industry.

Monetary Reform and Performance

Cambodia has made much progress in allowing market forces to determine exchange and interest rates. In 1993, interest ceilings on bank deposits were eliminated, and in early 1994, the exchange rate was liberalised. External assistance enabled the Government to run a tighter monetary policy, contributing to greater macroeconomic stability.

There is strong preference for US dollars, which circulate freely in the economy. Previous episodes of de-monetisation and high inflation have engendered widespread public distrust of the domestic currency and banks.[10] Increased macroeconomic stability has not yet affected the extent of 'dollarisation' in the economy; greater use

10 The lingering public distrust of the domestic currency and banks is a legacy of the Khmer Rouge's abolition of money and banks in 1975. All savings held in cash or banks were lost.

of foreign currency was observed in 1994. The strong preference for cash transactions in US dollars means banks must maintain large stocks of foreign currencies, which is costly and inefficient. The World Bank (1996) expects that overcoming public distrust will take some time, even with sound economic management, reasonable rates of return to savers, and good banking services.

The scope for effective implementation of monetary policy also is limited because of 'dollarisation'. Despite reforms, monetary policy instruments are weak, so fiscal policy is the main method of maintaining macroeconomic stability, although aid spending and foreign investment inflows potentially weaken this mechanism.

AGRICULTURAL REFORMS

Important agricultural reforms underway include dissolving agricultural collectives and privatising agricultural land, removing price controls on most agricultural inputs and outputs, and eliminating licensing requirements for imports and exports of agricultural products, except logs. Most commodity prices now are market determined and influenced by international trade. Furthermore, most price subsidies to state-owned agricultural enterprises[11] have been eliminated.

The Government plans to improve the provision of rural finance and to upgrade rural infrastructure, particularly transport, irrigation and water supplies. It plans to privatise a number of state agricultural enterprises, particularly the rubber plantations, so that they can again become an important source of employment and foreign exchange. World Bank and bilateral donor assistance is focusing on this sector.

Agricultural development is the key to sustaining growth and reducing poverty since about 85 per cent of the population live in rural areas. The priority the Government attaches to accelerating agricultural development is therefore appropriate, particularly since food security is a concern. Almost 70 per cent of rural households in Cambodia do not produce enough rice in an average year to provide them with even half their calorific requirements (World Bank, 1996).

Agricultural Performance

Resource allocation in the agricultural sector has improved greatly as a result of land reform and increased reliance on market prices, allowing agricultural production to make a substantial recovery from its depths during and immediately after the Khmer Rouge period. For example, in early 1996, after an unusually good harvest, the Government announced plans to export at least 120 000 tons of rice, the first rice exports for 25 years (Economist Intelligence Unit, 1996).[12]

11 The state-owned agricultural enterprises consist of six rubber plantations, an agricultural inputs supply company, a fishing company and three agricultural import-export companies (World Bank, 1996).

12 However, in late 1996, serious flooding resulted in requests for food aid.

Agricultural growth of less than 3 per cent per year since reforms began is respectable, given fluctuating weather conditions, infrastructure shortages (especially poor transport links), the security situation and the serious problem posed by land mines (World Bank, 1996, p. 32). Expanding the area of land under cultivation probably would not result in large increases in crop production because the soils away from the Mekong flood plain generally are poor. Also, rice is excessively relied upon, even in areas unsuited to its production. Agricultural productivity is very low, only one third of that of Vietnam, suggesting significant scope for increased output, with improved seeds, increased irrigation and use of fertiliser, without expanding the area of land cultivated.

Lack of infrastructure and inadequate physical security, as a result of land mines, banditry and Khmer Rouge activity (although this last problem is diminishing) deter increased agricultural production and investment.

LAND MINES

Ridding Cambodia of land mines is a high priority. Land mines render large portions of valuable agricultural land unusable and pose a serious hazard to rural people. They continue to kill or maim about 300 people per month.

The area planted to rice has fallen by 20 per cent, from 2 444 000 hectares in 1967 to 1 947 000 hectares in 1994, because of the presence of land mines (World Bank, 1996). Ten million mines may exist, with about 4 million concentrated on 10 to 20 per cent of cultivated land (Shawcross, 1994).

UNSUSTAINABLE FORESTRY EXPLOITATION

Forests are Cambodia's most important natural resource. Market-oriented forestry reforms and sustainable exploitation of this resource could earn the nation US$500 million per year and over US$100 million per year in government revenue (United Nations Development Program et al, 1996).

However, the forestry sector has been subject to serious abuse:

- uncontrolled logging, mostly for export, has reduced Cambodia's forests from around 70 per cent of total land area in the 1960s to 35 to 40 per cent in 1995 (Economist Intelligence Unit, 1996). At the current rate of exploitation, the remaining forests will be destroyed in five to ten years (Global Witness, 1996)
- deforestation is resulting in the siltation of the Tonle Sap, the large freshwater lake that is the nation's main source of fish. Loss of forest cover also is partly blamed for floods, droughts and rice crop failures.

Aid Threatened

In response to pressure from aid donors, the Government banned all logging activities from 1 January 1995 and banned the export of processed and unprocessed timber from 1 May 1995. It has agreed to implement the recommendations of the June 1996 report (United Nations Development Program et al, 1996) and has asked for help to manage its forestry resources and devise a new formula for concession contracts.[13]

Despite the ban on exporting logs, large quantities were exported during the remainder of 1995 and 1996. The two Prime Ministers entered into a major new logging contract after the Tokyo donor countries' meeting in July 1996. This contract led donors to consider conditionality for future international support for Cambodia.[14] In October 1996, the International Monetary Fund decided to suspend a pledged budget support payment of US$20 million and the World Bank decided to delay the funding of a US$27 million loan for agricultural development unless profits generated from logging were channelled into the state budget. In response, the Government banned the exports of logs and sawn timber from 31 December 1996. There are mixed reports regarding compliance with this latest ban and strong pressures remain on both sides of the Thai-Cambodia border for the log trade to continue.

Observers suggest that despite the strong international pressure, the two coalition parties will be unwilling to wind back logging activities in the lead-up to elections. The funds generated are used to garner political support as well as for personal enrichment. The involvement of the Khmer Rouge and elements of the Thai, Lao and Vietnamese armies in illegal logging and smuggling also complicates the issue.

ROUGECONOMICS

After 1991, China ceased its economic support for the Khmer Rouge. The organisation then depended for its livelihood on the smuggling of timber and gems through Sino-Thai networks. Until the mid 1990s, the Khmer Rouge controlled a sizeable land area outside the traditional rice-growing areas that was rich in forestry and gems. Generally, the Khmer Rouge did not exploit the resources themselves: the capital, machinery and labour were largely foreign. In the early 1990s, 22 000 Thais and Burmese worked illegally inside Cambodia. The Khmer Rouge authorised and protected these illegal activities, and took a large share of the proceeds.

The Khmer Rouge may have earned up to US$20 million per month extracting hardwood and gems from around Pailin in western Cambodia (Shawcross, 1994). Other estimates suggest that, during the early 1990s, crossborder trade in gems and logs was worth as much as US$110 million per month (Wannabovorn, 1996). The Khmer Rouge also reportedly traded weapons for heroin with Burmese narco-insurgents, leading US officials to warn that Cambodia had become a major route for smuggling heroin out of Burma.

A major split in the Khmer Rouge in August 1996 cut off hard line Khmer Rouge forces from their major source of financial support, the timber and gem rich territory surrounding Pailin.

[13] A number of long term logging concessions agreed to in 1994 remain in operation. These concessions, covering most of the commercial forest area available in Cambodia, were awarded without public bidding or consultation. Their continuation will result in only one fifth of the resource's economic value being realised (United Nations Development Program et al, 1996).

[14] At the Tokyo meeting in 1996, donor countries stressed that aid would be suspended if Cambodia did not fulfil economic obligations, including transferring realistic forestry royalties to state coffers.

OIL, GAS AND MINERAL RESOURCES

No precise data exist on oil and gas reserves in the Cambodian continental shelf.[15] Encouraged by preliminary studies, the Government signed six exploration contracts with foreign oil companies in 1991. To date, however, only three contracts have been implemented. In response to criticism that the bidding processes for oil and gas reserves are insufficiently transparent, the Government will establish the Cambodian Oil and Gas Authority to regulate exploration, oversee distribution, and protect the environment.[16]

Cambodia's mineral resources are not well documented, but potential exists for sapphires, rubies, alluvial gold, alluvial cassiterite, silica, manganese, slate, peat, pagodite, granite, limestone, sand, gravel, clay, bauxite, zinc and copper. So far, mineral exploration has been limited to artisanal mining of gold and gems. Artisanal mining is illegal, so no accurate figures exist on mining activities. Moreover, significant gem mining is in areas the former Khmer Rouge elements occupy.

Two draft laws, a Minerals Law and a Petroleum Law, await Council of Ministers' approval after which they will be sent to the National Assembly for consideration. In the meantime, the Petroleum Regulations adopted by the Cambodian People's Party regime in 1991 remain in force.

INDUSTRY

Cambodia has only light industrial activity. This sector, particularly construction materials and textiles, responded well to trade and domestic market reform, and to the injection of investment funds following the liberalisation of foreign investment. The sector accounted for 19 per cent of GDP in 1995, up from 15 per cent in 1991 and only 5 per cent in 1985. Forty per cent of Cambodian industrial establishments are in Phnom Penh.

As of February 1997, 44 private garment enterprises employed 50 000 workers (Garment Manufacturers' Association, 1997). Most garments are exported to Europe. Twenty seven countries have granted generalised system of preferences (GSP) status to Cambodia, contributing to the rapid rise of this sector. The US decision to grant most favoured nation (MFN) status to Cambodia in July 1996 should give a further boost to the fledgling garment and electronics industries.

SERVICES SECTOR PERFORMANCE

The services sector, particularly construction, has grown very strongly, mainly due to the large inflow of international aid to Cambodia.

The tourism industry is growing well and, if the security situation improves, the tourism boom could last.[17] In 1996, almost 260 500 tourists visited Cambodia,

....

15 Some potential blocks are in areas of dispute between Thailand and Cambodia.

16 The Cambodian Oil and Gas Authority will be established with Indonesian assistance once substantial reserves have been pinpointed in the Gulf of Thailand.

17 In Thailand, for example, despite many years of strong industrial growth, tourism remains the biggest earner of foreign exchange.

18 per cent more than in 1995. The Government's target is for foreign arrivals to grow by 35 per cent per year until 2000; by then, it hopes to receive a million visitors per year. Realising this target, however, will be contingent on major improvements in security, infrastructure and tourist facilities.

THE FINANCIAL SECTOR

The formal financial sector is small; in 1995, six banks accounted for 90 per cent of deposits and 60 per cent of credit advances. Only three commercial banks have branches outside Phnom Penh, leading to a virtual lack of formal rural credit.

The National Bank was re-established in 1980 as a central government controlled bank. In 1993, most of its central bank and commercial banking responsibilities were separated. To complete the separation into a two-tier banking system, however, the National Bank needs to divest itself of its interests in joint venture banks and its branches engaged in commercial activities.

In March 1995, lending and deposit rates were completely liberalised. Interest rates have remained positive in real terms largely because of the deceleration in inflation. Interest rates on riel instruments, however, do not provide a good indication of financial prices because of the low level of local currency usage. New, larger denomination bank notes were introduced in March 1995 to encourage the use of the domestic currency and reduce dollarisation. The Commercial Banking Law, which is compatible with ASEAN norms, was enacted in August 1996.

The Government plans to establish a stock exchange, probably in 1998; this may merely increase opportunities for money laundering. The Government also announced it will offer small supplies of short term treasury bills to help finance the budget deficit.

Performance

Elimination of bank financing of the budget deficit and growth in the private sector has increased substantially credit available to the private sector, from 12 per cent of total domestic credit in 1991 to 66 per cent in 1995. Nevertheless, the total amount of bank credit to the private sector remains very low at only 4 per cent of GDP (Table 8.3).

Most commercial bank credit is absorbed by trade financing; this is the simplest and lowest risk form of bank lending. Central bank supervision of the banking system remains rudimentary and weak, and lacks uniform, well understood accounting standards. Some smaller commercial banks have failed while some banks are said to spend more time laundering money than lending it (Thayer, 1995).

Table 8.3

Monetary Indicators as a Proportion of GDP, 1991 to 1995

Indicator	1991	1992	1993	1994	1995
Net foreign assets	-0.1	1.0	1.9	6.4	7.5
Net domestic assets	6.0	8.9	4.2	1.0	1.6
Private sector credit	0.7	3.9	3.0	3.9	4.1
Currency outside banking system[a]	4.9	6.3	3.5	2.9	3.5

Note: a. Narrow money.

Source: World Bank, 1996, p.13 and p. A-21.

Priorities for Future Reform

Cambodia is progressing towards a two-tier banking system, but the National Bank still needs to:

- establish a more effective system of bank supervision, to encourage confidence in the banking system
- oversee the complete privatisation of banks
- allow more foreign bank competition to improve banking system efficiency.

STATE-OWNED ENTERPRISES

SOEs were privatised in two phases, between 1991 to 1993, and after April 1995, when new privatisation regulations were approved. During the first phase, ministries privatised their own enterprises. They negotiated their own terms of sale or lease of assets and brought the resulting revenues directly into their own budgets. It was generally a condition of both sales and leases that current employment was maintained.[18]

Of an initial stock of 152 state enterprises, 50 were sold, mostly service establishments and small production facilities. The bulk of the remainder, particularly larger enterprises, were leased on a long term basis, for up to 70 years, with rents adjusted at five-year intervals. Many members of the Coalition Government simply leased state assets to their respective political parties; moves to curtail such practices have been resisted. The real value of these sales or leases resided in the land, so equipment and buildings of little value were discarded. As a result, by September 1995, half the leased enterprises no longer operated.

[18] Workers could be laid off but employers were required to pay severance pay of one month's salary per year of employment, with a minimum of three months' salary and a maximum of ten months' salary.

After April 1995, the central Government tightened the privatisation process, increasing its control over the process. A privatisation committee was charged with three main tasks:

- compiling a list of all enterprises and assets to be divested
- formulating strategies for privatising the enterprises and assets
- monitoring progress.

Since the Government aims to reduce subsidies, most SOEs are screened to see if they are commercially viable. Most recently, some SOEs have been sold by competitive bidding processes and have fetched the best possible price. For example the Phnom Penh airport is now French owned; the state-owned oil distribution enterprise, Companie de Kampuchea des Carburances, after selling for US$10 million, now belongs to Cambodia's largest private fuel distribution company; and the state-owned power company, Electricite du Cambodge, is to be privatised.

Privatisation Performance

The privatisation process has had mixed results. While the early phase lacked transparency, it resulted in roughly two thirds of enterprises being transferred to private owners within a short period. Although reform of SOEs is progressing, some strategic industries will not be privatised. However, the relative importance of the remaining enterprises is being reduced by the rapid growth of the private sector (World Bank, 1996).

THE WORKFORCE

Cambodia's population is growing at a rapid 2.8 per cent per year with almost half the population aged under 15. Perhaps as many as a 250 000 people are unemployed. Underemployment is also a problem, with many surplus low productivity workers in agriculture, SOEs, the public service and the military. Because of the large number of disabled and displaced workers, the Cambodian labour force supports a much greater proportion of the non-working population than is the case in most other countries. A quarter of all households are headed by single women, and many others are headed by men with war disabilities. The traditional extended family support system has been destroyed (Shawcross, 1994).

Fewer than 10 per cent of the labour force earn wages. The rest work in agriculture or small scale enterprises, either as owners or family workers. Even in Phnom Penh, the average household earns less than 15 per cent of its income from wage employment, indicating the importance of informal sector employment. A third of rural workers also have a second source of income (Shawcross, 1994).

GROWTH OF THE PRIVATE SECTOR

The private sector has grown strongly, from a minuscule base, since the comprehensive program of economic stabilisation and reforms introduced in 1993. A highly competitive small business sector has emerged.

The bulk of Cambodia's non-farm private enterprises are local new entrants. They fall into two categories: micro-enterprises, and small and medium sized enterprises.[19] Informal sector micro-enterprises[20] provide two thirds of the employment in urban areas, where 15 per cent of the population live. Small and medium sized enterprises[21] dominate Cambodia's formal sector. There are no official statistics on this sector, but unofficial estimates put the number of such enterprises at 50 000 with approximately 26 000 registered in Phnom Penh.

ETHNIC CHINESE INVOLVEMENT IN THE ECONOMY

In the 1960s, the ethnic Chinese population in Cambodia was estimated to be around 500 000. However, under Khmer Rouge rule about half of Cambodia's Chinese population perished (East Asia Analytical Unit, 1995). Returning and new immigrants, most of whom live in Phnom Penh, have since swollen the population to around 300 000.

The Economist Intelligence Unit (1996) notes that Chinese involvement in the Cambodian economy is expanding rapidly and that the actual level of Chinese investment is probably much higher than official figures suggest because much of it enters through unofficial channels. Malaysian interests, the biggest official investors in Cambodia, are also mainly ethnic Chinese. Many ethnic Chinese investors form business associations with entrepreneurs from Singapore, Hong Kong and Taiwan, enabling these entrepreneurs to bypass restrictions on foreign ownership of land. In addition, in 1995, approximately 50 mainland Chinese companies were involved in ventures in Cambodia, with cumulative approved investment of around US$40 million.

The ethnic Chinese community is most prominent in retailing, banking, hotels, gold and rice trading, manufacturing and importing. The community also is active in property development, particularly in Phnom Penh. Much of the observed entrepreneurial energy, particularly in Phnom Penh, comes from the Chinese community. The Economist Intelligence Unit (1996) sees this resurgence of the Chinese business community as positive for Cambodia's future economic development. Elsewhere in the region, Chinese investors tend to be more pioneering than other investors, often paving the way for more cautious but larger scale investors from Japan, the USA and Europe.

....

19 The following information on Cambodia's micro-enterprises and small and medium sized enterprises draws heavily on a survey carried out by the Association of Cambodian Local Economic Development Agencies and the World Bank in 1995, subsequently reported by the World Bank (1996).

20 In the World Bank survey, micro-enterprises are defined as employing three or fewer workers. Most consist of self-employed workers or their family members.

21 In the World Bank survey, small and medium sized enterprises are defined as businesses with more than three but fewer than 50 workers.

Despite the success of reforms in creating a highly competitive small business sector, private sector development still faces serious obstacles, including an unclear legal environment, inadequate physical infrastructure, lack of access to credit and financial services, and lack of skilled labour (World Bank, 1996).

LIBERAL TRADE REGIME

Cambodia's trade regime is now regarded as liberal by regional standards. The main reforms include:

- permission in 1989 to establish trading companies
- the elimination in 1993 of general import and export licensing requirements for most goods traded by registered companies
- streamlining of the import tariff system in 1993, using four rates (7, 15, 35 and 50 per cent) covering over 93 per cent of tariff items
- with the exception for logs, sawn timber, antiquities and rice, the elimination by 1996 of quotas and other quantitative restrictions on all exports and imports.

Because of its low customs duties and weak enforcement, Cambodia has become a hub of transit trade in the region, especially with Vietnam.[22]

Trade Performance

The country's legal exports amounted to US$484 million in 1995 (almost 17 per cent of GDP), less than its re-exports of US$597 million. Domestic exports and re-exports have increased approximately four fold since 1990 (Figure 8.8).

Timber accounted for 85 per cent of total legal domestic export earnings in 1994 and 70 per cent in 1995.[23] The garment sector also performed strongly, with 1995 exports increasing nine fold over 1994, to US$27.5 million. Despite Cambodia's strategic location and agricultural advantages, 1995 agricultural exports remained below the level reached in the mid 1960s.

Imports, totalling US$631 million in 1995, consisted mainly of consumer goods, motorcycles, cars, electrical items, alcohol and soft drinks. High aid and rising foreign investment flows underlie the growing trade imbalance.

---

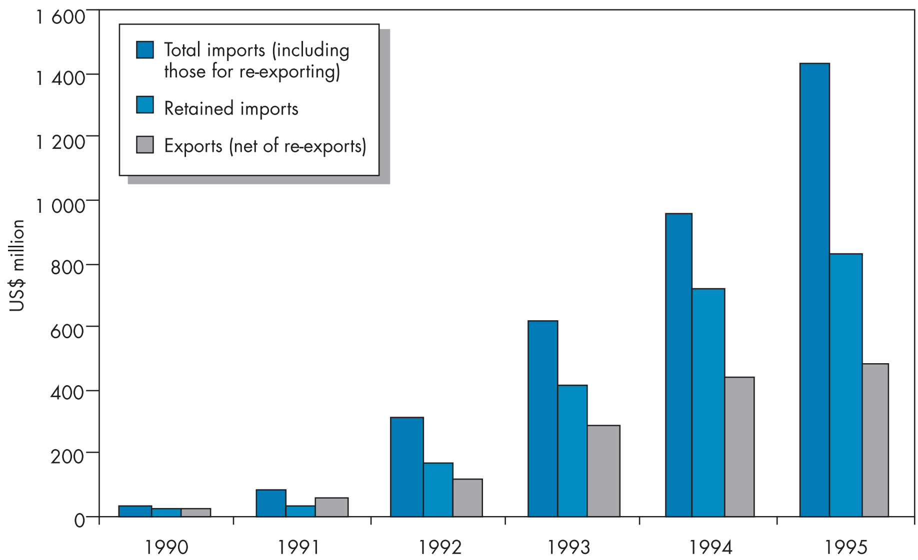
22 Re-exports, mostly to Vietnam, dominate Cambodia's legal exports.

23 Timber, rubber and gems are the main export commodities but most of the trade is illegal and unrecorded (Annear, 1996).

Figure 8.8

Trade Increasing Strongly

Total Imports, Retained Imports and Net Exports, 1990 to 1995



Source: World Bank, 1996, p. A-15.

ASEAN Regional Integration

ASEAN countries were the most important export destinations in 1995, taking more than 60 per cent of Cambodia's exports. Industrialised countries have increased their share of exports at the expense of former communist bloc countries (included in the 'all others' category in Figure 8.9).

The declining importance of trade with the former communist bloc countries is more marked on the import side; their share fell from 23 per cent in 1989 to only 7 per cent in 1995. ASEAN's importance increased with its import share rising from 54 per cent in 1989 to 69 per cent in 1995 (Figure 8.9).

However, the level of smuggling makes it difficult to identify underlying trends in trade performance.

The Government has had some success in integrating Cambodia's trade regime with the regimes of its neighbours and is working towards membership of the World Trade Organisation.[24] The USA recently granted Cambodia MFN trade status.

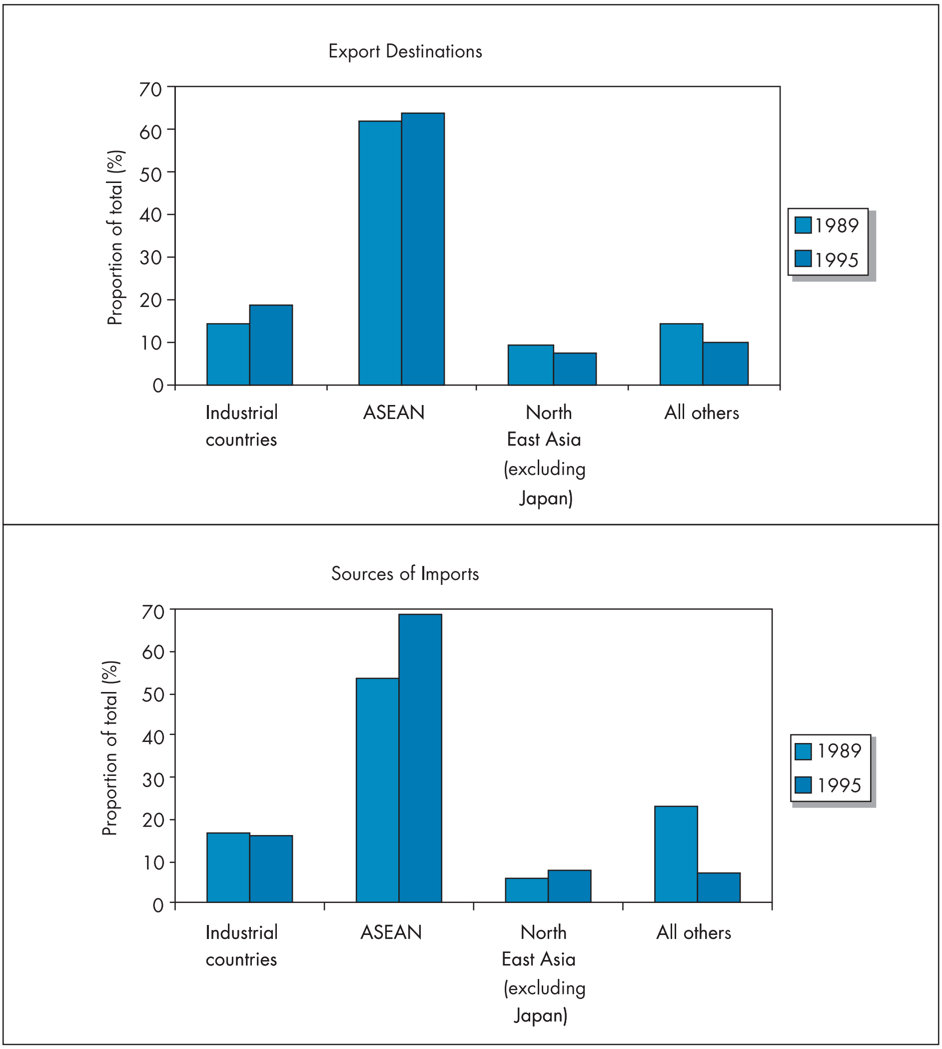
....

[24] Cambodia gained observer status in the World Trade Organisation in 1995.

Figure 8.9

East Asia Replaces Soviet Bloc as Main Trade Partner

Export Destinations and Sources of Imports, 1989 and 1995



Source: International Monetary Fund, 1996.

External Debt

Cambodia has a large external debt, which in the short to medium term, it has a limited capacity to service. The true size of the debt is hard to measure as it depends on the rouble conversion rate used but the Economist Intelligence Unit (1996) estimates the debt to be about US$1.6 billion, or around 55 per cent of GDP. The debt is, however, being rescheduled through the Paris Club and bilateral negotiations. In January 1996, Cambodia received highly concessional terms for the rescheduling of its debt to Paris Club creditors. The Government currently is seeking debt relief from other bilateral donors, particularly Russia.

FOREIGN INVESTMENT

In August 1994, Cambodia enacted its Investment Law and the Government established the Council for the Development of Cambodia (CDC) as a 'one-stop shop' for approving foreign investment projects. (See Chapter 7 - *Cambodia: Politics*.)

Strong Foreign Investment Performance

Realised foreign investment has increased dramatically since 1994; there was a ten fold increase in 1995, to around US$100 million per year. The level of the stock of approved investment was much higher. Between August 1994 and September 1996, the Cambodian Investment Board, which approves incentives available to domestic and foreign investors as well as investment applications, approved 330 applications, with a registered capital of US$2.8 billion.[25] Of these, 42 were from fully domestically owned firms, 124 were from foreign-owned firms and the remainder were joint ventures.

According to the World Bank (1996), 57 of the approved applicants were operating by September 1995; 29 of those applicants reported a registered capital of US$1 million or more, and four reported a registered capital of US$10 million or more. Most foreign investment has been in hotel construction, casinos and logging, although light industry, particularly garment manufacturing, is starting to attract large foreign investment flows (Figure 8.10).

ASEAN members provide the bulk of foreign investment. Most investment applications come from Malaysia[26], Singapore, China, Thailand and Taiwan. Some also come from the USA, the United Kingdom and France.

....

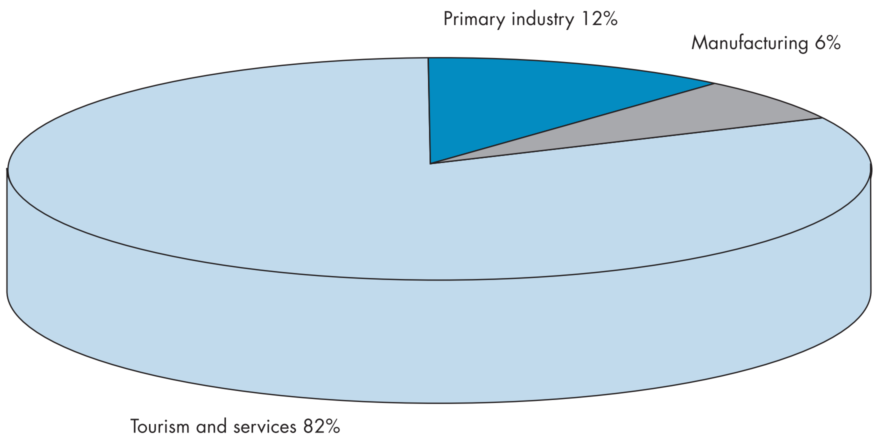
25 One of the main reasons for the slow rate of disbursement of investment is a loophole in the existing legal framework; there is no set time in which investors must abide by their obligations. Another reason is that some investment projects appear to involve land speculation.

26 Malaysia holds more than 60 per cent of investment approvals.

Figure 8.10

FDI Mainly in Hotels and Casinos

Foreign Investment Approvals by Sector, 1995



Outlook for Foreign Investment

In the longer term, Cambodia will have to rely on foreign and domestic investment rather than aid to promote growth. It will have to compete for foreign investment on the basis of its economic policies and natural comparative advantage. The World Bank (1996) expects realised foreign direct investment to rise to US$200 million per year by 2000.[27]

The Cambodian Government is aware that official corruption deters foreign investment. Cambodian officials, with US assistance, have prepared a draft law on corruption control that would establish a National Corruption Agency. All politicians would be required to declare their financial interests. However, the legislation is yet to be passed by the National Assembly, leading some observers to speculate that it is being delayed by those with a vested interest in maintaining the status quo.

To attract more serious rather than speculative foreign investment, the Government needs to improve the climate for private sector development by improving infrastructure and security and creating a more transparent and predictable business environment. (See Chapter 9 - *Cambodia: Business*.) At present investment is short term (apart from hotels) and some areas attracting interest (such as sex tourism) need to be discouraged. Cambodia's recent decision to join the International Finance Corporation, the private investment arm of the World Bank, should assist in securing some larger foreign investment funds for development projects at commercial lending rates.

....

27 Since realised foreign investment had already risen to US$171 million per year in 1996, this forecast would seem too pessimistic.

ASEAN MEMBERSHIP

Cambodia became an ASEAN observer in 1992 and becomes a full member in 1997. (See Chapter 14 - *Expanded ASEAN*.) Membership of ASEAN is very important to Cambodia. The nation desperately needs to reduce internal conflict and create political stability. Integration into the region will contribute to stability by allowing the economy to build on the reforms already introduced and gradually raise incomes. ASEAN membership also may encourage the Cambodian political elite to move away from the politics of survival to those of development.

The Government, however, fears the little domestic industry currently in Cambodia will be unable to withstand international competition and ASEAN Free Trade Area (AFTA) membership could be at the expense of Cambodia's infant industries. Equally, the Government recognises that membership of ASEAN and AFTA is in Cambodia's long term interests.[28] Foreign Minister Ung Huot has asked ASEAN countries and their dialogue partners to give Cambodia preferential access to their markets. Australia, France, the United Kingdom, Germany and Austria already have done so. The ten year phase in of AFTA also should give infant industries sufficient time to be competitive.

Singapore is extending ASEAN training awards to Cambodian officials. A team of US lawyers is helping to draft a new Commercial Code, to be completed in 1997. The Cambodian Government wants to ensure that laws affecting business are consistent with those applying in established ASEAN member countries.

AID

When democratic government in Cambodia was restored in 1993, ties with the international aid community were resumed. In particular, official aid through the International Committee on the Reconstruction of Cambodia and financial assistance to restructure the economy from the International Monetary Fund were recommenced. Between 1992 and 1995, the international community pledged about US$2.3 billion in official aid to rehabilitate Cambodia; approximately US$1.39 billion of this has been disbursed despite severe administrative limitations on Cambodia's capacity to absorb aid (Figure 8.11).

In July 1995, at the Tokyo World Bank Consultative Group meeting, representatives of 16 countries and five international aid institutions pledged a further US$518 million in grants and low interest loans.

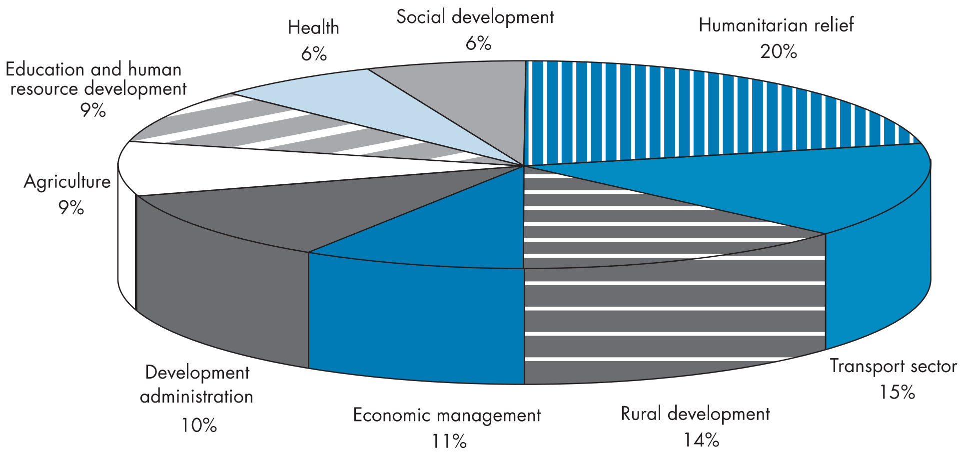
....

[28] King Sihanouk and his exiled half-brother and former Foreign Minister, Prince Sirivudh, both spoke out against Cambodia becoming a member of ASEAN, but this did not affect the political decision to join.

Figure 8. 11

Aid Favours Infrastructure

Aid Flows, Cumulative from 1992 to 1995



Aid Performance

Aid has underpinned the strong growth in construction and rural infrastructure rehabilitation. Some argue[29] however, that Cambodia may be receiving too much aid, making it easy for the nation's leaders to avoid the economic decisions needed. Some foreign investors also argue that the curtailment of aid flows would force economic policy to become more commercially-oriented.

International aid agencies such as the World Bank, the Asian Development Bank and the International Monetary Fund, however, will continue to play an important role in rebuilding the Cambodian economy, provided donors' concerns are allayed. The Economist Intelligence Unit (1996) notes that some members of the donor community increasingly worry about domestic political developments and the Government's authoritarian direction. Donors also are concerned about the management of revenues from Cambodia's forestry resources and over-exploitation of those resources. (See section on Forestry.)

INFRASTRUCTURE

After years of war and lack of maintenance, Cambodia's transport infrastructure was in ruins by the 1980s. Since then, its capacity has been restored to about half the pre-war level, but many provincial and local roads are in poor condition and impassable in the rainy season (World Bank, 1996).

29 One such commentator is Sam Rainsy, President of the Khmer Nation Party cited in *Far Eastern Economic Review*, 22 February 1996.

MAJOR INFRASTRUCTURE PROJECTS

Improvements in Cambodia's basic infrastructure particularly in urban areas should proceed as a result of the large number of projects currently planned or underway, for example:

- the rehabilitation by the end of 1996 of Phnom Penh's port by the Japanese Government to allow ships of up to 6 000 tonnes to dock
- the upgrading of Phnom Penh airport by France's Dumez-GMT and Malaysia's Muhibbah Engineering, at a cost of US$120 million over three years
- the doubling of Phnom Penh's electricity generating capacity through funding from international aid agencies and private sector involvement from Japan's Itochu and the US firm Beacon Hill Associates Inc
- the rapid development of Cambodia's telecommunications industry with the total number of lines increasing by 27 per cent to 28 000 lines (including 9 000 fixed lines) in 1996. The number of fixed lines is expected to increase by another 19 000 by June 1997.

Infrastructure Priorities

Rural infrastructure must be upgraded to reduce poverty. In particular, rural transport, irrigation and water supply networks urgently need new investment:

- about half the primary road network linking Phnom Penh with the main provincial cities needs major improvement as do most provincial and local roads[30]
- dry season irrigation is restricted to 2 per cent of rice land and supplementary irrigation to 4 per cent
- despite a large lake, many rivers and high rainfall, many villages are without a reliable, year-round supply of water for people and livestock. The World Bank (1996) estimates that south east Cambodia alone needs around 27 000 wells.

Cambodia's infrastructure requirements are likely to exceed US$500 million between 1996 and 1999 (Asian Development Bank and the Ministry of Public Works and Transport). Other estimates suggest that to reach a target of only 2 per cent telephone penetration by 2000, US$600 million will need to be invested. Much of this funding will have to come from external sources.

FUTURE CHALLENGES

In a relatively short period, tangible progress has been made in restructuring and rebuilding Cambodia's war-shattered economy. Government policies have successfully stimulated private sector development and Cambodia now has a highly

[30] Between 1992 and 1996, bilateral and multilateral donors (including Australia) undertook to repair the most dilapidated sections of the primary road network. By the end of 1996, more than 1 000 kilometres of national and provincial roads were to have been rehabilitated.

competitive domestic market, with one of the most liberal retailing regimes in the region. However, Cambodia still faces many serious problems that could jeopardise its development prospects unless addressed. The current high level of dependence on aid, the rapid depletion of forestry resources, and the heavy reliance for revenue on import taxes are all unsustainable. The task confronting policy makers is to move from rehabilitation and recovery to sustainable development (World Bank, 1996). The top priorities for the short to medium term include:

- undertaking fiscal restructuring to reduce aid dependency
- broadening the base of economic growth
- accelerating administrative and state sector reforms
- demonstrating responsible, effective government by tackling corruption and effectively managing the nation's forestry resources
- strengthening the human capital base by increasing literacy rates and training
- improving infrastructure, especially in rural areas, to promote agricultural development
- increasing internal security
- re-integrating the economy into the wider regional economy.

Macroeconomic Stabilisation and Aid

Although large amounts of aid can be expected for the remainder of the decade, they will not persist indefinitely. The Government must consolidate macroeconomic gains by exercising increased fiscal discipline in public administration and military expenditure. Political instability, growing corruption, and strong vested interests could well retard the progress of future reforms.

Broadening Economic Growth

Growth is not broadly based. It is concentrated in construction and services, mainly in Phnom Penh, and is largely aid sponsored. This causes the divergence in living standards between urban and rural populations to grow. As 85 per cent of the population lives in rural areas, accelerating rural economic development, particularly in agriculture, would reduce poverty substantially and hasten national reconciliation and consolidation. Similarly, the growth of labour intensive industry in urban and rural areas would provide higher productivity employment and reduce income disparities.

Accelerating Structural Reforms

It is important that structural reforms accelerate. Priorities include reducing public service staff numbers, and increasing salaries and training opportunities for the remaining staff; transparently divesting remaining SOEs; completing the two-tier banking system; and creating a more effective bank supervisory system to increase confidence in the banking system. An improved legal framework also is needed to underpin private sector development and prevent human rights abuses. (See Chapter 7 - *Cambodia: Politics*.)

Responsible Government

Most urgently of all, Cambodia needs good governance.[31] Many commentators have expressed concern about the political will of Cambodia's leaders to ensure development of an open, transparent economy and an accountable political system. The danger is that both the Government and the military may interpret continuing economic reform as reducing their power or opportunities for rent seeking. The reforms most likely to affect vested interests are public service streamlining and demobilisation, anti-corruption legislation, and tax and customs duty reforms. Furthermore, attempts to privatise the remaining SOEs also will encounter entrenched vested interests, as will controlling unsustainable logging (Economist Intelligence Unit, 1996).

CORRUPTION

Aid donors, foreign investors, and Cambodian citizens and officials acknowledge that corruption is an integral part of the economic and administrative system. Shawcross (1994) describes Cambodia as a semi-feudal society, a place of bargaining, survival, and lawlessness; a state of patronage, where anyone who defies his or her patron is immediately labelled enemy or traitor. It is often the Government's own poorly paid employees who are most involved in this system of patronage and graft.

Customs is a prime example of where the Government faces difficulty in eradicating corruption. The Coalition inherited an administration where much of the customs revenue was used for private gain. Both Prime Ministers agreed to reform the customs system making it more neutral and efficient. They have employed a Swiss company, Societe General de Surveillance (SGS), to undertake pre-shipment inspections, which have significantly increased the revenue collected.[32]

Human Capital

The lack of qualified local personnel severely constrains potential growth. Improved access to education and training is urgently required for the nation's fast growing young population, to improve productivity and reduce unemployment and underemployment.

Human resource development is receiving greater attention from the Government. The allocation for education in the 1997 budget, while small at US$34 million, was up 9 per cent on 1996. In July 1996, the Ministry of Education launched a US$30 million Cambodian Assistance to Primary Education (CAPE) project funded by the US Government to provide training to some 45 000 primary school teachers and principals.

[31] Good governance is vital to the success of fast growing East Asian economies (Root, 1996). (See Chapter 13 - *New ASEANs*.)

[32] The Indonesian Government successfully took similar action to end corruption by customs officials.

Anecdotal evidence suggests that young urban Cambodians are keen to learn English and absorb new knowledge and technologies, with many among Phnom Penh's youth already computer literate.

Improved Infrastructure

High priority to infrastructure investment is essential. This will require funding through the combination of aid, government revenue and private sector sources. Lack of infrastructure deters foreign and domestic investment and inhibits more rapid economic growth. The Cambodian Government, international aid agencies, regional governments and foreign investors are cooperating to meet, at least in urban areas, a number of basic infrastructure needs. Poor rural infrastructure, such as the lack of all-weather roads, inadequate irrigation and irregular water supplies, deters investment in agriculture.

Security

The security problem in the nation's remote areas, the scene of long running guerrilla warfare, seems to be diminishing as Khmer Rouge forces gradually diminish. However, some former guerrillas have taken up freelance banditry, and in Phnom Penh, the law and order problem is growing. This situation must be remedied to maintain the basic conditions for economic development, including donor and investor confidence. Concern is increasing about the Government's capacity to control the nation's growing criminal networks because some of the responsibility for the rise in urban lawlessness lies with the nation's political leaders and police.

Regional Integration

ASEAN membership should create business opportunities for Cambodia and boost investor confidence. Already, with low customs duties and weak enforcement, Cambodia is a regional hub for transit trade. To maximise the advantages of its geographical location, however, the nation needs to increase the transparency of its competitive business environment. Otherwise, it will fail to attract serious long term investors and will be in danger of becoming an exploited regional backwater of ASEAN.

ECONOMIC PROSPECTS

The World Bank (1996) projects Cambodia's GDP will grow at around 7 per cent per year for the next five years, converging to a long term trend of 6 per cent beyond 2000, assuming:

- a favourable external environment continues
- the support of the international community continues
- the political and security situation remains reasonably stable
- the Government continues to make good macroeconomic progress through tight fiscal and monetary policies

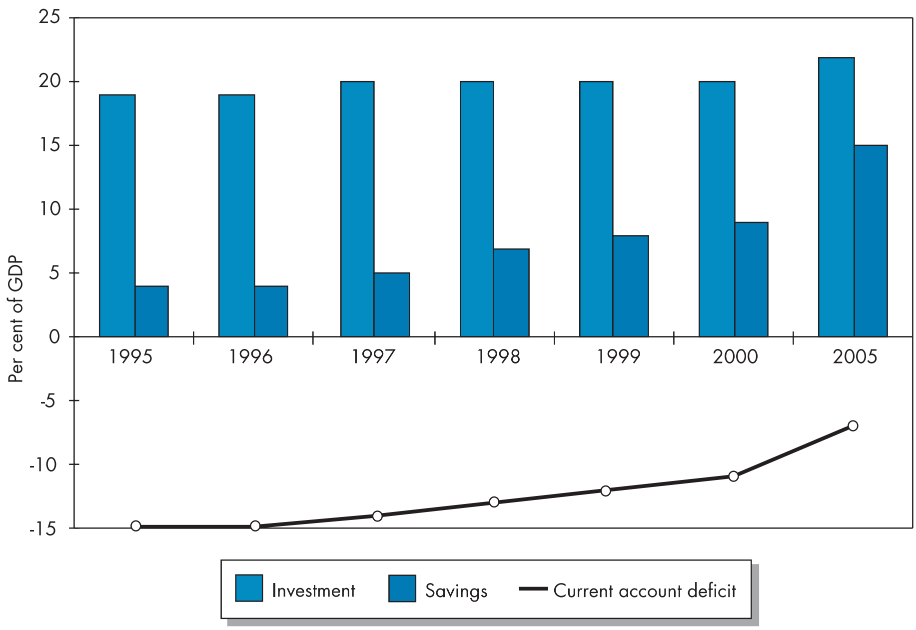
- the Government continues to encourage the private sector and rural development.

