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Trade and Investment in the Greater Mekong Subregion: Remaining Challenges and the Unfinished Policy Agenda

Jayant Menon and Anna Cassandra Melendez
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We are grateful for comments from Prema-Chandra Athukorala, Vo Trih Thanh, and participants at the Regional Conference on GMS: From Geographical Corridor to Economic Corridor at ISEAS, without implicating them in any way. Address comments or queries to jmenon@adb.org

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Abstract

The Greater Mekong Subregion (GMS) is one of the most successful stories of economic transition and integration among developing countries. Strong rates of economic growth since the early 1990s have been fueled by increased trade and foreign direct investment (FDI) in the subregion. This economic progress has translated into marked improvements in living standards and human development outcomes, and dramatic reductions in poverty. Unilateral policy reforms and greater economic cooperation through the GMS Program in particular have led to positive trade and investment growth. More recently, membership in the World Trade Organization (WTO) and participation in the Association of Southeast Asian Nations (ASEAN) Free Trade Agreement (AFTA) and