These projections are a best case scenario, if all necessary policy reforms occur. The World Bank concedes a number of risks are associated with its projections, including external factors such as deteriorating security or bad weather. The most serious potential risk is political instability, which would slow structural reforms and deter foreign investors. This could also result in inadequate budget revenue mobilisation or lack of expenditure control, or both.

Achieving this rate of growth also requires national savings to increase from the current very low level of about 4 per cent of GDP to about 15 per cent by 2005 (Figure 8.14). Government saving would need to increase from current negative levels to almost 2 per cent of GDP by 2000 and expand further to 3 to 4 per cent of GDP by 2005. The current account deficit is projected to fall as a percentage of GDP over the medium term as Cambodian sourced exports increase (Figure 8.12).

Figure 8.12

Projections of National Savings and Investment

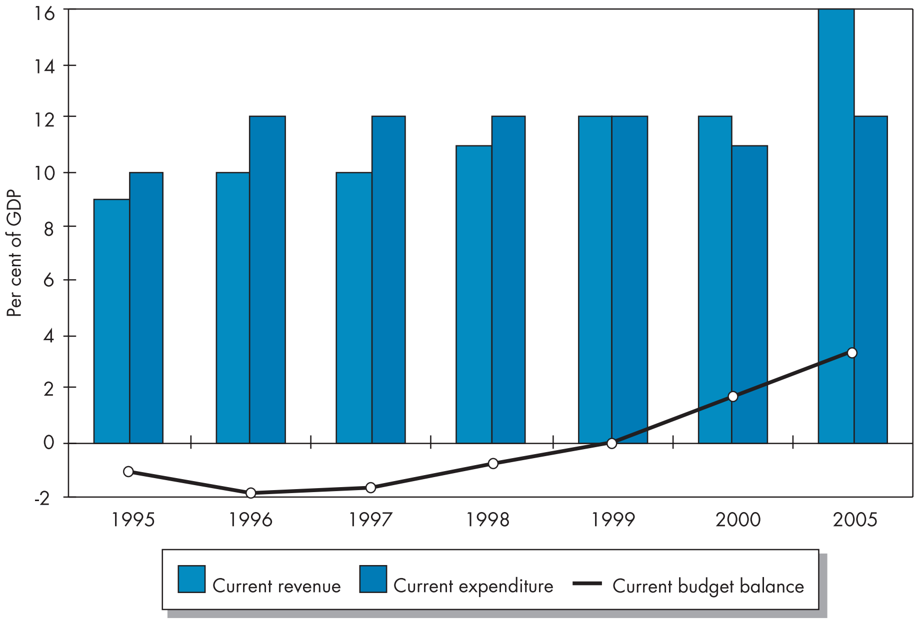


Source: World Bank, 1996, p. 53.

Government revenue is projected to increase at a more rapid rate than government expenditure allowing the budget to move into surplus from 1999 onwards (Figure 8.13).

Figure 8.13

Projections for the Budget



Source: World Bank, 1996.

The main source of export growth would be non-traditional, labour intensive, light manufacturing products, in particular garments. Rubber, rice and other agricultural products would also contribute, especially in later years.

In the short term, merchandise exports, including re-exports, would fall as a result of the ban on log exports. Timber exports could resume, however, after sustainable forestry management techniques are introduced. Re-exports will drop steadily as import liberalisation in neighbouring countries proceeds, leading to a fall in fiscal revenues.

Total external financing requirements should increase from US$520 million in 1995 to US$551 million in 2000. Foreign direct investment rather than foreign aid would meet an increasing proportion of this financing requirement.

Sectoral Performance to 2005

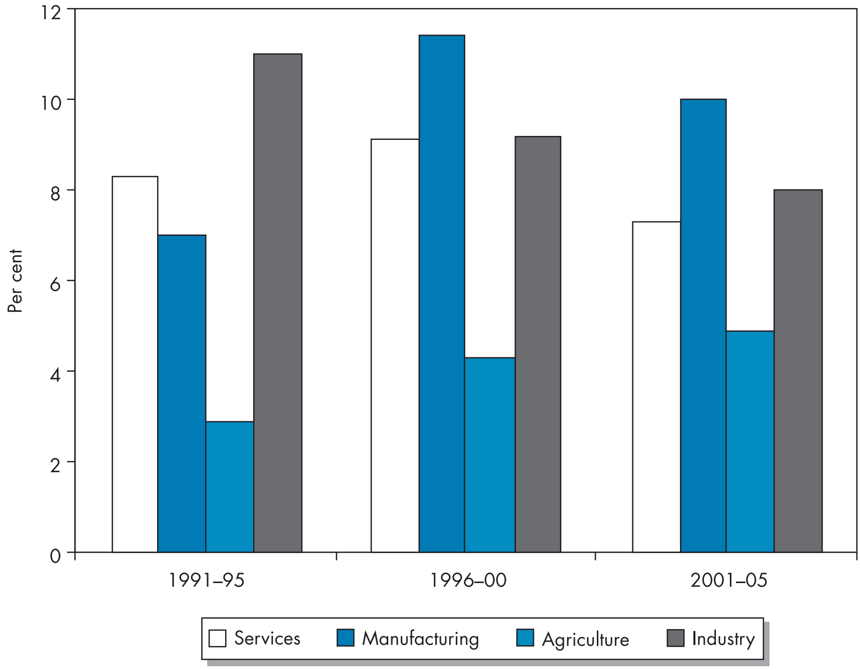
Agriculture, including forestry and fisheries, is projected to grow by 4.0 to 4.5 per cent per year in the next five years (assuming normal weather patterns) and by 4.5 to 5.0 per cent in the following five years (Figure 8.14). While this growth is high for agriculture, it represents a recovery that should be possible by improving infrastructure and continuing to improve the security situation, including removing land mines.

Industry is projected to grow, largely as a result of increased foreign investment, by an average rate of 9 per cent per year for the next five years and about 8 per cent thereafter. Manufacturing, especially of garments and electronics, would be the leading sector (Figure 8.14), but production of basic consumer goods for the domestic market also would grow rapidly in response to rising per capita incomes.

Services are projected to grow by 9 per cent per year for the next five years, reflecting increased tourism, and by about 7 per cent thereafter as a result of a normal complementary expansion of wholesale and retail trade, financial services and infrastructure services (Figure 8.14). The relatively faster rate of industry and services growth would result in agriculture's share of GDP declining to around 35 per cent by 2005.

Figure 8.14

Projected Annual Growth of GDP by Sector to 2005



Source: World Bank, 1996, p. 53.

Overall, the World Bank projections seem optimistic and may not be achieved, especially as escalating political tension in the lead-up to the 1997 and 1998 elections could hamper economic performance.[33] However, these projections indicate Cambodia's economic potential if it can overcome deficiencies in human resources, physical infrastructure and physical security, and create a stable polity and transparent economic environment.

[33] For example, the level of cooperation between the two coalition parties is diminishing in the lead-up to the elections, paralysing decision making within the bureaucracy. Furthermore, decisions taken during the lead-up are less likely to be soundly based, and are more likely to reflect political favouritism.

Unfortunately, past national trauma has instilled among Cambodia's political elite a mind set focused on short term survival and rent seeking, when what is urgently needed is far-sighted leadership. Despite this, many of Cambodia's deficiencies are being redressed across a broad front, with international and bilateral donors, including ASEAN countries, assisting. With relatively rapid progress to date, Cambodia's economic and social development indicators should improve in the next five to ten years.

Although there is almost no prospect that Cambodia will return to a command economy, continued political instability and escalating corruption and lawlessness mean that some reforms can be expected to proceed slowly. Much has been achieved, but even more remains to be done to rebuild the economy and integrate it into regional and global markets. It may be unrealistic to assume that the nation can progress substantially on all fronts at once, so, while the general trend will be forward, economic players should be prepared for setbacks in some areas.

REFERENCES

Annear, P., 1996, 'Cambodia's Economic Development 1954-1995: Economic Transition and the Role of the Private Sector', *Development Bulletin*, Vol. 38, pp. 42-46.

Keat Chhon, 1996, personal communication with East Asia Analytical Unit.

East Asia Analytical Unit, 1995, *Overseas Chinese Business Networks in Asia*, Department of Foreign Affairs and Trade, Canberra.

Economist Intelligence Unit, 1996, *Country Report: Cambodia*, 1st quarter, Economist Intelligence Unit London.

____ *1995, Cambodia: EIU Country Profile 1995-96*, Economist Intelligence Unit, London.

Far Eastern Economic Review, various issues.

Garment Manufacturers' Association Phnom Penh, 1997, communication with East Asia Analytical Unit.

Global Witness, 1996, 'Corruption, war and forest policy: the unsustainable exploitation of Cambodia's forests', a briefing document, February.

International Monetary Fund, 1996, *Direction of Trade Statistics Yearboook*, IMF, Washington DC.

Lee, M., 1995, 'Cash and Carry: Money Laundering Becomes a Major Industry', *Far Eastern Economic Review*, 12 October, pp. 29-30.

Shawcross, W., 1994, 'Cambodia's New Deal', Contemporary Issues Paper No. 1, Carnegie Endowment Publication.

Thayer, N., 1995, 'Bankers' Bluff: Cambodia Starts to Clean up Its Banks', *Far Eastern Economic Review*, 1 June, p. 72.

Thion, S., 1994 'Explaining Cambodia: A Review Essay', Working Paper No. 11, Research School of Pacific and Asian Studies, Australian National University, Canberra.

United Nations Development Program, Food and Agricultural Organisation and World Bank, 1996, joint report.

Wannabovorn, S., 1996, 'War Will End Soon, Say Khmer Soldiers', *The Australian*, 27 June.

World Bank, 1996, 'Cambodia: From Recovery to Sustainable Development', Washington DC, 31 May.

Chapter 9

FREEWHEELING BUSINESS

To date, Australia's interests in Cambodia have focused mainly on bilateral and multilateral aid programs; Australia is the fourth largest bilateral donor to Cambodia. Although not extensive, Australia's business links with Cambodia are growing.

AUSTRALIAN BUSINESS PROFILE

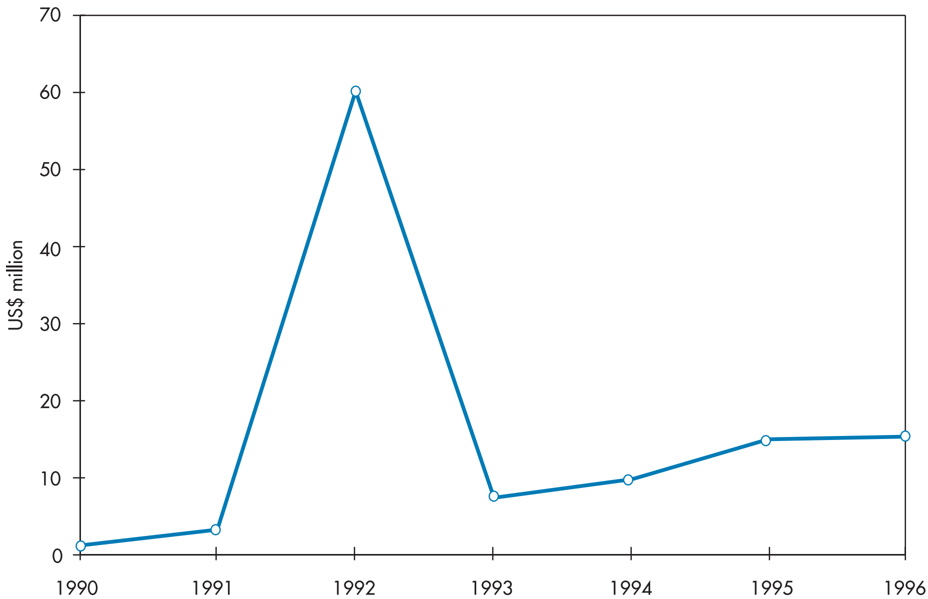
Trade

Australia played a central role in the United Nations Transitional Authority in Cambodia (UNTAC) administration from 1991 to 1993. While Australian merchandise exports to Cambodia, particularly machinery and transport equipment, rose sharply during this period, they dropped quickly at its conclusion (Figure 9.1). Australian exports to Cambodia, although small in volume, now are more diversified than they were in the early 1990s (Figure 9.2).

Figure 9.1

Exports Stabilise ...

Australian Merchandise Exports to Cambodia, 1990 to 1996

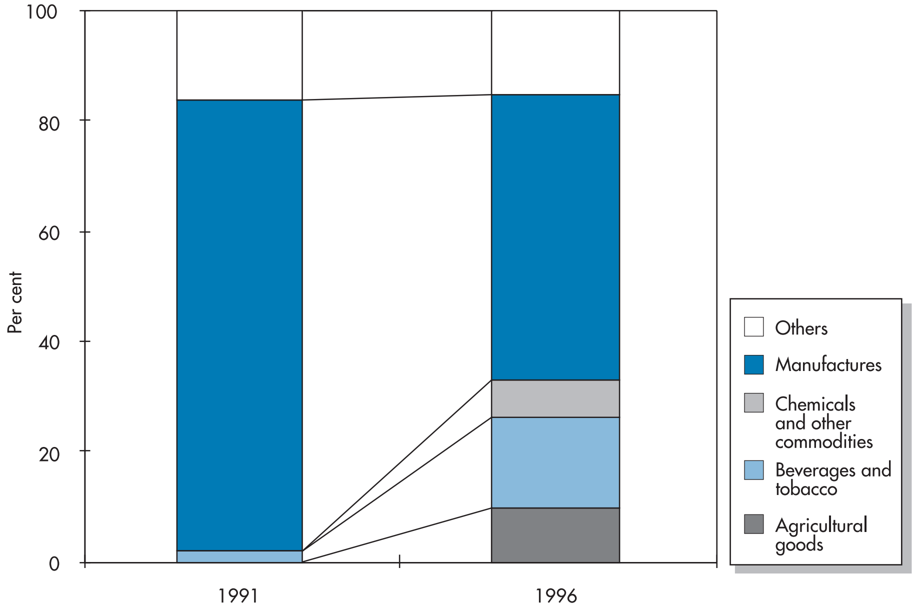


Source: Department of Foreign Affairs and Trade, 1997.

Figure 9.2

… and Diversify

Composition of Australian Exports to Cambodia, 1990 and 1996



Source: Department of Foreign Affairs and Trade, 1997.

Australia's merchandise imports from Cambodia have risen sharply since 1990[1] reaching more than US$600 000 in 1996 (Figure 9.3). Foodstuffs accounted for 80 per cent of imports in 1996.

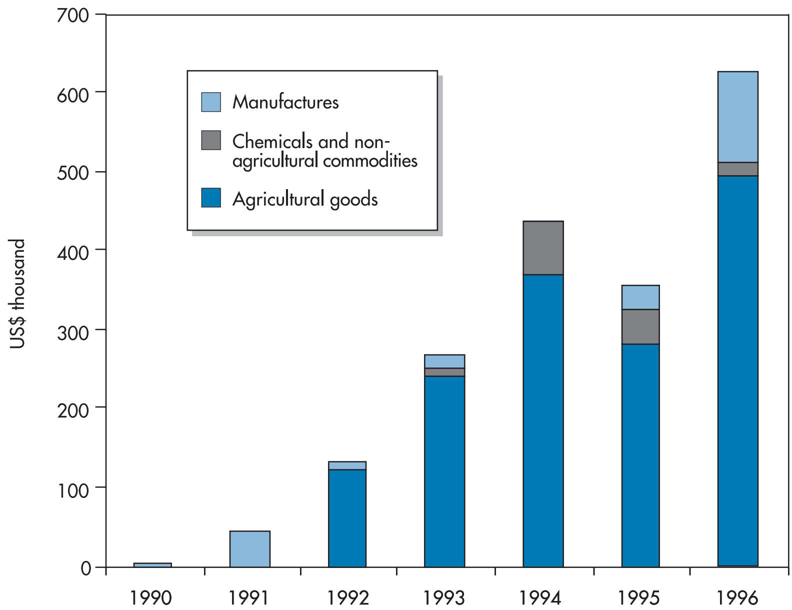
………………………………

1 Cambodia's financial year is the calendar year.

Figure 9.3

Agricultural Products Dominate Imports

Australian Merchandise Imports from Cambodia, 1990 to 1996



Source: Department of Foreign Affairs and Trade, 1997.

Investment

Australia is a relatively small investor in Cambodia, with realised investment totalling around US$20 million in 1996. Most Australian investors are small or medium sized companies;[2] only three investments (in telecommunications, oil exploration and infrastructure provision) are of any size or strategic importance. Between January 1995 and August 1996, Australian investment was concentrated in garment production, building materials, engineering services and furniture.

Three main factors prompted Australian (and other foreign) companies to enter the Cambodian market:

- the UNTAC period provided an opportunity to gain first hand knowledge of the market when aid related demand was high
- early entrants could establish a monopoly or near monopoly position in the market
- investment in Cambodia could be part of a regional strategy that included Vietnam and Laos.

[2] The Australian Business Association of Cambodia was established in 1995 and at the end of 1996 had 31 paid up members.

Australian investment in Cambodia therefore is largely linked either to the current bilateral or multilateral aid programs or to the earlier UNTAC period. Considering Cambodia's aid dependence, this is unsurprising. However, Australia's two largest investments have strong commercial rationales: Telstra provides Cambodia's international telecommunications link under an agreement expiring in 2000; the Royal Group of companies, owned by Khmer-Australians with Singaporean and Thai equity, has interests in importing, distributorships, banking, construction, machinery and telecommunications.

Most Australian investors are relatively small scale employers of both expatriate and local staff. No Australian investor operates as a 100 per cent foreign-owned company or joint venture; instead, investors have either representative offices, exploration agreements, branch offices, or informal structures such as business cooperation agreements with the Government. The pattern of most Australian investment is a consequence of the uncertain legal framework, and small and medium sized companies adopting cost minimisation strategies.

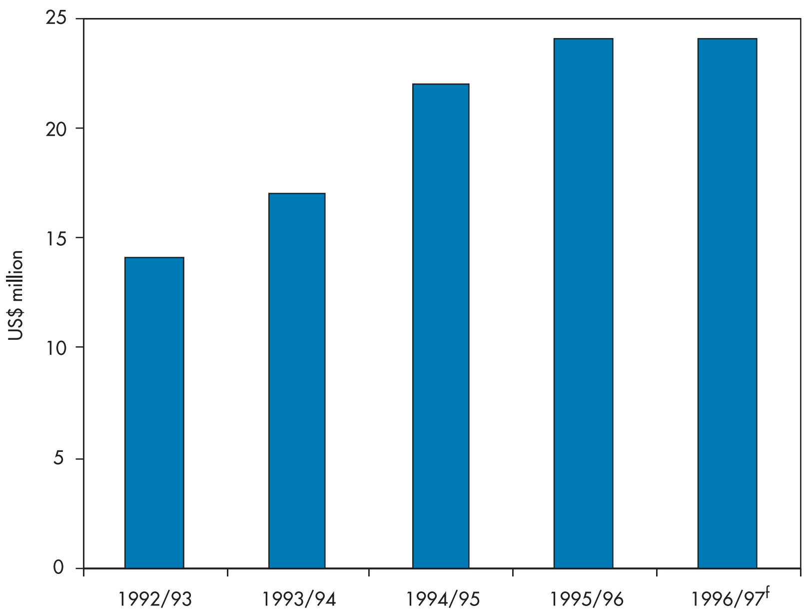
Aid

Australia resumed bilateral aid to Cambodia in 1992, following the signing of the 1991 Paris Peace Accords. In March 1992, the Australian Government approved a US$40 million development cooperation program for the next four years. In April 1994, the amount was increased to US$74 million for the four years to 1998 (Figure 9.4).

Figure 9.4

Australian Aid Remains High

Australian Aid Flows to Cambodia, 1992-93 to 1996-97



Note: The Australian fiscal year ends 30 June. 1996-97 is a forecast.

Source: Department of Foreign Affairs and Trade, 1997.

Reflecting a conjunction of Cambodia's development priorities and Australian capabilities, the four-year development cooperation program focuses on four sectors: infrastructure, education, agriculture and health. Funds are to replace or repair bridges, provide English language training, and support immunisation and water sanitation programs. Special funds also are allocated to land-mine removal, food aid, public administration and legal reform.

CHARACTERISTICS OF THE BUSINESS ENVIRONMENT

Cambodia has developed a highly competitive private sector in a relatively short time, following the devastation of the Khmer Rouge years (1975 to 1979). Cambodia has some of the most liberal retailing and advertising policies in the region. The business environment however, is risky and unregulated; corruption and smuggling are the norm. Despite this, many foreign businesses operate successfully in the market, although 'the high risks … are not necessarily compensated for by high returns'.

Besides aid related infrastructure projects, most foreign investors concentrate on distribution and retail activities and professional services, such as accountancy. Light industry, such as garment manufacturing, attracts growing investment, and this will expand with the recent US granting of most favoured nation (MFN) status to Cambodian imports. Heavy manufacturing attracts little or no interest, though some foreign investors are undertaking new projects in electricity generation.

Cambodia's main attractions as an investment destination are the Government welcomes foreign investment and the market is largely free of regulation and interference and offers attractive property leasing conditions.[3] However, these attractions are not unqualified. While the Investment Law provides incentives, access to these is not easy to obtain as there is no supporting decree. Furthermore, considerable legal uncertainty accompanies market freedom.

The main problems associated with the business environment are: lack of physical infrastructure; lack of personal and legal security;[4] the poor human capital base; poor profit margins, high operating costs and the high level of competition; and a situation of oversupply in a relatively small market. The high incidence of smuggling, bribery and corruption also increases the costs of doing business and distorts the market.

Freewheeling Business Environment

Cambodia's business environment is unregulated and freewheeling. Among other things, this is a result of the nation's low level of economic development and recently introduced market economy. It also reflects the Government's eagerness to encourage foreign investment. Most companies commented on the ease of doing

....

3 Companies can lease prime land and buildings for up to 70 years with attractive rentals and a fixed inflation index.

4 In one case, a business dispute between foreign business partners led to the arrest and detention of one for about a week, without charges being laid.

business in Cambodia compared with elsewhere in the region: the level of government and bureaucratic interference in business matters is low once initial approvals are granted.

While the lack of market regulation keeps prices low, it also results in low quality control and safety standards in some industries. This 'Wild West' business culture tends to attract the so-called 'cowboy' investors. Although some play a role in developing a competitive business environment, identifying and occupying market niches, others are more interested in excessive profits from short term operations.

This lack of market regulation favours small firms over large ones. Uncertainty associated with the evolving legal framework and investment incentives has led some small and medium sized foreign investors to delay formalising their business structures, allowing them to flexibly minimise costs and tax liabilities. Many such firms operate on the fringes of the legal, regulatory and tax systems; some are not licensed by local authorities, or registered with any ministry. The larger and more prominent foreign investors, on the other hand, prefer more formal structures.

Can-Do Government

Cambodia has a 'can-do' Government that is keen to attract foreign investment. 'The Government understands business and is relatively quick to issue basic business licences'. The Government also provides generous incentives for foreign investors, although the International Monetary Fund and World Bank regard these incentives as overly generous, particularly since they discriminate against domestic companies[5] and undermine efforts to widen the Government's revenue base.

The interaction between the Government and business is positive. The larger foreign companies established an informal business group, the Corporate Club, which the Government recognises as an acceptable voice for foreign investor opinion on policy questions.

Another important communication channel between foreign investors and the Government is provided by foreign accounting and legal firms, who lobby the bureaucracy on administrative matters, such as accounting and tax procedures. These firms are especially useful for smaller companies, that do not have an organisation like the Corporate Club. A gap still exists between business and government expectations in areas such as profits, taxes and incentives, but the level and quality of communication between the two sides is good. The business sector will soon face some important government decisions, including the decree on investment incentives and the new mining law and decrees; these will test the relationship.

[5] Except in natural resources, foreign investment theoretically attracts a 9 per cent corporate tax, compared with 20 per cent for local companies (Chong, 1996). Foreign companies also can claim eight year tax holidays and carry forward losses for five years if they meet certain criteria, such as producing for export and employing disabled people.

Dual Government and Right Relationships

Establishing the right relationships is the key to success in Cambodia. The relationships may be family or patron based, or both. The value of a relationship depends on the power and status of the family or patron. Long term loyalty is rare, and allegiances follow the shifts in political, economic or military power. Relationships are built on mutual benefit; the client helps to increase the wealth and power of the patron and so increases the size and range of benefits the patron can deliver to the client in the future.

Party loyalty also is a critical element of decision making within the bureaucracy. It therefore is essential to develop strong relations with both sides of politics in the bureaucracy and the major ministries. Even handed, high quality relations with both sides of the Government are needed if important issues are to be resolved smoothly. (See Chapter 7 - *Cambodia: Politics*.) Projects or solutions not supported by both political parties are unlikely to proceed; outcomes must be seen to benefit equally both sides. Having two ministers for most portfolios prolongs the decision making process because the signature of one must invariably be countersigned by the other (World Bank, 1996).

Infrastructure Shortcomings

Inadequate infrastructure, including unreliable supplies of electricity, poor, war-damaged transport networks and a lack of safe drinking water, add substantially to business costs and is one of the most serious obstacles to private sector development (World Bank, 1996).

However, these shortcomings are being remedied relatively rapidly, at least in and around Phnom Penh. Cambodia's telecommunications industry, for example, is developing rapidly. In 1996, the number of lines increased by 27 per cent to 28 000 lines; by July 1997, another 19 000 lines will be added, bringing the number of lines per 1 000 people to 3.45. Outside Phnom Penh, poor infrastructure and the security situation seriously impede investment.

Skilled Labour Shortages

The pool of skilled workers is very small and worker productivity is low (World Bank, 1996). Cambodia's human capital has been severely depleted by the events of the past 25 years and, unlike Vietnam, Cambodia has benefited little from returnees; relatively few Cambodians have returned because they are concerned about security and the lack of well paid jobs.

The lack of skilled labour will be a major long term problem. Although staff are keen to work and learn, the cost of training people for technical and middle management roles is high. This problem applies equally to the public and private sectors. However, companies that have invested in employee training tend to be positive about their prospects in Cambodia.

FUTURE TRENDS IN THE BUSINESS ENVIRONMENT

The main difficulties for foreign investors lie in the oversupply of Cambodia's relatively small market and increasing corruption and lawlessness. These factors partly determine the kind of firms that thrive in Cambodia. In the short term, political tension in the lead-up to Cambodia's 1998 elections also is affecting the business environment.

Highly Competitive, Oversupplied Market

Although consumer demand is growing strongly, it is starting from a very low base and supply, both legal and illegal, is outstripping demand in some industries, particularly in the oil, tobacco, motorcycle and car retail industries, reducing profits.

Size Matters

Business advisory firms, in particular, commented that in Cambodia, the size of a company matters. It matters more than the sector in which the company operates or the amount of time the company has been in the market. Different sized firms are subject to differing market forces and also differing government pressures.

Large firms perform less well due to taxes, restricted market demand and intense formal and informal competition. Many large companies entered Cambodia during the UNTAC period to strategically position themselves in a market where they expected to generate high growth and profits in the future. Now competition is intense, and smuggling is rife, reducing legal products and disrupting the market through the impact on price, quality and brand name reputation.

Large companies are subject to a variety of pressures because of their high profile and the length of time required to recoup their investment. They are an important source of government revenue through taxes, import duties, and other imposts, and need to develop careful relationships with both government parties. They are also targets for demands for bribes. Large companies, their expatriate executives and their plant and equipment, are potential targets for politically and economically motivated violence. The immaturity of the legal system is a prime concern for the larger companies, whose investments need the protection of greater certainty and clarity.

Government attitudes to larger companies may swing the pendulum even further against them. Analysts have commented on the Government's bias against larger companies, particularly Western ones. Second Prime Minister Hun Sen is reported to believe that larger companies, if human rights concerns grow, may be more vulnerable to economic sanctions or Western government pressure. Such a bias, if true, would reduce Cambodia's access to foreign capital and technology, with obvious repercussions for the nation's future development.

Medium sized companies are in a better position. Their markets are usually less subject to, but not immune to, the disruptions of smuggling and bribery. Typically, these companies entered the market early, often during the UNTAC period, established a monopoly position, quickly recovered their initial capital, and rely on past profits to survive the current lower profit period. If medium sized companies minimise their political and bureaucratic profile, they avoid the costs, attention and inflexibility that often beset larger companies. Their lower profile allows them to benefit from the unregulated environment by minimising costs (including taxes) and maximising profits.

Smaller companies face the greatest competition from local entrepreneurs, small and medium sized firms as well as micro sized enterprises[6] which have lower establishment costs. The smaller foreign companies also tend to be niche suppliers and suffer from restricted market demand, resulting in low returns. However, they benefit from greater freedom of action and their greater ability to minimise costs.

Corruption

Corruption operates at all levels of the decision making process, acting as a brake on development and business (Hiebert and Lee, 1996). Many companies consider that paying bribes and such like are just a normal part of the business culture and that foreigners should adjust to this if they want to do business in Cambodia. Such companies regard 'facilitation' costs as undesirable but inevitable. The effect of such practices varies from company to company. For example, US companies operating overseas are obliged to abide by the US Foreign Corrupt Practices Act, which prohibits all facilitation payments, but such compliance greatly disadvantages them in the Cambodian market.

Lawlessness

While not as bad as the international community portrays, Cambodia's security situation still constrains business activity, particularly in the countryside. Most companies are concerned at deteriorating personal and property security. The rise in lawlessness may be attributed partly to increased tensions as the 1998 elections approach, but much is merely economically motivated. (See Chapter 7 - *Cambodia: Politics*.)

Favouring Asian Investors

Asian companies stand out as successful operators in the current business environment in Cambodia. Some have made long term commitments (Economist Intelligence Unit, 1996). In contrast, few large mainstream investors from Europe and the USA have established a presence in the market. It seems likely that this reflects Asian companies, particularly those from ASEAN and China, generally feeling more comfortable in an unregulated business environment where fostering relationships and networks is critical to success. The relatively small size of the market also is likely to deter large Western multinationals.

Increasing Tension as Elections Approach

Although political tension is increasing in the lead-up to the 1998 elections, its effect on the nation's overall political stability and on foreign investors is uneven.

....

6 Micro enterprises are those that employ three or fewer workers.

Most companies associate increased tension with deteriorating political stability, which deters potential foreign investors and hampers growth and development. Some companies will wait until after the elections before they increase their commitment to Cambodia. They perceive a risk to the security of their investment, even if both Prime Ministers sign contracts. On the other hand, some companies did not see increased political tension as adversely affecting business. Moreover, they thought that after the elections, Cambodia would benefit from having a single party in power, which would accelerate the decision making process for business.

COMPANY STRATEGIES

Foreign companies use a range of strategies to deal with the challenges of operating in Cambodia's unregulated business environment. Generally, the high operating risks encourage firms to adopt a low investment strategy to minimise possible losses. The costs associated with corruption encourage firms to minimise taxes and maintain a low profile to avoid unwanted attention.

Successful Bids

The strategies of international companies that compete successfully to undertake large scale investments in manufacturing and infrastructure have several common elements:

- a clear vision of what the investment entails and how it would benefit Cambodia
- a comprehensive statement to the Government, detailing how the benefits of the investment would be shared between the foreign investor and Cambodia
- a statement of intention to act as a good corporate citizen by, for example, providing training, employing disabled people and providing community services.

One experienced and successful company in Cambodia summarised its approach:

> If Cambodia wants your investment, if you approach the Government with a clear vision of mutual benefit, conduct yourself in a businesslike and culturally sensitive manner and don't seek to take unfair advantage, then difficulties can be overcome and a successful and profitable business established.

Right Partner or Local Staff

Most foreign companies identify the choice of local partner as a 'make or break' factor: 'selecting the right local partner is vital'. Most companies use locally engaged staff for their primary contact with the bureaucracy. These Cambodians, who are often also shareholders in the company, have access to 'the system' through family or personal patrons who have links with the Royal Family, the Government, the bureaucracy or ministers. These contacts facilitate dialogue with different sections of the administration.

EXPATRIATE STAFF

A number of successful Australian companies rely on their senior expatriate staff to manage relationships and negotiations. They focus on specific individuals, such as ministers or officials, who are the key decision makers operating in the company's environment. Typically, contact is stratified; the expatriate manager deals with lower or medium level officials to resolve day-to-day matters; the expatriate managing director engages only with high level contacts on major issues.

Negotiating with Decision Makers

It is important in Cambodia to negotiate at the right level. Even for smaller projects, foreign investors should negotiate directly with the real decision makers. Many potential investors by-pass the Council for the Development of Cambodia, the Government's 'one-stop shop' for approving foreign investment projects, to deal directly with officials having access to real power or relevant ministers (World Bank, 1996). For very large projects, the backing of both Prime Ministers is essential. (See Chapter 7 - *Cambodia: Politics*.)

NEGOTIATE AT THE RIGHT LEVEL

One foreign company's strategy to enter the Cambodian market was to build initial support for its project bid within the bureaucracy. It then intended to lobby relevant ministers for support. In the meantime, another competing foreign investor directly approached the joint Prime Ministers to garner support for its bid. The competitor succeeded in gaining their support and the bureaucracy followed their decision.

The first company lost out to its competitor because it did not negotiate at the decision making level. All decisions involving very large projects are made by, or require the agreement of both Prime Ministers, so a top down negotiating strategy is advisable in these cases.

Combating Lawlessness

Personal security is increasingly threatened by politically and commercially motivated violence. Larger companies adopt a two-tier strategy to minimise risks:

- they employ their own security forces to protect factories, transport routes, and expatriate and local employees. One company spends US$2 000 per month on guards; another retains 150 police and guards on its payroll
- they build employee loyalty and community support to increase the general level of information gathering for indirect protection. Companies build employee loyalty through training, assisting disabled workers and providing good occupational health and safety conditions. They build community support by establishing community based health and education facilities and extending

factory security to encompass villages. These measures encourage employees and communities to warn companies of danger and provide protection.

PROSPECTS FOR BUSINESS

The combination of high levels of foreign support since 1992 and economic reform has produced significant economic and social progress in Cambodia in only a few years. Cambodia's business environment now is very competitive.

Nevertheless, Cambodia is still a small, high risk market and will remain so for the foreseeable future. Furthermore, the market is currently oversupplied in a number of sectors. The security situation may well deteriorate before it improves, so companies entering the Cambodian market should consider the possibility of taking precautions to protect staff, plant and equipment, especially in rural areas.[7] These factors will, and should, deter some foreign investors.

Despite the risks, profitable opportunities exist for foreign firms that are prepared to take the plunge into the rough and tumble of Cambodia's freewheeling business environment.

7 The Government has put in place security checkpoints on all major roads, where police or soldiers collect informal tolls.

REFERENCES

Bardacke, T., 1996, 'Cambodia casino plan fails to come up trumps', *Financial Times*, 12 March.

Chong, F., 1996, 'Cambodia lifts sights to sustainable development', *The Australian*, 16 July, p. 25.

Department of Foreign Affairs and Trade, 1997, *Cambodia: Country Economic Brief*, Department of Foreign Affairs and Trade, Canberra.

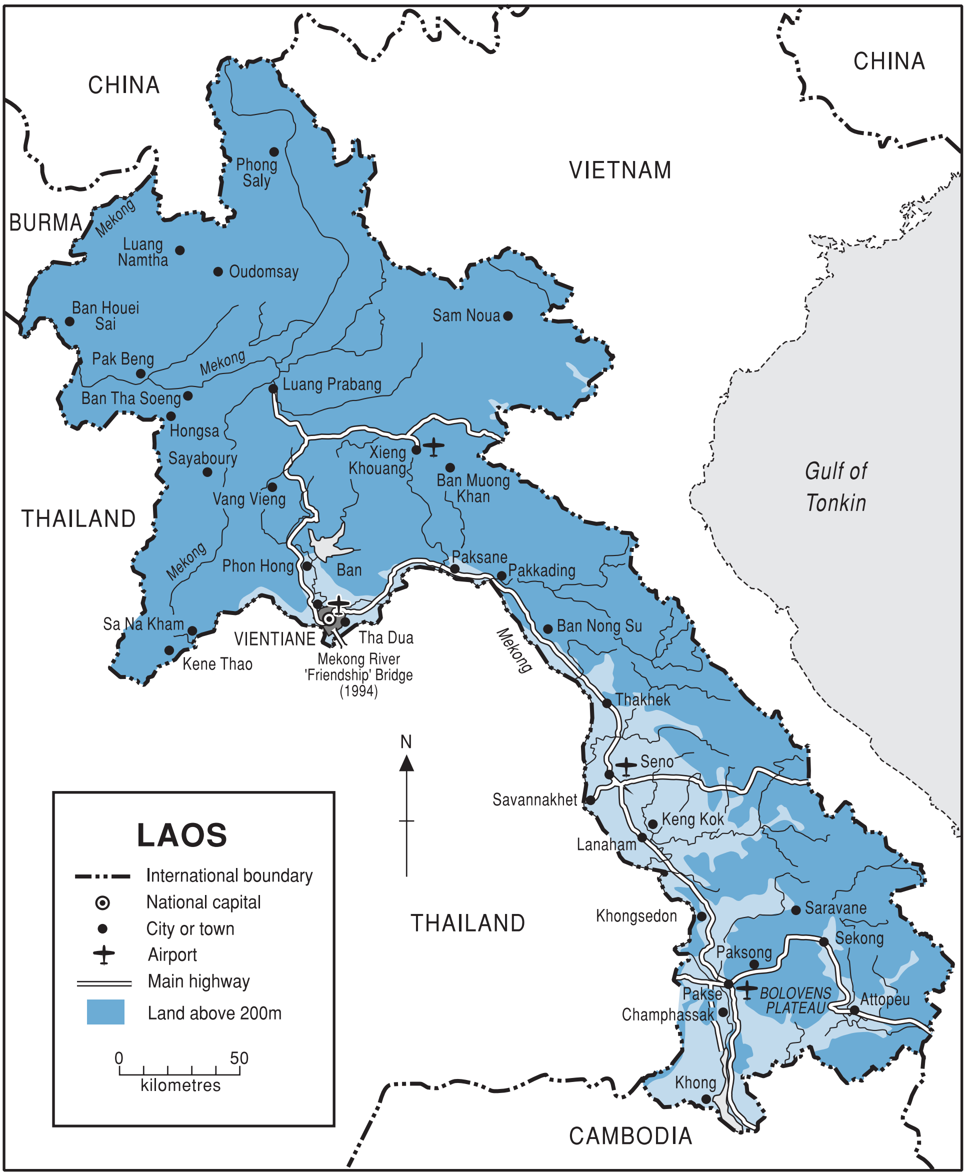
Economist Intelligence Unit, 1996, *Country Report: Cambodia, Laos*, 1st quarter.

Hiebert, M. and Lee, M., 1996, 'Hidden Costs: Investors Flock to Cambodia, but Beware', *Far Eastern Economic Review*, 11 July.

World Bank, 1996, *Cambodia: From Recovery to Sustainable Development*, World Bank, Washington DC.

P A R T F O U R

LAOS



CHINA
VIETNAM
BURMA
THAILAND
Gulf of Tonkin
CAMBODIA
Phong Saly
Luang Namtha
Oudomsay
Ban Houei Sai
Pak Beng
Ban Tha Soeng
Hongsa
Sayaboury
Vang Vieng
Luang Prabang
Sam Noua
Xieng Khouang
Ban Muong Khan
Paksane
Pakkading
Phon Hong
Ban
Sa Na Kham
Kene Thao
VIENTIANE
Tha Dua
Mekong River 'Friendship' Bridge (1994)
Ban Nong Su
Thakhek
Seno
Savannakhet
Keng Kok
Lanaham
Khongsedon
Saravane
Sekong
Paksong
Pakse
BOLOVENS PLATEAU
Attopeu
Champhassak
Khong
Mekong
N
LAOS
International boundary
National capital
City or town
Airport
Main highway
Land above 200m
0
50
kilometres

Chapter 10

PRESERVING ONE PARTY RULE

Reflecting the close historical ties between the Lao and Vietnamese communist movements, amounting, until very recently, to Vietnamese hegemony over Laos (Stuart-Fox, 1986, p. 199), Laos and Vietnam have followed roughly similar economic and political paths since 1975. Initially, Laos, in step with Vietnam, pursued central economic planning depending heavily on the Soviet Union. As in Vietnam, however, economic stagnation exacerbated by the impending loss of once generous Soviet assistance, encouraged the Lao Government to introduce economic reforms in 1986 under the rubric of the 'New Economic Mechanism' and 'new thinking',[1] which together constitute the Lao equivalent of Vietnam's *doi moi* ('renewal').[2]

This chapter examines the challenges confronting Laos' aging party leadership as it tries to secure continued one party rule while developing institutions and laws supporting foreign investment and a market economy, and integrating Laos with ASEAN.

FRENCH COLONY TO PEOPLE'S DEMOCRATIC REPUBLIC

Before 1893, today's Laos consisted of two separate kingdoms based on Luang Prabang and Champassak.[3] Both had been invaded and subject to hegemony by more powerful monarchs in neighbouring Burma, Thailand and Vietnam. After 1893, France gained control of all territory east of the Mekong River under a treaty with the Kingdom of Siam, and incorporated the two Lao kingdoms as one into the Indochinese Union (with Vietnam and Cambodia). Vientiane was the administrative capital, and the Luang Prabang monarch became the King of Laos.

French Colony

French policy was to develop Laos not as a separate entity, but rather for the benefit of French Indochina as a whole. The French envisaged an influx of settlers to Laos from neighbouring Vietnam. This never occurred on the scale hoped for - that would have reduced the Lao to a minority in their own country, but many Vietnamese held positions throughout the French administration of Laos, in preference to Lao (Stuart-Fox, 1986, p. 12). This deliberate policy of Vietnamisation is partly to blame for the lack of qualified personnel that hampers economic development today in Laos.

....

1 *Pean pang mai* in Lao.

2 However, Laos has no *glasnost* or even the relative openness that has accompanied *doi moi* in Vietnam (Ivarsson et al, 1995).

3 A third kingdom based on Vientiane ceased to exist in 1828: it was destroyed by Siam and its royal line came to an end (Stuart-Fox, 1997).

The Japanese occupied Laos during World War II, forcing the Lao King to declare his country's independence from France. In 1945, the Lao formed the *Lao Issara* (Free Laos) Government, but the French took back control in 1946. Laos secured formal independence on 2 October 1953, just before the military defeat of the French by the Vietnamese at Dien Bien Phu. The ensuing Geneva Conference on Indochina endorsed a royal parliamentary regime in Laos with French and US backing (Stuart-Fox, 1997).

Pathet Lao and the Vietnam War

In 1957, the Lao communist movement known as *Pathet Lao* (Lao Nation) joined the regime in an uneasy coalition. Laos' first coalition government, and a second formed with the *Pathet Lao* in 1962, fell victim to the Cold War as Laos was drawn increasingly into the wider Indochina conflict. In 1973, shortly after the Paris Peace Agreement secured US military withdrawal from Vietnam, Laos' third coalition government with the *Pathet Lao* was formed. Two years later, following communist victories in Saigon and Phnom Penh, the Lao communists seized full power. They abolished the monarchy and on 2 December 1975,[4] proclaimed the Lao People's Democratic Republic under the Lao People's Revolutionary Party. The Party's rule continues.

THE PARTY

The Lao People's Revolutionary Party originated in the Indochinese Communist Party Ho Chi Minh formed in 1930. A Lao section was established in 1936, but before 1940, almost all communists in Laos were members of the expatriate Vietnamese community. It was not until the mid 1940s that Lao were recruited as a result of their connections, through marriage for example with Vietnamese (Stuart-Fox, 1986, p. 16).[5]

In 1950, Lao members of the Indochinese Communist Party and ex-*Lao Issara* members founded the *Pathet Lao* movement in Vietnam under Vietnamese patronage. From 1951, the Indochina Communist Party was reconstituted as separate national communist parties for the three Indochina states, although in Laos, the Lao People's Party was not inaugurated until 1955 (Frost, 1997). In 1972, at its second congress, it became the Lao People's Revolutionary Party. The Party claims a membership of between 65 000 and 75 000, up from 50 000 five years ago, representing around 1.5 per cent of Laos' 4.6 million population.

4 This date is now celebrated as Laos' National Day.

5 The current President of Laos, Nouhak Phoumsavanh, for example, was one of the earliest communist recruits and drove a truck between Laos and Vietnam. He married a Vietnamese. The previous President, Kaysone Phomvihane, who died in 1992, was half Vietnamese.

Leadership

Generational change in the party leadership is occurring very slowly. The founding generation of revolutionary leaders, with their close ties to Vietnam, have all but departed. However, the Party says 'veteran revolutionaries' from the pre-1975 conflict comprise 90 per cent of the current Central Committee. The average age of central committee members is 53 years, while the age of the nine members of the Politburo, the Party's inner decision making and policy setting body is around 70. Four women are in the Central Committee; none is in the Politburo.

Ethnic Minority Representation

Laos has one of Asia's most ethnically diverse populations, and ethnic minorities recently increased their profile in the party leadership. Three of the four new politburo members appointed at the Sixth Party Congress in March 1996 are from ethnic minorities, and most of the 15 new central committee members come from provinces other than Vientiane. Although ethnic minorities comprise 40 per cent of the population, they comprise less than 20 per cent of central committee membership.[6]

ETHNIC DIVERSITY

Laos' population divides into three broad ethnic groups:

- *Lao Loum* (Lowland Lao)
- *Lao Theung* (Midland Lao)
- *Lao Soung* (Highland Lao)

Lao Loum, concentrated in the lowland rice farming areas of Laos, make up around 60 per cent of the population. The remaining 40 per cent, the non-*Lao Loum* or ethnic minorities, are spread over 68 linguistic groups and engage mainly in subsistence agriculture.

Decision Making

As in Vietnam, the Lao leadership practises decision making based on consensus. The downside of this is that differences of view are rarely resolved and therefore fester. Unity often is achieved at the expense of rigour and timeliness.

Political Outlook

While the Lao leadership does not fully understand free market reform, it sees it as the only way to improve living standards, especially in rural areas, without which the Party's political dominance could be increasingly questioned. In common with

---

6 The number of ethnic minority representatives on the Central Committee is imprecise because people tend not to identify their ethnic minority status.

counterparts in Vietnam and China, the Lao leadership encourages economic openness but preserves one party rule. So, economic pragmatism has gone hand in hand with the Party's firm resistance to democratic political reforms.

No significant opposition to the Party's political monopoly exists either inside or outside Laos. Briefly in 1990, the leadership encouraged internal party discussions about democracy. These served, however, to flush out party members who had been influenced by developments in the Soviet Union and Eastern Europe, and China before Tiananmen Square: around 40 were suspected of being 'social democrats'. Three of the most influential were arrested and each sentenced to 14 years imprisonment (Ivarsson et al, 1995).[7] In 1991, the Fifth Party Congress formally rejected political pluralism and Laos adopted a new constitution enshrining the Party's leading role.

Since then, overt dissent has disappeared; none is likely to surface for the time being. Multi-party democracy is not even a topic for discussion, nor is policy discussed publicly outside the party framework. The regime remains authoritarian: political stability in Laos is maintained through tight control at all levels of society. This is justified on the basis of past revolutionary struggles and the best interests of national economic development.

Opposition Groups

Efforts by groups of exiles to promote opposition to one party communist government and mount an armed struggle against it have failed.[8] Insurgent activity, now little more than banditry, continues sporadically outside the capital, but with waning external support (Lintner, 1996a, p. 32).

Members of the royal family fled to France, Australia and the USA after the communist takeover in 1975. Sections of the Lao communities in each of these countries maintain their royalist allegiances but do not threaten the Government. Restoring the monarchy was a rallying point for opposition in the past, but the last king died without leaving an obvious successor.[9]

Sixth Party Congress

The Party held its Sixth Congress over three days in March 1996.[10] In the new leadership line-up, reformers were sidelined in favour of conservatives. For foreign investors, this meant Deputy Prime Minister Khamphoui Keoboualapha, reputedly the architect of many of Laos' economic reforms and chief of the powerful and investor friendly State Committee for Planning and Cooperation, was ousted from the Politburo and Central Committee. This and other congress outcomes signalled a more reserved and cautious approach to economic reform for the immediate future. Political reform was not contemplated.

7 The three were also high ranking public servants and had formed a 'Social Democrat Club'.

8 Thousands of ethnic Hmong, with US support, fought against the communist *Pathet Lao* during the 1960s and 1970s. Tens of thousands of Hmong fled Laos after the communist victory in 1975. Roughly 150 000 Hmong are settled in the USA. The planned closure of Hmong refugee camps in Thailand is almost complete.

9 A person who approximates to a Lao crown prince lives in Paris.

10 As in Vietnam, under the Party Constitution, congresses are held every five years.

The new leadership also reflected the increasing political influence of the military. Of the nine politburo members, six are generals; one is a colonel; only two have no military background. The current party General Secretary and Prime Minister, Khamtay Siphandone, was head of the armed forces from 1961 until he became Prime Minister in 1991.

Socialism

Decisions and comments from the Congress indicate a significant section of the party leadership is uncomfortable with some side effects of economic reform. One senior party figure even described free market forces as a Trojan horse ‘sent in by the imperialists to undermine our socialist system’ (Lintner, 1996b, p. 23).

Laos’ socialist system, however, is becoming an increasingly shadowy concept. In the political report presented to the Congress, socialism still appears as the Party’s and Laos’ ideological goal; renovation summarises the policy; and market economy describes the mechanism. What socialism means is not clear, although, like the Vietnam Communist Party’s Eighth Congress, a few months later, the political report confirmed the state sector has the main role in the economy.

THE STATE

The 1991 Constitution strengthened the administrative role of Laos’ state institutions. The deliberative powers of the unicameral National Assembly, Laos’ legislature, were widened. The National Assembly now selects the President, the Council of Ministers and the Chief Justice of the Supreme Court, albeit from lists the Party prepares. The Party also vets and approves all candidates for election to the National Assembly, thus limiting autonomy (Nguyen, 1996, p. 209). Most national assembly members are also party members, but a handful are independent. The National Assembly is not yet as ‘independent’ as its counterpart in Vietnam.

The Council of Ministers is Laos’ highest executive body. It functions as a cabinet, with executive power concentrated in the Prime Minister. As the current Prime Minister is also the top party man, he exercises virtually unfettered control over the Government. Indeed, almost all government decisions, even those, for example, on public service promotions, are referred to his office. The power to make decisions is rarely delegated, so the process is very slow.

This situation was exacerbated when a number of government ministers lost their senior party positions at the Sixth Congress. Rather than positively separating party from state functions, this weakened the ability of the individuals, now without a party power base, and the current Council of Ministers to deliver effective government.

ADMINISTRATIVE REFORM

When the New Economic Mechanism was introduced in the mid 1980s, it became necessary to reform government structures and institutions to improve economic management and sustain economic reform and growth over the long term. Since then, the internal machinery of government has been reorganised to change fundamentally the role of government in the economic system. The aim is to create an efficient and considerably reduced public service, new public institutions responsive to the demands of a market economy and a modern legal system. Financial and technical assistance from international institutions and bilateral grants support these government efforts.

Restructuring

In 1992 and 1993, the Government restructured its ministries, reducing the number from 25 to 13. Some were eliminated. Others were combined or subdivided. All were reorganised to consolidate vice ministers, departments and divisions. The aim was to centralise decision making within ministries and create a leaner, more efficient administration (World Bank, 1994, p. 97).

After the Sixth Party Congress, the powerful State Committee for Planning and Cooperation (CPC), the Government's 'one-stop shop' for both foreign investment and bilateral aid, was restructured as the Committee for Investment and Foreign Economic Cooperation (CIFEC) and shifted to the all powerful Office of the Prime Minister. Like its predecessor, CIFEC has two departments dealing separately with foreign investment and aid.

In its early days, the CPC had fairly effectively implemented reform, but over time, the very top level of government and the Party took over most decisions on applications for foreign investment licences. Positioning CIFEC within the Office of the Prime Minister simply formalises this arrangement, but makes the approvals process even more clogged and inefficient than before.[11]

New Public Service

One of the legacies of socialist central planning is the special position of Laos' 65 000 public servants. Not only are they the regulators and facilitators of economic and public life as in other societies, but they are in a sense, the leaders of Lao society. Laos has virtually no indigenous mercantile class, beyond shopkeepers and street vendors, to challenge this role. Public servants, especially those from the defence and interior ministries, also comprise the bulk of the party membership, and the party elite hold public service positions.

Transforming government's role under the New Economic Mechanism requires a refocusing of public servants' skills and a paring back of numbers to ease the fiscal drain. The Party recognised the importance of human resource development for Laos' future at its Sixth Congress.

Many public servants trained under the old system are redundant; relatively few are familiar with how a market economy operates (World Bank, 1994, p. 94). The public service was reduced by 20 per cent between 1990 and 1996, but still constitutes 1.4 per cent of the population, which is high by international standards. The slow progress in pruning public service deadwood reflects, among other things, the Lao

11 Vietnam carried out a similar restructuring, combining the old State Planning Committee's management of bilateral aid with the old State Committee on Cooperation and Investment's management of foreign investment in the new Ministry of Planning and Investment. (See Chapter 1 - *Vietnam: Politics*.)

avoiding confrontation.[12] Overstaffing is especially severe in the provinces. After accelerating retrenchments and job rationalisations in 1994, the Government embarked in 1995 on a broader strategy that included competing to enter the public service, increasing retrenchments, identifying redundancies, reallocating and retraining staff to upgrade skills, and recruiting better qualified personnel.

In recent years, the Lao public service has recruited younger staff and aid donors have provided increased training for public servants in Laos and overseas. To prepare for ASEAN membership, the Government undertook an intensive human resource development drive, especially in market economic reform. The Politburo decreed in 1996 that public servants should be fluent in a second language.

In September 1996, the Government placed Laos' public servants under the direct control of the party Central Committee.[13] This surprise move formally extended party control over the public service and, through it, Lao society. Bureaucratic decision making could be streamlined by the move. The ostensible decision makers may now also be the real ones (that is party functionaries), and the wasteful system under which party headquarters separately clears all decisions may cease.

Impact

These reforms are yet to improve significantly economic planning, decision making and public administration more generally. Laos remains hamstrung by its weak institutional capacity and a serious deficit of suitably skilled personnel to administer the new systems (World Bank, 1994, p. 97). These deficiencies contribute to the Government's difficulties in achieving economic reform objectives within a set time and continue to hamper foreign business operations in Laos. Concentrating decision making power in the Office of the Prime Minister only slows things down.

Tertiary educated technocrats gradually are assuming middle level positions in the bureaucracy. Building a new administration will, however, take time, and the Government's program to clear bureaucratic deadwood through retrenchments is proceeding slowly. Public service salaries are well below private sector equivalents and cannot sustain even a basic livelihood. When the Lao currency was devalued in 1995, public service salaries were not raised to cover the increased cost of living.[14] Consequently, moonlighting is common (World Bank, 1994, p. 95).

Other obstacles inhibiting the effectiveness of public service reforms include the continuing lack of coordination between different government offices (World Bank, 1994, p. 97).

12 This characteristic was evident in Khamphoui Keoboualapha's retention of the title of Deputy Prime Minister, despite his removal from the party Politburo and Central Committee at the 1996 Sixth Party Congress and the consequent loss of most of his decision making responsibilities.

13 Managing the public service had been the responsibility of the Prime Minister's Office.

14 The devaluation meant an effective 25 per cent increase in the cost of consumer goods in Laos, most of which are imported from neighbouring Thailand.

LEGAL REFORM

Laos' legal system is still in its infancy. In 1996, the entire body of Lao legislation consisted of just 34 laws; all had been passed since 1988. Laws are derived from a mixture of Lao tradition, French civil law and socialist practice. When the Party took power and proclaimed the Lao People's Democratic Republic in 1975, it completely abolished the existing constitution and legal system. Between 1975 and 1991, when Laos adopted a new constitution, the Party ruled by decree, combining socialist dogma and Lao tradition as the legal base. French administrative law was applied in tribunals.

Under the 1991 Constitution, the National Assembly is Laos' primary law making body although, in practice, individual ministries draft laws and the Ministry of Justice vets them before they are introduced into the National Assembly. The National Assembly also supervises the judicial system, and appoints and removes judges.

When it introduced the New Economic Mechanism in 1986, the Government acknowledged a need to develop a body of laws to support economic reform and development. Laos has not adopted wholesale a legal system from elsewhere, even as an interim measure; instead, it has enacted laws and issued decrees piecemeal. These then are inserted one by one into a weak but gradually evolving legal system. The aim is, over time, to develop a completely new, comprehensive legal system tailored to Laos' specific needs and conditions (World Bank, 1994, p. 98).

The body of Lao legislation remains small because the Government covers legal gaps by issuing executive decrees. It justifies this practice on the basis that, in the current transition period, Laos needs to experiment with legal reform before formally enacting new laws (World Bank, 1994, p. 99). As in Vietnam, Lao legislation often consists of little more than a statement of general principles; details are in implementing decrees or guidelines issued by individual ministries.

Commercial Law

Laos, drawing partly on the law making experience of Vietnam, gradually is developing basic commercial legislation, covering contracts, torts, taxation, insurance, labour, foreign investment, bankruptcy, domestic investment promotion and private property rights. Laos' 1990 Contract Law is brief. It talks only in general terms but is quite comprehensive in scope. The 1994 Business Law is Laos' companies act and recognises five types of business structures, including private and state owned enterprises (SOEs). The 1994 Labour Law gives foreign companies virtually unlimited rights to employ Lao citizens but restricts employment of foreign nationals.

Land Law

Under the 1997 Law on Land, all land belongs to the 'Lao national community'. Lao citizens cannot own, buy or sell land; they can only enjoy a long term right to use land, which includes a right to transfer and inherit. Foreigners can lease land for different periods according to use. Lease periods can be extended, case by case. The new law will take effect when the Prime Minister's implementing decree and detailed regulations are issued.[15]

Foreign Investment

The Government updated its 1988 Law on Foreign Investment with the 1994 Law on the Promotion and Management of Foreign Investment. The new law, a response to competition for foreign investment from Laos' neighbours, aims to streamline licensing procedures and unify and simplify taxation while maintaining the liberal framework of the earlier legislation.

Laos' foreign investment regime is one of the most liberal in the region. Most sectors of the economy are open to foreign investment; only a few are reserved for Lao citizens. Fully foreign-owned companies and joint ventures (with at least 30 per cent foreign equity) are permitted, with attractive tax and other incentives.

Initially, fully foreign-owned ventures were preferred for foreign investment, as SOEs other than those under military control were reluctant to enter into joint ventures with foreign companies. However, the position changed recently. The Government now encourages foreign investors to enter into joint ventures with domestic investors or SOEs; these are approved more easily than fully foreign-owned companies. Lao military interests, however, continue to dominate the field.

Although the Committee for Investment and Foreign Economic Cooperation is the 'one-stop shop' for approving foreign investment projects, most foreign investors find it necessary to develop relations with all relevant Lao ministries and authorities. Processing foreign investment applications remains slow and cumbersome. It can take up to 18 months to obtain an investment licence unless 'facilitation' payments are made, and investors need to follow up regularly with the bureaucracy. (See Chapter 12 - *Laos: Business*.)

Dispute Resolution

In Laos, as in other countries in the region, disputes traditionally are settled through mediation or arbitration rather than adversarial 'win-lose' court proceedings. Duties, rather than rights, are emphasised. Compromise solutions, representing a balance of social duties and relationships on the one hand and legal rights on the other, are the norm, even where right and wrong are clear (Flipse, 1996, p. 16).

These principles strongly influence Laos' judicial system. Civil cases begin with mediation or conciliation before progressing to adjudication. Generally, both the Government and the private sector try to find workable solutions to conflicts rather than submitting them to the courts or international arbitration bodies (Flipse, 1996, p. 16). In these circumstances, personal connections remain important.

The court system operates on three levels: a People's Supreme Court (Laos' highest judicial organ), people's provincial courts and people's district or municipal courts.

....

15 Australia will contribute US$5.1 million for a national land titling project being carried out under World Bank auspices. The project should help clarify much of the confusion surrounding rights to use land.

Economic courts have been mooted, but have not yet been established, so the people's courts deal with commercial disputes. Judges normally have little knowledge of business matters and are ill equipped to handle commercial cases. The Committee for Investment and Foreign Economic Cooperation and certain ministries mediate on a case-by-case basis, but their extra-judicial remedy must be accepted contractually by the disputants, if it is to be effective (Flipse, 1996, p. 16).

In 1994, Laos passed an arbitration law prepared with World Bank assistance and based on the United Nations Commission on International Trade Law (UNCITRAL) model. When the new law begins to operate, foreign lawyers can act as arbitrators. The process will begin with mediation then progress, if necessary, to arbitration. Court intervention is supposed to be limited.

Under the 1994 Law on the Promotion and Management of Foreign Investment, parties may submit a dispute to either the Lao arbitration organisation, the arbitration commission of a third country or an international economic decision making organisation. In practice, the Lao legal and court system has not yet reached the stage where it can resolve commercial disputes involving foreign companies. Many foreign companies therefore make contractual disputes subject to foreign law and arbitration. (See Chapter 12 - *Laos: Business*.)

Laos so far has not signed any treaties or international conventions dealing with dispute resolution but may sign the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. Also Laos has taken the first steps towards recognising the authority of the International Chamber of Commerce (ICC) in resolving commercial disputes. The first arbitration ever conducted by the Chamber involving the Government of Laos is currently underway (Flipse, 1996, p. 16).[16]

Legal Profession

Almost all lawyers in Laos work for the Government. In August 1996, after long deliberation, the Government re-established the Lao Bar Association, supervised by the Ministry of Justice. Over 20 private lawyers are registered members.

As yet, no rules govern foreign lawyers in Laos. They still are treated as foreign investors. Three US trained lawyers were granted the first licence to operate a foreign law firm (or, more strictly, a legal consultancy) in 1993.[17] A number of other foreign law firms or lawyers, including several Australians, also either practise or maintain a presence in Laos on a fly in-fly out basis. Foreign law firms can employ Lao lawyers and practise local law but cannot appear in court.[18]

16 The Lao Government is the claimant in the ICC arbitration.

17 Two of three are still in practice in Vientiane as Dirksen, Flipse, Doran and Le.

18 This contrasts with the position in Vietnam, where foreign lawyers are prohibited from employing Vietnamese lawyers and from practising Vietnamese law.

Further Reform Required

Laos' legal and regulatory framework needs to develop further to support the creation of a vibrant private sector and effective institutions of government administration, and promote foreign investment (World Bank, 1994, p. 94). Priorities include a commercial arbitration law and further improvements to legal administration.

Law implementation and enforcement need strengthening. To be fully effective, once passed by the National Assembly, laws need to be followed quickly with detailed regulations. Enforcement mechanisms need tightening.

Although the body of Lao legislation is still small, when executive decrees and the regulations issued separately by each ministry are included, the total volume of laws in Laos is quite large. In these circumstances, it is difficult to say which law or laws apply in a given situation. Laos has no central database on its laws and publishes few of its decrees. A United Nations Development Program project to 'Build a Legal Framework for Laos' may go some way to rectifying this fundamental problem.

PROSPECTS AND OUTLOOK

Political stability in Laos seems assured for the foreseeable future. The Party enjoys a constitutionally guaranteed monopoly of political power and is unlikely to be challenged for some time: no other political group is allowed to exist. Overt political dissent ceased with the arrest of the Social Democrat Club trio in 1990 and no democracy movement exists in Laos. Anti-communist insurgent and exile groups probably will remain an irritant, but even their limited impact will diminish.

For now, the Party is relatively free to determine Laos' political and economic direction. The pace and scope of change depends substantially on the party leadership. The Sixth Party Congress saw a resurgence of conservatism at the top, with the leadership now firmly in military hands. This presages a more cautious approach to economic reform, which is unlikely to be seriously wound back. If it were, the Party would have little prospect of delivering growth and prosperity. Moreover, the military is important in the Lao economy; it has access to resources and, in practice, is independent of the state budget. Its interests will be best served, therefore, by continuing, indeed expanding economic reforms (Nguyen, 1996, p. 208). As in Vietnam, the state sector is set to take on a greater economic role.

Generational change in the leadership has been postponed. President Kaysone Phomvihane was succeeded on his death in 1992 by two of his long standing collaborators, Khamtay Siphandone and Nouhak Phomsavanh. This secured continuity and stability, but at the price of rejuvenation (Ivarsson et al, 1995, p. 52). The composition and outlook of the leadership will evolve as the still dominant pre-1975 revolutionaries gradually give way to a younger, possibly technocratic, generation, perhaps shaped by entrepreneurial leanings including a desire to emulate Thailand's economic prosperity.

The emergence of a younger leadership will not necessarily signal a loosening of the Party's political stranglehold. Younger leaders also will be party products, although less steeped in its history and rhetoric, and therefore more open to change. They will need to be if, as in Vietnam, the growing divide between the Party's rhetoric and the aspirations of mainstream society is not to become a chasm.

The military will not surrender easily its current political dominance, which is matched by a central business role. This could see nationalism increasingly filling the ideological vacuum left by the retreat of socialism (Lintner, 1996b, p. 22). By replacing Marxism with *Lao Loum* nationalism, however, the Party could undermine its efforts to integrate Lao society.

The importance of this is underlined by Laos' multi-ethnic composition; the strategic location of minorities along the country's borders and their crossborder ethnic affiliations; and the important part played by minorities in the pre-1975 conflict and the continuing Hmong insurgency. Ethnic *Lao Loum*, especially from the south, continue to monopolise power at the national level, and the Government's efforts to promote industry and services more than agriculture have led to unbalanced economic development. Wealth disparities between the urban centre and the rural hinterland where most Lao live, are serious. Unless this bias is corrected by, for example, giving minorities a greater say in economic policy making, it could undermine political stability and national unity (Than and Tan, 1997, p. 14).

The Party appeared to recognise this at its Sixth Congress, when it co-opted ethnic minority representatives into the leadership. Investment is being promoted in outlying provinces and party officials regularly visit these. However, the Party probably will need to do more than this to distribute more evenly future economic growth throughout the population.

Obligations, pressures and influences arising from Laos' membership of ASEAN and the ASEAN Free Trade Area (AFTA) will present the Party with hard economic and other choices. The imperative to secure Laos' future by integrating the country economically with the region could force the Party down a broader reform path than it might otherwise choose. It is an open question, however, as to whether ASEAN membership will, of itself, lead to significant political relaxation.

REFERENCES

Flipse, M.S., 1996, 'Legal issues relevant to conducting business in the Lao People's Democratic Republic', paper presented at the Greater Mekong Growth Summit, Ho Chi Minh City, 16-18 September.

Frost F., 1997, personal communication with the East Asia Analytical Unit.

Ivarsson, S., Svensson, T. and Tonnesson, S., 1995, *The Quest of Balance in a Changing Laos,* Nordic Institute of Asian Studies.

Lintner, B., 1996a, 'Road of Death: Hmong Tribesmen Are Killing Travellers in the North', *Far Eastern Economic Review*, 28 November.

____ 1996b, 'Shedding Its Skin: Communist Party Seeks to Define a New Role', *Far Eastern Economic Review*, 21 March.

Nguyen, M., 1996, 'Laos: Back to a Land of Three Kingdoms', *Southeast Asian Affairs*.

Stuart-Fox, 1997, personal communication with the East Asia Analytical Unit.

____ 1986, *Laos: Politics, Economics and Society,* Frances Pinter Publishers.

Than, M. and Tan, J.L.H. (eds), 1997, *Laos' Dilemmas and Options*, Institute of Southeast Asian Studies, Singapore.

World Bank, 1994, Lao People's Democratic Republic: Country Economic Memorandum, World Bank, Washington DC.

Chapter 11

NEW ECONOMY

Laos is South East Asia's only land-locked nation and the most ethnically, culturally and linguistically diverse, with 68 officially recognised ethnic groups. Laos borders China to the north, Thailand to the south west, Burma to the west, Cambodia to the south east and Vietnam to the east. All its neighbours strongly influence Laos socially and economically, and these influences are likely to increase as their economies grow.

Laos covers an area of nearly 237 000 square kilometres, but about 60 per cent of the land is mountainous and only 10 per cent is arable. In these areas, soil and rainfall are generally good but only about 15 000 square kilometres are cultivated. Over one third of this is for shifting slash and burn cultivation. The climate is tropical, with monsoon rains from May to September. According to the 1995 national census, Laos' population was 4.85 million. With an average of 19.3 people per square kilometre, the country has one of the lowest population densities in South East Asia.

OVERVIEW OF ECONOMIC DEVELOPMENT

Conditions in Laos, in many ways, are similar to those elsewhere in South East Asia 30 years ago. Poverty is widespread and often extreme, particularly in rural areas. Health indicators such as life expectancy and infant mortality are the poorest in Asia (Table 11.1). Over half the Lao population lives in small, scattered villages without regular road transport or electricity. Hospitals, schools and safe drinking water are in short supply (World Bank, 1996).

Laos has a dual economy. Commercial activity is concentrated in the capital city, Vientiane, which has a population of nearly 530 000 (about half the urban population). However, most people live in the rural lowland, working in subsistence agriculture. The agricultural sector, mainly focusing on rice production, provides over half of GDP and employs over 80 per cent of the labour force. Industry consists mainly of small scale manufacturing and processing for domestic consumption. Laos' economy remains vulnerable to natural disasters, such as droughts and floods. Despite impressive economic growth in the past decade, Laos still is among the world's least developed economies. According to United Nations estimates, per capita GDP in 1996 was only US$350. So far, the country has been largely untouched by South East Asia's recent phenomenal economic growth.

Table 11.1

Basic Social Indicators Still Low

Population	4.85 million people (1995)
Per capita GDP	US$350 (1996)
Life expectancy at birth	52 years (1994)
Infant mortality	92 per 1000 live births (1994)
Maternal mortality	660 per 100 000 live births (1994)

Table 11.2

Growth Strong but Trade Slowing

Economic indicators, 1990 to 1997

	1990	1991	1992	1993	1994	1995	1996[e]	1997[e]
Real GDP growth (annual per cent change)	6.7	4.0	7.0	5.9	8.1	7.1	7.5	7.0
Consumer prices (annual per cent change)	35.6	13.5	9.8	6.3	6.7	19.4	13.8	5.8
Exports (annual per cent change in value)	24.3	22.8	37.1	80.5	25.0	16.0	-9.5	3.2
Imports (annual per cent change in value)	-4.4	6.4	23.3	63.0	30.6	4.4	15.1	4.4
Current account balance (excluding official transfers, per cent of GDP)	-11.4	-11.3	-8.8	-9.4	-14.4	-11.2	-17.0	-16.0
Gross foreign reserves								
(US$ million) end of period	64.8	57.2	85.5	150.9	158.2	191.1	na	na
equivalent months of total imports (cif)	3.9	3.2	3.9	4.4	3.4	3.9	na	na
External debt [a]								
Debt-GDP ratio (per cent)	35.7	32.8	34.7	36.0	37.7	39.6	na	na
Debt-service ratio (per cent of exports)	10.3	11.2	6.4	4.2	3.4	4.8	5.4	7.0
Exchange rate (kip:US$, end of period)	696	712	716	716	719	925	954	975

Note: a. To convertible currency area only; debt to non-convertible currency area of 796 million roubles not included.
e. Estimated.

Source: International Monetary Fund, 1996; Asian Development Bank, 1997; Otani and Pham, 1996.

NATURAL RESOURCES

Compared to many other low income countries, Laos is relatively abundant in natural resources, particularly forests, minerals and agricultural land, as well as hydro-electric potential. These could contribute greatly to economic progress if they were exploited efficiently and sustainably.

Laos has one of the highest ratios of forest cover to land in East Asia. However, deforestation is a problem due to commercial logging and traditional slash and burn farming. In 1940, Laos had 17 million hectares of forest covering 70 per cent of its total area, but this has dropped to 11 million hectares or 47 per cent of land area (Domoto, 1997, p. 310). The rate of exploitation accelerated in the second half of the 1980s, when Thai demand rose sharply after the Thai Government imposed a ban on commercial logging. Recently, the Lao Government drastically reduced the number of logging permits, but illegal logging continues.

Hydro-electricity offers Laos important opportunities. Around US$13 billion in hydro-electricity projects (or almost 10 times Laos' current GDP) can be developed in the coming decade (Saignasith and Lathouly, 1995). Only about 2 per cent of the potential 18 000 megawatts have been exploited to date. Three medium scale hydro-electric plants operate, with a total generating capacity of about 200 megawatts, with about 70 per cent of the power generated being exported to Thailand. Numerous rivers run through Laos' mountainous area and the United Nations Industrial Development Organisation (UNIDO) identified many possible dam sites where no major population would be displaced, although environmental impact studies would be needed (United Nations Industrial Development Organisation, 1995, p. 189). Laos currently is trying to achieve a balance between fully exploiting its hydro-electric potential and minimising the social and environmental impact.

Laos' mineral resources are highly prospective, particularly for gypsum, iron ores, manganese, tin, copper, gold, silver, lignite coal, oil and natural gas. Over 500 mineral deposits are recorded but few are assessed. Lack of infrastructure and constraints associated with Laos' early stage of development hinder commercial exploitation. Mining is predominantly small scale, although a number of multinational companies are exploring (United Nations Industrial Development Organisation, 1995, p. xii).

INFRASTRUCTURE

Very limited and poorly maintained physical infrastructure inhibits creating an integrated domestic market, extending international trade and developing mineral and hydro-electric potential. Mountainous country and a low population density make the cost of providing infrastructure prohibitive. In its 1994 to 2000 Public Investment Program, the Government allocated US$671 million to develop basic physical infrastructure.

The road network, particularly in rural areas, is inadequate. The main routes need reconstruction or repair, partly as a result of US bombing during the Vietnam War. Less than half of Laos' 18 857 kilometres of roads are surfaced and almost all are in poor condition. Important areas, notably the northern provinces, are virtually inaccessible during the monsoon. Around one third of all villages or 22 per cent of the population are in areas which are never accessible by vehicle (Economist Intelligence Unit, 1997).

Telecommunications are being developed. The current 0.7 telephones per 100 people should increase to 3 telephones per 100 by 2000. Current equipment often is obsolete and not interconnected. However, the situation in Vientiane improved in the early 1990s when a new telephone system was installed.

Laos has several large power plants, among them the 150 megawatt Nam Ngum hydro-power station north of Vientiane. There are three main distribution grids with the largest grid covering Vientiane and Luang Prabang. Small, isolated local grids also operate. Distribution in the rest of the country is poorly developed and electricity is available only in a few cities.

Multilateral and bilateral aid projects gradually are improving Laos' infrastructure. Over 30 per cent of aid in recent years has gone to improve transport. Commercially funded infrastructure projects, such as tollways and bridges, associated with large hydro-electric, mining and tourism projects are underway.

CURRENT ECONOMIC CONDITIONS

Overall economic performance has improved significantly since Laos commenced its transition from central planning in 1986. Between 1990 and 1996, GDP grew at an average of 7 per cent per year and the World Bank estimates annual GDP will continue to grow at 7 per cent from 1997 to 2000 (Figure 11.1). Laos' GDP composition shifted during 1990 to 1995, with agriculture's share declining from 61 to 55 per cent, the share of industry expanding from 14 to 19 per cent and the services sector's share increasing from 25 to 26 per cent.

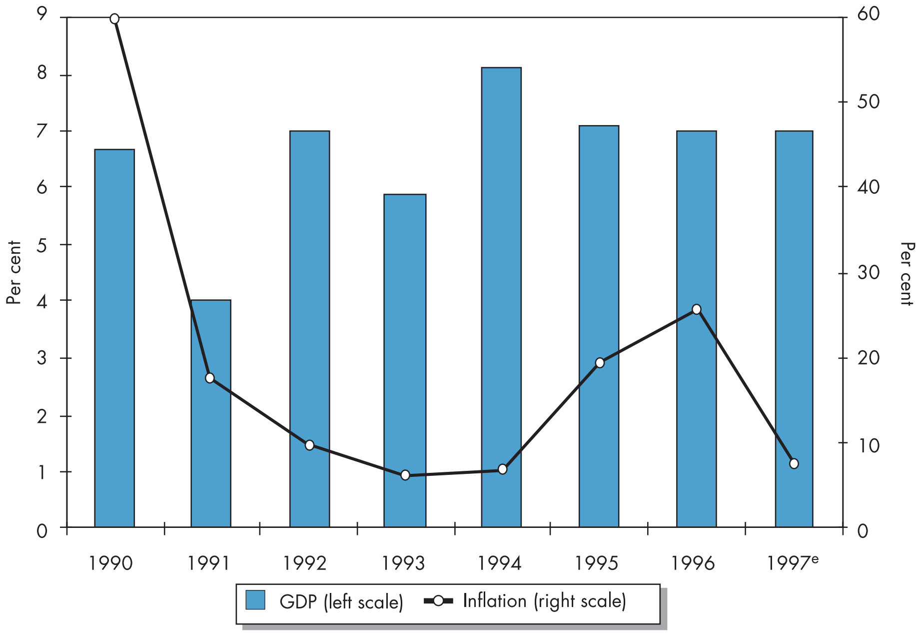
Fiscal performance is improving steadily as the tax base broadens, and current and capital expenditure are reoriented and contained. Although inflation rose sharply in 1995-96 (to about 23 per cent), following three consecutive years of single digit inflation, prices are now broadly under control due to improved fiscal and monetary policies. While the price rise in 1995-96 was partly due to food shortages after floods, lax monetary policy caused a rapid expansion of bank credit, fuelling a rapid rise in demand for construction materials and services (Figure 11.1).

The Lao economy's external performance has been moving, albeit slowly, in a favourable direction, with exports generally growing faster than imports. During 1990 to 1995, exports grew at 35 per cent per year and imports grew at 24 per cent per year. Strong export performance has been attributed to increases in exports from the resources/energy and labour intensive manufacturing sectors. However, it is questionable whether this trade performance is sustainable. High imports have accompanied strong aid and foreign investment inflows. In 1996, exports declined by about 10 per cent while imports grew by about 15 per cent (Figure 11.2). The World Bank estimates that the growth of both exports and imports will slow in 1997 to 2000, with exports growing by 12 per cent per year and imports growing by 5 per cent per year (World Bank, 1997).

Figure 11.1

Improving Economic Activity, 1990 to 1997

Annual Real GDP Growth and Inflation Rate



Note: e. Estimated. Inflation rate is measured by the Vientiane Consumer Price Index.

Source: International Monetary Fund, 1996; World Bank, 1997.

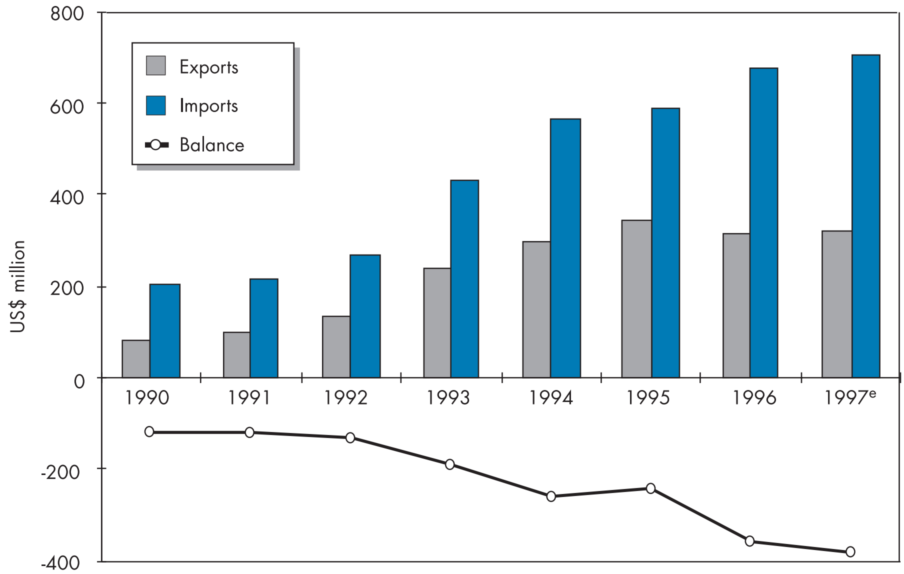
Laos' main exports are based on its forestry and hydro-electric resources. Recent exports from the nontraditional manufacturing sector, particularly in garments and textiles and re-exports of assembled motorcycles and cars grew strongly with trade liberalisation and foreign investment. Laos depends on imports for many consumption goods, and most capital and manufactured intermediate goods for investment.

Increased foreign direct investment has spawned many new industries. From the opening of the Lao economy in 1986 to the end of 1995, the Government had approved over 600 new private foreign direct investment licences mostly from East Asia, worth more than US$7.1 billion.

Figure 11.2

Strong Trade Growth Tapering

Exports and Imports, 1990 to 1997



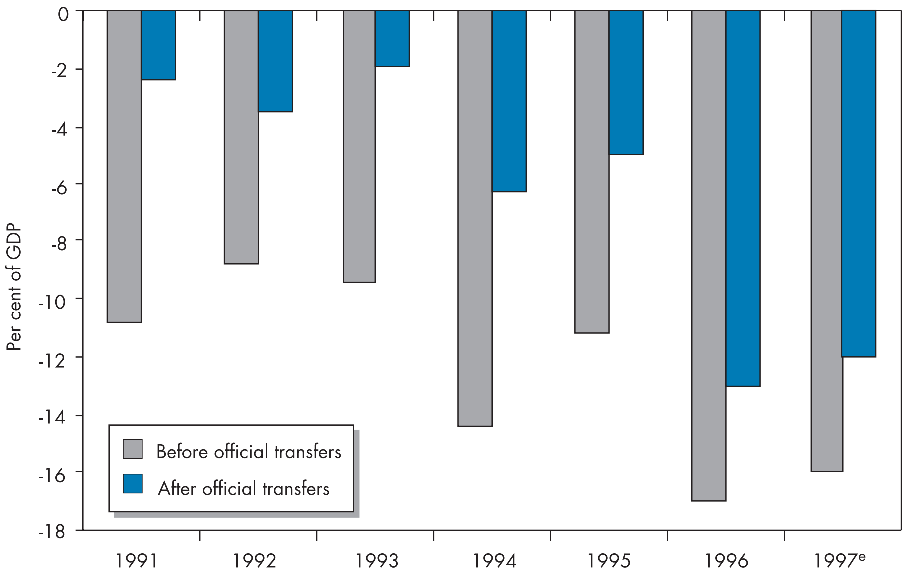
Note: e. Estimated.

Source: International Monetary Fund, 1996; World Bank, 1997.

Laos continuously records a current account deficit, mainly as a result of its merchandise trade deficit (Figure 11.2). In 1996, the current account deficit was estimated at 17 per cent of GDP before including official transfers (Figure 11.3). Laos funds this deficit through foreign aid and concessional loans, sourced from multilateral and bilateral agencies, and from private foreign direct investment. Official transfers, which largely consist of bilateral grants for project financing, were well above US$100 million during 1993 to 1995.

Figure 11.3

Current Account Continuously in Deficit, 1991 to 1997



Note: e. Estimated.

Source: International Monetary Fund, 1996; The World Bank, 1997.

PRE-REFORM ECONOMY

Laos' economic structure is largely the product of centuries of isolation, warfare and domination by neighbours.[1]

As a French protectorate, Laos enjoyed relative peace and stability from the end of the nineteenth century until 1945, but little economic growth and limited investment in infrastructure and social services. From independence in 1953 until the communist takeover in 1975, Laos experienced continuing political instability and civil war, as it was drawn into the wider Indochina conflict. Many died; rural areas were damaged severely; natural resources were destroyed; and industrial development was constrained. (See Chapter 10 - *Laos: Politics*.)

In 1975, the new Government took over a war-torn and extremely underdeveloped economy. It faced a formidable task of reconstruction exacerbated by the withdrawal of US aid and the disruption of crossborder trade with Thailand. In addition, between 1975 and 1985, over 300 000 Lao (or about 10 per cent of the population), including most of the educated middle class, fled leaving Laos bereft of skilled labour.

One of the Government's first challenges was to establish control over the economy. It gradually developed a planning structure and created socialist institutions assisted by Soviet advisers. During the Interim Three-Year Plan from 1978 to 1980, a system

[1] This overview is drawn mainly from Saignasith and Lathouly, 1995, p. 154.

of centralised physical planning was introduced: agricultural and industrial prices, output decisions and trade were determined administratively; most private enterprises were nationalised and placed under state control; and trade between provinces was restricted. Industry consisted largely of state-owned enterprises (SOEs) that met centrally determined production targets and made predetermined annual transfers to the budget, regardless of financial performance. Land was nationalised and its use was determined according to central planning needs.

The Government experienced significant setbacks in its 'socialist transformation' of the economy. As regulation increased, traders, entrepreneurs, professionals and capital fled abroad. Collectivisation of agriculture met with heavy resistance from agricultural workers and was never as widespread as the Government claimed (Pomfret, 1995, p. 68).

Throughout the 1970s living standards continued to decline, production levels stagnated or fell, and financial instability increased as the growing fiscal deficit and rapid monetary expansion combined with acute shortages of most basic commodities to generate high inflation. The balance of payments position also deteriorated as an overvalued and multiple exchange rate limited trade development. Laos depended almost totally on external sources (mostly Soviet bloc countries) to finance investments because domestic saving was negligible and resource mobilisation poor.

Facing a deteriorating economy and increasing resistance to its policies, the Government in 1979 introduced limited economic reforms to raise efficiency and production. Reforms included liberalising agricultural trade and prices, removing a number of restrictions on internal and external trade, and substantially depreciating the exchange rate. Agricultural reforms aimed to achieve self-sufficiency in food production and promote a more balanced and diversified sector, essentially formalising what was already prevalent in the countryside, since collectivisation had not proceeded far.

While these reforms slowly improved economic performance, the Government persisted with its Marxist philosophy, indicating the anticipated capitalist reforms were only an intermediate stage towards socialism (Otani and Pham, 1996, p. 9).

Following closely on *doi moi*[2] in Vietnam, reforms gathered momentum in 1986, with the Government launching a far reaching reform program, the New Economic Mechanism, which marked a decisive move away from central planning towards a market-oriented economy. This made Laos one of the earliest systemic reformers among the former Soviet bloc centrally planned economies. The 1991 Constitution enshrined the commitment to reform by basing the economic system on market principles (United Nations Development Program, 1995, p. 9).

NEW ECONOMIC MECHANISM

A distinctive feature of the Lao reform program is the speed and intensity with which the New Economic Mechanism was implemented. Rather than a piecemeal

....

2 *Doi moi* normally is translated as 'renewal' or 'renovation'. (See Chapters 1 - *Vietnam: Politics* and 2 - *Vietnam: Economy*.)

approach, the Lao Government opted for a bold and rapid restructuring of the entire economy. Four main factors helped it in this:

- the small and underdeveloped nature of the economy
- the primarily subsistence agrarian base, which could be reoriented relatively easily to market demands
- the limited role played by state-owned industrial enterprises (particularly the lack of large, loss making heavy industries)
- the lack of an entrenched bureaucracy. Laos did not have communist cadres intent on maintaining their power and privileges and undermining reforms, as in some areas of Vietnam (Rigg, 1995, p. 153).

Economy-wide production targets were abandoned and the focus shifted to macroeconomic stability and fiscal adjustment through revenue enhancing and expenditure containing measures (Otani and Pham, 1996, p. 1). Public enterprises were given autonomy to determine production levels, production mix, investment, employment and wages.

The effects of these reforms are widely evident. Both structural transformation and macroeconomic management have progressed considerably. The basic elements of a market-oriented economic system now operate: a market based price system, a small but dynamic private sector, a commercial banking system and a central bank, and a relatively open foreign trade regime (Otani and Pham, 1996, p. 48). Overall economic activity has improved notably, albeit from a very low base (Table 11.3).

Table 11.3

All Sectors Performing Better

Annual Real GDP Growth by Sector, 1990 to 1997 (Per Cent)

	1990	1991	1992	1993	1994	1995	1996	1997[e]
Annual growth:								
Total	6.7	4.0	7.0	5.9	8.1	7.1	7.0	7.0
Agriculture	8.7	-1.7	8.3	2.7	8.3	4.9	5.4	4.2
Industry	16.2	19.9	7.5	10.3	9.0	11.4	11.0	11.3
-Manufacturing	15.5	29.7	9.4	7.7	4.7	11.7		
Services	-0.5	6.5	3.9	7.7	6.5	8.5	9.0	9.0
Sectoral share of total								
Agriculture	60.7	57.3	58.0	56.3	56.3	55.2	na	na
Industry	14.4	16.6	16.7	17.4	17.5	18.5	na	na
-Manufacturing	9.9	12.3	12.6	12.8	12.4	13.1	na	na
Services	24.9	26.1	25.3	26.3	26.2	26.3	na	na

Note: e. Estimated.

Source: World Bank, 1994; World Bank, 1996; EAAU consultant, 1997.

AGRICULTURE

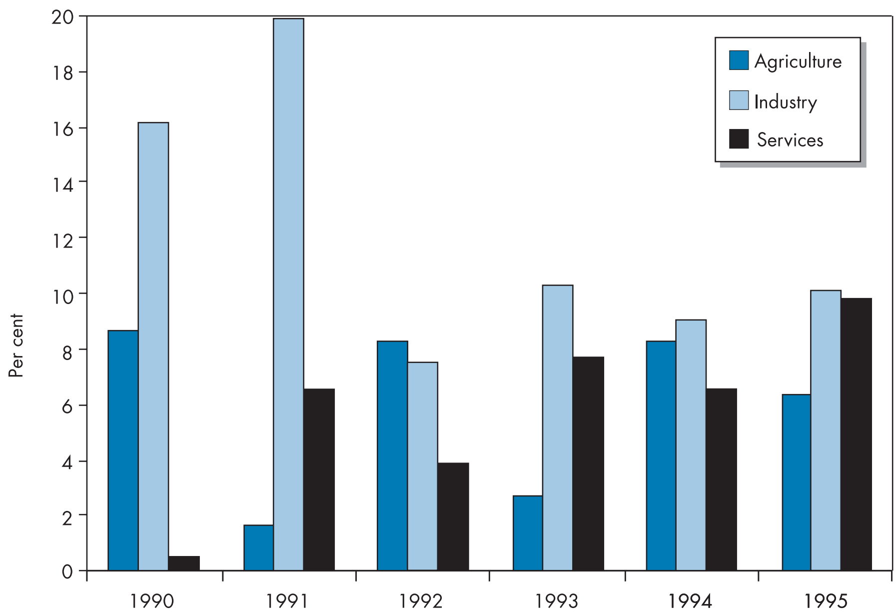
Laos' agriculture consists of food and industrial crops (51 per cent of sectoral output), livestock and fisheries (39 per cent) and forestry (10 per cent). Rice is the most important food crop, followed by sweet potatoes, cassava, corn and potatoes. Tobacco and coffee are the main industrial crops.

Before reform, vestiges of government central planning inhibited growth in the agricultural sector. Now, limited access to all-weather transport infrastructure, market information on available prices and market demand, agricultural extension services and formal sources of credit are the main constraints to growth.

Liberalisation of agricultural prices in 1989, the removal of internal trade barriers, and favourable weather conditions sharply increased agricultural production. Agriculture remains vulnerable, however, to periodic droughts and flooding. As a result, growth in this sector was mixed from 1990 to 1995 with sharp rises and falls (Figure 11.4). However, sector performance generally has been good with annual growth averaging 6 per cent. Industrial crops (cotton and coffee) grew fastest. Good agricultural performance has supported the shift of resources from agricultural to non-agricultural production. (Table 11.3).

Figure 11.4

Real GDP Growth by Sector, 1990 to 1995



Source: Department of Foreign Affairs and Trade, 1996.

INDUSTRY

The industrial sector has performed strongly since 1986, maintaining about 10 per cent growth from 1993 to 1995 (Table 11.3 and Figure 11.4). Industrial activity is mainly concentrated in small scale, labour intensive manufacturing, processing, construction and assembly plants; heavy industry is virtually non-existent. Expansion of manufacturing, particularly in garment production for export and assembly industries, and construction accounts for most recent growth.[3] In 1995, manufacturing accounted for over 70 per cent of industrial output, construction for 20 per cent, utilities for 7 per cent and mining for less than 1 per cent.

Despite rapid growth, manufacturing activity is still small and not well diversified, in 1995 accounting for only 13 per cent of GDP. Manufacturing is largely agriculture based: about half of manufactured production is from rice milling and one quarter from beer brewing and soft drink production. Most of the remaining manufacturing activities are based on Laos' other natural resources, particularly the wide range of forestry based industrial activities. (Figure 11.4).

STATE-OWNED ENTERPRISE REFORM

The Government's considerable divestment of SOEs has improved the efficiency of industry. Privatising enterprises, closing non-viable enterprises and improving the efficiency of enterprises has been much easier in Laos than in other centrally planned economies because SOEs played a relatively small role.

From 1986 to 1990, reforms focused on increasing SOE managerial autonomy, ending direct budget subsidies and giving up ownership of some SOEs. Reforms initiated in 1989 laid the groundwork for the State to divest itself of all but 32 strategic enterprises (among them banks, post offices and utilities), which are nevertheless expected to operate commercially. Since 1989, over 500 SOEs (90 per cent of the total) have been privatised, leaving only 59 to be divested in 1996-97. Divestment of SOEs between 1989 and 1995 netted about US$73 million.

Initial privatisation was to lease to domestic and foreign companies.[4] Recently, SOEs have been sold outright or transformed into joint ventures with the private sector (by selling a 51 to 75 per cent shareholding). Many small state enterprises have been liquidated.

The privatisation program was criticised at the 1996 Sixth Party Congress for being 'too much, too fast and poorly executed'. Remaining SOEs were attacked for operating inefficiently. Party conservatives claimed hasty privatisation of some SOEs (for example, Laos' only brewery) had resulted in lost revenue. They argued that lost access to staples distributed through the former state-owned trading companies at

....

[3] However, garment exports were set back by an European Union decision in late 1995 to suspend Laos' access to Generalised System of Preferences (GSP) privileges because manufacturers failed to conform to 'local content' requirements.

[4] Problems with asset stripping have reduced reliance on this technique since 1994. Many expiring leases are not renewed but are offered for outright sale.

controlled prices had caused the population to suffer unduly from market based pricing when inflation was high, as in 1995.

PRIVATE SECTOR EXPANDING

Expanding domestic and foreign private investment in industry, and the privatisation of many SOEs, means the private sector now accounts for an increasingly large share of industrial production.

THE STATE'S ROLE IN THE ECONOMY

Insufficient information makes it difficult to determine the relative GDP shares of the public and private sectors. The World Bank estimates that the public sector accounts for approximately 20 per cent of GDP. The private sector's share of production is increasing as domestic and foreign private investment increase and SOEs are privatised. A survey of small and medium sized business in Laos found the private sector grew by about 20 per cent in 1995. Most of these businesses are in rural areas; about half are in the retail sector and one third in manufacturing. Outside agriculture, the private sector provides almost half of employment and accounts for 7 to 9 per cent of GDP. Most agricultural production is by the private sector, and in the services sector, retail trade, hotels and restaurants show high levels of private participation.

SERVICES REFORM

The New Economic Mechanism has transformed the services sector, quickly spawning private enterprises providing a range of consumer services. While the sector's share of GDP remained relatively constant at 24 per cent, its composition shifted away from public services (such as administration and defence) towards private commercial services, such as financial, tourism, transport and retail trade services. Since 1990, the number of small, private commercial enterprises operating in Vientiane and the other sizeable cities has increased remarkably. Businesses providing agricultural, engineering, legal, and medical services also have been established (Saignasith and Lathouly, 1995, p. 175). Public services continue to decline, reflecting the Government's policy of downsizing public administration and shifting services to the private sector (Asian Development Bank, 1997, p. 86).

FINANCIAL SECTOR REFORM

Laos' financial sector has been completely restructured. Before 1988, Laos had a monolithic socialist banking system based on the Soviet model, similar to Vietnam's. In March 1988, in one of the first major economic reforms, the Government reorganised the state bank into a two-tier system that separated central banking from commercial banking. This involved creating several state-owned commercial banks out of branches of the state bank. The Central Bank Law of June 1990 formally outlined the powers of the central bank, renamed it the Bank of the Lao PDR, and gave it autonomy to conduct monetary and exchange rate policy. Progress in other areas included eliminating directed lending from banks mainly to SOEs, allowing the entry of foreign banks, liberalising interest rates and developing indirect instruments of monetary management.

The establishment of a two-tier banking system, combined with the Government's high real interest rate policy, has attracted higher levels of savings-the ratio of savings to GDP was 15 per cent in 1995, encouraging an expanding market for banking services. Deposits in commercial banks have risen dramatically, from kip 25.8 billion in 1990 to over kip 140.0 billion in 1995 (Asian Development Bank, 1997). While the central bank has liberalised maximum interest rates since 1995, some minimum nominal interest rates remain. However, the Government has agreed with the International Monetary Fund to remove minimum rates. Interest rates on foreign currency deposits and loans have been completely liberalised. New private banks were allowed entry in December 1992. Several foreign banks (mostly Thai joint ventures) operate in Vientiane and compete freely with state-owned commercial banks.

Reserve requirements for banks were introduced in September 1990 and foreign exchange reserves were transferred to the central bank. In 1994, the Bank of the Lao PDR started holding regular treasury bill auctions and introduced a discount facility that should contribute to better liquidity management through open market operations and the development of an interbank money market (World Bank, 1996, p. 641). The Central Bank Law was amended in 1995 to strengthen the authority of the Bank of the Lao PDR. Nevertheless, the central bank's supervisory function needs to be strengthened further. The current staff establishment is too small and insufficiently trained to supervise effectively the commercial banking sector.

PRICE REFORM AND INFLATION

Early, pre-1986 price liberalisation adjusted official retail and wholesale prices, bringing them temporarily in line with free market prices. However, as free market prices rose, partly in response to rising private sector wages, the gap between official and free market prices again widened. In principle, official prices were set to reflect production costs plus margins, but they often involved large subsidies, particularly since vouchers redeemable at state shops were increasingly used for public sector payments in lieu of cash.

One of the most important economic reforms implemented in 1987 was a market-oriented, single price policy, eliminating the dual price system for goods and foreign exchange. The market now determines nearly all prices for goods and services, although the Government still sets the prices of public utilities, transport and petrol.

Inflation peaked at over 60 per cent in 1989, largely because the money supply expanded excessively and price controls were removed in 1988. By the 1990s, the inflation rate had fallen and stabilised, reaching a low of 6 per cent in 1992, mainly in response to a relatively tight monetary policy. A build-up of liquidity, an easy credit policy and shortages of rice and construction goods in 1995 caused inflation to rise to 19.4 per cent in that year, peaking at 29.1 per cent in February 1996.

However, in the latter half of 1996, inflation fell significantly to an estimated year-on-year average rate of 13 per cent (Figure 11.1).

MACROECONOMIC MANAGEMENT

The reform program has given priority to improved macroeconomic management. Prudent fiscal policies are central to the economic stabilisation program: reducing non-essential government expenditures and increasing fiscal centralisation enhance the Government's control over the budget. Other reforms broaden and deepen the tax base.

Tax Reforms

To adapt its revenue system to the requirements of a market economy, the Government implemented two major tax reforms in 1988 and 1989. Before March 1988, the Government's main source of revenue were the operating surpluses of state enterprises. The March 1988 tax reforms introduced a uniform tax system for all sectors and enterprise types, including company income, sales and agricultural production taxes and import duties.

Further tax reforms in June 1989 dealt with some of the problems of previous reforms, reducing multiple profit tax rates, limiting coverage of indirect taxes, and introducing new taxes such as personal income taxes and an expanded natural resources tax covering mineral resources, land concessions, agriculture and forestry products. The Government centralised fiscal management in 1993 by restructuring timber royalties, implementing a minimum corporate income tax, and passing property and land tax legislation.

These measures have been less effective than anticipated. In 1995, concern about slow progress in increasing revenue prompted renewed government efforts to strengthen its revenue position by introducing new tax measures, committing to fully implement previous tax measures and strengthening tax administration. The tax law adopted in 1995 and implemented in early 1996 provides Laos with a relatively efficient tax system containing all major taxes, although tax administration still needs improving (International Monetary Fund, 1996, p. 12).

Sound Fiscal and Monetary Policies

The Government stresses sound fiscal and monetary policies for macroeconomic stability supporting the wider process of transition to a market economy. Since initiating the New Economic Mechanism, the Government has taken strong measures to reduce the fiscal deficit and strengthen government savings.

However, inadequate public and private savings constrain economic development. Despite government efforts to mobilise domestic resources, savings rates remain low, at 15 per cent of GDP in 1995, and the economy still relies on external financing.

Overall fiscal performance in 1994-95 improved and met program targets agreed with the International Monetary Fund. Current revenue increased from 10 per cent of GDP in 1991-92 to 13 per cent in 1994-95, while current expenditure fell from over 12 to 10 per cent of GDP in the same period. As a result, the fiscal current account moved from a deficit of 1.7 per cent of GDP in 1991-92 to a surplus of 1.7 per cent in 1994-95. Total government expenditure was 22 per cent of GDP in 1994-95; aid funded capital expenditure accounted for 11 per cent of this. The overall budget deficit (excluding official grants) was 9.7 per cent of GDP in 1994-95.

The 1995-96 budget sought to continue progress towards fiscal sustainability by further broadening the tax base and reorienting current and capital expenditure. It aimed for a surplus on current operations of 2.3 per cent of GDP, and an overall budget deficit (before grants) of 9.2 per cent of GDP (Table 11.4).

Table 11.4

General Government Operations, 1991-92 to 1995-96

Item	1991-92	1992-93	1993-94	1994-95	1995-96
			As percentage of GDP		
Revenue	10.5	12.0	12.7	12.5	12.6
Tax	7.4	9.1	10.0	10.2	10.4
Non-tax	3.0	2.9	2.7	2.3	2.2
Expenditure	21.4	18.1	24.2	22.2	21.8
Current expenditure	12.2	11.2	11.9	10.8	10.3
Capital expenditure	9.2	7.0	12.3	11.4	11.6
Current balance	-1.7	0.9	0.8	1.7	2.3
Overall balance					
Including grants	-7.5	-4.4	-5.2	-4.2	-3.8
Excluding grants	-10.2	-6.1	-11.5	-9.7	-9.2
Domestic financing	1.8	1.5	0.5	-0.4	-1.2
Foreign financing	5.8	2.9	4.7	4.6	5.0

Source: International Monetary Fund, 1996.

BALANCE OF PAYMENTS

The Lao economy has recorded large merchandise trade deficits since 1988. In 1995, the trade deficit was US$241 million, US$23 million less than the previous year, mainly as a result of slower growth in imports (4.4 per cent in 1995) following depreciation of the exchange rate. The (prior to official transfer) current account deficit in 1995 was US$200 million, or 13 per cent of GDP (Table 11.5), which is quite large even by regional standards. Laos funds its current account deficit mainly through foreign aid and concessional loans from multilateral agencies and bilateral donors, and from private foreign direct investment.

Table 11.5[5]

Growing Deficit Matches Capital Inflows

Balance of Payments, 1991 to 1995

Item	1991	1992	1993	1994	1995
			US$ million		
Exports (fob)	96.6	132.6	240.5	300.4	347.9
Imports (cif)	215.0	265.6	431.9	564.1	589.0
Trade balance	-118.4	-132.9	-191.5	-263.7	-241.0
Services (net)	-1.4	21.5	33.1	25.4	22.8
Net factor income	-1.1	-1.2	2.8	-2.1	-5.7
Transfers	95.9	71.5	113.0	234.2	131.0
Private	10.4	8.6	9.5	9.5	21.7
Official	85.5	62.9	103.5	124.7	109.3
Current account balance	-25.0	-41.1	-42.6	-106.3	-91.1
(excluding official transfers)	-110.5	-104.0	-146.1	-231.0	-200.4
Capital account	57.2	46.3	56.5	93.8	105.5
Medium and long term loans	35.1	62.1	69.5	55.7	90.5
Foreign investment	8.0	9.0	77.8	43.4	83.9
FDI	6.9	7.8	47.6	42.4	77.2
Portfolio investment	1.1	1.2	30.3	1.0	6.7
Commercial banks	34.9	-14.9	-35.8	7.5	10.2
Errors and omissions	-20.8	-9.9	-55.0	-12.8	-79.1
Overall balance	32.2	5.2	13.9	-12.5	14.4
			As percentage of GDP		
Current account	-2.4	-3.5	-3.2	-6.9	-5.2
(excluding official transfers)	-10.8	-8.8	-11.0	-15.0	-11.4
Official gross reserves	28.9	41.4	63.3	61.1	92.5
(in months of cif imports)	1.6	1.9	1.8	1.3	1.9

Source: International Monetary Fund, 1996.

EXTERNAL DEBT

Calculating Laos' external debt (principally public debt) is complicated by the exchange rate used in converting the debt with former Eastern bloc countries to US dollars. Until 1988, the former Soviet Union was the main lender to Laos. The Bank of the Lao PDR estimated the total official external debt at US$1.2 billion at the end of 1995. Debt to Western donor countries, the World Bank, the Asian Development Bank and the International Monetary Fund, increased in recent years, accounting for US$678 million (55 per cent of total debt) at the end of 1995.

5 Figures quoted here may not be the same as those used in previous charts because of different sources. It is difficult to cross-check these sources.

The bulk of Laos' debt to the countries with non-convertible currencies has been rescheduled, interest free to 2000, and loans from multilateral agencies are on concessional terms, with an average interest rate of 1 per cent and long grace periods and repayment times. Consequently, despite the high overall level of external debt, 120 per cent of GDP, debt service payments in 1995 were only about US$21 million, or about 5 per cent of exports.

EXCHANGE RATE POLICY

The Government recognised that a stable exchange rate was necessary to expand exports, increase private investment and reduce the trade deficit. Reform of the exchange rate system initially lagged behind other reforms and the system of multiple exchange rates, ranging from the official rate of kip 10:US$1 to the parallel rate of about kip 400:US$1, was extremely complicated. In 1987, the number of exchange rates was reduced from seven to four and although the overall span of the rates was not decreased, this brought the rates for most transactions close to the parallel market rate.

In January 1988, the Government unified the system of multiple exchange rates, creating one rate close to that prevailing in the parallel market. This resulted in an initial sharp depreciation (of about 90 per cent) in the nominal exchange rate. The Government subsequently adjusted periodically the official rate to move close to the parallel market, and the rate remained stable, at about kip 750:US$1, between 1990 and 1994. Despite tighter monetary policy, successive devaluations and foreign exchange restrictions, pressure mounted on the exchange rate early in 1995 as inflation accelerated, causing a decline in official reserves as the Government attempted to maintain the official exchange rate. The parallel market rate depreciated by about 15 per cent by mid May 1995. In September 1995, the Lao Government abandoned the official rate, lifting all remaining exchange restrictions, and introduced a managed floating exchange rate system. The commercial bank rate remained relatively stable, at about kip 925:US$1 until late 1996. In early 1997, the official exchange rate depreciated to kip 980:US$1, while the parallel market rate peaked at kip 1200:US$1 (in February).

Government intervention in the exchange market continues, although the Bank of the Lao PDR claims this is limited and consists mainly of smoothing operations. The Government has not yet succeeded in reducing the widespread use of the Thai baht and US dollar in the economy.

FOREIGN AID

The Lao economy depends heavily on foreign aid. Total development assistance in 1995 was US$232 million, with US$123 million in loans and US$109 million in grants. Of the total, about half is from bilateral sources; Japan is the largest bilateral donor and Australia is equal second largest with Sweden. About 45 per cent of aid is from multilateral sources such as the Asian Development Bank, the World Bank and the International Monetary Fund. Disbursement rates are low because of infrastructure bottlenecks and a lack of skilled government administrative personnel. In 1995, about 30 per cent of World Bank assistance was disbursed, up from 11 per cent in 1993.

Aid goes mainly to five sectors:

- economic management; as reform implementation intensified in 1989, a third of development assistance went to supporting economic reform through concessional loans and technical assistance
- transport and communications, the biggest aid recipient since 1991
- agriculture, forestry and fisheries
- energy
- social development with health and education increasingly emphasised in aid funding in recent years (United Nations Development Program, 1995, p. 37).

TRADE REFORMS AND CHANGING PATTERNS OF TRADE

Since reforms, the external sector has developed successfully. Laos has historically been a closed economy, exporting some primary goods and conducting informal trade along its long borders, particularly with Thailand, China and Vietnam. Unofficial imports consist mainly of consumer goods; unofficial exports consist mainly of livestock, agricultural and forestry products, semi-processed precious stones, metals and narcotics. Long and porous borders make policing crossborder trade, especially the illegal trade in narcotics, very difficult.

THE DRUG TRADE

Laos borders on the Golden Triangle and the production and trade in illegal drugs, mainly narcotics (opium and its derivatives, morphine and heroin), remain important in some parts of the country, particularly in the isolated and very mountainous northern provinces. Some media reports suggest Laos is becoming again a crossroads in the international heroin trade. Lao opium production in 1994-95, for example, was estimated at 180 tonnes, a 6 per cent increase on the previous year, making it Laos' largest export earner, albeit an unofficial one. While with US and other donor assistance, Laos is moving to strengthen its counter-narcotics enforcement efforts, these are largely ineffective to date. Difficult terrain and poor infrastructure make law enforcement difficult and crop substitution programs are lacking.

In 1987, the trade regime was reformed to facilitate the inter-regional flow of goods. Before the reforms, the market system was complex and administrative interference in the direction and volume of trade flows was extensive. For example, farmers could not sell rice across provincial borders and only state companies could move goods across borders. Domestic trade now is open to private and cooperative traders and state trading companies have either been restructured to improve efficiency or abolished, increasing internal trade.

The foreign trade sector also was liberalised after 1986. Before the reforms, the state sector almost completely monopolised trade but now, all businesses have access to imported goods through licensed traders, which include state bodies and mixed and private import-export companies. Apart from specifically listed 'strategic' commodities, the range of goods licensed traders can import is unrestricted. However, only in rare cases will the Government grant an import licence to a foreign company.

In March 1988, an import tariff was introduced and in 1993, the Government began a program of tariff rationalisation: the number of tariff rates has been reduced and the range of items covered extended. The maximum tariff rate fell from 80 to 40 per cent and the number of tariff bands from 12 to six. By 1995, the Government abolished quantitative restrictions on imports, except motor vehicles, and special agreements with importers concerning duty payments, although customs officials continue to make 'informal arrangements' with individual importers.[6] Customs administration is improving and a GATT valuation system is being implemented. Imports now are valued at the market exchange rate for tax purposes and no tariff exemptions for specific countries (former socialist countries) exist. Exporters now have access to imported inputs at duty free prices.

The Government intends to deepen its external trade reforms by moving to a lower and uniform tariff structure, further improving customs administration, and fully implementing the GATT valuation system. It also has agreed to remove remaining non-tariff barriers on motor vehicles and reduce the number of duty exemptions (World Bank, 1996, p. 643). As a member of ASEAN, Laos will need to make further commitments to trade liberalisation. (See Chapter 13 - *New ASEANs*.)

Expanding Trade

Reform is expanding merchandise trade, and Laos is becoming more integrated into the international economy. Total merchandise trade (exports and imports) as a ratio of GDP rose from about 31 per cent in 1991 to 61 per cent in 1995 (Table 11.6). Both exports and imports have grown strongly since the late 1980s; exports grew from 9 per cent of GDP in 1991 to 23 per cent in 1995, and imports grew from 21 to 38 per cent of GDP in the same period.

Timber and hydro-electricity are the main exports (Table 11.6).[7] Recent increases in foreign direct investment have diversified exports, particularly in garments, textiles and manufactures, including motorcycles. The share of traditional exports such as timber, wood products and electricity therefore has fallen from 80 per cent of total exports in 1985 to 44 per cent in 1995. Garment exports have increased significantly but are held back by quotas industrialised countries impose.

The structure of imports is changing, too. While consumer goods still dominate, accounting for about half of all imports, industries like textiles and garments, now depend heavily on imported capital and intermediate goods.

[6] Scope for corruption in customs administration is considerable.

[7] Except for Brunei (which relies on oil and natural gas exports), Laos has the narrowest export base of any country in South East Asia.

Table 11.6

Commodity Breakdown of Trade, 1991 to 1995

Trade	1991	1992	1993	1994	1995
			US$ million		
Total exports	96.6	132.6	240.5	300.4	347.9
Timber products	40.9	42.7	65.8	96.1	88.3
Electricity	21.3	17.0	19.6	24.8	24.1
Agriculture	3.7	7.3	9.2	12.1	13.7
Coffee	3.0	2.4	4.1	3.1	21.3
Manufactures [a]	12.6	29.4	38.1	36.3	78.3
Garments	15.1	27.3	49.0	58.2	76.7
Motorcycles	-	-	36.0	46.2	17.7
Car re-exports	-	6.5	14.5	4.5	-
Gold re-exports	-	-	4.2	18.8	21.8
Others	-	-	-	0.4	6.0
			Percentage		
Total exports/GDP	9.4	11.2	17.6	21.9	22.7
Export growth rate	22.8	37.1	80.5	25.0	16.0
			US$ million		
Total Imports (cif)	215.0	265.5	431.9	564.1	589.0
Investment goods	43.0	69.9	113.8	146.1	189.2
-Machinery and equipment	8.6	14.0	22.7	32.0	43.8
-Vehicles	10.4	16.9	27.5	25.0	35.9
-Construction equipment	18.5	30.1	48.9	67.7	78.8
Consumption goods	90.4	140.5	224.7	276.5	283.8
			Percentage		
Total imports/GDP	20.9	22.5	31.2	37.9	38.4
Import growth rate	6.4	23.3	63.0	30.6	4.4

Note: -. below zero. a. Excludes garments and wood products.

Source: International Monetary Fund, 1996.

Direction of Trade

Trade direction also has been substantially reoriented: particularly, trade with East Asia has increased markedly at the expense of former Eastern bloc countries (Table 11.7). In 1995, Thailand was Laos' largest trading partner although the trade included a large volume of trans-shipments through Thailand to and from third countries.

Table 11.7

Direction of Trade, 1991 to 1995

(US$ million)

Trading partner	1991	1992	1993	1994[e]	1995[e]
Exports (fob)	96.6	132.8	240.5	300.4	348.2
Thailand	64.1	67.1	88.9	122.8	142.3
Vietnam	15.0	13.2	23.1	75.7	87.7
France	2.8	7.7	12.5	20.4	23.6
USA	0.5	2.5	10.7	9.7	11.2
Former Soviet Union	3.0	5.9	7.0	9.7	11.2
China	0.9	13.2	25.5	8.2	9.5
Germany	-	3.7	8.9	4.3	5.0
Taiwan	1.6	1.9	10.1	3.3	3.8
Canada	1.6	2.4	2.8	3.0	3.5
Japan	-	7.0	8.8	1.8	2.1
Imports (cif)	209.7	239.2	431.9	564.1	627.8
Thailand	108.3	110.0	212.4	272.8	284.0
Japan	44.9	41.5	56.0	66.6	69.3
Vietnam	14.4	11.0	19.6	23.3	24.3
Singapore	10.7	42.5	19.2	22.7	23.6
China	8.4	7.1	18.0	21.3	22.2
France	3.3	3.2	6.5	7.7	8.0
Taiwan	3.6	3.5	4.8	5.7	5.9
USA	2.4	2.7	4.3	5.1	5.3
Hong Kong	2.4	2.4	4.2	4.9	5.1
Australia	0.7	0.7	3.3	4.0	4.2

Note: e. Estimated.

Source: International Monetary Fund, 1996.

FOREIGN INVESTMENT EXPANDING

Before 1989, Laos had very little foreign direct investment except from the former Soviet Union. Since then, the Government has encouraged foreign and private domestic investment in most sectors, improving the overall economic climate for investors. (See Chapters 10 - *Laos: Politics* and 12 -*Laos: Business*.)

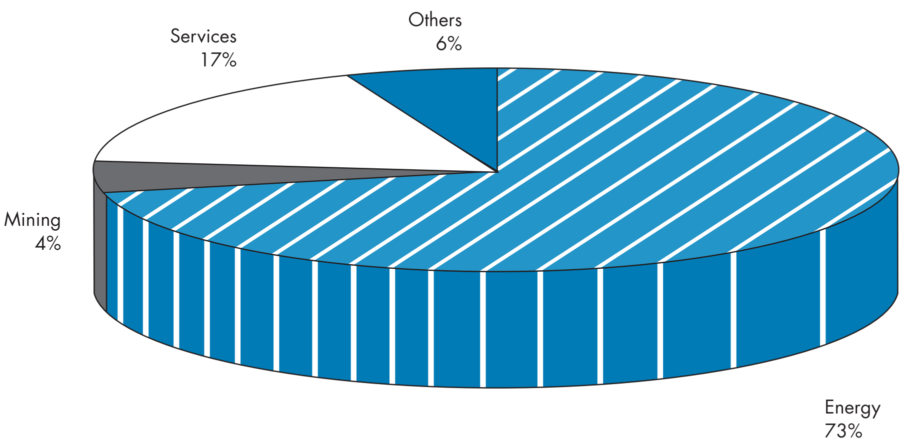
Between 1988 and 1996, the Government issued over 600 new investment licences worth more than US$7.1 billion in private investment commitments. Measuring actual foreign direct investment implemented is difficult because the Government only releases data on the number and value of approvals.[8] Initially, most foreign investment was in joint ventures, but by 1994, wholly foreign-owned investment accounted for about half of total investment approved. The current trend is back towards joint ventures with SOEs.

Hydro-electric projects account for about 75 per cent of the total value of investments approved (Figure 11.5). In terms of the number of licences awarded, the most attractive sectors for foreign investors are garments, other manufacturing and agribusiness. However, most individual investments in these sectors are quite small. Other important sectors are mining, hotels and tourism (Table 11.8). The Lao Government promotes investment in remote provinces to reduce the growing income disparity between these areas and Vientiane. (See Chapter 10 - *Laos: Politics*.)

More than 26 countries have invested in Laos. At the end of September 1996, East Asian countries accounted for 62 per cent of new licences issued and 55 per cent of the value of foreign investment (Table 11.9). By June 1996, Australian firms had 42 projects approved, worth US$303 million, or 5.3 per cent of total foreign direct investment (FDI).

Figure 11.5

Composition of Approved FDI in Laos, 1985 to 1996



Source: Table 11.8.

[8] According to World Bank estimates, about 30 per cent of foreign investment approvals are implemented.

Table 11.8

Approved FDI by Sector, 1992 to 1996

(Number of Projects and Value US$ million)

Sector		1992	1993	1994	1995[b]	1996	1985 to 1996[a]
Agriculture	Number	14	23	7	3	3	59
	Value	15.7	16.9	6.8	5.1	1.0	55.7
Textile and garments	Number	20	14	8	6	1	70
	Value	13.2	13.6	12.3	13.1	1.0	69.3
Wood processing	Number	5	5	5	1	0.0	32
	Value	34.5	6.8	22.4	0.6	0.0	71.4
Processing industry and handicrafts	Number	17	34	20	9	8	111
	Value	20.3	59.6	18.0	46.0	12.2	176.1
Mining	Number	2	5	3	9	0.0	28
	Value	200.2	18.0	9.6	27.1	0.0	312.3
Trade	Number	12	24	16	4	1	93
	Value	2.7	6.9	8.9	0.4	0.2	54.5
Hotels and tourism	Number	5	6	6	1	2	32
	Value	6.6	4.8	279.3	0.3	211.1	604.9
Energy	Number	0	0	3	2	2	9
	Value	0.0	0.0	2 054.0	1 107.9	586.8	5 147.6
Bank and insurance	Number	3	3	1	1	1	11
	Value	15.0	15.0	5.0	5.0	6.0	73.8
Consultancy services	Number	3	7	18	8	0	47
	Value	0.1	1.7	1.7	0.7	0.0	7.2
Other services	Number	9	19	24	16	5	80
	Value	2.1	5.1	4.1	12.2	0.8	24.8
Construction	Number	5	9	16	3	0	34
	Value	18.0	13.9	19.3	6.0	0.0	57.5
Telecommunications and transport	Number	1	3	3	1	1	12
	Value	0.2	0.7	64.8	0.1	400.0	471.6
Total	Number	96	152	130	64	24	618
	Value	328.5	163.1	2 506.3	1 224.5	1 219.1	7 126.7

Note: a. Cumulative. b. First six months of 1996.

Source: Foreign Investment Management Committee, 1996.

Table 11.9

Approved Foreign Investment, by Country of Origin, 1988 to 30 June 1996

Country	Number of projects	Value (US$ million)	Per cent share
Thailand	233	2 377.0	41.7
USA	40	1 736.9	30.5
Republic of Korea	16	592.1	10.4
France	68	317.6	5.6
Australia	42	303.5	5.3
Malaysia	11	188.7	3.3
Taiwan	31	65.2	1.1
Norway	1	54.0	0.9
China	60	38.6	0.7
United Kingdom	13	28.7	0.5
Total	515	5 702.3	100.0

Source: Foreign Investment Management Committee, 1996.

STRENGTHENING REGIONAL TIES

As South East Asia's only land-locked country, Laos views its international relations as extremely important, especially relations with Thailand, China and Vietnam. In the past, Laos was reclusive. The country kept a low international profile and attracted little international attention because it was perceived as economically marginal and politically peripheral (Rigg, 1996, p. 89).

Recently, the Government has adopted a higher international profile. Lao leaders have officially visited Thailand, China, Vietnam, Burma, Cambodia, Singapore, Indonesia, Japan and Australia. As a member of ASEAN, Laos will further integrate itself into the regional economy.

Laos' new outward orientation also is a response to the collapse of its former ally and main source of aid, the Soviet Union. Being reliant on external assistance, Laos had to look for new economic partners. Laos also needed to spread the risks associated with being land locked by developing and sustaining good relations with its more powerful neighbours. Bilateral business relations with these countries also are expanding. The Lao Government feels it needs to counterbalance its relationships with Thailand and China, so it continues to seek close cooperation with its longstanding ally, Vietnam, whose political outlook it broadly shares. This is reflected in the large number of official visits between the two countries. (See Chapter 1- *Laos: Politics*.)

The relationship with Thailand is sensitive. This is partly a result of confrontation in South East Asia from 1975 to 1989, when Thailand closed its border with Laos (to gain both political and economic leverage), and partly a result of longstanding perceptions in both countries of the subordinate position of Vientiane vis-a-vis

Bangkok (Rigg, 1996, p. 158). As reforms proceed, however, Laos probably will become even more enmeshed economically with Thailand as the 'natural' pattern of trade is reasserted. However, the relationship is strained, so social problems such as gambling and prostitution in Laos are often blamed on Thailand, rather than on the West, which is more usual in other parts of South East Asia.

Development plans for the Mekong subregion should strengthen Laos' international position: in a regional cooperation framework Laos can obtain a degree of security by locking its powerful neighbours into a relationship of mutual benefit. (See Chapter 15 - *Mekong Subregion*.) Membership of ASEAN is also very important for increasing Laos' diplomatic options.

CHALLENGES FOR FUTURE REFORM

The New Economic Mechanism has dramatically reoriented Laos' economy. However, the economy remains embryonic and faces several potential constraints to its future development.

The Lao Government is committed to its program of economic reform, although the pace of reform is debated. The measures now required are different from those of the earlier reform period when efforts focused on redressing problems caused by central planning. Current reforms emphasise rebuilding the financial system, developing a professional public service, completing the privatisation of state enterprises and constructing a modern legal system. These reforms cannot be implemented quickly and will not occur at all if institutional capacity and technical skills are insufficient. The latter will take time to develop, given Laos' small population and the earlier exodus of skilled people.[9]

THE REFORM DEBATE

The pace of economic reform and some of its effects are causing disquiet within the Government. The large income disparities between Vientiane and the remote provinces are a particular concern. The Government also appears uncomfortable with aspects of a free market economy and appears to monitor foreign companies' activities more carefully than in the past.

Despite these signals, the Government is unlikely to stall or reverse its reform program. However, the Government increasingly debates the pace and scope of future reforms. This was evident at the Sixth Congress of the Lao People's Revolutionary Party in March 1996. Leadership changes and government statements following the Congress suggest that the pace of reforms may slow for a while, with the Government emphasising traditional values and central control.

9 Lack of institutional capacity and the administrative challenges facing Laos are discussed in Chapter 10 - *Laos: Politics*.

The main policy challenges facing the Lao Government involve improving domestic resource mobilisation and strengthening the institutional basis for sound public administration and market functioning. Greater outward orientation and integration with Laos' dynamic neighbours are important development objectives. For SOEs, the challenges are to privatise remaining assets according to transparent procedures, phase out leases in favour of full private ownership, and improve the efficiency of those enterprises that remain state owned.

In the medium term, the Lao Government aims for broad-based and sustainable economic growth by:

- improving education, skill levels and living standards
- strengthening the private sector and vigorously promoting exports
- strengthening domestic resource mobilisation through tax and financial sector reforms
- strengthening instruments for macroeconomic management and the capacity for policy planning and implementation
- improving efficiency and performance in the public sector
- coordinating more efficient foreign aid flows (World Bank, 1996, p. 642).

Opportunities

In the past, Laos was geographically, politically and economically isolated from the dynamic South East Asian region. This is changing. Arguably, Laos now lies at the centre of an emerging and increasingly dynamic expanded regional economy taking in all of mainland South East Asia. Transport links and trade ties are increasing. Laos aims to become the link or transit point connecting economically vibrant areas such as Vietnam, China and Thailand, and Burma and Cambodia. Laos also seeks to integrate itself with the broader South East Asian economy and should benefit from the continuing spillover effects of dynamic regional growth.

CONSTRAINTS

The economic development of mainland South East Asia is still at a relatively early stage and, although Laos is physically located at the centre of a dynamic economic subregion, it currently offers limited opportunities for foreign traders and investors. Its small population consists mainly of poor farmers with very little spending power, low levels of education and few marketable skills (Rigg, 1996, p. 164). Niches for profitable investment are few and those that do exist are largely geared to exploit Laos' natural resource base, particularly forestry, mining and hydro-electricity. (See Chapter 12 - *Laos: Business*.)

'Land Lockedness'

Laos' land-locked position, rugged terrain, and widely dispersed and ethnically diverse population centres constrain development. The high cost of providing transport, communications and other physical infrastructure hampers the Government's efforts to achieve rapid and equitable improvements in the economy and living standards. The benefits of economic development are concentrated heavily in urban areas. In rural areas poverty remains widespread.

Lack of Skilled Labour and Weak Institutional Capacity

The dearth of skilled labour and the weakness of Laos' institutional capacity are further constraints. While most developing countries are deficient in these areas, in Laos the problems are particularly acute. The complex requirements of an economy in transition may overstretch the Government's administrative and budgetary capacity (World Bank, 1996). Therefore strengthening Laos' institutional capacity is fundamental, with clear goals required (World Bank, 1996). For the time being, the shortage of skilled labour can only be redressed, albeit partly, by employing foreign advisers. An extensive road building program in the north, for example, is supervised by Swedish, Chinese and Vietnamese engineers.

Other Constraints

Inadequate physical infrastructure, low levels of domestic resource mobilisation, heavy reliance on foreign aid, the narrow production and export base also inhibit development and make the Lao economy vulnerable to external shocks.

PROSPECTS

The Government is committed to improving living standards and has progressed significantly in liberalising the economy. This has involved a major overhaul of the economic system affecting virtually all sectors of the economy. However, Laos is still a poor developing country with low income levels. Growth is not yet broadly based and extreme poverty prevails in many rural areas.

Growth will be supported by the increasing outward orientation of the Lao economy. This will promote the continued expansion of trade and foreign investment but the economy is likely to depend heavily on external assistance for some time.

The recent acceleration in economic activity and improved macroeconomic management should be maintained if the Government continues with structural reforms. Highest priority is to develop a professional public service, reduce public sector involvement in SOEs and reform the financial sector. Future reforms may prove difficult because of their increased political or social sensitivity and the greater administrative and technical demands they will make on Laos' already overstretched bureaucracy. Reform also is hampered by consensus, highly centralised decision making and a degree of inertia in 'the system'. In these circumstances, strong commitment to continuing reforms will be essential.

REFERENCES

Asian Development Bank, 1997, *Asian Development Outlook* 1996 and 1997, Oxford University Press, London.

Department of Foreign Affairs and Trade, 1996, *Country Brief: Laos*, Department of Foreign Affairs and Trade, Canberra.

Domoto, K., 1997, 'Environmental Issues in Laos: Balancing Development with Preservation', in Than, M. and Tan, J.I.H. (eds), *Laos' Dilemmas and Options-The Challenge of Economic Transition in the 1990s*, Institute of South East Asian Studies, Singapore.

Economist Intelligence Unit (EIU), 1997, *Laos-Country Profile 1996-97*, Economist Intelligence Unit.

Foreign Investment Management Committee, 1996 communication with East Asian Analytical Unit.

International Monetary Fund, 1996, *Lao PDR Recent Economic Developments*, IMF, Washington DC.

Otani, I. and Pham, C.D., 1996, 'The Lao People's Democratic Republic: Systemic Transformation and Adjustment', Occasional Paper No. 137, IMF, Washington DC.

Pomfret, R., 1995, *Asian Economies in Transition*, Edward Elgar, United Kingdom.

Rigg, J., 1996, 'Managing Dependency in a Reforming Economy: the Lao PDR', *Contemporary Southeast Asia*, Vol. 17, No. 2, September.

Saignasith, C., and Lathouly P., 1995, 'Transitional Economy of the Lao PDR', in Naya, S.F. and Tan, J.L. (eds), *Asian Transitional Economies*, Institute of South East Asian Studies, Singapore.

United Nations Development Program, 1995, *Development Cooperation: Lao People's Democratic Republic 1994 Report*, UN, Paris.

United Nations Industrial Development Organisation, 1995, *Lao People's Democratic Republic-Industrial Transition*, UN, Paris.

World Bank, 1997, *Lao PDR Public Expenditure Review: Improving Efficiency and Equity in Spending Priorities*, Report No. 16094-LA, World Bank, Washington DC.

___ 1996, *Country Briefs: Lao PDR*, World Bank, Washington DC.

___ 1994, Lao People's Democratic Republic: Country Economic Memorandum, World Bank, Washington DC.

FURTHER READING

Freeman, N., 1996, 'Laos takes initial steps towards progress', *Business Times*, 28 February, p. 9.

Lintner, B., 1996, 'Laos Shedding Its Skin: Communist Party Seeks to Define a New Role', *Far Eastern Economic Review*, 21 March.

Chapter 12

NICHE BUSINESS

In Laos, economic reform and steady growth over recent years have been accompanied by expanded private sector activity and an influx of foreign traders and investors seeking market opportunities. Like the institutions of government and administration, Laos' commercial infrastructure and its business environment are being redeveloped to meet the needs of the new market economy. This is proving a challenge.

While Laos' economic prospects are promising, the country remains a very small, low income market with underdeveloped physical infrastructure, and subsistence agriculture still is important. (See Chapter 11 - *Laos: Economy*.) Export-oriented investments in resources, energy and infrastructure projects continue to provide the major opportunities for Australian companies.

AUSTRALIAN BUSINESS PROFILE

Australian companies are prominent and active in Laos, with over 20 in the capital, Vientiane. The two nations have enjoyed more than 40 years of continuous diplomatic relations. The high degree of goodwill at the political level predisposes the Lao to look positively on Australian companies, although it does not guarantee success in the market. Bilateral aid has been a feature of relations, and in recent years has provided an entree to Laos for some Australian companies.

Aid

Australia is one of Laos' main bilateral donors. In 1994, the centrepiece of Australia's aid program, the Mekong River 'Friendship' Bridge between Laos and north east Thailand, was completed at a cost of US$30 million. Australia's aid continues with a four-year aid commitment totalling around A$47.5 million for 1994 to 1998.[1] The focus is on physical and transport infrastructure, education, health and community development, and agriculture, with increasing emphasis on community based rural development.

Trade

Australia's exports to Laos are limited and fluctuating (Figure 12.1). Gold is the only significant trade commodity;[2] exports of gold to Laos rose from zero in 1990-91 to

....

1 This figure represents the bilateral program. Regional program funding increases the average annual aid package for Laos to around A$17 million.

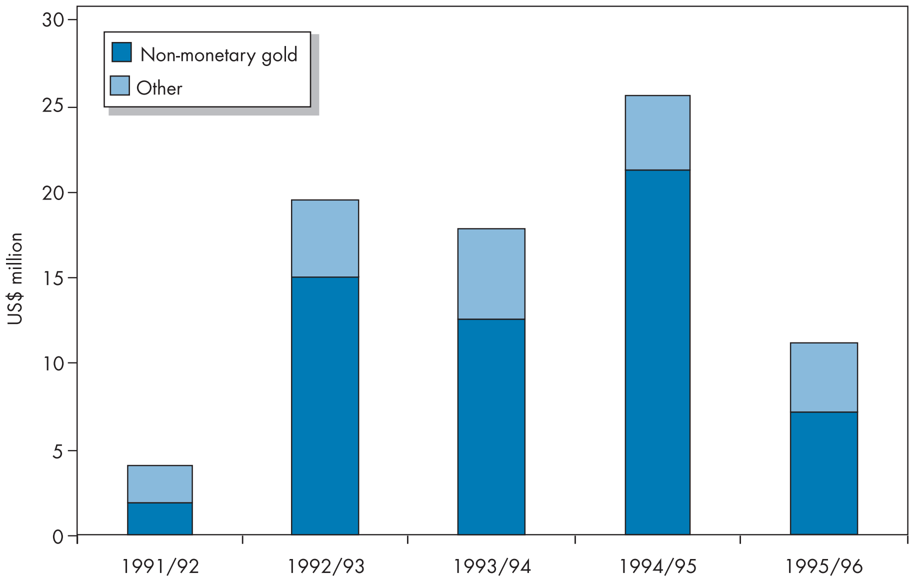
2 Much of this gold is re-exported. Moreover, most of the gold trade is tied to a single importer with family connections to Australia.

US$21.2 million in 1994-95 but dropped to US$7.5 million in 1995-96. Small volumes of silver and platinum, telecommunications services, equipment and machinery also were exported regularly to Laos in that period.

Figure 12.1

Exports Limited and Fluctuating

Australian Exports to Laos: 1991-92 to 1995-96



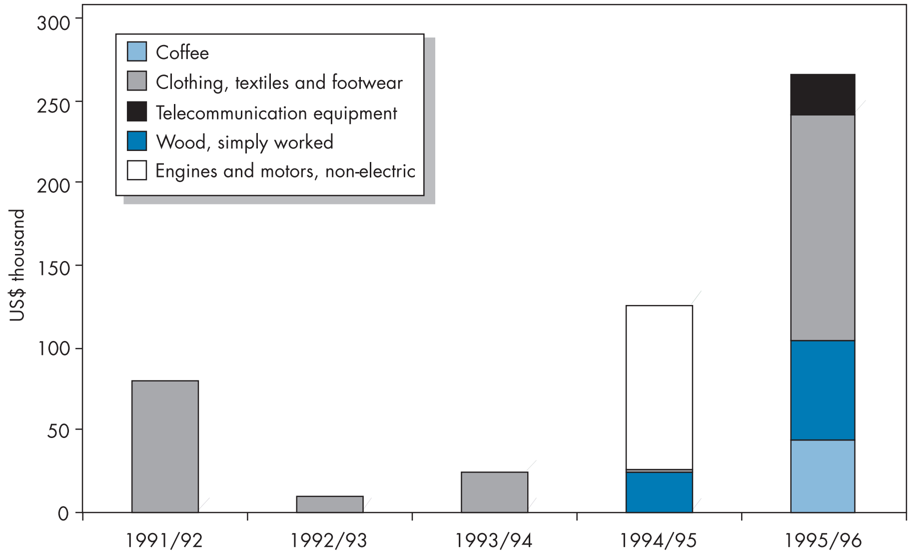
Source: Department of Foreign Affairs and Trade, 1996.

Australian imports from Laos, mainly clothing, coffee and wood products increased steadily but remain small, at just US$0.21 million in 1995-96 (Figure 12.2). Until 1993-94, Australian imports were primarily clothing, textiles and footwear.

Figure 12.2

Imports Limited but Increasing

Australian Imports from Laos: 1991-92 to 1995-96
($US thousands)



Source: Department of Foreign Affairs and Trade, 1996.

Investment

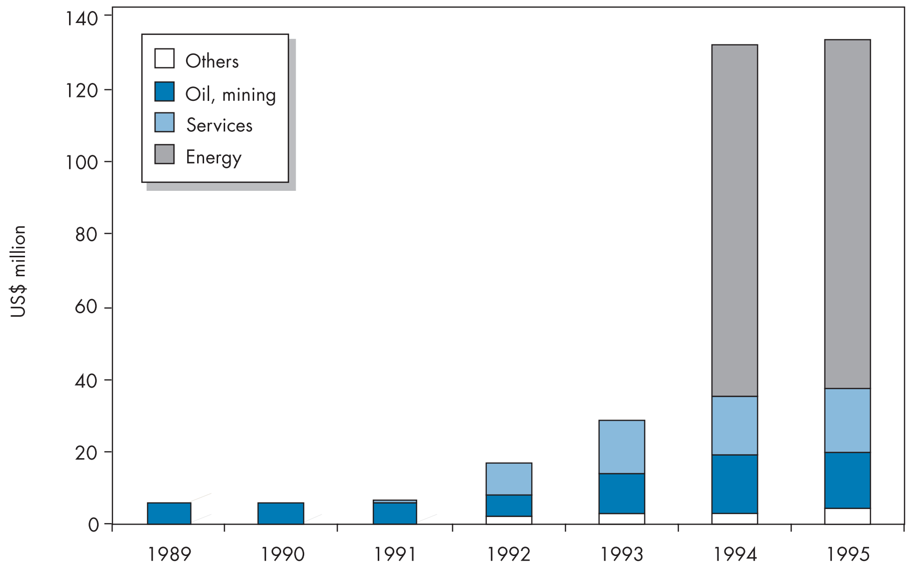
In contrast with the low level of bilateral trade, investment in Laos is considerable and growing. The focus shifted recently from oil exploration and mining projects to energy (Figure 12.3). Between 1988 (when Laos introduced its Law on Foreign Investment) and June 1996, 42 investment licences were granted to Australian companies to develop projects worth US$303 million.[3] Australia ranks fifth among foreign investors in Laos, behind Thailand (US$2 377 million), the USA (US$1 737 million), the Republic of Korea (US$592 million) and France (US$317 million) (Foreign Investment Management Committee, 1996). In 1994, Australia and Laos signed a standard bilateral Investment Promotion and Protection Agreement which came into force in 1995.

3 In May 1994, the Law on the Promotion and Management of Foreign Investment replaced the 1988 Law on Foreign Investment.

Figure 12.3

Investment Growing and Changing

Australian Investment in Laos by Sector, 1989 to 1995[4]



Source: Department of Foreign Affairs and Trade, 1996.

For many Australian investors in Laos, aid motivated their entry. Aid provided a relatively low cost, rapid means of setting up an office, establishing a profile, researching the market and making contacts. Most importantly, investors gained access to government decision makers with the power to help expedite the issuing of licences for investment projects.

Australia's funding, design and construction of the Mekong River 'Friendship' Bridge, for example, enabled Australian civil engineering companies to establish a beachhead in Laos from which they bid successfully for several other, smaller projects. This helps explain the relative concentration of Australian investment in Laos in civil engineering and construction. These companies are negotiating further contracts worth hundreds of millions of dollars. However, they face stiff competition from low cost operators from Thailand, China, the Republic of Korea and Vietnam for low technology projects such as roads and simple bridges. The main Mekong River Bridge contractor acknowledges that major infrastructure projects in Laos also are hard to win.

4 Data on the sectoral breakdown of Australian investment in Laos are only available to the end of 1995. The cumulative amount of Australian investment recorded in the text of this chapter is for the period ending June 1996.

Smaller niche investors have been attracted by:

- tax holidays, flexible laws and regulations, reasonably cheap labour and reliable electricity supplies
- free quota access to the European Union and North American markets for certain Lao products
- low competitiveness compared to other regional markets, notably China and Vietnam, and less difficulty, time and expense to establish a business
- the presence in Laos of Australian companies that are the investors' traditional customers in Australia and elsewhere. This has led to smaller Australian service companies clustering around some larger Australian investors.

CHARACTERISTICS OF THE BUSINESS ENVIRONMENT

Companies identified Laos as having: a generally 'business friendly' government; a slow, consensus driven bureaucracy; legal uncertainty; formal and informal networks; low wage costs but low productivity; a low but rising level of corruption; and relatively good personal security.

Business Friendly Government

The Government is politically stable and generally supports foreign investment; it honours its contractual obligations to foreign investors and does not interfere unduly in day-to-day business operations. This contrasts with Vietnam, for example, where a multiplicity of government agencies at several levels regularly and often arbitrarily interfere for the purposes of control or rent seeking, or both.

Slow, Consensus Driven Bureaucracy

With most of its personnel trained in socialist central planning, the Lao bureaucracy is not yet adequately equipped to manage the complexities of a market economy or to deal with foreign business people. Many officials are uncomfortable with some market economy features, such as profit. In the late 1970s and early 1980s, most of Laos' educated elite departed, leaving behind relatively few qualified bureaucrats, who now determine economic planning, policy coordination and licensing. A new cadre of bureaucrats is being trained, but the expertise gap remains. Skilled technicians and middle managers are in short supply. This problem also affects the private sector, but private companies usually offer higher salaries to attract better quality personnel.

The bureaucracy practises consensus style decision making, so all points of view are canvassed exhaustively and, if possible, accommodated in the final decision. The process is very slow, but 'professional' nevertheless. Decision making processes are also opaque and 'paper driven'. Companies need to carefully guide the paperwork through the bureaucracy and ensure that a fully stamped, signed and legally correct set of documents emerges at the end. The highest level of government often needs to make routine or minor decisions, leading to frequent and lengthy bottlenecks. It can take 18 months or more to obtain an investment licence.

Uncoordinated policy between different areas of the bureaucracy also causes problems for foreign investors; ministries do not always respect each other's decisions. However, competing centres of power are fewer than, for example, in Vietnam.

Legal Uncertainty

Much of the fabric of modern commercial legal practice is being developed and is not yet well understood. New laws provide general guidelines only; invariably, they require implementing decrees. The text and accurate translations of new laws and decrees affecting foreign investors can be difficult to obtain.[5] In some cases, establishing the exact legal position is extremely difficult, especially if different ministries declare contrary interpretations of a particular law. In some cases, legal interpretation can be negotiated. Furthermore, laws can change quickly but the public is not necessarily advised of the changes, either before or after they occur. An importer may find, for example, that Lao customs impound its goods as prohibited imports because of a rule change between the time the order was placed and the time the goods arrived in Laos.

The lack of legal certainty particularly concerns larger investors, whose proportional risk is greater and usually spread over longer periods than that of smaller investors. Small and medium sized companies, on the other hand, often see the inherent flexibility in interpreting laws as working to their advantage. Many ground rules for commercial activity are open to negotiation, something normally not possible in a more developed business environment. The apparent lack of regulation may discourage newcomers from entering market niches that already are occupied.

Importance of Networks

Given the subtle interplay of Laos' cultural, political, legal and administrative systems, and the frequent legal gaps, formal and informal networks are important for gaining access to the various arms of government at all levels. Good government access speeds up decision making and problem solving; it also enables companies to gather information that may be vital to their operations, such as an anticipated change in regulations that may not be disseminated to the business community.

Low Wage Costs but Low Productivity

Wage costs and worker productivity are both low relative to neighbouring economies. Cheaper labour costs have to be balanced by the lack of a skilled labour force. Lao workers operate at well below optimum efficiency. Turnover of personnel can be high, perhaps because the Lao are unfamiliar with mass production in high output factories and are not highly motivated by financial rewards.[6]

5 Unofficial translations of new laws and decrees have been available, however, since 1991. Since 1993, the Government has published an official gazette in Lao, English and French.

6 Another possible explanation for high worker turnover is the common Lao practice, especially among government workers, of holding down two jobs.

Corruption Not Serious but Increasing

Corruption is not regarded as a serious problem in most business transactions in Laos. However, 'creeping corruption', requests by bureaucrats for extra payments for special or urgent tasks or to reduce official interference, is becoming common.[7]

Personal Security

Foreign business people in Vientiane rate personal safety as 'good'. In some up-country areas, however, particularly the stretch of road between Vang Vieng (north of Vientiane) and the old royal capital of Luang Prabang, and on many mining leases, insurgent activity or banditry (the two are often difficult to distinguish) are persistent dangers. Foreigners, including in 1994, an Australian employed on an infrastructure project and in 1996, the French proprietor of a prominent Vientiane-based tour company, have been killed in up-country attacks (Lintner, 1996, p. 32).

STRATEGIES

Business strategies for Laos concentrate on dealing with the slow and cumbersome process of bureaucratic decision making, business structures, foreign investment incentives, dispute resolution procedures, taxation and labour.

Dealing with the Bureaucracy

Patience and persistence are essential attributes for foreign investors. Companies need to exercise patience as the consensus decision making process runs its course. At the same time, they need to check regularly (weekly) on progress to identify and remove actual or potential blockages as early as possible. However, they must respect Lao sovereignty and dignity. Although the Lao are a relatively easygoing people, it is a serious error to take them for granted.

Personal relationships are very important, and companies invariably seek to develop close working relations with the bureaucracy relevant to their business interests. Most take a 'multi-status' approach to dealing with the bureaucracy. Locally engaged Lao staff or Lao consultants handle routine negotiations and problem solving. The expatriate manager normally deals only at senior levels of the bureaucracy, to confirm information, discuss a position or formalise understandings, but not to negotiate. The overseas based managing director normally restricts meetings to top level bureaucrats and ministers. This approach minimises opportunities for conflict and preserves 'face' on both sides.

7 Even relatively senior public servants earn only US$30 to $60 per month.

Most companies also use a ‘multi-contact’ strategy in their dealings with the bureaucracy. The Committee for Investment and Foreign Economic Cooperation (CIFEC),[8] promoted by the Lao Government as a ‘one-stop shop’ for foreign investment licence applicants, remains the main point of contact, but all ministries and other government agencies at both central and provincial levels with a role in the decision making process also are regularly lobbied. This facilitates the resolution of differences or misunderstandings within and between ministries and other government agencies, thereby improving inter-agency coordination. Companies often will maintain simultaneous contact with lower, middle and upper level bureaucrats of the CIFEC and each ministry and agency on any given matter to ensure a speedy and favourable decision.

Important decisions regularly involve the responsible minister, the Minister for Finance, the Council of Ministers and the Prime Minister. Companies therefore usually seek to bring the main elements of their investment proposals to the attention of these top level decision makers once the bureaucratic processes are under way. The Australian Embassy in Vientiane often plays a role in facilitating these contacts.

A ‘MULTI-STATUS’ APPROACH TO NEGOTIATIONS

A wholly foreign-owned company identified five areas in the bureaucracy with critical decision making power affecting its business operations consequently,

- the company’s locally engaged Lao staff maintain daily contact with lower and middle level officials in each of the five areas
- the expatriate manager handles day-to-day contact on routine and policy matters with upper level officials
- the investor’s chief executive handles important policy discussions on visits from Australia
- the investor matches Australians and Lao on the basis of age and seniority
- the Australian Embassy in Vientiane plays an important supporting role by making representations to Lao ministers on major policy matters affecting the company’s business.

8 CIFEC is still commonly known as ‘FIMC’, standing for ‘Foreign Investment Management Committee’, the name of its predecessor organisation that was restructured and renamed after the 1996 Party Congress.

A number of larger companies have created and maintained a reputation for openness and transparency in their dealings with the Government, especially the provincial authorities, who only have limited legal authority over foreign investment activities but have substantial influence.[9] These companies recognise that their business reputation plays an important part in their access to high level decision makers in the Government and thus in the ultimate success of their ventures.

Formal and informal channels are used to keep the Government fully informed of technical and financial details together with current and planned activities. Locally recruited Lao staff and consultants are probably preferred for this role, although returnees also may be employed. Lao returnees, like the *Viet kieu* (overseas Vietnamese) in Vietnam, are sometimes viewed with suspicion in Laos. However, they can normally overcome this by using local contacts, knowledge, linguistic and cultural skills, which make returnees a relatively 'comfortable' group for local Lao to deal with, particularly compared with non-Lao expatriates.

Transparency is especially important during economic transition in Laos. Government officials have limited knowledge and understanding of international finance, business practices or high technology. Transparency builds confidence and trust.

A 'MULTI-CONTACT' APPROACH TO NEGOTIATIONS

A well established foreign exporter to Laos wants to expand its range of products with two new lines. The company opens multi-level (lower, middle and upper) discussions more or less simultaneously with CIFEC and ministries responsible for imports, industry and finance to establish the correct classifications, duties, quotas and import regulations for the two new products.

The results of these separate discussions are distilled to obtain the most favourable interpretation from the company's point of view. The company then starts a second round of discussions with the same ministries, and a number of new ones it identified during the first round, to obtain general acceptance of this interpretation. Consensus is reached and the company brings in a trial shipment, which successfully clears customs. Only then, seven months after it began the process, does the company place a commercial order for the two new product lines.

Business Structures

In the past, foreign investors generally preferred to structure their investments in Laos as wholly foreign-owned companies. Lao state owned enterprises (SOEs), apart from those owned by the military, were reluctant to enter joint ventures with foreign partners. The only joint venture in Laos involving an Australian company was abandoned.

....

9 On the other hand, a number of companies have tied up deals with the provincial authorities first, only to have central authorities subsequently react against them.

The position, however, changed recently: the Lao Government now encourages foreign investors to enter into joint ventures with domestic investors or SOEs. The Government appears keen to secure a stake in foreign investment projects and their profits. Joint ventures also provide skills training for Lao government employees.

Foreign Investment Incentives

The extent to which companies benefit from incentives offered under Laos' foreign investment legislation varies. Some companies formed under the 1988 Law on Foreign Investment choose to continue operating under their original licences rather than bringing themselves under the 1994 Law on the Promotion and Management of Foreign Investment. (See Chapter 10 - *Laos: Politics*.) Both laws but particularly the former are ambiguous and the incentives they offer are subject to interpretation and negotiation. The critical legal document for foreign investors remains the individual licence.

Dispute Resolution Procedures

Opinions vary on the value of the legal system for settling disputes. Most foreign companies accept that all business problems need to be resolved by negotiation and compromise if the companies are to have a long term future in Laos.

Larger companies tend to be more concerned about legal certainty in the business environment and take a relatively legalistic view of dispute resolution, although they normally accept the need to compromise. The Lao legal and court system has not yet reached the stage where it can resolve commercial disputes involving foreign companies. To obviate this problem, many foreign companies make contractual disputes subject to Malaysian law and arbitration. This strategy is yet to be tested in practice.

Larger investors also sometimes seek political risk insurance through home governments, the Asian Development Bank and World Bank systems. Malaysian arbitration and political risk insurance together help cover some gaps in the Lao legal system.

Taxation

Taxation is important. Larger companies say they are punctilious in paying taxes to demonstrate transparency and build trust. Small and medium sized companies, on the other hand, tend to focus more on cost minimisation and try to ensure they are not being over-taxed. These companies find that tax regimes are negotiable and that they can defer tax payments while they undertake often lengthy negotiations with the taxation authorities.

Labour

Five motivational factors seem to affect Lao employees:

- employment is important to self-esteem
- the status and reputation of the company and its management reflect on the employees

- teamwork is preferred to individual competitive performance
- training is highly valued and is a Lao government requirement for most foreign investors who have negotiated licences
- salary is important but productivity incentive payments are of dubious value.

CONCLUSION AND OUTLOOK

Overall, small and medium sized companies are fairly comfortable with the current business environment in Laos. Typically, these companies negotiate investment packages or agreements that suit their needs; they establish their investment niches with a relatively modest commitment; and they develop a range of strategies to manage the vagaries of doing business in Laos. One such company representative commented, 'under the current structure of swings and roundabouts, the cost of the slow swings is offset by the benefits of the slow roundabouts. An example of this is the ability to defer tax payments during negotiations with the taxation authorities'. The slow pace and opacity of official decision making and the limited market size partly protect these niche investors against the entry of new competitors. Mining companies operating under separate exploration agreements, which specifically insulate them from future legal changes, also are generally happy with the status quo.

In contrast, larger investors outside the mining sector tend to focus more on changes they would like to see in the business environment: greater legal certainty and consistency, greater transparency and speedier decision making within the bureaucracy. However, their demands are normally not strident.

Investors of all sizes generally do not expect any rapid improvement in the business environment although younger, more energetic people are emerging in the bureaucracy. As the Lao adjust to the needs of foreign investors and the country's physical infrastructure gradually improves, doing business in Laos should become easier. A large increase in the volume of foreign investment, could, however, overwhelm the bureaucratic decision making system. This would also increase the potential for corruption and place a further strain on the already over-extended skilled end of the labour market.

Companies are confident that the Government will continue to honour contractual agreements in the future. The foreign business community is confident that the political climate will not turn against foreign investment, even though, 'some government officials discreetly admit to distrusting private investors' (*The Economist*, 1996, p. 29).

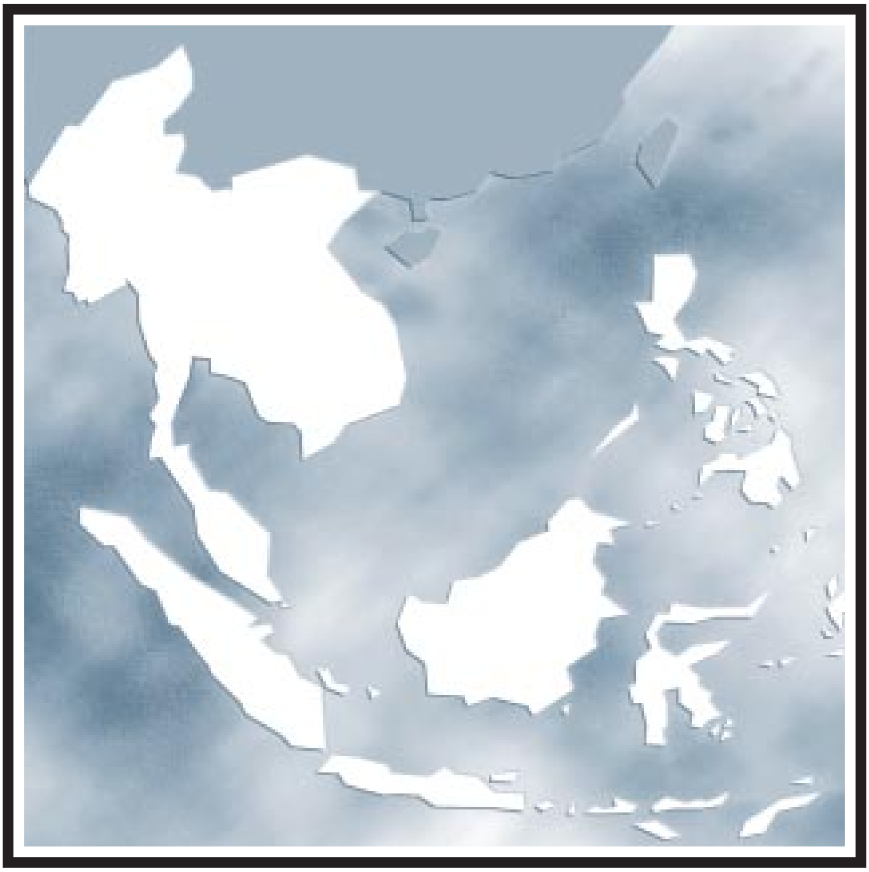
Increasing corruption is a concern. The current relatively low level of corruption distinguishes Laos from the other new ASEAN economies. If corruption were to increase unchecked, it could diminish Laos' comparative attractiveness as a place to invest.

REFERENCES

Department of Foreign Affairs and Trade, 1996, STARS data base.

The Economist, 1996, 'One dam thing after another', 30 March.

Linter, B., 1996, 'Road of Death: Hmong Tribesmen Are Killing Travellers to the North', *Far Eastern Economic Review*, November.



P A R T F I V E

REGIONAL ISSUES


CHINA
EAST
CHINA
SEA
INDIA
BANGLADESH
BURMA
Hanoi
LAOS
Vientiane
Gulf of
Tonkin
Taipei
Taiwan
Hong Kong
PACIFIC
OCEAN
Luzon Strait
Rangoon
THAILAND
VIETNAM
Bangkok
CAMBODIA
Phnom Penh
Gulf of
Thailand
SOUTH
CHINA
SEA
Manila
PHILIPPINES
ANDAMAN
SEA
Strait of Malacca
BRUNEI
Bandar Seri Begawan
Kuala Lumpur
MALAYSIA
SINGAPORE
JAVA
SEA
Jakarta
INDONESIA
Sunda Strait
INDIAN
OCEAN
THE NEW ASEANS
IN SOUTH EAST ASIA
0
1000
kilometres (approx)
AUSTRALIA

Chapter 13

NEW ASEANS IN TRANSITION

This chapter compares the economic performance of the new ASEANs, Vietnam, Burma, Cambodia and Laos, and examines their shared and contrasting development features. This provides a basis to assess the economic prospects of the four economies and the likely impact of ASEAN membership on each. While all four economies are at a lower level of development than ASEAN's established members, they are growing rapidly from a low base.

COMPARATIVE ECONOMIC PERFORMANCE[1]

The four new ASEANs are at similar stages of development (Table 13.1) and are making the transition from central planning to market economies. Vietnam joined ASEAN in 1995, the other three countries become full members in July 1997.

Table 13.1

Basic Economic and Social Indicators for the New ASEANs

Country	Total area ('000 sq km)	Population (mid 1994 million)	Population growth rate av 1990-94 (per cent)	Per capita GNP (1994 US$)	Life expectancy at birth (years)	Infant mortality (per 1 000 live births)	Adult literacy rate (per cent)
Vietnam	330	72.5	2.3	190	67	44	88
Burma	677	46.0	1.9	200[a]	58	72	81
Cambodia	181	11.0	3.0	240	51	116	65
Laos	237	4.7	3.1	320	51	97	67
East Asia		1 735	1.4	890	68	34	76

Note: a. Estimates of Burma's GNP per capita differ widely. The World Bank (1996b), for example, estimates Burma's GNP per capita to be higher than that of Vietnam or Laos; Cambodia is not included in the World Bank's survey.

Source: World Bank, 1996a.

Macroeconomic Performance

Since economic reforms were introduced in the late 1980s and early 1990s, the four economies have grown faster than before and improved their economic performance. Growth rates are similar to or greater than those of long-established ASEAN members (Figure 13.1).

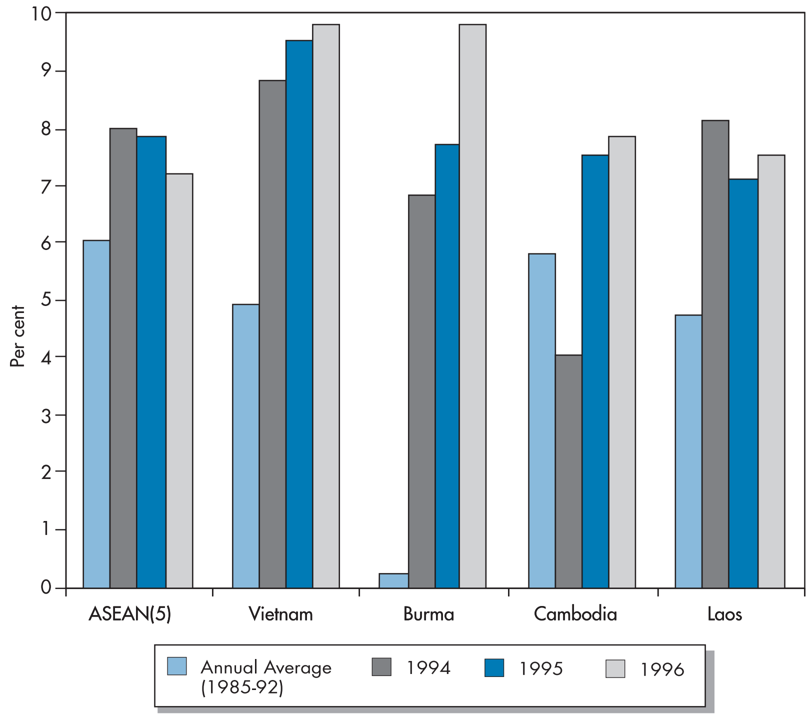
....

1 Statistical sources used in this chapter reflect the availability of comparative data. As a result, figures provided in country chapters may differ slightly.

Figure 13.1

GDP Growth Equals or Surpasses ASEAN

GDP Growth Rates, 1985 to 1996



Note: ASEAN(5) refers to the unweighted average for Indonesia, Malaysia, the Philippines, Singapore and Thailand; Brunei is not included. For the annual average (1985 to 1992), the period for Cambodia is 1988 to 1992 and for Laos is 1986 to 1992.

Source: Estimates are from Asian Development Bank, 1995, p. 204; Asian Development Bank, 1996, p. 223.

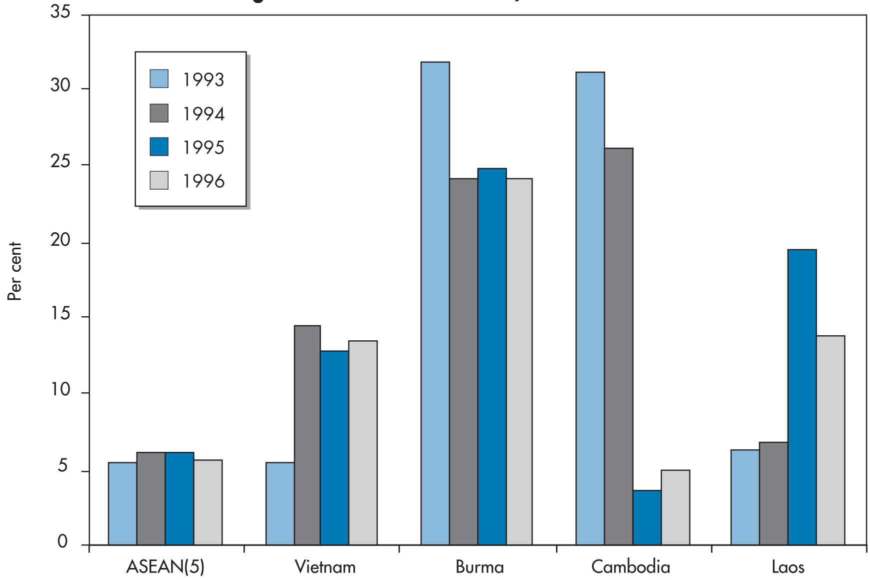
Except for Cambodia, the new ASEANs experience higher rates of inflation than do established ASEAN members (Figure 13.2). Vietnam and Laos recovered quickly from hyperinflation in earlier periods. Burma's inflation rate remains the highest among the four, largely because of its monetary financing of sizeable budget deficits.

Strong growth requires a stable macroeconomic environment. In the four countries except Vietnam, government revenue and expenditure is a low proportion of GDP (Figure 13.3). This demonstrates that to reduce government deficits, it is better to increase revenues rather than to lower expenditures. Improved physical infrastructure and increased human capital investment increase growth, although government monies overall also could be spent more efficiently. While Vietnam, Laos and Cambodia have had some success in increasing government revenue as a proportion of GDP, only Vietnam has revenue levels similar to those of other ASEAN members. In Burma in the 1990s, revenues actually fell as a proportion of GDP from already low levels (Figure 13.3).

Figure 13.2

High Inflation Persists Only in Burma

Changes in Consumer Prices, 1993 to 1996

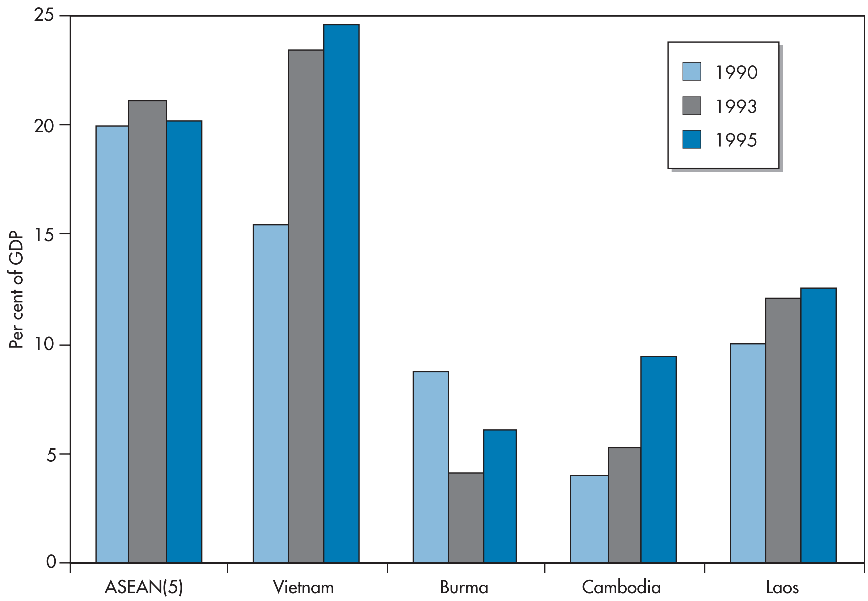


Note: ASEAN(5) average is unweighted.
Source: Asian Development Bank, 1996, p. 231.

Figure 13.3

Except in Vietnam, Government Revenue is Low

Total Government Revenue as a Per Cent of GDP, 1989 to 1994



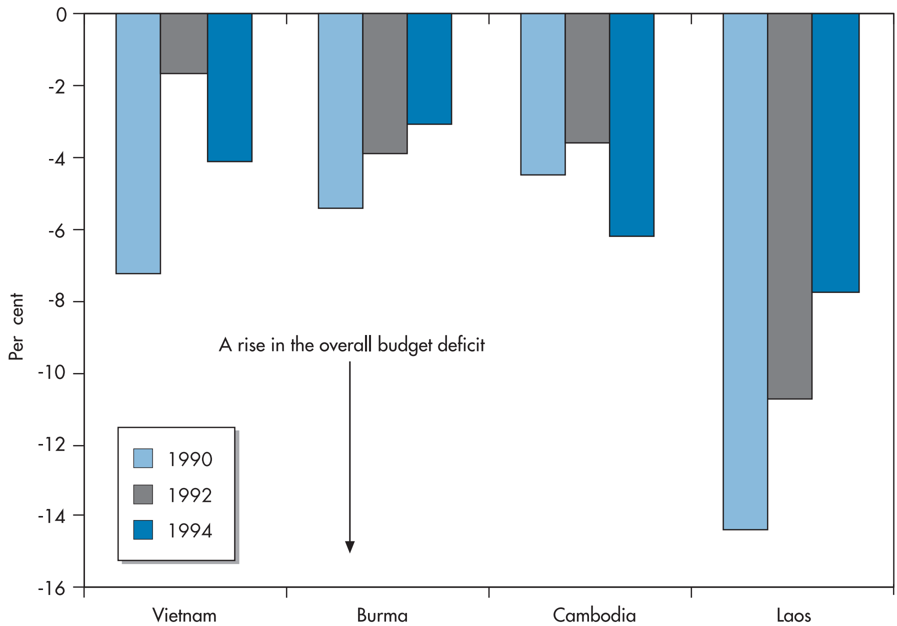
Note: ASEAN(5) average is unweighted.
Source: Asian Development Bank, 1995, p. 260.

In the new ASEANs, except Cambodia, budget deficits have declined over the 1990s mainly due to improved revenue raising; Burma's budget deficits have declined because of sharp spending cuts, especially in health, education and capital expenditure (Figure 13.4). Burma's reduced budget deficit disguises its fragile macroeconomy.

Figure 13.4

Except in Cambodia, Budget Deficits Fall

Government Budget Deficits as a Per Cent of GDP, 1990 to 1994



Source: Asian Development Bank, 1995, p. 261.

AGRICULTURAL PERFORMANCE

Agricultural output has risen in all four countries in response to economic reforms. Vietnam was the most impressive performer, increasing output by 80 per cent from 1981 to 1993. Comparing fertiliser use and paddy yield in each of the new ASEAN economies and Thailand suggests that Burma, despite its rich soils, has done the least to exploit the agricultural potential apparent in its naturally high yield per hectare (Table 13.2).

Table 13.2

Comparisons of Agricultural Performance and Productivity

Country	Total nutrients (kg per hectare of cropped land)[a]	Paddy yield (tons / ha)[b]
Burma	7	3.1
Cambodia	na	1.3
Laos	na	2.5
Vietnam	135	3.4
Thailand	54	2.1

Note: a. 1992; b. Burma 1993; Cambodia 1992 and 1994; Vietnam, Laos and Thailand average 1992 to 1994.

Source: World Bank, 1995, p. 35; World Bank, 1996b, p. 33.

INDUSTRIAL AND SERVICES SECTOR GROWTH

In the new ASEANs, industry and services have grown strongly since economic reforms were introduced. However, poor physical infrastructure, energy shortages, bureaucratic inefficiency and inefficient resource allocation continue to constrain growth in these sectors (Table 13.3).

Table 13.3

Energy Shortages Hamper Industry

Comparison of Per Capita Commercial Energy Consumption for Selected South East Asian Economies

	1991	1992	1993
Burma	46	47	48
Cambodia	18	17	17
Laos	24	26	25
Vietnam	81	84	106
Indonesia	302	321	338
Philippines	235	259	286
Thailand	574	610	675

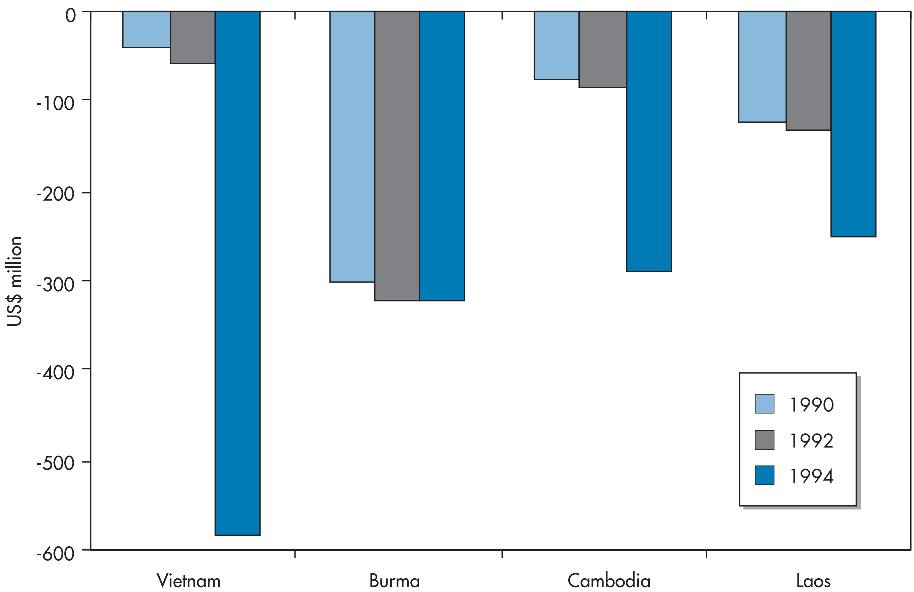
Source: Asian Development Bank, 1996, p. 207.

TRADE PERFORMANCE

All four economies have strong trade growth. In each case, however, imports are growing faster than exports, widening the trade deficit (Figure 13.5) and exacerbating current account imbalances. In all four countries, trade deficits have been driven partly by growing levels of foreign investment and capital inflows.

Figure 13.5

Rising Trade Deficits, 1990 to 1994



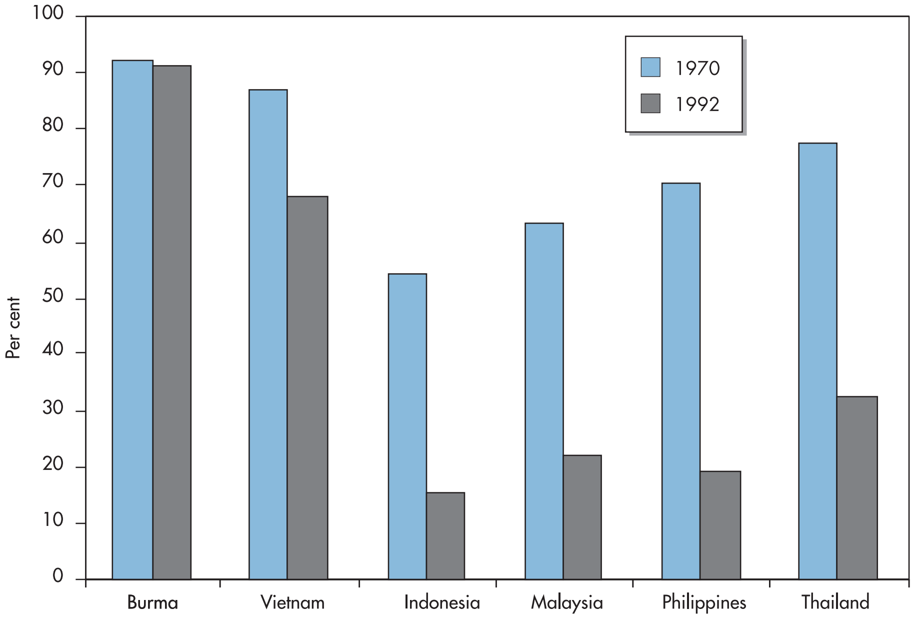
Source: Asian Development Bank, 1995.

Of the new ASEANs, only Vietnam has reduced substantially its export dependence on primary commodities, although Vietnam's dependence remains high when compared with other ASEAN economies (Figure 13.6)

Figure 13.6

Export Dependence on Primary Commodities Remains High

Export Share of Primary Commodities



Source: World Bank, 1995, p. 26.

TRANSITION TO MARKET ECONOMIES

The new ASEANs are all low income, developing economies and face common challenges as they pursue durable growth and improved living standards for their populations (Table 13.1). All four new ASEANs have progressed towards creating a market economy (see box) but the smaller economies, Cambodia and Laos, generally have liberalised more than the larger ones, Burma and Vietnam (Table 13.4).[2] Their adoption of market-oriented reforms has been reinforced by the success of their East Asian neighbours, who, for the most part, liberalised their trade and investment policies to promote economic growth.

Many issues in the transition from a socialist to a market economy are significantly more complicated than those facing a typical developing country. They include removing price controls, privatising state-owned enterprises (SOEs) and developing a market economy regulatory framework.

[2] This finding is supported by the business survey results in Chapters 3, 6, 9 and 12.

For example, governments in the new ASEANs each confronted the issue of divesting themselves of SOEs. However, their efforts have met with mixed results; SOEs remain important economic players, particularly in Vietnam and Burma, and to a lesser extent in Laos (Table 13.4).[3]

Table 13.4

The Reform Track: Cross-Country Comparisons

Macroeconomic reforms	Vietnam	Burma	Cambodia	Laos
Fiscal reforms	*Weak to moderate*	*Weak*	*Weak to moderate*	*Moderate*
Modern tax system	Direct and indirect taxes since 1990, but still no modern tax system	Several new taxes introduced and laws amended but still no modern tax system	Several new taxes introduced but still no modern tax system	Comprehensive tax reform undertaken, but still no modern tax system
Expenditure reform	Subsidies reduced considerably	Subsidies continue	Most subsidies eliminated	Most subsidies eliminated
Monetary reform	*Moderate*	*Weak*	*Moderate*	*Moderate*
Interest rate liberalisation	Administered rates increased but not liberalised	Some adjustments but rates still highly negative in real terms	Liberalised since March 1995, but has had little impact due to limited use of local currency (riel)	Liberalised since 1989, but floor and ceiling ratios still set by Central Bank
Two-Tier banking system	Since 1988	Since 1976	Initiated in 1993, but incomplete	Since 1988

3 This is unlikely to change as the Vietnamese and Lao Constitutions award the State the primary economic actor's role. Party Congresses in Hanoi and Vientiane in 1996 confirmed the primacy of the state sector in each case.

Table 13.4 (cont.)

The Reform Track: Cross-Country Comparisons

Macroeconomic reforms	Vietnam	Burma	Cambodia	Laos
Trade reforms	*Moderate*	*Moderate*	*Extensive*	*Moderate to extensive*
Exchange rate	Exchange rate unified in 1989; small deviation between official and unofficial rate	Large deviation between official and unofficial rate	Exchange rate unified in 1993; small deviation between official and unofficial rate	Exchange rate unified in 1988; small deviation between official and unofficial rate
Controls over imports and exports	Restrictions on trade reduced to some extent	Since late 1988, restrictions on exports reduced significantly	Restrictions on trade reduced significantly	Restrictions on trade reduced significantly
Replacement of quantitative restrictions and tariff reductions	Little action	Little action	Few quantitative restrictions; tariffs streamlined	Quantitative restrictions eliminated (except cars) and tariffs streamlined
Price reforms	*Extensive*	*Moderate*	*Extensive*	*Extensive*
	Two-track system until 1989, when almost total price deregulation occurred	Most formal pricing controls removed (except on energy products, rice and SOE output to government officials)	Almost no pricing controls	Almost total deregulation since 1988
Agricultural reforms	*Extensive*	*Moderate*	*Moderate*	*Extensive*
	By the end of the 1980s, largely household agriculture	Agriculture never collectivised; marketing largely deregulated	Agriculture never effectively controlled; now largely household agriculture	By the end of the 1980s, largely household agriculture
Privatisation of state-owned enterprises (SOEs)	*Weak*	*Weak*	*Moderate to extensive*	*Moderate to extensive*
	Increasingly SOEs dominate the economy. SOEs receive preferential treatment	Only fisheries successfully privatised	Between 1991 and 1993, over 65 per cent of SOEs privatised; pace has since slowed	Since 1989, more than 90 per cent of SOEs privatised, mainly by leasing
Foreign investment laws	Since 1987; revised in 1996	Since 1988	Since 1991	Since 1988; revised in 1994

Source: Except for Burma, information and assessments largely adapted from Rana and Hamid, 1995, pp. 20-23.
For Burma: World Bank, 1995.

ASIAN APPROACH TO TRANSITION

The new ASEANs generally have adopted the Chinese approach of evolutionary and gradualist reform programs, implementing a series of small steps to move away from central planning to market economic management, while retaining authoritarian governments. This creates a dual economy in which the market emerges and grows and the planned segment gradually shrinks (Luce, 1996, p. 6).

Factors Supporting Transition

Several positive factors assist the transition process (Rana and Hamid, 1995, p. 20). For example, the dominant role of the rural sector in the new ASEANs makes a sizeable proportion of their economies relatively resilient to change; the household's central role in agricultural production minimises the risk of large scale unemployment.

Economic transition in Asia has not been driven by dramatic political change like in Eastern Europe, although the process unleashes forces that undermine stability. (See Chapters 1 - *Vietnam: Politics*, 4 - *Burma: Politics*, 7 - *Cambodia: Politics* and 10 - *Laos:Politics*.) Relative political stability, particularly in Vietnam and Laos, although less so in Burma and Cambodia, facilitated the implementation of economic reforms.

Transition also is easier in the new ASEANs as none had a heavily centralised, large state enterprise sector. This has helped limit the costs of transition and allowed a more flexible production response than would have been possible had these economies been dominated by large, capital intensive, state-owned industries such as in Eastern Europe and Russia, and to a lesser extent China.

Constraints to Transition

Each new ASEAN still faces domestic constraints to reform. The ruling elites are concerned about the political and social effects of economic liberalisation, particularly on their continuing political ascendancy. This partially explains why the state sectors in Vietnam, Burma and Laos, will continue to play a major role in the economy.

'Transformation fatigue' also could constrain reforms. Economic restructuring involves significant costs and major adjustments to the existing economic and political order. If the structural shift is too rapid, it can impose extremely high economic costs, as occurred in Central and Eastern Europe. If the pace of change is too slow, inadequate results can erode support for reform and lobbying by vested interests can undermine it. In both cases, popular support for reform is likely to wane.

Lack of experience and expertise of governments and bureaucracies in managing a market economy constrains the four new ASEAN economies. (See Chapters 2 - *Vietnam: Economy*, 5 - *Burma: Economy*, 8 - *Cambodia: Economy* and 11 - *Laos: Economy*.) Added to this is the weakly developed system of laws, regulations and enforcement procedures that are needed to support the effective operation of a market based economy. In all cases, these shortfalls significantly compromise the efficiency of the business environment.

THE ROLE OF BLACK MARKETS

Before economic reforms were introduced, extensive black markets[4] co-existed with central planning in all the new ASEANs. Price distortions and supply restrictions typical of centrally planned economies created significant parallel markets for foreign currency, merchandise trade and credit (International Monetary Fund, 1996).

Paradoxically, black markets can deliver a number of important benefits when normal market activities are supressed (Hope, 1996). They act as a safety valve for excess demand pressures and help to mitigate supply shortages caused by unrealistically low official prices. They also provide employment and a training ground for entrepreneurs. As well, they provide most of the credit to small scale producers, including farmers and enterprises. Overall, black markets contribute significantly to economic growth and GDP, and therefore reduce poverty.

On the other hand, black markets encourage bribery and corruption and often become a breeding ground for criminals involved in smuggling and drug trafficking. They also complicate economic management by distorting official statistics and fuelling inflation, if black market funds are channelled into speculative investments. During the transition to a market economy, black markets often hamper developing a taxable base and establishing a viable banking system; both are fundamental to sustaining economic growth. As well, they undermine the effectiveness of monetary policy by encouraging currency substitution and large holdings of foreign currency bank notes and gold (International Monetary Fund, 1996).

Black markets appear to be growing in most developing Asian economies irrespective of whether the formal sector is declining or expanding (Hope, 1996). Since black market activities replicate legal activities in many respects, albeit with some fundamental differences,[5] policy makers, particularly in transitional economies, would do well to legalise and benefit from activities that market economies normally permit, rather than containing or eliminating them.[6] Obviously, this does not apply to criminal activities.

NEED FOR GOOD GOVERNANCE

The crucial element in the success of East Asian economies has been good governance whereby a government delivers what it promises and implements the policies it chooses (Root, 1996).

Good governance has two key concepts: bureaucratic capability, and effective dialogue between the State and society (Root, 1996). Bureaucratic capability exists

....

4 The black market includes unregulated border trade, drug-related commerce and informal economic activity. Income derived from black market activities generally is not reflected in official statistics.

5 Black markets, by definition, are not supported by a rule of law and no formal property rights exist. A formal legal structure, which defines and protects property rights and trade through the laws of contract and bankruptcy must pre-exist, however, before a viable sophisticated market economy can emerge from a centrally planned one (Greenspan, 1993, p. 26).

6 Hope (1996) notes that donor agencies are increasingly willing to support the ‘subterranean’ sector that prevails in many developing economies, due to the major role the sector is likely to play in the development process.

when public servants are subjected to performance evaluations and act as neutral referees in the development process. Effective dialogue enables the private sector to participate in the policy process and provides government with the information it needs to select policies that work and eliminate those that fail.[7]

Good governance is problematic in the new ASEANs. The growth in corrupt practices across most levels of government undermines the potential for good governance and harms the prospects for continued economic reform and growth. In the initial stages of transition, new opportunities for rent seeking and graft abound and officials and others with vested interests are often reluctant to give these up, so corruption grows.[8] The other aspect of good governance, effective private sector participation in policy making, is also not well developed in the new ASEANs.

Donor countries focus increasingly on issues like good governance and scale down assistance where they judge governance is particularly poor.

CORRUPTION CUTS THROUGH RED TAPE

Not all observers agree that corruption is necessarily detrimental. Corruption can be efficient and spur growth if:

- payments to officials eliminate red tape in an overly regulated inefficient bureaucratic system; when payments are so prevalent with more-or-less accepted rules, they create a degree of transparency
- only a powerful system of patronage can force reforms, such as privatising inefficient, yet powerful state-owned monopolies
- it introduces competition, for example the smuggling of non-illicit goods to avoid high tariffs or other restrictions (Backman, 1996).

In the above examples, corruption may increase competition, either through the bidding process or in the marketplace. However, corrupt practices are unsatisfactory for addressing bureaucratic and economic inefficiency and have many negative effects.[9]

7 Root (1996) noted that the regime type did not affect the quality of the dialogue between the private and public sectors. The region's democracies did not promote participation in the policy process more effectively than countries in which national leaders were not elected. Furthermore, many non-democratic regimes managed to attain high levels of accountability and transparency.

8 Corrupt activities can generate huge returns. For example, an *Asian Wall Street Journal* report (cited in the *Australian Financial Review*) found that 6 major illegal activities in Thailand accounted for US$24 billion to $32 billion in economic activity each year between 1993 and 1995. This was equal to between 14 and 19 per cent of Thailand's GDP in 1995.

9 While Backman (1996) recognises some of the serious negative effects, such as lack of equity, he fails to acknowledge the extent to which vested interests can delay reform and in the long term retard or skew economic activity. Also, a corrupt business environment may deter prospective foreign investors who are not 'comfortable' in such an environment, or permitted to participate in such practices by home country legislation or company ethics policies. Empirical evidence suggests that public corruption lowers investment and retards economic growth to a significant extent; the higher the level of public corruption, the lower the level of spending on education (International Monetary Fund, 1996).

STATE AND MILITARY AS ECONOMIC PLAYERS

The military is an important economic player in all four economies, particularly in Burma, where it dominates the economy through political control, continuing state monopolies and military enterprises. Privatisation has made little headway except in Laos. In 1991, in low income countries worldwide, SOEs accounted for a substantially larger share of GDP than they did in middle income countries, 14 per cent compared with 9 per cent. In Burma, it was 22 per cent and in Vietnam, 42 per cent (World Bank, 1996c).[10] Despite extensive efforts over the past two decades to privatise, divestiture has yet to change substantially the balance between the state-owned and private sectors in most developing countries (World Bank, 1996c, p. 32).

Reducing the government's role in production is important as large, inefficient SOE sectors dearly cost developing countries, especially the poorest ones (World Bank, 1996c, p. 23).[11] Furthermore, the role of governments as market regulators in the new ASEANs is compromised by their substantial role also as market players. In Vietnam, for example, foreign companies complain the Government does not treat them in the same way as it treats Vietnamese SOEs. (See Chapter 3 - *Vietnam: Business*.)

The dual role of governments also undermines the commitment to specific economic reforms if they adversely affect government interests. For example, unifying the exchange rate in Burma would render non-viable a substantial number of state- and military-owned enterprises. (See Chapter 5 - *Burma: Economy*.)

CHANGED INTERNATIONAL TRADING ORDER

The changed international trading environment offers developing economies their best chance to promote rapid economic growth by undertaking trade and domestic economic reforms to create an efficient competitive economy. Enhanced trade integration, measured as the proportion of trade to GDP, tends to promote higher growth through better resource allocation, greater competition, technology transfer and access to foreign savings (World Bank, 1996d). Most East Asian countries are in the fast lane toward global economic integration; Burma and Papua New Guinea are two exceptions (World Bank, 1996d).

The new ASEANs benefit from their geographic proximity to the fastest growing region in the world economy.[12] In this environment, trade reform is essential to participate in globalised production. As production and trade increasingly globalise, the notion of promoting national industries becomes less relevant as borders and local content rules become meaningless. For example, every US dollar of Thai exports contains 43 cents worth of imported materials (Chaipravat, 1996, p. 54). This trend will be increasingly important as the new ASEANs develop.

....

10 The SOE sector's share of GDP in Vietnam rose from 32 per cent in 1990 to 42 per cent in 1995.

11 SOEs often absorb more funds than basic social services and receive a disproportionate share of credit, thereby crowding out the private sector.

12 The World Bank (1995) predicts in 1995 to 2004, East Asia will remain the world's fastest growing region at an average annual rate of 7.7 per cent.

In some respects, the new ASEANs face a less favourable international environment as they seek to open up their economies than did the ASEAN(6).[13] The increased emphasis in international trade negotiations on reciprocity may retard efforts by the new ASEANs to pursue export led industrialisation. Attempts to emulate the postwar export push strategies[14] of nations such as Japan and the Republic of Korea are no longer supported by wealthy 'target markets' such as the USA and the European Union.

The new ASEANs may face threats to their trade promotion strategies from the 'new trade issues' in the World Trade Organisation (WTO) context: trade and competition policy, trade and investment, trade and the environment and trade and labour standards.[15] In addition, the European Union is pushing for a human rights clause to be included in all trade framework agreements between itself and non-European Union countries.

INFRASTRUCTURE NEEDS

Over the next decade, East Asia as a whole will face an enormous demand for infrastructure funds, in excess of US$1.5 trillion (World Bank, 1995a, p. i). As the new ASEANs are among the poorest countries in the region, their infrastructure needs are particularly acute and their potential finance sources the weakest. In response, the Greater Mekong Subregion masterplan calls for US$40 billion to be spent over the next 25 years on infrastructure development. (See Chapter 15 - *Mekong Subregion*.) The private sector of each country will need to provide at least 10 per cent of this funding. For Burma, this proportion is likely to be higher because it receives little bilateral or multilateral aid.

The new ASEANs face stiff competition, especially from China and the other ASEANs, for investment funds. To ensure they attract sufficient funds, the new ASEANs need to create an appropriate environment, particularly a liberal trade and investment regime and a stable macroeconomy, to attract foreign investors. Furthermore, as infrastructure normally requires long term investment, the new ASEAN governments need to focus on reducing the commercial and political risk foreign investors face. The high level of political risk investors in Burma and Cambodia face, for example, is a serious obstacle to long term investment.

IMPORTANT DIFFERENCES

While the four new ASEANs are, broadly speaking, economically similar, important differences emerge. Some differences reflect the differing stages of transition and development, others affect the pace and nature of transition and future development,

....

13 ASEAN(6) refers Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand.

14 These strategies generally involved creating a highly competitive export manufacturing sector while at the same time protecting uncompetitive domestic industries, especially agriculture but also service industries such as banking and insurance.

15 Australia has opposed the use of the WTO to pursue the last two issues, believing they are essentially rearguard protectionism.

including the impact of ASEAN and ASEAN Free Trade Area (AFTA) membership on each economy. (See Chapter 14 - *Expanded ASEAN*.)

Natural Resources

Of the new ASEANs, Burma enjoys the best endowment of natural resources, in agriculture, forestry, fisheries, minerals and energy, all of which generally are underdeveloped and offer enormous potential for future development. (See Chapter 5 - *Burma: Economy*.) Laos and Cambodia have fewer known natural resources; nevertheless, these may be substantial.[16] Laos has significant hydro-electric potential. Cambodia's forests, its main natural resource, are being depleted at an alarming rate. (See Chapter 8 - *Cambodia: Economy*.) Vietnam is starting to develop more fully its oil and natural gas resources, often through joint ventures with foreign investors.

Legal Framework

Burma's British common law based legal system distinguishes it from the other new ASEANs, which have mainly French civil law based systems; however, each country has incorporated elements from other systems. Although Burma's legal system is familiar to many foreign investors and should assist it in meeting its ASEAN membership obligations and commitments, many Burmese laws are outdated.

Market Size

Their large populations give Vietnam and Burma larger markets than either Cambodia or Laos and this divergence will increase as the four economies develop.[17] In larger markets, firms can grow by servicing domestic markets before entering more competitive foreign markets. In smaller markets, rapidly growing firms quickly need to become internationally competitive, or be 'born global'.[18]

Regime Type

The four new ASEANs have different ideological bases. Vietnam and Laos remain one party communist states declaring a commitment to the economic primacy of the state sector; moreover, socialist concepts colour the attitudes of the Party and bureaucracy to market-oriented reforms and foreign investment. Similarly in Burma, socialist thinking lingers on in the predilection for centralised control. Only in Cambodia, the State plays a minimal role in the economy and socialist thinking appears to have little continuing resonance. While the Cambodian military is an

....

16 The full extent of mineral and other deposits in all four new ASEANs is unknown as exploration generally is at an early stage.

17 Differences in market size should increase due to a number of factors. As Vietnam and Burma have better natural resource endowments and better educated populations (Table 13.1) and larger markets, they should attract more foreign investment. With appropriate economic policies these advantages should result in higher levels of growth relative to the other two new ASEANs.

18 The expression 'born global' refers to companies that from their inception view the global market, not just the domestic market, as their target market. Such companies need to be internationally competitive and have their operations and strategies reflect this.

important economic player, its business activities have more to do with revenue and profit, than control.

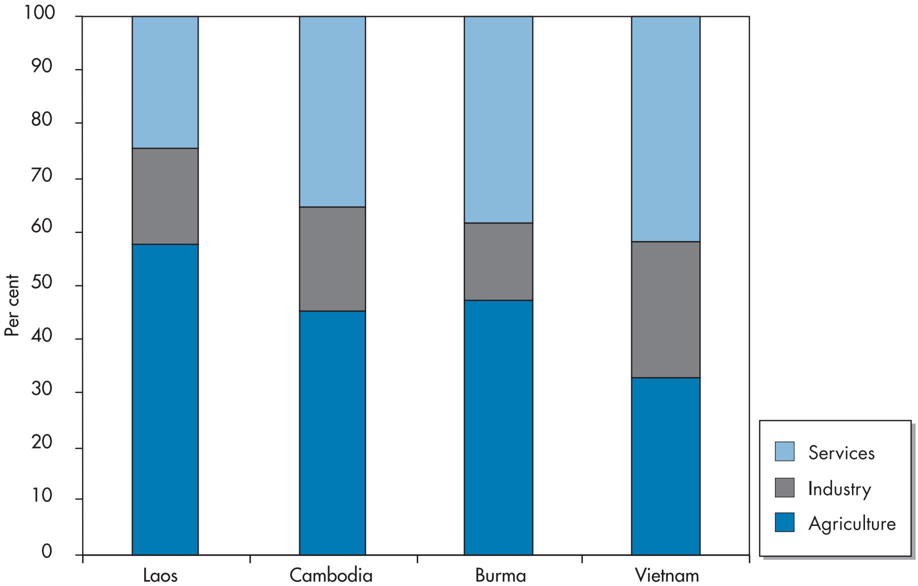
Economic Development

Vietnam is more economically advanced than the other new ASEANs with its economy more balanced and industrial sector more strongly developed (Figure 13.7). On the other hand, Vietnam's industrial sector was built up behind protective barriers, so it may resist the speedy opening of this sector to greater competition. This is a less serious concern for the other three economies, which can develop internationally competitive industrial sectors from the outset.

Figure 13.7

Vietnamese Industry More Developed

Sectoral Share of GDP, 1994



Source: Asian Development Bank, 1995, p. 244.

Differences in economic development will affect the type of foreign investment attracted and future growth prospects. They also will impinge on countries' ability to fulfil the requirements of AFTA membership; the less developed new members are likely to experience greater difficulty in meeting AFTA's technical requirements, such as harmonising customs procedures. (See Chapter 14 - *Expanded ASEAN*.)

REFERENCES

Asian Development Bank, 1995, *Asian Economic Outlook 1995 and 1996*, Oxford University Press, New York.

Asian Development Bank, 1996, *Annual Report 1995*, Asian Development Bank, Manila.

Australian Financial Review, 1996, 'Corruption isn't all bad-it creates jobs', 3 December, p. 10.

Backman, M., 1996, 'The economics of corruption', *The Asian Wall Street Journal*, 3 September 1996.

Chaipravat, O., 1996, *Far Eastern Economic Review*, 31 October.

Greenspan, Alan, 1993, 'Centrally Planned Economies and Capitalist Market Economies: The Process of Transition and the Lessons Learned', *The World of Banking*, July-August.

Hope, R.H., 1996, *Development in the Third World: From Policy Failure to Policy Reform*, M.E. Sharpe, Inc., New York.

International Monetary Fund, 1996, 'Macroeconomic Experiences of the Transition Economies in Indochina', IMF Working Paper 96/112.

Katz, S.S., 1995, 'Some Key Development Issues for Transitional Economies-East and West', in Naya, S.F. and Tan, J.L.H. (eds), *Asian Transitional Economies: Challenges and Prospects for Reform and Transformation*, Institute of Southeast Asian Studies, Singapore.

Lachiaca, Eduardo, 1996, 'East Asia noted for global integration', *Asian Wall Street Journal*, 8 May.

Luce, Edward, 1996, 'ADB backs gradual Asian reforms', *The Financial Times*, 16 April.

Organisation for Economic Cooperation and Development (OECD), 1994, *The Transition to a Market Economy*, Organisation for Economic Cooperation and Development, Paris.

___ 1991, *The Transition to a Market Economy*, Organisation for Economic Cooperation and Development, Paris.

Rana, P.B. and Hamid, N. (eds), 1995, *From Centrally Planned to Market Economies: The Asian Approach*.

Root, H.L., 1996, *Small Countries, Big Lessons, Governance and the Rise of East Asia*, Oxford University Press, London.

World Bank, 1996a, *Country Briefs*, World Bank, Washington DC.

___ 1996b, *Cambodia: From Recovery to Sustainable Development*, World Bank, Washington DC.

___ 1996c, *Bureaucrats in Business: The Economics and Politics of Government Ownership*, Oxford University Press, Washington DC.

___ 1995a, *Infrastructure Development in East Asia and Pacific-Towards a New Public-Private Partnership*, World Bank, Washington DC.

___ 1995b, *Myanmar: Policies for Sustaining Economic Reform*, World Bank, Washington DC.

Chapter 14

ENRICHING ASEAN

This chapter explores the implications of ASEAN's expansion for both the group's established and newer members.[1] The group as a whole will benefit; expansion will enrich ASEAN but it may strain the group's cohesion. There also will be both costs and benefits to the newer members. Some are foreseeable; others are intangible. However, all the newer members should gain from membership; the benefits to them clearly outweigh the costs.

EXPANDING ASEAN'S POTENTIAL

ASEAN has become an important player in the Asia Pacific region. ASEAN's international status has risen due to the strong economic performance of its members and its diplomatic achievements. In recent years, ASEAN has sought to provide a counterweight to Asia's large powers, China, prospectively Asia's largest economy, Japan, Asia's economic powerhouse, and India. ASEAN aims to ensure long term stability and peace in the region. Expanding ASEAN furthers this objective and increases ASEAN's weight in the region and globally.

The expansion of ASEAN so that it encompasses all ten countries of South East Asia will realise a long-held vision for a united South East Asia; established ASEAN members, the three former Indochinese countries and Burma will be integrated into one single market. The Cold War, and in particular the Vietnam War, had entrenched a regional schism between them (Nakatomi, 1996).

The four new ASEANs will increase the size of ASEAN's GDP by around 6 per cent to around US$650 billion, in 1995 prices (Figure 14.1)[2], equivalent to approximately nine tenths of China's economy.[3]

....

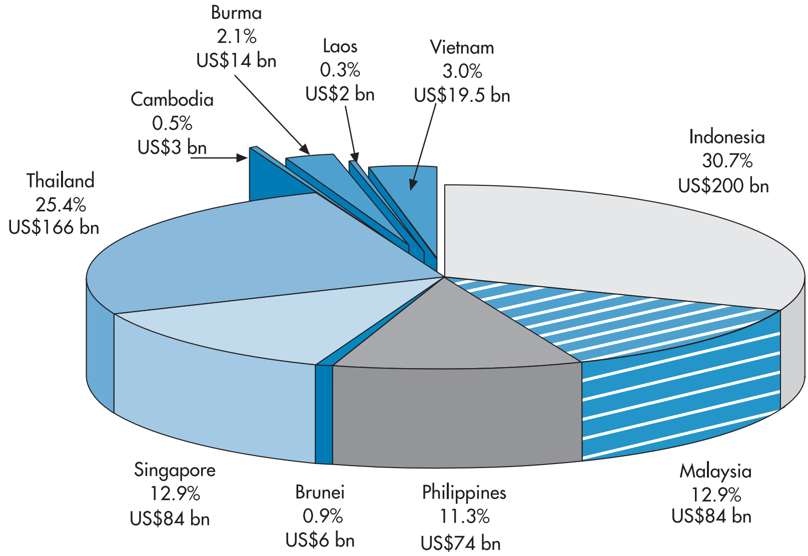
1 The five original members, Indonesia, Malaysia, the Philippines, Singapore and Thailand established ASEAN in 1967. Brunei joined in 1984. Vietnam joined in 1995. Burma, Cambodia and Laos join in 1997.

2 The new ASEANs probably add more to the economic size of ASEAN than official figures suggest; in each of the new ASEAN economies, the size of the black economy as a proportion of the official economy is significantly larger than is the average for the ASEAN(6).

3 The size of China's economy is disputed. The calculation here is based on International Monetary Fund estimates. See East Asia Analytical Unit (1997) for a fuller discussion of this issue.

Figure 14.1

Expanded ASEAN GDP, 1995



Source: Estimates are derived from International Monetary Fund and Department of Foreign Affairs and Trade figures.

The addition of the new ASEANs will increase ASEAN's population and market size from 340 million to almost 500 million.

The new ASEANs will add greatly to ASEAN's existing diversity: the regional identity will necessarily become more complex. However, the expansion and the fall in trade and investment barriers in many sectors will stimulate trade and investment, bolstering economic growth.

ECONOMIC INTEGRATION

The expansion of ASEAN will bring economic benefits to members, whose economies already are becoming more integrated with one another.

Patterns of Trade

Trade among the ASEAN(6) grew at an annual trend rate of 21.6 per cent from 1991 to 1995 to US$137 billion, or 23 per cent of their total trade.[4] This is substantially faster than ASEAN(6) trade to the world which grew at a trend rate of 15 per cent over the same period. Trade between the new ASEANs and the ASEAN(6) has also been growing rapidly: the ASEAN(6) are already important trading partners for the new ASEANs (Figure 14.2).

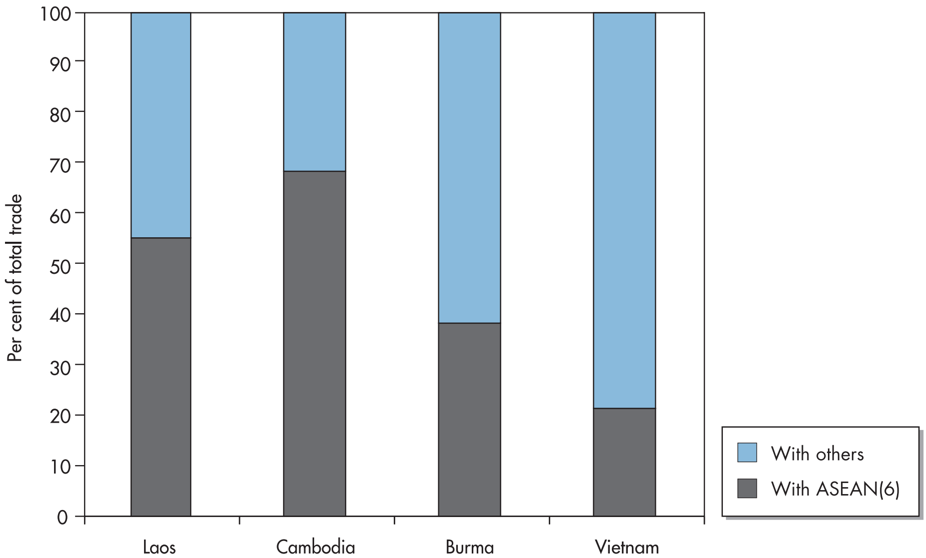
....

[4] Singapore's entrepot role in ASEAN makes the figure higher than would otherwise be the case. If goods trans-shipped through Singapore are discounted, the level of intra-ASEAN trade falls to just 12 per cent (Oxley, 1996).

Figure 14.2

ASEAN-New ASEAN Trade Already Intense

The New ASEANs: Trade with the ASEAN(6) as a Proportion of Their Total Trade



Increasing Trade Complementarity

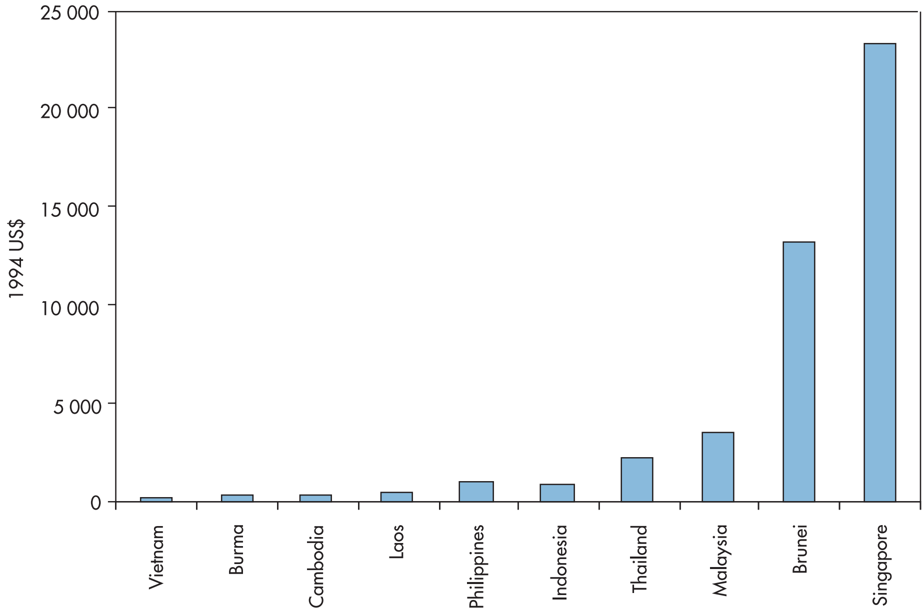
Economic development and trade in East Asia over the past few decades have recycled comparative advantage[5] and the new ASEANs will increase trade complementarity within ASEAN. The already quite wide income disparities within the region become even wider, increasing the economic opportunities for trade and investment based on differing comparative advantage (Figure 14.3).

....

5 This expression refers to the pattern of development observed in East Asia where countries move up the development ladder producing middle and higher technology goods and services, as their incomes rise and their economies become more technologically advanced. Labour intensive manufacturing production then shifts to countries lower down the development ladder, which have lower wages and technological capabilities.

Figure 14.3

Disparity in Expanded ASEAN Widens GDP Per Capita 1994



Source: Asian Development Bank, 1996.

The expansion of ASEAN should lead to an expansion in both intra-regional trade and ASEAN's total trade.[6] The new ASEANs will become part of the regional division of labour based on their respective comparative advantages.

The ASEAN(6) also will benefit from the expanded division of labour in the region, which will assist their companies in staying internationally competitive by sourcing cheaper raw materials and finding cheaper production locations. This is especially important to the ASEAN(6) as they gradually leave the Generalised System of Preferences (GSP).[7] The new ASEANs (except for Burma),[8] with their continuing access to GSP, can serve the ASEAN(6) as export points to the rest of the world for textiles, garments, leather and electronic assembly industries. A shift to sourcing inputs and labour intensive manufactures from the new ASEANs also will release resources within the ASEAN(6), allowing the ASEAN(6) to develop their evolving comparative advantage. The investment required to affect these changes will stimulate growth in the new ASEANs.

....

6 Some trade may be diverted both within ASEAN away from the ASEAN(6) to newer members, and away from the rest of the world. The latter will not be substantial unless the differential treatment of members and non-members increases.

7 The GSP scheme is an autonomous development-oriented trade policy instrument designed to offer developing countries tariff preferences which give their exports access to industrialised country markets on easier terms than those from industrialised countries. Singapore is no longer entitled to GSP access.

8 Early in 1997, the European Commission withdrew Burma's GSP access.

Patterns of Investment

The ASEAN(6) have been concerned about the failure of ASEAN to maintain its share of international investment flows; ASEAN's share of foreign direct investment to Asia halved from 62 to 31 per cent between 1991 and 1994 (*Financial Times*, 5 July 1996, p. 4). If this trend continues, ASEAN economies may find it difficult to sustain their pace of industrial development and economic momentum in line with planned national economic objectives (ASEAN Secretary General, Ajit Singh, cited in *The Financial Times*, 5 July 1996, p. 4).

The expansion of ASEAN, however, should enhance coordination of economic and investment policies in investment hungry South East Asia. This should improve the group's ability to attract funds from outside the region. Rather than competing as ten separate markets, the expanded ASEAN(10) can promote itself as an emerging single large market, offering a range of services, wage levels and skills, and endowed with substantial natural resources. Lower or fewer internal trade barriers under the ASEAN Free Trade Area (AFTA) will enhance the attractiveness of an enlarged ASEAN.

ASEAN Free Trade Area (AFTA)

ASEAN leaders agreed to create AFTA in January 1992, to liberalise trade, create a more integrated regional market and attract increased foreign investment (East Asia Analytical Unit, 1994). The initial AFTA agreement reduced intra-ASEAN tariffs to 0 to 5 per cent over a 15 year period commencing January 1993, subject to some notable exclusions (Table 14.3). This has since been wound back to 2003 and on a 'best endeavours' basis, the ASEAN(6) will bring as many tariffs as possible to 0 to 5 per cent by 2000. ASEAN expects close to 90 per cent of ASEAN(6) tariff lines to be in that range by 2000 and on current commitments, just over 40 per cent of items would be duty free by 2003.

Burma, Cambodia and Laos are likely to be given an extension, beyond the 2003 deadline applicable to other ASEAN members to reduce their intra-ASEAN tariffs to 0 to 5 per cent. Vietnam already has longer, to 2006, to complete its tariff reductions.

REDUCING TARIFFS IN AFTA

The mechanism for implementing AFTA is the Common Effective Preferential Tariff (CEPT). The CEPT contains fast[9] and normal tracks for reducing tariffs.

- For items attracting a tariff of more than 20 per cent, under fast track, the tariff is scheduled to fall to 0 to 5 per cent by 1 Jan 2000, and under normal track, to 20 per cent by 1 Jan 1998.
- For items attracting a tariff of less than 20 per cent, under fast track, the tariff is scheduled to fall to 0 to 5 per cent by 1 Jan 1998, and under normal track, to 0 to 5 per cent by 1 Jan 2000.

The CEPT scheme divides each country's tariff lines into temporary and permanent exclusion categories (Table 14.3).

....

[9] The fifteen product lines to be included in the fast track were agreed upon at AFTA's inception. It is unclear whether new members have to conform to the fast and normal tracks of the other ASEANs.

Table 14.3

Exclusion Categories

Category type	Timeframe for ASEAN(6)
Temporary exclusions	
Manufacturing and minerals	1995 to 2000
Unprocessed agricultural goods	1997 to 2003
Highly sensitive list - no more than 15 items (includes items such as rice, sugar and cloves)	By 2010
Permanent exclusions	
Sensitive list (includes defence and cultural items)	Permanent, although items on this list are subject to review

The AFTA agreement also requires all quantitative restrictions and non-tariff barriers for goods brought within the Common Effective Preferential Tariff (CEPT) scheme to be removed within five years of the goods reaching the 20 per cent tariff level. Services are not yet included. A 'green lane' system for express customs clearance of AFTA products has been introduced. Overall progress on harmonising customs procedures however, has been slow.

The new members are unlikely to affect the pace of tariff reductions already agreed under AFTA as the 2003 target is legally binding. Even if the new ASEANs do not adhere to their agreed timetable, the ASEAN(6) countries are likely to adhere to it, although highly sensitive items such as rice and cars[10] may test the resolve of some members. If the new ASEANs feel unable to maintain the agreed pace of tariff reductions and resist pressure from long standing ASEAN members to conform to the AFTA timetable, then a '2-speed' process could develop, which should not delay a comprehensive ASEAN(6) free trade area becoming a reality in 2003.

The new ASEANs would benefit from rapidly removing tariff barriers to ensure their scarce investment funds are not allocated wastefully to sectors in which they have no real comparative advantage. With the Bogor Declaration of the Asia Pacific Economic Cooperation (APEC) forum, the ASEAN(6) agreed to remove all tariff and non-tariff barriers by 2020.

The new ASEAN members could slow down progress in ASEAN customs harmonisation and standards conformance programs because in some cases, they lack the technical capacity to meet these requirements.

An expanded ASEAN, with continued strong economic performances by all members, should enjoy increased influence and importance in international trade and economic forums such as the World Trade Organisation and APEC.[11] However, ASEAN may not become a large integrated regional trading bloc comparable to the European Union or the North American Free Trade Area (NAFTA).

....

10 Oxley (1996) suggests that in some very important areas, such as cars, tariffs are so high as to effectively prevent trade.

11 Currently only Burma is a member of the World Trade Organisation (although Laos has being admitted as an observer) and none of the new ASEANs is a member of APEC.

ASEAN Economic Program

Besides AFTA, ASEAN has a number of economic programs designed to promote regional integration. Many programs are in the early stages of development with definitions, treatment and timetables yet to be agreed, so the newer members will have more opportunity to influence developments than in the case of AFTA. Many observers, however, are concerned that newer members will use their influence to slow down liberalisation and integration.

ASEAN ECONOMIC INITIATIVES

The ASEAN economic program includes the following:

- working on a prioritised list for the removal of non-tariff barriers. Definitional problems, however, remain and other distortions to trade such as subsidies are yet to be addressed
- planning an ASEAN Investment Area (AIA) to stimulate intra-ASEAN and foreign investment in ASEAN. An ASEAN Investment Action Plan which includes a proposed ASEAN Investment Code was accepted at the December 1995 ASEAN Economic Ministers meeting
- finalising initial Services Negotiations by no later than 31 December 1998. The agreement will deal with market access and national treatment; the sectors targeted for initial examination are financial services, maritime transport, telecommunications, air transport, tourism, construction and business services
- possibly creating an ASEAN Patent System and ASEAN Trademark System, following the signing by ASEAN leaders in December 1995 of a Framework Agreement on Intellectual Property Cooperation.

STRAINING ASEAN COHESION

ASEAN has an influential voice in Asia and the Pacific, and the group's role on the regional and international stage is set to grow, partly as a result of ASEAN's recent decision to become a more active player in regional and global forums, for example APEC, the World Trade Organisation and the United Nations. ASEAN's cohesion is important in its emergence as a major regional player. Although ASEAN demonstrated its capacity for cohesion when all ten countries signed the South East Asian Nuclear Weapons Free Zone Treaty in 1995, the addition of new members may strain that cohesion.

Consensus Decision Making

ASEAN's consensus style of decision making may be tested by its expansion to include a new group of members. Increased numbers could make consensus, and therefore decisions, harder to reach. Past practice has been to defer decisions until a consensus can be reached. So decision making may become slower.

ASEAN members will be reluctant to move to a more flexible political and security decision making process, but the new reality may force change. ASEAN's heavy annual schedule of meetings, which stretches human and financial resources, may itself force change in the decision making process.

ASEAN leaders recognised at their Summit in 1995 the delays and difficulties the consensus decision making process caused when the principle of 'flexible consensus' was introduced into the economic decision making process. However, greater 'flexibility' or even an entirely new approach might be needed to avoid a slow down; currently, the slowest member of the group dictates the pace of integration within ASEAN (Haflah and Noor Aini, 1996). Failure to develop strategies for 'bypassing' reluctant reformers, for example, could affect adversely economic reforms, including tariff reductions, the harmonisation of customs and investment rules, and ultimately development and growth.

A Rise in Contentious Issues

The addition of new members also results in contentious issues already being dealt with by the ASEAN(6) being augmented by several new ones. For example, Burma's international pariah status is an issue likely to cause tension, both between ASEAN members and between ASEAN and the rest of the world. ASEAN members do not completely agree on how best to engage Burma's military government, but group solidarity on 'constructive engagement' and non-interference in the internal affairs of member countries, is likely to hold, unless the political situation in Burma deteriorates considerably. The re-detention of Aung San Suu Kyi, for example, could test group solidarity.

The inclusion of Burma will affect relations between ASEAN and non-ASEAN countries, especially the USA and the European Union. Relations with Australia could also be complicated. Group solidarity is likely to lead ASEAN members to reject attempts by 'outsiders' to press one of their members, namely Burma, to reform. Even so, Burma's inclusion may affect the overall credibility of the group in the wider international community.

Framework for Resolving Issues

Although the expansion of ASEAN membership will test the group's cohesion, it also provides a framework for resolving some issues, such as integrating Burma into the regional framework and bridging economic differences in the region. Malaysia, the ASEAN chair for 1997, was tasked to look at how ASEAN can deal with some perennial issues such as economic crime, drug trafficking, money laundering and piracy (Earl, 1996, p. 12). These issues may be considered at the next ASEAN Post Ministerial Conference (PMC) where foreign ministers engage in extensive discussion with dialogue partners, including Australia. Success in dealing with some of these issues would greatly enhance ASEAN's international status.

PREPAREDNESS FOR MEMBERSHIP OF ASEAN AND AFTA

Some costs and benefits of membership for the new ASEANs can be readily predicted. Others cannot be foreseen easily and some, for example, political implications, are intangible and therefore difficult to measure. New ASEAN policy makers undoubtedly factored into their deliberations on ASEAN membership some of these costs and benefits, although their assessments of costs may have been distorted by a less than full understanding of what ASEAN and AFTA membership entails.

None of the new ASEANs hesitated in seeking membership; each presumably recognised the long term benefits of ASEAN membership outweighed short term costs. Certainly, the long term potential cost of not joining, of being politically and economically marginalised in the region would be high.

The experience of Vietnam's recent admission has raised doubts about whether the newcomers will be able to meet their AFTA obligations. These doubts centre on the new members' willingness to grant most favoured nation (MFN) status to other members, to produce lists of goods for ASEAN's CEPT scheme, meet demanding deadlines for reducing tariffs on goods traded within the group and remove non-tariff barriers.

The ability of the new ASEANs to comply with the AFTA deadline will depend on the pace of economic reform generally and the pace of SOE reform particularly (Buszynski, 1996). Vietnam, Laos and Burma may find, for example, that their AFTA commitment conflicts with the degree of control political or military leaders want to have in economic decision making.

The new ASEANs are at differing levels of preparedness to meet their AFTA tariff reduction timetables; none has developed a clear vision across its government institutions of the restructuring and reform required to achieve the targets. This may slow implementation of tariff reductions, particularly in the early stages. The need, however, to bring traded items into AFTA CEPT before the new members can enjoy the stipulated trade concessions will stimulate more rapid tariff reduction.

Vietnam

Although Vietnam has established an ASEAN Directorate in the Foreign Ministry and an ASEAN Department in the Office of the Government, its bureaucracy remains largely unprepared for AFTA.[12] Inter-ministry communication is often poor and there is little understanding, even in some key ministries and agencies, of what AFTA entails. Officials tend to believe Vietnam will enjoy more flexibility in reducing tariffs than AFTA specifies.

A few months after Vietnam joined ASEAN, to meet its obligations over the next decade under the CEPT agreement, it submitted a list of 1 622 goods for tariff reduction and 857 CEPT tariff lines covering 18 sectors of Vietnam's economy (Truong and Gates, 1996). In January 1997, Vietnam listed a further 600 products to

....

[12] This may start to change following the creation in 1996 of a National ASEAN Committee, headed by a deputy prime minister, and tasked to coordinate ASEAN policies across institutions.

include in its AFTA CEPT schedule. The list binds tariffs already within the range of 0 to 20 per cent. However, Vietnam has not made any reductions under the CEPT schemes to date, but government officials suggest that it may do so in 1998. Seventy per cent of Vietnam's total tariff lines - more than 2 200 lines - are targeted to be included in CEPT by the January 2006 deadline (Vu Tuan Anh cited in Truong and Gates, 1996, p. 162).

Compared to some other ASEAN members, Vietnam's task of reducing tariffs to 0 to 5 per cent should not prove inordinately challenging (Truong and Gates, 1996, p. 161). This is because 53 per cent of Vietnam's total tariff lines are already in the 0 to 5 per cent bracket (Table 14.4), although 17 per cent of its tariff lines carry high duties of 21 to 60 per cent (Truong and Gates, 1996).

Table 14.4

Breakdown of Vietnam's Tariff Regime, End of 1996

Tariff range	Number of product lines	Per cent of total
0 to 5 per cent	1 705	53.1
6 to 10 per cent	299	9.3
11 to 20 per cent	636	19.8
21 to 60 per cent	546	17.0
Over 60 per cent	25	0.8

Most of the products on Vietnam's highly sensitive list which presumably should be reduced between 2001 and 2010[13] (Table 14.3) are unprocessed agricultural products. While this may entail some short term adjustment costs, Vietnam should benefit when other ASEAN members reduce non-agricultural tariffs because Vietnam's lower cost structure should make its labour intensive manufactures an area of comparative advantage.[14] Vietnam is increasingly an agricultural exporter and this trend will be enhanced by agricultural trade liberalisation.

Burma

An embryonic ASEAN Division was established in the Foreign Ministry, but like other new members, poor communication across the bureaucracy resulted in a lack of understanding about the implications of AFTA membership. English language skills and a British based legal system give Burma a significant advantage in meeting some membership obligations. Burma's tariff levels compare reasonably favourably with the ASEAN average, but export and import restrictions together with a failure to unify its exchange rate cause Burma's trade regime to be illiberal relative to the other new members. This could make Burma's task of complying with its AFTA tariff

[13] Because Vietnam has longer to conform with CEPT tariff reductions, it also may be given an extension for items on its highly sensitive list.

[14] This is based on the assumption that a number of deterrents to investment, such as the lack of infrastructure, workforce skills and a 'business-friendly' legal framework, are eliminated over time.

reduction timetable and achieving the wider objective of economic integration extremely difficult.

Cambodia

In 1996, most ministries established either an ASEAN department or unit subordinate to the ASEAN National Secretariat within the Ministry of Foreign Affairs. In addition, the two Prime Ministers chair an ASEAN Internal Coordination Network; this network has convened only once, probably due to ongoing political tensions. Communication across Cambodia's bureaucracy is complicated by cleavage in the bureaucracy along political party lines. Cambodia attaches priority to providing government officials with training in English and appropriate technical skills. Work to make Cambodia's commercial and legal framework compatible with those of ASEAN members also is underway. (See Chapter 7 - *Cambodia: Politics*.)

Of the new ASEANs, Cambodia has the most liberal trading regime, partly because of weak enforcement. Cambodia benefits from the illiberal trade regimes in the region, so trade liberalisation in the region, especially by Vietnam, will dent Cambodia's sizeable re-export trade, much of which is in goods smuggled to Vietnam. However, regional trade liberalisation should enhance Cambodia's overall trade prospects. In 1993, Cambodia's import tariff system was streamlined; a four-band rate system of 7 per cent (inputs needed for domestic production), 15 per cent (capital goods), 35 per cent (goods competing with infant industries), and 50 per cent (consumer goods) applying to over 93 per cent of tariff items was introduced. Quantitative import restrictions also were eliminated but a number of export restrictions still apply.

Cambodia will have some difficulty in complying fully with AFTA's program of tariff reductions because the Government depends heavily on import duties for more than half of total taxation revenue. However, new measures to bring Cambodia's tax and tariff structures into line with the CEPT were announced in January 1997. (See Chapter 8 - *Cambodia: Economy*.)

Laos

Although Laos has taken steps to prepare for AFTA, it faces the greatest problem of any of the new ASEANs in terms of resources: lack of capital and qualified English speaking bureaucrats. The Government has established a specialist ASEAN Department within the Ministry of Foreign Affairs, which is responsible for training a core group of public servants in the English language and appropriate technical skills. Like the other new ASEANs, communication across the Lao bureaucracy is poor and few officials have a clear vision of the implications of AFTA membership.

However, Laos already has progressed substantially in reducing tariff barriers; for example, the Government reduced the maximum tariff rate from 80 to 40 per cent and the number of tariff bands from 12 to 6. Also, Laos has eliminated virtually all quantitative restrictions on imports, except motor vehicles.[15]

15 Laos' relatively liberal trade regime reflects in part its small industrial base and its lack of a sizeable domestic market. As a result, foreign investors tend to target the larger regional market. To these investors, regional access is more important than domestic protection.

MEMBERSHIP COSTS

Reduced National Sovereignty

ASEAN membership will entail some loss of national sovereignty by the new ASEANs, particularly over economic policy. The likely outcome is less clear with respect to internal political matters.

Burma may hope that ASEAN membership will confer some protection against international scrutiny and castigation of its poor record on human rights and lack of respect for democratic freedoms. However, to avoid unwanted international pressure, other ASEANs are likely to urge Burma to advance reforms so that the organisation as a whole is not tainted and its international dialogue on important strategic, political and economic issues compromised by Burma's membership. The Burmese Government may find that as its regional economic and political links expand, it has to compromise in managing its internal affairs. However, it is an open question whether this will substantively improve Burma's human rights performance.

Demands and Adjustment Costs of AFTA Membership

AFTA membership is likely to have the biggest impact on how the new ASEAN governments determine national economic policy. Their capacity to determine their own macroeconomic, trade and investment policies will be reduced substantially as reform in each economy accelerates to meet AFTA requirements.

In an increasingly globalised market for capital, goods and services, however, small players in the world economy, such as the new ASEANs, could not have expected much freedom in determining their own macroeconomic, investment or trade policies, unless they were prepared to risk becoming marginalised and face future economic crises. By providing a trade and investment liberalisation timetable, ASEAN offers the new ASEANs a cohesive policy framework for more rapid liberalisation. It also gives the new members a voice in global economic forums.

The new members may face some short term adjustment costs in meeting their AFTA commitments, despite the ASEAN(6) providing funds to bring the new members quickly into the ASEAN framework. Perceived adjustment costs may include:

- a significant fall in government revenues resulting from reduced tariffs, currently a large component of revenue. However, the new ASEANs already are developing other sources of revenue
- the inability to nurture or protect infant[16] and state-owned industries
- industry adjustment and possible contraction creating worker dislocation in economies where unemployment (and underemployment) is already high and little or no social welfare net exists.

The new ASEAN members also must overcome some technical shortcomings, such as a lack of computerisation, trained staff and technical resources, if they are to

....

16 This will obstruct any government plans to 'create' new industries or comparative advantage. However, it is unlikely that such government action is an effective use of economic resources.

comply with AFTA's requirements and with programs like the planned customs harmonisation and standards conformance agenda. The need to meet such requirements may place considerable pressure on government resources, especially in the smaller countries such as Laos.

MEMBERSHIP BENEFITS

Belonging to a Community of Nations

The most important political benefit that membership bestows on the new ASEANs is membership of a community of all South East Asian nations. For different reasons and to differing degrees, all four new ASEANs have been isolated politically and economically from the international and regional mainstream for decades. Attaining ASEAN membership is a major step towards participating fully in the regional, if not the international community.

There are other political gains. For Vietnam, two national objectives behind its decision to join ASEAN were to develop amicable relations with regional states and improve its bargaining position with both China and the USA (Thayer, 1997, p. 10). For example, from the Vietnamese perspective, the Spratly Islands dispute changed from a bilateral dispute between China and Vietnam to a multilateral one involving ASEAN as a group and China (Thayer, 1997, p. 10). Vietnam's ultimate objective is to create a stable, non-threatening regional and international order to continue domestic economic development.

Economic Benefits

The ASEAN(6) are already important sources of trade and investment for the new ASEANs. ASEAN membership will provide the new ASEANs with a common regional identity and through AFTA, a framework to rapidly develop and integrate into the region. In particular, the new ASEAN members are likely to benefit from and contribute to the emergence within ASEAN of a regional division of labour.

- In the early stages of industrialisation, the export of agriculture and raw materials usually underpins industrial expansion.[17] All the new ASEANs have the potential to build on their existing agricultural and natural resource bases. This applies especially to Burma whose agricultural and natural resources remain largely underdeveloped and unexploited. While agriculture's share of an economy typically declines as the economy develops, the best performers in East Asia have dynamic agricultural sectors as a result of reform and investment (World Bank, 1993, p. 32)
- Responding to rising incomes in the ASEAN(6), companies especially those involved in labour intensive manufacturing, are looking elsewhere for cheaper production sites with cheaper wages, land, rentals and raw materials. The

---

[17] For example, this was the case with Japan, whose exports of tea, silk and other rural products in the 1890s earned it foreign exchange to import the raw materials and machinery it needed to build up the modern sector of the economy (Duus, 1976, p. 137).

ASEAN(6) already are among the largest investors in the new ASEANs[18] and relocating some industries requiring cheaper labour is underway.[19]

Other economic benefits for new members include:

- increased likelihood of locking in their respective reform programs, providing a catalyst for further reform, particularly trade liberalisation. The new ASEANs will be disadvantaged, compared to the ASEAN(6), if their reform and tariff liberalisation agendas fall behind
- a framework and assistance for undertaking economic reform, and for their governments, some support against vested domestic interests while doing so
- easier access to world markets which will not need to be negotiated individually in multilateral forums and bilateral trade negotiations
- ASEAN(6) providing relevant sources of economic advice and sound models for economic development
- coordination of economic structures and investment policies between the ASEAN(6) and the new ASEAN members improving economic performance and increasing international investor confidence in the new ASEAN economies (Haflah and Noor Aini, 1996)[20]
- coordination of economic policies, particularly in export industries such as textiles, garments, rice production and agri-products processing (Buszynski, 1996), and expanding trade growth between ASEAN members and between ASEAN and non-ASEAN members
- accelerated subregional cooperation, such as the Greater Mekong Subregion initiative (see Chapter 15 - Mekong Subregion)
- enhanced involvement of new ASEAN members in large regional infrastructure projects such as railways, major road links, electricity generation and gas transmission.

....

18 On an approvals basis, Singapore is the largest investor in Burma. In Vietnam, Singapore is the second largest investor (behind Taiwan). In Cambodia, Malaysia is the largest investor. In Laos, Thailand is the largest investor.

19 Some North East Asian investments previously located in the ASEAN(6), have shifted to the new ASEANs.

20 The internal investment environment in the new ASEANs will remain paramount, however, to maintaining investor confidence. For example, Vietnam's membership of ASEAN was not sufficient to prevent a downturn in foreign investment in the first half of 1996 in response to the harsher regulatory environment in the lead up to the Eighth Party Congress (Forbes, 1996).

ASEAN GAS TRANSMISSION PROJECTS

After long running discussions, ASEAN energy ministers agreed in 1996 to a plan for a regional gas transmission system. Demand for gas in the ASEAN market is forecast to rise nearly seven fold, from 23 million tonnes of oil equivalent in 1995 to 150 million tonnes in 2020. A joint transmission system will enable ASEAN countries to share resources and use them more efficiently. It will link all seven current members and cost US$15 billion.

Thailand and Burma have signed an agreement to pipe gas from at least two major fields in Burmese waters in the Gulf of Martaban. This project, which is expected to be completed in 1998, creates a critical piece of ASEAN infrastructure.

BEYOND 2000

Once ASEAN stabilises after admitting the new members, over a number of years, ASEAN will consolidate its economic and political achievements. Some new members may assume an ability to choose, smorgasbord-like, what they want from ASEAN and AFTA and ignore the rest.[21] Such unrealistic assumptions could result in minor setbacks to ASEAN, including member governments disagreeing. However, regional integration will continue as it is an important part of the longstanding ASEAN members' regional vision.

Economic Integration

Recently increased momentum to liberalise intra-ASEAN trade suggests that much of AFTA's tariff reduction program is likely to be achieved by 2000; only a few unprocessed agricultural goods and highly sensitive products will remain protected. Much of ASEAN's economic program will be agreed upon and partially implemented. Overall, the ASEAN(6) will have achieved the bulk of its economic liberalisation and regional integration objectives.

However, it is less clear that the new ASEANs will manage to keep pace with the other ASEANs. Indeed, successful regional economic integration by the new ASEANs is not guaranteed. Poor bureaucratic and administrative capacity and procedures, corruption and policy capriciousness could cause foreign investors from within ASEAN and elsewhere in East Asia to lose their initial enthusiasm for new ASEAN markets. If this occurs, ASEAN's four new members would risk becoming marginal players in the expanded ASEAN.

21 For example, 'despite announcing its commitment to the Treaty of Amity and Cooperation signed in Bali in 1976, Hanoi is not so certain whether it accepts the rules of the game, that is, accepts all the written and unwritten norms of the relationship among ASEAN countries without exception' (Pham Cao Phong cited in Thayer, 1997, p. 19).

Two-Speed AFTA?

AFTA's tariff reduction timetable should not present major difficulties to the new ASEAN members (aside from the few perceived short term adjustment costs previously discussed). First, within broad guidelines, new members can decide how they achieve their targets. Second, resistance to the tariff reduction timetable should not be high, as overall, the newer ASEANs do not have high tariff barriers compared with most of the ASEAN(6) countries.

In the first years of the new century, however, as tariff reduction target dates draw near, the new ASEAN members may seek preferential treatment where trade liberalisation measures encroach on internal objectives. (Longstanding members, incidentally, may also seek to do so.) For example, the Vietnamese Government's predilection for large SOE conglomerates and nurturing strategic industries may cause it to seek exclusions for certain sectors or industries. This may pose a dilemma for other ASEAN members, some of whom may have sympathy for such a request. Many of the ASEAN(6) have at some stage pursued import substitution and protection, as have some North East Asian countries, although most now largely reject this approach. Furthermore, if the ASEAN(6) accede to such requests, it could slow down ASEAN's economic reform schedule. Ultimately, the main cost to the ASEAN(6) from expanded membership will depend on the extent of special or differential treatment it grants the newcomers during their transitional stage in ASEAN (Haflah and Noor Aini, 1996).

However, AFTA's tariff and non-tariff reduction timetable is not as flexible as some of the new ASEANs appear to believe. Furthermore, the forces of international trade and investment will not allow ASEAN members any breathing space; economic reform and regional integration will need to be maintained or quickened.[22] As a result, new members may be allowed less flexibility by current members than they anticipated and face pressure to shorten their adjustment periods. The result may be that one or more members slows down its individual pace of liberalisation (thereby making AFTA a two-speed regime), but at a price.

- Until an item is brought into Common Effective Preferential Tariff (CEPT), it does not attract the intra-ASEAN tariff level. Delay by any member in bringing items within CEPT therefore will penalise its exports.
- Incorporating 'flexible consensus' into economic decision making means that rather than allowing reluctant reformers to slow the pace of liberalisation, they simply can fall behind or drop out of any particular process. If this went far enough 'drop out' economies could become seriously marginalised.
- ASEAN membership has instilled greater confidence in these transitional economies and domestic and foreign investors have responded accordingly. However, confidence is based on ASEAN's ability to maintain the new ASEANs' commitment to reform and provide them with access to other ASEAN markets.[23] If these two assumptions are not met, new membership benefits could be foregone.

....

22 To maintain its relevance, in the face of other tariff reduction timetables, for example WTO and APEC, ASEAN cannot allow the pace of trade liberalisation to slacken.

23 Foreign investors generally will value market access over protection. This is because many invest in the new ASEANs to export to the wider region.

AFTA - How Preferential?

It is unclear how open AFTA will be to non-ASEAN countries. Possibly, trade barriers to non-ASEAN trading partners will be significantly higher than between ASEAN countries (Oxley, 1996).

Several ASEANs, including Indonesia, Malaysia and Thailand, have unilaterally reduced their MFN rates. Despite this, the overall differential between MFN rates and the ASEAN CEPT rates appears to be increasing (Table 16.1). Some ASEANs may seek to deflect some short term adjustment costs associated with trade liberalisation by allowing external tariff and non-tariff barriers to non-ASEANs to increase. For example, recently Vietnam increased the non-CEPT tariff on petroleum to 15 per cent, while pegging the ASEAN CEPT rate at 1 per cent; this may be a cause for concern as it goes against the trend of lowering tariffs to members and non-members alike.

ASEAN members want to maintain or increase their access to global markets. They can help ensure this by contributing, by their example, to freer trade. Furthermore, reflecting the pattern of globalised production, ASEAN's imports and exports both are often intermediate goods. ASEAN's intermediate and final good exports often are intended for wealthy markets such as Japan, the USA and the European Union. To remain competitive in such markets, ASEAN companies must either produce or import inputs for production at best prices. This may entail importing inputs from outside the region.[24] ASEAN economies also need to import the best management practices and technical processes. Experience elsewhere suggests that protected companies and industries do not do this.

ASEAN policy makers are aware of the need to maintain competitive export industries and the concomitant advantages of free and open trade. Reflecting this awareness, some ASEAN members have floated the idea of extending AFTA tariff preferences to non-ASEANs on an MFN basis. (This proposal was first publicly aired by the former Philippine Finance Minister, Jesus Estanislao in mid 1996.)

Wider Economic Cooperation

To maintain current strong growth levels well into the next century, the ASEAN(10) will need to address substantially other remaining impediments, especially non-tariff ones to growth. To address such impediments, ASEAN has initiated a wider economic program which includes an ASEAN Investment Code and proposals to deal with non-tariff barriers and services within ASEAN. ASEAN's economic agenda also is likely to include cooperation on such matters as human resource and capital market development, and legal and transport issues.

At present, the likely outcomes from ASEAN's economic program are unclear because members have not agreed on issues under the program. Debate and negotiations within ASEAN on issues is likely to continue over the next few years; the new ASEANs may influence these negotiations.

---

[24] It is possible, however, to quarantine imported inputs as Laos has already done; imported inputs enter Laos duty free.

The greater the degree of agreement and cooperation on these issues, the deeper will be the level of regional economic integration. This will benefit the ASEAN(6) and the new ASEANs alike. The best outcome for all ASEAN members and non-members, however, would be that ASEAN's treatment of issues under the wider economic program meshes with the treatment of those same issues in the World Trade Organisation and APEC.

Cooperation on Infrastructure Development

By 2000, ASEAN's Mekong Subregion Development Cooperation initiative should be accelerating economic growth and development in the Mekong subregion by supporting economic reform and garnering support from donor countries and multilateral organisations for large scale development of transport and other infrastructure. (See Chapter 15 - *Mekong Subregion*.)

Political Integration

The many similarities of the ten nations of South East Asia do not obscure their important historical, cultural and religious differences. Although many differences will remain, by 2000, ASEAN is likely to have greater unity of purpose. This will be assisted by:

- exchanging views on the proposed vision for the region. At the ASEAN informal summit held in Jakarta in December 1996, ASEAN ministers were asked to develop an ASEAN vision towards 2020
- encouraging substantive dialogue on security and related issues at ASEAN Regional Forum meetings
- continuing measures to assist new members to participate fully in ASEAN's schedule of meetings and economic programs and AFTA's trade liberalisation agenda. Assistance already includes language training, technical assistance and infrastructure assistance
- fulfilling ASEAN's broader agenda of promoting greater understanding and knowledge in the region, thereby evolving towards an ASEAN community. At the ASEAN informal summit in Jakarta in December 1996, ministers also agreed to establish an ASEAN Foundation to promote ASEAN awareness, student exchanges and scholarships.

Beyond 2000

Over the short to medium term, the ASEAN(6) will remain pre-eminent in developing and pursuing ASEAN's policy objectives, partly because the newer members will lack the confidence and experience to contribute significantly. Beyond 2000, as their confidence and economic influence increases, the new ASEAN members will have a larger say about ASEAN's future directions. This may alter the disposition and complexion of the group over time, although convergence of the new and more established members' views is likely.

By 2000, ASEAN is likely to be a more integrated regional identity; ASEAN will be able to promote itself to investors as a single, large market. Tariff cuts will encourage

ASEAN[25] and non-ASEAN companies to think in regional terms. For example, investors could establish a single large factory to manufacture products for the entire region; the single market then becomes a window of opportunity to act on quickly (Holloway, 1997, p. 48).

However, the integration process will be far from complete by 2000. By 2003, only 12 to 15 per cent of ASEAN trade will be duty free, as the bulk of ASEAN trade will still be with non-ASEAN members (Oxley, 1996). Many of the ASEAN(10) still will have low per capita incomes and their governments will continue to face major challenges to accelerate economic reforms delivering improved living standards.

Non-ASEAN countries in the region will be affected by the expansion of ASEAN and AFTA. The trade negotiation focus of the ASEAN(6) will be to assist the integration of the newer members. Some trade and investment diversion may arise from the addition of new members and the acceleration of ASEAN's economic programs. This should only be substantial if the degree of tariff or investment preference ASEAN and non-ASEAN members face markedly increases. It also could be substantial if external barriers increase. Otherwise, the impact on the wider community is likely to be very positive with rising income levels, and the enormous demand for infrastructure and structural change in the region creating many new trade and investment opportunities.

25 'You can no longer be satisfied with being merely national players; you must go regional', advice given by the Secretary-General of ASEAN, Ajit Singh, to Indonesian business in November 1996 (cited in Holloway, 1997).

REFERENCES

Asian Development Bank, 1996, *Asian Development Outlook 1996 and 1997*, Oxford University Press, London.

Buszynski, L., 1996, 'Southeast Asia: Trends, Developments and Challenges', in *Southeast Asian Affairs 1996*.

Department of Foreign Affairs and Trade, 1996, *The APEC Region: Trade and Development*, Department of Foreign Affairs and Trade, Canberra.

Duus, P., 1976, *The Rise of Modern Japan*, Houghton Mifflin Company, Boston.

East Asia Analytical Unit, 1997, *China Embraces the Market: Achievements, Constraints and Opportunities*, Department of Foreign Affairs and Trade, Canberrra.

____ 1994, *ASEAN Free Trade Area: Trading Bloc or Building Block?*, Department of Foreign Affairs and Trade, Canberra.

Earl, G., 1996, 'Downer splits with US on labour codes', *The Australian Financial Review*, 25 July, p. 12.

Economist Intelligence Unit 1995, *Laos: EIU Country Report*, Economist Intelligence Unit.

Financial Times, various issues.

Forbes, D., 1996, 'Regional influences on economic development: summary and overview', research paper, unpublished.

Holloway, N., 1997, 'Now's Your Chance: US Consumer-Goods Firms Gird for ASEAN Single Market', *Far Eastern Economic Review*, 30 January, pp. 48-49.

International Monetary Fund, 1997, 'Why Worry about Corruption', *Economic Issues 6*, drawing on IMF Working Paper 96/98 by Paolo Mauro.

Mohd. Haflah Piei and Noor Aini Khalifah, 1996, 'Vietnam in ASEAN: Trade, Investment and Other Economic Effects', *ASEAN Economic Bulletin*, Vol. 13, No. 12, November.

Nakatomi, Hisahsi, 1996, 'Economic relation of Vietnam with foreign countries after joining ASEAN - spread of "Flying Geese" pattern of development of Vietnam in the phenomenon of regional integration', paper presented at the AusAID/ NCDS Fourth Vietnamese Economy Workshop, Australian National University, Canberra, 2 December.

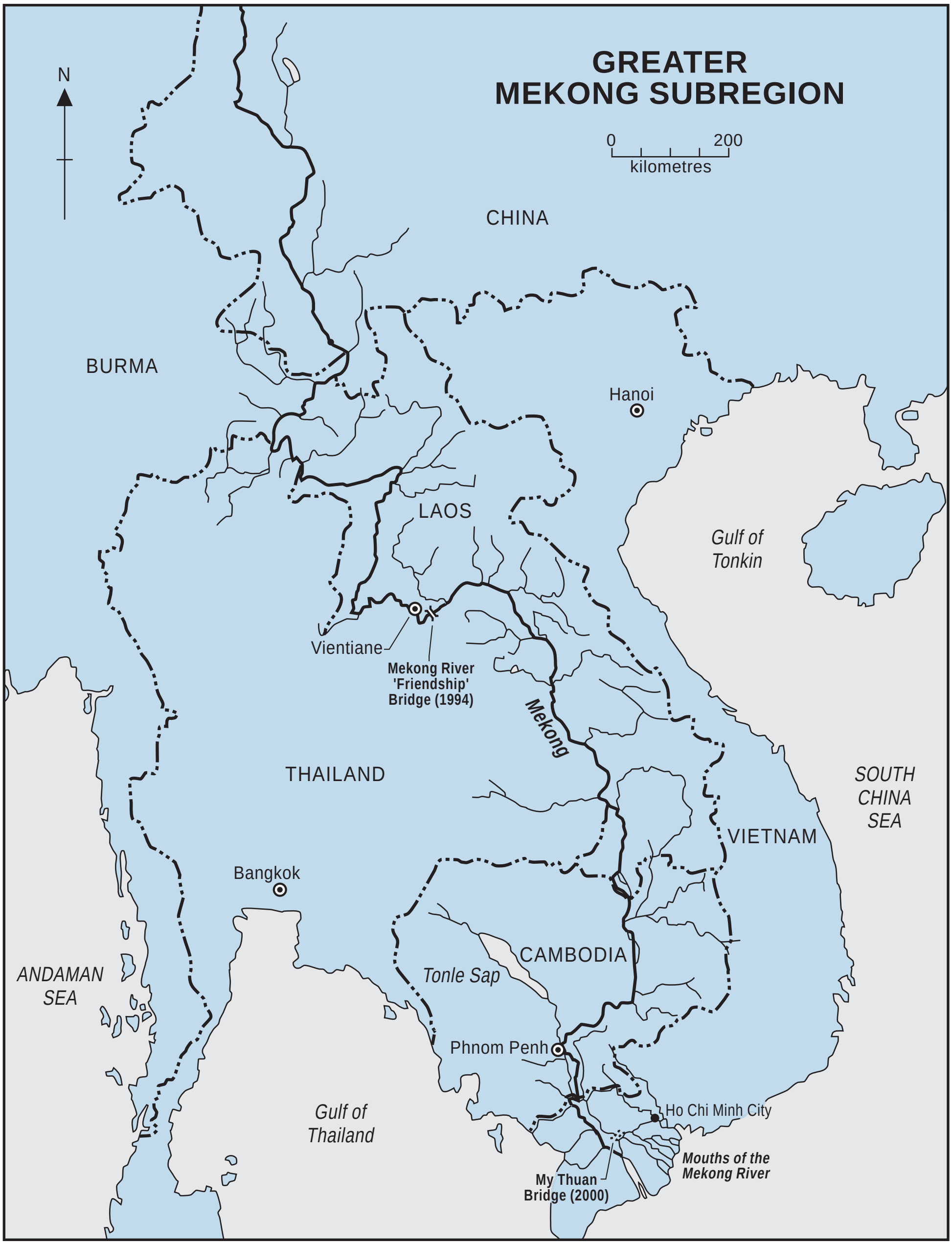
Oxley, A., 1996, 'The value of the ASEAN Free Trade Agreement to Australian business: a strategic assessment', based on a paper delivered at the Indonesia and the World Conference, the Indonesian Forum in Jakarta, 18 October.

Thayer, C.A., 1997, 'Making friends with all countries: Vietnam and the dilemmas of multilateralism', presentation to the meeting of the Australian Member Committee Council for Security Cooperation in the Asia Pacific, Australian National University, 5 February.

Truong, H. and Gates, C.L., 1996, 'Vietnam in ASEAN, Economic Reform, Openness and Transformation: An Overview', *ASEAN Economic Bulletin*, Vol. 13, No. 12, November.

World Bank, 1996, *Country Briefs*, World Bank, Washington DC.

____ 1993, *The East Asian Miracle*, Oxford University Press, New York.


GREATER MEKONG SUBREGION
N
0
200
kilometres
CHINA
BURMA
Hanoi
LAOS
Gulf of Tonkin
Vientiane
Mekong River 'Friendship' Bridge (1994)
Mekong
THAILAND
SOUTH CHINA SEA
VIETNAM
Bangkok
CAMBODIA
ANDAMAN SEA
Tonle Sap
Phnom Penh
Ho Chi Minh City
Gulf of Thailand
Mouths of the Mekong River
My Thuan Bridge (2000)

Chapter 15

GREATER MEKONG SUBREGION

The Mekong is the world's tenth largest river, measured by volume, and at 4 200 kilometres, the twelfth longest river (Richardson, 1997, p. 24). It is South East Asia's dominant geographical feature. The upper Mekong encompasses Yunnan province in southern China and parts of Burma. The lower Mekong flows through north east Thailand, Laos, Cambodia and southern Vietnam. The Mekong subregion covers a land area of 2.3 million square kilometres and supports a population of about 237 million (1996), including 60 million rice farmers and fisherfolk.[1]

Recent economic liberalisation and promotion of foreign trade and investment in the six countries of the Mekong subregion have created important opportunities to accelerate economic cooperation. A range of initiatives and increasing inflows of foreign capital from overseas development assistance and foreign direct investment[2] support moves to increase economic cooperation and develop the subregion as a 'corridor of commerce' (Mellor and Clewley, 1996).

In response to recent market-oriented economic reforms, the Mekong subregion countries have generally achieved rapid economic growth-averaging around 8 per cent per year in the past five years. Total GDP of the Mekong subregion economies was about US$236 billion in 1996. Per capita GDP ranged from around US$250 to $3 100 and averages close to US$1 000 (Table 15.1).

The Mekong subregion countries share borders, have close cultural and historical ties, and are rich in human and natural resources. The Mekong River, which either borders or flows through the six countries, offers significant navigation, irrigation, fisheries, hydro-electric power and flood control potential. The subregion has complementary natural resources, labour and capital, and if exploited, these could generate more vigorous growth (Asian Development Bank, 1996a, p. 1). Moreover, cooperative development of the Mekong River is essential to avoid the negative impact on downstream countries of uncoordinated upstream projects such as polluting industries, excessive irrigation and hydro-damming.

1 Vietnam claims 55 per cent of its rice output comes from the Mekong delta.

2 Net foreign direct investment disbursements for 1981 to 1993 were US$15.35 billion, with US$12.25 billion of it in Thailand. Commitments were considerably higher, for example, in Vietnam US$30 billion and in Laos US$6 billion. Disbursements have increased since 1993 and are around 25 per cent of commitments (Asian Development Bank, 1997, p. 47; Stensholt, 1997).

Table 15.1

Greater Mekong Subregion

Selected Social and Economic Indicators, 1996

	Cambodia	Laos	Burma	Thailand	Vietnam	Yunnan (PRC)
Population						
million	10.6	4.7	45.5	60.1	75.6	40.5
growth (% p.a., 1990-96)	3.4	2.2	1.9	1.2	2.2	1.6
Life expectancy at birth (years)	38 (1992)	55 (1992)	62 (1992)	69 (1990)	65 (1992)	69[c] (1990)
Infant mortality rate (per 1 000 live births)	117 (1992)	125 (1995)	98 (1992)	36 (1993)	38 (1994)	30[c] (1993)
Maternal mortality rate (per 100 000 live births)	700-1500[d]	656 na	123 na	na na	110 na	na na
Adult literacy (% of adult population)	38 (1992)	50 (1992)	82 (1992)	93 (1990)	92 (1992)	63[c] (1990)
Access to safe water (% of population)	37 (1995)	36 (1995)	32 (1992)	72 (1991)	30/70[e] (1992)	71[c] (1991)
GDP level						
US$billion	3.1	1.8	10.0	184.0	24.0	13.0
GDP/per capita (US$)	295	390	250	3 100	320	400
Real GDP Growth (%)	6.0	7.5	6.0	6.7	9.5	11.2
Agriculture	1.5	3.0	na	3.1	4.5	6.5
Industry	13.5	14.5	na	8.2	13.3	na
Services	7.7	10.7	na	6.1	11.1	na
Savings (% of GDP)	5.7	13.6	na	34.5	17.6	39.3[c]
Investment (% of GDP)	19.6	30.3	23.9	42.8	29.5	39.6[c]
FDI ($million)						
Committed (1992-96)	na	5181	na	33 523[b]	24 445	na
Disbursed (1992-96)	402	287	na	7 142[b]	5 920	na
Inflation rate (%)	10.0	12.8	25.2[a]	5.9	6.0	6.1[c]
Money supply, M2 (%)	33.0	23.1	41.4[a]	15.0	22.3	26.8[c]
Foreign trade						
Export growth (%)	13.6	-9.5	9.0	-0.1	30.4	1.5[c]
Import growth (%)	16.8	15.1	6.0	3.3	35.2	5.1[c]
Current account deficit (% of GDP)	13.9	17.9	6.4[a]	8.2	11.9	0.3[c]
External debt (% of GDP)	20.7	43.3	70.0[a]	44.0	38.2	13.3[c]
Fiscal balance (% of GDP)	-7.0	-9.1	-4.3[a]	2.5	-0.9	-0.2[c]
Revenue (% of GDP)	9.0	13.0	6.0[a]	18.3	22.5	10.8[c]
Expenditure (% of GDP)	16.0	22.1	8.6[a]	16.0	23.4	11.0[c]

Note: a. Figures are for 1995; b. Commitments for 1992 to 1996 are to the end of October, 1996. Disbursements are to the end of 1995; c. Figures for People's Republic of China; d. AusAID estimates; e. 30 per cent for rural and 70 per cent for urban residents. Figures may differ from those used elsewhere in this publication because of the different data sources used in each case.

Source: Asian Development Bank, 1997; Rollason, 1996.

ECONOMIC COOPERATION INITIATIVES IN THE SUBREGION

Governments, business and development assistance agencies are keen to promote subregional economic development. The growing intensity of private investment has spurred governments and relevant international organisations to develop a range of economic cooperation initiatives. Some initiatives are more likely to be implemented in the short to medium term than others (Stensholt, 1997).

The Greater Mekong Subregion Initiative

A major proposal is the Greater Mekong Subregion initiative, which started in 1992 supported by the Asian Development Bank. The initiative gathered momentum after a ministerial meeting in Hanoi in 1994 agreed to intensify efforts to promote economic cooperation in the subregion. It aims to promote economic cooperation between Vietnam, Laos, Cambodia, Burma, Thailand and China's Yunnan province.

The proposal has been boosted by overseas development assistance. Between 1992 and 1996, the Asian Development Bank provided over US$280 million in loans for priority projects, particularly in transport and energy, and US$7.6 million in technical assistance grants to support activities identifying programs and projects, and promoting consultation. The Bank expects to spend more than US$2 billion in the subregion by 2000 (Nette, 1997, p. A8). Bilateral donors such as Australia, Japan and the European Union, and the major multilateral financial and development assistance institutions such as the International Monetary Fund, the World Bank and the United Nations Development Program also provide capital and technical assistance. Australia's largest aid funded infrastructure project anywhere in the world is the My Thuan bridge across a lower Mekong tributary.

Priority sectors to develop include transport, tourism, energy, human resources, trade and investment, and telecommunications. Initially, the focus was on projects designed to enhance economic interaction, particularly in infrastructure and energy. Sector studies resulted in ministers agreeing on priority subregional projects. Each sector's masterplan sets these out; now many are at the implementation stage.

Because these projects require large investments, private sector participation is vital. Investment seminars with private sector players are being held in Asian, European and North American financial centres, and a Greater Mekong Subregion Business Forum involving national and ASEAN chambers of commerce and industry has been established. The Greater Mekong Subregion has sector working groups to carry forward detailed action between ministerial meetings. At the Seventh Ministerial Meeting in Manila in April 1997, it was agreed that future working groups will include meetings with the private sector. These policy level working groups increasingly attend to 'software' issues to develop appropriate legal, institutional and administrative frameworks in each sector (Stensholt, 1997).

The Mekong River Commission

The Mekong River Commission established in 1995 under the Agreement on Cooperation for the Sustainable Development of the Mekong River Subregion[3] is the latest restructuring of the Mekong Committee, which was first established in 1957, and is therefore the oldest Mekong subregion cooperation initiative.

With the support of donor countries (including Australia) and international development agencies, the Commission has initiated many programs and activities to develop the Mekong's resource potential. It provides principles for, and coordinates sustainable development, use, management and conservation of the water and other resources of the Mekong subregion to optimally use and mutually benefit from these resources, and to minimise harmful effects from natural occurrences and human activities (Lim, 1996). The Commission works closely with the Asian Development Bank to identify and initiate priority projects.

In mid 1996, the Commission was implementing nearly 50 programs or projects and another 50 proposals were seeking donor support. Their total cost is more than US$200 million, about half of which has been secured. Each year the Commission publishes the Mekong Work Program, providing details of programs and projects that cover the environment, irrigation, hydro-electric power, hydrology and human resources development. The Commission also helps prepare the Mekong Subregion Development Plan to provide a long term framework to develop resources.

The Commission promotes the sustainable development of the Mekong River's resources, particularly in the lower Mekong subregion. However, two years after its formation, critics say it has achieved few of its key objectives and is a 'marginalised' player in the Mekong's development (Nette, 1997, A8). China's limited role in formal cooperation undermines the Commission's effectiveness.[4]

ASEAN - Mekong Subregion Development Cooperation

The ASEAN Summit in Bangkok in December 1995 endorsed officially the concept of ASEAN-Mekong Subregion Development Cooperation; Malaysia played a prominent role (McGovern, 1996, p. 86). A basic framework for cooperation was agreed in June 1996, focusing on agriculture, tourism, infrastructure, utilities, energy, telecommunications, and trade and investment generating projects. The objectives aim to accelerate economic growth and development in the Mekong subregion and improve living standards, support moves to more market oriented economies, garner support from donor countries and multilateral organisations, and help Cambodia, Laos and Burma adjust to ASEAN membership.

Malaysia heads a group looking at subregional rail links and is funding a feasibility study now underway. Thailand heads a group looking at financing options, including a proposal to establish a Mekong Fund to promote investment by providing soft loans to governments and private investors. Project proposals also are being developed in agriculture and fisheries.

....

3 This agreement was signed by Laos, Cambodia, Thailand and Vietnam in April 1995. Burma and China attend meetings as observers but have not joined the Commission (Spencer, 1996a, p. 18).

4 The section of the Mekong flowing through Yunnan province contributes around 20 per cent of the river's flow.

Forum for the Comprehensive Development of Indochina

The Forum for the Comprehensive Development of Indochina is a Japanese initiative, formally established in 1995 in Tokyo. The Forum coordinates development activities of countries and multilateral agencies providing aid to Vietnam, Laos and Cambodia to enhance their efficiency and effectiveness. It has working committees on infrastructure and human resource development and a private sector advisory group. It commissioned the Asian Development Bank and United Nations Development Program to compile a compendium of all aid projects in the three countries to prevent duplication and identify areas that had been overlooked.[5]

The ‘Golden Quadrangle’

In the mid 1980s, provincial and chamber of commerce officials from Chiang Rai Province in northern Thailand proposed establishing closer economic links within the ‘Golden Quadrangle’ of Yunnan, Burma and Laos. The proposal, covering the upper Mekong subregion, gained a national profile in Thailand in early 1993. High level officials agreed to promote economic cooperation between the four countries. Since late 1993, however, action on the proposal has been minimal and has been overtaken by other initiatives, particularly the Greater Mekong Subregion initiative.

Other Mekong Initiatives

A range of other Mekong initiatives and programs involve to varying degrees governments and organisations in the subregion. Of note is the ASEAN Economic Ministers-(Japanese) Ministry of International Trade and Industry (AEM-MITI) program for Laos, Cambodia and Burma focusing on market economy transition, infrastructure, investment, trade and industry policies. New Zealand and Thailand have established a Mekong Institute at Khon Kaen in Thailand which will offer training programs and undertake policy research on the subregion. A Mekong Law Centre has been established with several research networks, for example the Mekong Development Research Network and the Mekong Dialogue for Sustainable Development. International organisations and aid agencies, including Australia’s AusAID, have established subregional programs, usually on a sector basis.

Initiative Overload?

The large number of initiatives provides grounds for optimism, indicating that many countries and organisations will assist in developing the Mekong subregion countries. However, the prospect of initiative overload causes concern, mainly because of the strain on the resources of the six countries. Concern about possible resource wastage and duplication prompted the six to request the Asian Development Bank to help coordinate and facilitate the various initiatives.

5 The *Compendium of Infrastructure Projects in Cambodia, Lao PDR and Viet Nam* was published by the Asian Development Bank in two volumes in September 1996.

PRIORITY PROJECTS

Development plans for the Mekong subregion countries vary enormously in size and practicability. They aim to create a foundation for sustained rapid growth and modernisation, particularly through infrastructure development. For example, the Asian Development Bank's master plan for the Greater Mekong Subregion initiative identifies projects, such as in transport, telecommunications and energy sectors. Participating countries have endorsed nearly 100 projects. The master plan calls for US$40 billion to be spent in the next 25 years on infrastructure development alone, to provide the basis for the subregion's economic development.[6]

However, the costs of subregional infrastructure far exceed the financial capacity of the six governments and official development assistance commitments. Many proposed projects require the support of the international financial institutions and the private sector. While at present the private sector is funding only 10 per cent of infrastructure investment, commercial investors may supply over half of the US$40 billion. However, so much private sector investment would seem improbable unless the investment environments in the subregion substantially improve.

Many of the projects identified in the Asian Development Bank's master plan are underway, including the US$280 million Theun Hinboun hydro-power project involving Laos and Thailand, and the upgrading of roads in Yunnan, Laos and Cambodia. Other projects are entering the implementation stage including projects in the environment, tourism, human resource development and trade and investment sectors.

Transport Infrastructure

Transport infrastructure receives top priority, especially roads, ports and airports, to facilitate crossborder trade.[7] The road network, in particular, will be important as currently, roads are very poor and unable to support anticipated volumes of traffic.

Most high priority projects in the transport sector focus on upgrading existing infrastructure rather than building from scratch. Priority road projects include:[8]

- upgrading the road linking Bangkok with Phnom Penh, Ho Chi Minh City and Vung Tau at an estimated cost of US$490 million. The project is entering the implementation stage, with detailed engineering studies being undertaken

6 This is only a small part of the US$1.2 trillion to $1.5 trillion that the World Bank estimates will need to be invested in infrastructure in the whole of East Asia in the next 25 years.

7 Crossborder trade is already considerable, although much (smuggling) is unregulated and unofficial. In the bordering mountainous regions of Thailand, Burma and Laos, the so-called Golden Triangle, drug trafficking is widespread. The Mekong subregion countries are liberalising trade and are likely to continue to do so as part of their commitments under the ASEAN Free Trade Area Agreement. This should expand legitimate trade in the subregion.

8 Details and estimated costs are taken from Asian Development Bank, 1996, *Compendium of Infrastructure Projects in Cambodia, Lao PDR and Vietnam.*

- developing a Thailand-Laos-Vietnam east-west corridor at an estimated cost of US$130 million[9]
- building a road linking Chiang Rai in Thailand and Kunming in Yunnan province via both Laos and Burma at an estimated cost of US$507 million to $829 million
- upgrading the Kunming-Lashio (Burma) road system at an estimated cost of US$629 million to $909 million.

Longer term interest includes developing and upgrading railways in the subregion. Existing rail is limited and has deteriorated because of lack of maintenance. Malaysia is funding a feasibility study for a railway from Singapore to Kunming in Yunnan province. Several routes are possible, with the total cost of the project estimated at US$7.12 billion to $8.15 billion if it is implemented before 2015.[10]

Top priority rail projects where work is underway include upgrading the Kunming - Hanoi rail link at an estimated cost of US$65 million, and building a 150 kilometre stretch of line across the Australian aid funded Mekong River 'Friendship' Bridge linking Thailand and Laos. The estimated cost is US$210 million.

Other proposals for subregional rail projects include the Yunnan - Laos or Burma - Thailand railway project, estimated to cost US$1.2 billion to $1.8 billion; the Thailand-Cambodia-Vietnam railway project, estimated at US$550 million; and the Yunnan-Burma railway project, estimated at US$0.7 billion to $1.2 billion (Asian Development Bank, 1996c, p. 81). Railway construction is expensive and railway infrastructure is currently lacking. Laos, for example, has no railway.

The subregion's port infrastructure generally is run down: berthing facilities are poor; cargo handling equipment is dilapidated; and operations are inefficient. Regional governments and donors are prioritising upgrading ports, developing inland water transport links (between Yunnan province, Burma, Laos and Thailand), and improving navigation in the Mekong Delta.

The Asian Development Bank proposed a number of projects to improve airports and establish new subregional air routes to facilitate transport, business and tourism links. Governments also are improving 'soft' infrastructure in the transport sector, including liberalising and harmonising rules and procedures governing crossborder access.

Energy

Development of the energy sector is a priority area within the Greater Mekong Subregion initiative. Hydro-electricity generation from the rivers has great potential to link subregion economies. Although the subregion is well endowed with potential

....

9 The Asian Development Bank Greater Mekong Subregion Cooperation Program identified three possible routes for the corridor. After a French funded feasibility study, the Vietnamese, Lao and Thai Governments decided to give priority to a route involving the construction of a second Mekong River bridge connecting Mukdahan with Savannakhet and proceeding to Danang or a possible new port at Cua Viet. The Japanese Government has agreed to help fund the project. If Burma joins, the route would connect the Pacific Ocean with the Indian Ocean at Moulmein (Theparat, 1997).

10 Singapore also is interested in the rail project, which is considered one of the most ambitious and long term of the various infrastructure projects proposed for the subregion.

energy resources, they are poorly developed and unevenly distributed. The Mekong River Commission estimates that Thailand will require over 88 per cent of the power to be generated from planned developments in the lower Mekong subregion, but 84 per cent of this potential lies in Laos and Cambodia. The subregion also has abundant coal deposits and promising oil and natural gas reserves.

Electrification levels in the subregion are low; only about 10 per cent of households in Vietnam, Cambodia and Laos have electricity. At current rates of growth, electricity demand in these countries will increase eight fold between 1993 and 2020. Many of the proposed projects in the energy sector involve power transmission and institutional strengthening as well as power generation. The following are priority hydro-electricity projects:

- the Xe Kong and Se San subregion project in Cambodia, Laos and Vietnam, with transmission interconnection between these countries and with Thailand
- a feasibility study of the Nam Tha project in Laos, with transmission interconnection with Thailand
- the Jinghong project in Yunnan with transmission interconnection with Thailand
- the Nam Theun subregion development in Laos, with transmission interconnection with Thailand and Vietnam
- the Salween subregion development in Burma and Thailand, with transmission interconnection between these countries
- the Theun Hinboun project in Laos, with interconnection between Laos and Thailand. This project is being implemented.

Developing subregional power generation and transmission systems is a longer term priority. Laos recently proposed that the Asian Development Bank coordinate a study of an interconnected high voltage transmission network that in the future could provide the basis for a subregional network. The Asian Development Bank currently is financing a study of this proposal, including the establishment of a separate Lao National Grid Company.

Telecommunications

Developing a modern telecommunications sector is essential to meet the needs of business and to promote more open, market-oriented economies. The state of telecommunications in each of the countries varies, although the international systems are generally much better than domestic systems. In Thailand, the private sector is engaged substantially in improving services in Bangkok and the provinces. Cambodia's telecommunications infrastructure requires urgent investment in both urban and rural areas. In Laos, the telecommunications system is being expanded and modernised; the focus is, however, on urban areas and very few lines are available in rural areas. In Vietnam, international telecommunications have improved but local telecommunications remain weak. Burma's internal and international telecommunications services are rudimentary and unreliable.

Large scale investment is needed to modernise telecommunications infrastructure and services. As this sector is well able to mobilise private sector capital, regional governments give priority to private sector involvement. For example, telecommunications projects in Phnom Penh, Hanoi and Ho Chi Minh City are being implemented with private sector participation, often in joint ventures with the state sector. Australia's Telstra is cooperating with the Governments of Vietnam and Cambodia to help develop telecommunications in the two countries.

The Greater Mekong Telecommunications Study, financed by Australia's AusAID, recommended a set of optical fibre loops under nine subregional projects. The East Loop linking Thailand, Cambodia and Vietnam will be the subject of an Asian Development Bank feasibility study France financed and will join Cambodia's optical fibre project Germany financed. Subregional training programs are promoted and a study on crossborder mobile phone communications is proposed.

Management of Water resources

Sustainably using the water resources of the Mekong River and its tributaries is another priority. Its water resources are largely under-used and could be further exploited to generate power, provide irrigation for food production, and increase navigation links. The Mekong River Commission has developed a comprehensive plan for jointly developing areas such as hydro-electricity generation, irrigation, flood control, drainage, navigation improvement, watershed management, fisheries and tourism. Proposed projects involve hydrological studies of the Mekong subregion, flood forecasting, control of soil erosion and development of water management models.

CHALLENGES

Developing cooperation between the six nations of the Greater Mekong Subregion requires a long term perspective. Political and economic challenges to realising the ambitious plans for the subregion are formidable. Despite their strong growth potential, the Mekong subregion countries, excluding Thailand, are still poor, with per capita incomes among the lowest in the world. Five of the countries are in transition to market based economic systems. The area is a mix of complex cultures and is experiencing rapid socioeconomic change. Political relations between the six riparian states are complex. As economic competition between them grows, it could frustrate efforts to promote economic cooperation. Upstream countries' use of the Mekong's resources may appear cavalier to the downstream ones. Concerns among the weaker economies about potential economic domination by the stronger ones could impede project implementation.

Inadequate Infrastructure

Inadequate roads, power, telecommunications and water supplies are common. These can add significantly to the cost of projects as investors may have to provide back-up power, water and other utilities. Additionally, governments increasingly recognise they must cooperate to remove non-physical barriers restricting the movement of goods and people across borders.

Financing Projects

Mobilising resources to finance the subregion's development requirements is an enormous challenge. Governments and donors increasingly recognise they will not be able to finance the scale of investment that is required without private sector involvement. Political stability; coherent and consistent industrial, investment and economic policies; transparent legislation allowing for the private sector to participate in specific areas of the economy; and foreign exchange available to repay offshore debt and repatriate profits therefore will be needed (Pike, 1996).

Obtaining project finance will be a great challenge for investors. The legal systems in these countries still are being developed. Vague laws defining property rights and differences in interpretation create uncertainty. The complexity of operating across more than one country, as many subregional projects propose, also brings with it increased political risk and makes finance approvals even more difficult to obtain. In addition, many infrastructure projects are very long term with low potential returns in the short to medium term, making it difficult to secure purely commercial financing. The rates of return private investors require could lead to higher tariffs than the subsidised rates the public sector infrastructure services providers currently charge, especially for electricity, rail and telecommunications services. While consumers will be able and willing to pay these tariffs in some sectors, in others they may not.

All this suggests that implementing many infrastructure projects may be slower than envisaged. The challenges however, also are creating new opportunities, as banks and professional advisers, accountants and lawyers are entering the markets of the subregion to help businesses deal with the difficulties they encounter.

Extensive Bureaucracy

Bureaucratic obstacles and delays are a significant challenge. Most of the countries have large, often poorly trained government bureaucracies with many public servants unfamiliar with market economies. Foreign businesses complain about an 'attitude problem' among officials accustomed to central planning (*Bangkok Post*, 2 March 1996) and investors complain about the bureaucracy, delays, lack of clear rules and uncertainties over contracts and property rights (Pike, 1996, p. 3). These can delay approvals and materials, adding costs and risks to development projects. Each Mekong subregion country has a different investment approval process; all of them are very time consuming.

Many challenges are part of the learning curve of developing economies but probably are more complex in the subregion because most countries are in transition to open, market economies. However, most foreign companies active in the subregion believe that while many problems exist, they cannot afford to wait until they are solved or they will miss important commercial opportunities open to early participants.

Environmental Management

Deforestation, soil erosion, siltation, salt intrusion in the delta, water pollution and loss of biodiversity are national concerns in developing the Mekong subregion. Environmental care will have important long term regional and global consequences. Scope exists to strengthen cooperation to sustain development in this sector despite rapid economic growth.

A main environmental concern is the potential effect on downstream fisheries[11] and water flows from constructing large dams upstream[12] and Laos' rapidly expanding hydro-electricity industry. The flooding of the (lake) Tonle Sap in Cambodia could affect drastically rural subsistence communities.

Deforestation is another important concern: about 500 000 hectares of forest in the Mekong subregion disappear every year (Asian Development Bank, 1996b). Legal and illegal logging, shifting cultivation and encroaching agricultural land reduce the forest cover. This is likely to seriously affect downstream watershed management in the Mekong subregion, particularly from siltation, soil erosion, climate change and flooding. Growing industrial pollution of the Mekong River is another problem.

OUTLOOK

Regional governments, established foreign investors, local businessmen and regional analysts all agree that potential for growth in the Mekong subregion is great: 'prospects are excellent-given the strategic location of the subregion and the sweeping structural reforms that have created a very positive environment for domestic and foreign investment' (Asian Development Bank, 1996b, p. iii). The subregion's human resources are extensive and offer low cost unskilled and semi-skilled labour.

Table 15.2

The Greater Mekong Subregion to 2020

Key Trends

Key indicator	1990	1995	2000	2010	2020
Population level (million)	213	234	255	300	348
Population growth rate* (% p.a.)	1.9	1.9	1.8	1.7	1.5
Urbanisation level (%)	23	27	30	38	50
Labour force level (million)	na	116	130	165	198
Labour force growth rate* (% p.a.)	na	2.5	2.4	2.2	2.0
GDP level (US$billion, in 1995)	135	202	295	636	1 250
GDP growth rate* (% p.a.)	na	8.0	8.0	8.0	7.0
GDP per capita (US$, in 1995)	710	875	1 156	2 120	3 600

Note: * Over preceding five years.

Source: Asian Development Bank, 1997.

11 In terms of fish biodiversity, the Mekong is the second most important river in the world (after the Amazon) with between 400 and 1 000 varieties of fish, most of which are migratory.

12 China has plans for at least seven dams in Yunnan province with a total capacity of 15 400 megawatts. The first, Manwan Dam, was completed in 1993 with a capacity of 1 500 megawatts. Construction of a second dam further downstream at Dachaoshan, with a capacity of 1 350 megawatts, began in 1996 (Chapman and Danning, 1996). A further nine dams are planned for the Mekong's tributaries, bringing the total output to 20 000 megawatts. One planned Chinese dam will be able to hold the entire flow of the upper Mekong (20 per cent of the total river) for up to six months (Spencer, 1996a, p. 18).

Based on the optimistic assumption of uninterrupted rapid growth, in 2020 the subregion is forecast to have a combined GDP of US$1 250 billion: agriculture will contribute less than 10 per cent; and services will contribute almost 50 per cent (Asian Development Bank, 1997, p. 43). If annual population growth is 1.9 per cent declining gradually to 1.5 per cent, the subregion will have 350 million people, with an average per capita GDP of US$3 600. Urban populations will double to 50 per cent. The labour force will grow rapidly to almost 200 million. Moreover, subregional economic cooperation is likely to help promote the investment attractiveness of the participating countries as a group, so the whole subregion becomes greater than the sum of its parts (Brimble, 1996, p. 3).

REFERENCES

Asian Development Bank, 1997, 'Article: GMS 2020', in *Greater Mekong Subregion Socio-Economic Review*.

____ 1996a, 'Economic cooperation in the Greater Mekong Subregion: an overview', paper presented to the Greater Mekong Growth Summit, Ho Chi Minh City, September.

____ 1996b, *Economic Cooperation in the Greater Mekong Subregion: Toward implementation*, Proceedings of the Third Conference on Subregional Economic Cooperation among Cambodia, People's Republic of China, Lao People's Democratic Republic, Myanmar, Thailand and Vietnam, Hanoi, April 1994, Asian Development Bank, Manila.

____ 1996c, *Compendium of Infrastructure Projects in Cambodia, Lao PDR and Viet Nam*, 2 vols, Forum for the Comprehensive Development of Indochina Working Committee on Infrastructure Development, Asian Development Bank, Manila.

Brimble, P., 1996, 'The Greater Mekong Subregion: a private sector perspective on recent developments', paper presented to the Greater Mekong Growth Summit, Ho Chi Minh City, September.

Brinsdon, J., 1996a, 'The Greater Mekong Subregion: Opportunities for Private Sector Participation', *Standard Chartered Viewpoints*, August.

____ 1996b, 'Sub-Regional corporate strategy: opportunities and challenges', paper presented to the Greater Mekong Growth Summit, Ho Chi Minh City, September.

Carter, 1997, personal communication with East Asia Analytical Unit.

Chapman and Danning, 1996, personal communication with East Asia Analytical Unit.

Lim, K.T., 1996, 'The Mekong River projects: present and future ones and potential impact on investments', paper presented to the Greater Mekong Growth Summit, Ho Chi Minh City, September.

Mellor, W. and Clewley, J., 1996, 'River of Dreams', *Asia Inc*., August.

McGovern, I., 1996, 'Regional Development in the Mekong Basin', in Stensholt, R. (ed.), *Development Dilemmas in the Mekong Subregion*, Monash Asia Institute, Monash University, Clayton, Victoria.

Nette, A., 1997, 'Wallowing in the backwater', *The Nation*, Bangkok, 4 April.

Pike, 1996, personal communication with East Asia Analytical Unit.

Rollason, Russell, 1996, 'Poverty and Participation in the Mekong Subregion', in Stensholt, R. (ed.), *Development Dilemmas in the Mekong Subregion*, Monash Asia Institute, Monash University, Clayton, Victoria.

Spencer, C., 1996a, 'Financial benefits to flow from river region development', *The Australian*, 5 December.

Stensholt, R., 1997, personal communication with the East Asia Analytical Unit.

Thaitawat, N. and Marukatat, S., 1996, 'Caution slows the Mekong', *Bangkok Post*, 2 March.

Theparat, C., 1997, 'Road link would increase trade', *Bangkok Post*, 25 April.

FURTHER READING

Amerasinghe, N., 1996, 'Statement by the Asian Development Bank to the Working Committee on Infrastructure Development Forum for the Comprehensive Development of Indochina', Sydney, 26-27 September.

Brady, D., 1996, 'The last frontier a Mekong River holiday? Tour operators see potential', *Asian Wall Street Journal*, 21 May.

Corben, R., 1996, 'Bank fights for Mekong forests', *The Australian*, 6 August.

Crampton, T., 1996, 'Mekong supplies new frontier for regional trade and red tape', *Asia Times*, 16 September, p. 4.

Dwyer, M., 1996, 'New habits for golden triangle', *Australian Financial Review*, 4 October, p. 4.

Grant, R.L., 1995, 'Greater Mekong', *World Link*, July/August.

Greater Mekong Task Force, 1996, 'Strategies for the development of the Greater Mekong Area', unpublished report submitted by the Greater Mekong Task Force, Ministry of Foreign Affairs, Tokyo.

Limeqeco, P., 1996, 'ADB plots course for Mekong', *Asia Times*, 4 March.

Nakajima, A., 1996, 'Statement Made at the Working Committee on Infrastructure Development Forum for the Comprehensive Development of Indochina', Ministry of Foreign Affairs, Tokyo, 26-27 September.

Richardson, M., 1997, 'Harnessing the mighty Mekong', *The Australian*, 28 April.

Spencer, C., 1996b, 'Challenge is to tap Mekong without being damned', *The Australian*, 6 September, p. 18.

Stensholt, R. (ed.). 1996, *Development Dilemmas in the Mekong Subregion*, Monash Asia Institute, Monash University, Clayton, Victoria.

Stewart, I., 1996, 'Mekong guidelines to test regional harmony', *The Australian*, 18 June, p. 26.

Chapter 16

AUSTRALIA ENGAGES AN EXPANDED ASEAN

Phenomenal growth in East Asia is likely to extend well into the next century, continuing the profound economic transformation of South East Asian nations including the new ASEANs. This chapter examines the business prospects and challenges for Australia as it engages an expanded ASEAN.

GROWTH FOLLOWS REFORM

The successful transition of the new ASEANs to prosperous market economies is not assured. However, the apparent determination of new ASEAN governments to integrate their economies with the region and fulfil commitments under the ASEAN Free Trade Area (AFTA) agreement lessens the likelihood of their halting or reversing economic reform for long. Continuing strong economic growth in East Asia should underpin strong GDP and trade growth in the new ASEAN economies, also providing a buffer for any sectoral adjustment costs of economic reform.

New ASEAN economies should continue to grow strongly provided Vietnam's, Laos' and Cambodia's Governments maintain the pace of reform, and Burma's Government accelerates reform. (See Chapter 5 - *Burma: Economy*.)[1] The ambitious short term growth scenario for the new ASEANs is achievable (Figure 16.1).

EAST ASIAN GROWTH PROSPECTS

The World Bank believes East Asia has enviable macroeconomic conditions and strong growth momentum, with fundamentals well established to sustain economic growth into the next century. It predicts East Asian growth overall will average over 8 per cent from 1997 with export growth between 10 and 15 per cent from 1997 (World Bank, 1996a).

East Asia, excluding Japan, accounts for only 8 per cent of global GDP, but attracts 17 per cent of world imports (World Bank, 1996a). For the remainder of the decade, it is expected to provide 20 per cent of world output growth and more than a quarter of the growth in global imports (World Bank, 1996a).

East Asia will continue to move into labour and skill intensive manufactured exports, anticipating that as these exports grow, imports would continue to expand 'with powerful complementarities both with resource-rich America and Australia, and technologically sophisticated and service-intensive producers in Japan, Europe and the United States' (World Bank, 1996a).

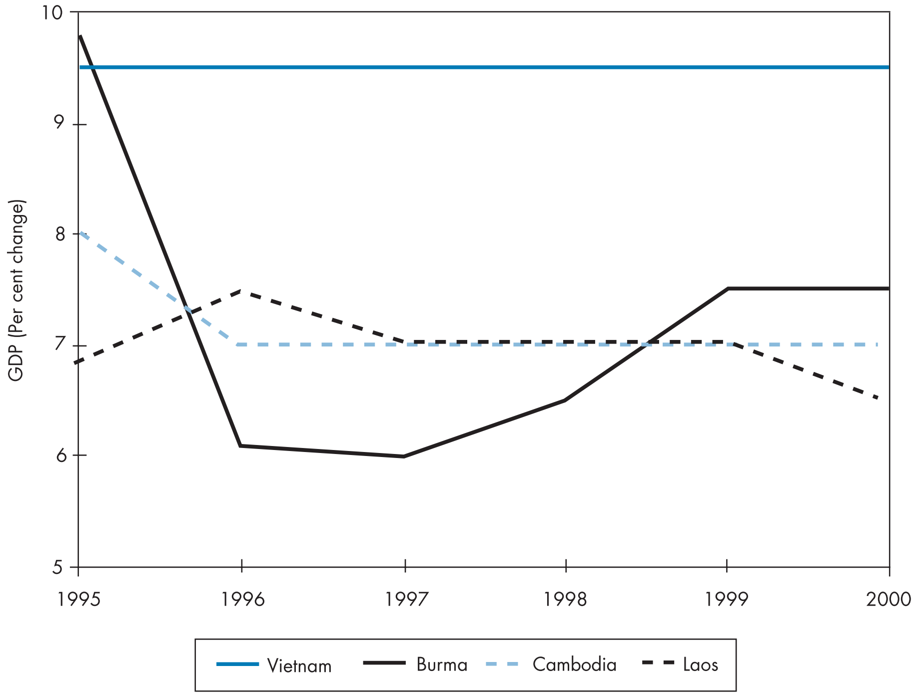
....

1 For an alternative low growth scenario see Figure 5.16.

Figure 16.1

Ambitious Growth Scenario

New ASEANs: Projected GDP Growth, 1995 to 2000



Source: World Bank, 1996a, p. 26; World Bank, 1997, p. 36; World Bank, 1996b, p. 53.

BUSINESS OPPORTUNITIES AND CHALLENGES

Continuing economic transformation of the new ASEANs, developing cooperation in the Mekong subregion and expanding cooperation in ASEAN and AFTA, create significant business opportunities and challenges resulting from:

- stronger GDP growth
- enhanced market access
- stronger trade growth
- increased international investor confidence
- increased promotion of large scale infrastructure projects
- increased natural resource development
- faster growth in developing legal, education, accountancy, banking and other services.

THE MEKONG SUBREGION[2]

Commercial opportunities in the Mekong subregion are enormous. Major potential lies in developing infrastructure as part of the Asian Development Bank's Greater Mekong Subregion initiative, particularly in the transport, telecommunications and energy sectors. In addition, considerable development potential is based on the Mekong subregion's natural resources and its large potential market.

Development Assistance

Many business opportunities in the Mekong subregion are linked directly and indirectly to international aid agencies. The major subregional donors in order are Japan, the World Bank, the Asian Development Bank, Australia and European Union countries. East Asian countries also are committed to promoting development in the Mekong subregion. As a result, large aid inflows probably will continue.

The Asian Development Bank is particularly active in promoting the subregion's development, supporting a recent series of seminars in international capitals to brief potential investors on planned projects in transport, energy and telecommunications as well as initiatives in tourism development, trade and investment, and environmental management. The compendia of aid projects in Vietnam, Laos and Cambodia, commissioned by Japan's Forum for the Comprehensive Development of Indochina, will help potential investors identify areas of opportunity (Asian Development Bank, 1996). (See Chapter 15 - *Mekong Subregion*.)

Natural Resources

The Mekong subregion is rich in coal, oil and natural gas and mineral reserves and has extensive hydro-electricity potential. It also has vast agriculture resources, and large aquaculture and fisheries potential. An increasing trend is to process these products domestically, generating investment opportunities in food processing, packaging and shipping.

Human Resources

The subregion's human resources also are extensive. Marked variations in labour costs generate opportunities for a subregional division of labour. Labour costs in Thailand, for example, are over 250 per cent higher than in Laos or Cambodia. Low labour costs and relatively high literacy and education rates in some subregional economies should combine with expanding power supplies and improving transport in future to make labour intensive manufacturing increasingly attractive.

Education and Training

Human resource development also will be a key new business frontier, particularly in the fields of language, management, commercial and technical education and training. These skills will be in high demand as these countries expand and globalise

[2] The Mekong subregion comprises China's Yunnan province, Burma, Laos, Thailand, Cambodia and Vietnam. (See Chapter 15 - *Mekong Subregion*.)

their services and industrial sectors. Human resource development also will strengthen governing institutions in the Mekong subregion countries.

Tourism

Tourism is another important area likely to benefit from subregional economic cooperation. The Mekong subregion countries have considerable tourism potential based on natural attractions and world class cultural sites. While each country attracts increasing numbers of tourists,[3] their potential as a single destination is far greater than that of any one country on its own. Several initiatives underway to promote the subregion as a single tourism destination are constrained by too few international hotels, tour operators and transport links, security problems in some areas and restrictions on crossborder movements. However, road and air transport links are improving and new foreign investment in hotels is significant.

IMPLICATIONS FOR AUSTRALIAN BUSINESS - MEKONG

Australian companies have expertise and are active in priority development areas in the Mekong subregion, particularly telecommunications, infrastructure, natural resources, environmental management and legal and financial services.

Australian companies need to be highly competitive and have a long term commitment to the region to succeed in bidding for large aid funded infrastructure projects and resource development projects. Regional and international competition for these projects is intense. Experience in privatising and corporatising public infrastructure will give Australian companies a competitive edge.

While many proposed projects may prove commercially viable, some plans should be viewed with caution; expectations need to be realistic. However, innovative financing packages, such as for Laos' Theun-Hinboun hydro-power project, are emerging. Risk allocation between public and private sector participants in infrastructure projects still is a major stumbling block for many joint projects. Legal and regulatory frameworks, while still weak, are improving, but doing business in these countries remains challenging. (See Chapters 3 - *Vietnam: Business*, 6 - *Burma: Business*, 9 - *Cambodia: Business* and 12 - *Laos: Business*.)

Subregional Strategies

While some Australian companies develop business activities country by country, others pursue regional strategies, including regional partnerships, by establishing operations in two or more countries. A successful project in one country, winning the trust and support of the national government, can be important in winning contracts in a neighbouring country. In engineering and construction, for example, with considerable investment in large infrastructure projects underway or planned for the

....

3 The number of visitors to Vietnam, Burma, Cambodia and Laos doubled in each of the past five years.

near future, the same select companies keep appearing as new projects are launched around the Greater Mekong Subregion.[4]

Similar market characteristics may make it advantageous for companies to adopt a total perspective on the Mekong subregion market, even if implementation is on a phased country-by-country basis. For example, the new ASEANs are in the process of moving to more open, market-oriented economies and have similar overall patterns of development, so experiences gained and techniques developed in one market often can be successfully employed in others.

The need for both goods and services in each market also is broadly similar. Significant opportunities exist for economies of scale in product and service support across the subregion. Improving transport and communications links and harmonising regulations on crossborder movements create opportunities to integrate distribution networks in the subregion. Membership of ASEAN for Burma, Cambodia and Laos should support the trend to integrate, suggesting the single market subregion will be more profitable than the sum of its separate parts.

GOING REGIONAL

International companies adopting a regional strategy in the Mekong subregion include:

- Telstra-telecommunications services
- 3M-consumer and industrial products
- Accor Group-tourism and hotels
- Daewoo Group-manufacturing and trading
- Krung Thai Bank, Citibank, Standard Chartered Bank-financial services
- Bank Pakong-real estate and industrial parks
- Kodak-film products

Source: The Brooker Group, 1996.

New Partnerships

New partnership opportunities are emerging. ASEAN companies, increasingly active in Mekong subregion countries, are likely to intensify their activities there with the expansion of ASEAN to include Burma, Cambodia and Laos. Emerging private sectors in the subregion also offer opportunities for new trade and investment partnerships to supply expanding domestic markets in each country and develop export markets.

....

[4] Some major Australian engineering and construction companies fit this profile.

ASEAN FREE TRADE AREA

The momentum of South East Asian regional integration has increased in recent years. Established ASEAN members will ensure expanding ASEAN and AFTA does not slow this process unduly. However, some economic reforms such as harmonising standards may be delayed and a 2, 3 (or more) track process could develop within AFTA. (See Chapter 14 - *Expanded ASEAN*.)

Initially, the addition of new ASEAN members will increase the degree of economic complementarity within ASEAN, by increasing the wage differential between member countries and greatly adding to ASEAN's natural resources base. Over time, some new ASEANs could begin to catch up economically to some of the original ASEANs, becoming competitors for their markets unless the latter already have progressed successfully to middle or higher level technology production. However, strong complementarities between countries like Singapore, Malaysia, and Thailand and the new ASEANs are likely to persist for many decades.

Single Large Market

Increasingly, ASEAN is likely to promote AFTA as a single, large market. While ASEAN members are apparently not inclined to create a formal ASEAN common market, some analysts interpreted the inaugural ASEAN Business Summit held in March 1997 as 'the latest initiative to create an informal ASEAN common market' (Earl, 1997). Whatever the intention, closer regional integration in South East Asia will have important implications for Australia's engagement with ASEAN and for Australian business.

Expanding AFTA enlarges the scope and breadth of tariff reductions and economic cooperation among ASEAN members, increasing commercial opportunities from:

- improving market access and increasing market size, as tariffs and non-tariff barriers fall
- falling business costs across the region from enhanced standards conformance and customs harmonisation
- increasing scope for regionally rationalising business activities.

Some opportunities also should arise directly or indirectly from ASEAN's infrastructure initiative, the Mekong Subregion Development Cooperation Program. (See Chapter 15 - *Mekong Subregion*.)

ASEAN BUSINESS SUMMIT

Six hundred business representatives from 30 countries attended the inaugural ASEAN Business Summit in Jakarta, 11-13 March 1997. The ASEAN Chamber of Commerce and Industry organised it and the Indonesian Chamber of Commerce and Industry hosted it. The theme was 'Linking Global Business Powers'. Delegates were told that by 2020, ASEAN would have 1 billion consumers and a combined economy of US$2 trillion.

Malaysia's Minister of International Trade and Industry called for the formation of ASEAN consortia, which, with the requisite capital and 'synergistic strength', could partner larger international companies (Earl, 1997). The Minister saw prospects for establishing consortia of shippers, offshore companies, franchise networks and financial groups that would be strong enough to compete internationally.[5]

The Minister also said the private sector needed to precede governments in identifying new areas for collaboration and that the next step would be to widen the scope of AFTA by adding regional schemes, noting that success would depend on the extent to which ASEAN business communities 'think and act ASEAN'.

Linking Markets

AFTA's trade and investment liberalisation agenda has encouraged Australia and New Zealand, who have progressed substantially in transforming their two markets into one larger market, to link CER and AFTA, for the mutual benefit of both markets.[6] Trade between the two regions doubled between 1990 and 1995, from US$7.9 billion to $15.9 billion. ASEAN accounts for 14 per cent of CER exports.

While governments are supportive (see box), the commercial possibilities have stimulated strong business interest in promoting AFTA-CER links. (See Appendix 16.1 - *AFTA-CER: Business in the Driver's Seat*). ASEAN's expansion adds to AFTA's diversity and enhances its attractiveness to Australian investors.

....

5 However, the Minister noted that for all ASEAN countries to benefit from these initiatives common ASEAN investment principles needed to be developed, national or preferential treatment extended to ASEAN investors, industrial sectors opened to ASEAN investors and the free flow of capital, skilled labour and technology permitted within ASEAN.

6 The Australia-New Zealand Closer Economic Relations Trade Agreement (CER) was established to forge closer trade and investment links between Australia and New Zealand.

AFTA-CER: MINISTERIAL LEVEL CONSULTATIONS

The Australian and New Zealand trade ministers meet informally with ASEAN counterparts in ASEAN Free Trade Area-Closer Economic Relations (AFTA-CER) talks annually to discuss facilitating trade cooperation between the two free trade areas. In addition, they promote the development of direct private sector links between ASEAN and CER countries.

At the second informal consultations between economic ministers from AFTA and CER countries held in Jakarta in September 1996, a MOU was signed on cooperation on standards and conformance between the ASEAN and CER countries. The Ministers also called on the private sector to identify constraints to trade and investment and encouraged joint studies to examine the medium to long term development of the AFTA-CER link.

IMPLICATIONS FOR AUSTRALIAN BUSINESS - ASEAN AND AFTA

Expanding ASEAN and AFTA creates opportunities and poses challenges for Australian business. The expanded ASEAN, as a group, is already an important trading partner for Australia. It is Australia's second largest export market after Japan, taking around 20 per cent (or US$12 billion) of total exports in 1996. Australia's imports from expanded ASEAN are roughly half the level of exports at just over US$6 billion.

AFTA's trade and investment liberalisation agenda will benefit companies operating within its boundaries. However, companies exporting products from Australia to ASEAN could face a significant competitive disadvantage due to discriminatory treatment of non-ASEAN countries (Table 16.1), although to date, many tariff reductions under AFTA have been on a non-discriminatory most favoured nation (MFN) basis (Oxley, 1996).

While many trade and investment barriers in the ASEAN region remain,[7] most impediments are faced by ASEAN and non-ASEAN companies. Both groups will benefit as impediments disappear under AFTA's trade and investment liberalisation timetable.

[7] At the request of the September 1996 meeting of ASEAN Economic Ministers and CER Trade Ministers, the ASEAN-CER Liaison Secretariat, compiled and made public a compendium entitled *Barriers to Trade and Investment in ASEAN*.

Table 16.1

AFTA May Discourage Australian Exports

Comparison of AFTA Rates in 2000 and Current MFN Rates Faced by Australia

Country	MFN rate faced by Australia 1997 (per cent)	Actual 1997 (per cent)	Intra-AFTA rate projected 2000 (per cent)	Projected 2003 (per cent)
Brunei	3.29	2.02	1.38	1.38
Indonesia	12.99	10.56	5.83	4.25
Malaysia	10.l1	5.38	3.23	2.58
Philippines	13.47	7.50	4.85	3.28
Singapore	0.00	0.00	0.00	0.00
Thailand	18.78	12.73	7.03	4.62

Source: Department of Foreign Affairs and Trade, 1997, ASEAN Secretariat.

Strategic Alliances

Expanding ASEAN to include the low cost, new ASEAN economies could provide Australian companies with opportunities to establish an ASEAN base, either alone or in a strategic alliance with an ASEAN company.

ASEAN governments encourage their companies to form strategic alliances with ASEAN and non-ASEAN partners. Encouraging these partnerships partly reflects the objective to increase ASEAN's share of global foreign direct investment. Australian firms forming mutually beneficial strategic partnerships offering increased competitiveness and capital or technology transfer can expect favourable treatment in ASEAN. For example, a consortium of companies from Vietnam, Malaysia and Australia could provide competitive advantages to each company by maximising its comparative advantage based on local knowledge, access to lower cost technical labour and regional sources of capital, or access to more advanced technologies and skilled personnel.

FUTURE OPPORTUNITIES

The new ASEANs are South East Asia's least developed economies. While success is not assured, integrating with the more advanced economies of the region provides their best opportunity to improve economic and administrative frameworks, overcome poverty and move up the development scale to become modern and prosperous nations of the twenty first century. The new ASEANs will remain difficult business environments for the forseeable future; however, conditions will improve gradually as the transition process in each country proceeds. Australian companies therefore should continue to seek opportunities in these emerging economies and make an important contribution to their economic advancement and to Australia's developing, mutually beneficial partnership with the region.

APPENDIX 16.1 AFTA-CER: BUSINESS IN THE DRIVER'S SEAT

AFTA-CER dialogue is mainly driven by business groups, albeit encouraged and supported by governments. The second AFTA-CER Business Forum, held in Jakarta on 10 March 1997 (the eve of the ASEAN Business Summit),[8] strengthened AFTA-CER business contacts. The meeting emphasised that an AFTA-CER link made both regions more attractive investment locations and increased their influence in world trade.

The meeting focused on building dialogue and laying markers for further cooperation. Agreement was reached to examine mechanisms and strategies to reduce barriers to trade and investment between AFTA and CER.

The meeting called on Australia and New Zealand to establish a coordinating body representing CER interests (Dwyer, 1997). Business delegates agreed to forward a report of the meeting to ASEAN economic ministers and CER trade ministers. The next meeting is scheduled to take place in Kuala Lumpur on 16 October 1997.

....

8 Australia was represented by senior officials from the Australian Food Council and MTIA.

REFERENCES

Asian Development Bank, 1996, *Compendium of Infrastructure Projects in Cambodia, Lao PDR and Viet Nam*, 2 volumes., Asian Development Bank, Manila.

Earl, G. 1997, 'Call for ASEAN consortiums', *Australian Financial Review*, 14 March, p. 24.

Oxley A. 1996, 'The value of the ASEAN Free Trade Agreement to Australian business: a strategic assessment', report presented to a conference on Indonesia and the World, hosted by the Indonesian Forum, Jakarta, 18 October.

World Bank 1996, 'Is the East Asian miracle over?', press statement, Washington DC.

___ 1996a, 'Vietnam: Fiscal decentralisation and the delivery of rural services', press statement, Washington DC.

___ 1996b, 'Cambodia: from recovery to sustainable development', press statement, Washington DC.

GLOSSARY OF ACRONYMS AND FOREIGN TERMS

AEM - MITI	ASEAN Economic Ministers - Ministry of International Trade and Industry (Japan)
AFTA	ASEAN Free Trade Area
AIA	ASEAN Investment Area
APEC	Asia Pacific Economic Cooperation
ASEAN	Association of South East Asian Nations
ASEAN(10)	Malaysia, Philippines, Singapore, Indonesia, Thailand, Brunei, Vietnam, Burma, Laos, Cambodia
ASEAN(6)	Malaysia, Philippines, Singapore, Indonesia, Thailand, Brunei
AusAID	Australia's development cooperation agency
BLDP	Buddhist Liberal Democratic Party (Cambodia)
BOT	build-operate-transfer
BSPP	Burma Socialist Program Party
BT	build-transfer
BTO	build-transfer-operate
CAPE	Cambodian Assistance to Primary Education
CDC	Council for the Development of Cambodia
CEPT	Common Effective Preferential Tariff
CGDK	Coalition Government of Democratic Kampuchea (Cambodia)
CIFEC	Committee for Investment and Foreign Economic Cooperation (Laos)
CMEA	Council for Mutual Economic Assistance, also called Comecon
CPC	Committee for Planning and Cooperation (Laos)
CPP	Cambodian People's Party (successor to KPRP)
DDSI	Directorate of Defence Services Intelligence (see MI, Burma)
dong	Vietnamese currency unit
DNUM	Democratic National Union Movement (Cambodia)
doi moi	'Renewal', or sometimes 'renovation', Vietnam's program of political and economic reform
EAAU	East Asia Analytical Unit
EU	European Union
FDI	foreign direct investment
FEC	Foreign Exchange Certificate

FIMC	Foreign Investment Management Committee (forerunner of CIFEC, Laos)
FUNCINPEC	(French acronym) National United Front for an Independent, Neutral, Peaceful and Cooperative Cambodia
GDP	Gross Domestic Product
GNP	Gross National Product
GSO	General Statistics Office, Vietnam
GSP	Generalised System of Preferences
ICC	International Chamber of Commerce
IMF	International Monetary Fund
kip	Lao currency unit
KNP	Khmer Nation Party (Cambodia)
KPNLF	Khmer People's National Liberation Front (Cambodia)
KPRP	Khmer People's Revolutionary Party (Cambodia)
kyat	Burmese currency unit
LDP	Liberal Democratic Party (Cambodia)
LORC	Law and Order Restoration Council (Burma)
MFN	most favoured nation
MI	Military Intelligence (Burma)
MITI	Ministry of International Trade and Industry (Japan)
MOGE	Myanmar Oil and Gas Enterprise (Burma)
Molinaka	Movement for Cambodian National Liberation (Cambodia)
MOU	Memorandum of Understanding
NAFTA	North American Free Trade Area
NLD	National League for Democracy (Burma)
NUF	National United Front (Cambodia)
PMC	(ASEAN) Post Ministerial Conference
PPP	Purchasing Power Parity
PRK	People's Republic of Kampuchea
RCAF	Royal Cambodian Armed Forces
riel	Cambodian currency unit
SOC	State of Cambodia
SLORC	State Law and Order Restoration Council (Burma)
SOE	State-owned enterprise
UMEH	Union of Myanmar Economic Holdings Limited (Burma)
UNCITRAL	United Nations Commission on International Trade Law
UNIDO	United Nations Industrial Development Organisation
UNTAC	United Nations Transitional Authority in Cambodia
USDA	Union Solidarity and Development Association (Burma)
Viet kieu	Overseas Vietnamese
WTO	World Trade Organisation

INDEX

A

B

L

M

N

P

R

S

T

U

V

Y

ALSO BY THE EAST ASIA ANALYTICAL UNIT

Australia and North-East Asia in the 1990s: Accelerating Change
Published February 1992 (ISBN No. 0 644 24376 7), 318 pages, A$29.95

Korea to the Year 2000: Implications for Australia
Published November 1992 (ISBN No. 0 644 27819 5), 150 pages, A$19.95

Grain in China
Published December 1992 (ISBN No. 0 644 25813 6), 150 pages, A$19.95

Southern China in Transition
Published December 1992 (ISBN No. 0 644 25814 4), 150 pages, A$19.95

Australia's Business Challenge: South-East Asia in the 1990s
Published December 1992 (ISBN No. 0 644 25852 7), 380 pages, A$34.95

Changing Tack: Australian Investment in South-East Asia
Published March 1994 (ISBN No. 0 644 33075 9), 110 pages, A$19.95

ASEAN Free Trade Area: Trading Bloc or Building Block?
Published April 1994 (ISBN No. 0 644 33325 1), 180 pages, A$26.95

India's Economy at the Midnight Hour: Australia's India Strategy
Published April 1994 (ISBN No. 0 644 33328 6), 260 pages, A$34.95

Expanding Horizons: Australia and Indonesia into the 21st Century
Published June 1994 (ISBN No. 0 644 33514 9), 350 pages, A$34.95

Subsistence To Supermarket:
Food and Agricultural Transformation in South-East Asia
Published August 1994 (ISBN No. 0 644 35093 8), 376 pages, A$37.95

Overseas Chinese Business Networks in Asia
Published August 1995 (ISBN No. 0 642 22960 0), 362 pages, A$39.95

Growth Triangles of South East Asia
Published November 1995 (ISBN No. 0 642 23571 6), 136 pages, A$26.95

Iron and Steel in China and Australia
Published November 1995 (ISBN No. 0 642 24404 9), 110 pages, A$26.95

Pacific Russia: Risks and Rewards
Published April 1996 (ISBN No. 0 642 24521 5), 119 pages, A$26.95

Asia's Global Powers: China-Japan Relations in the 21st Century
Published April 1996 (ISBN No. 0 642 24525 8), 158 pages, A$26.95

China Embraces the Market: Achievements, Constraints and Opportunities
Published April 1997 (ISBN No. 0 642 26952 1), 448 pages, A$39.95

A New Japan? Change in Asia's Megamarket
Published June 1997 (ISBN No. 0 642 27131 3), 512 pages, A$39.95

Reports can be obtained from major bookstores and
Commonwealth Government Bookshops Australia-wide.

Trade enquiries, contact Gary Allen Pty. Ltd.
Telephone 02 9725 2933, Facsimile 02 9609 6106

Telephone Order Enquiries: 06 261 3114 Facsimile 06 261 3321

Internet: http:/www.dfat.gov.au/bookshelf/
(provides access to Executive Summaries and Order Form)

The Unit also produces a range of Working Papers,
available from above contact numbers, A$15 each.

CONTENTS

CAVEAT

Burma

The Australian Government remains deeply concerned at the Burmese military regime's continuing violation of human rights and its relentless suppression of fundamental freedoms. The Government takes the firm view that without substantial progress in these areas, Burma's development as a nation is significantly constrained.

The Australian Government maintains a principled position of neither encouraging nor discouraging commercial ties with Burma. Nothing in this report should be taken as in any way diminishing this stance or otherwise affecting the Government's approach to Burma. Chapter 6 dealing with Burma's business environment is included for the sake of completeness but the EAAU did not conduct a survey of Australian and other foreign investors in Burma.

Names

Names in this report are rendered according to common Australian or international usage; 'Laos' rather than 'Lao PDR', for example.

Maps

Maps are included in this report as visual aids. They do not define the Australian Government's position on disputed territory in South East Asia.

Economic transformation in the new ASEAN's — Vietnam, Burma, Cambodia and Laos — generates forces for profound political and social change. This report assesses the prospects for economic reform and growth, good governance, political stability and a business-friendly environment in each nation, drawing out the opportunities and challenges for Australia.

The report also examines the political, economic and commercial implications of an expanded ASEAN, uniting all ten South East Asian nations in a single organisation and potentially as a single market.

The New ASEANs is designed for Australian business people seeking new opportunities in the region and for government, academics and the general reader seeking a better understanding of the political and economic prospects of these four emerging regional players.

ISBN 0-642-27148-8

9 780642 271488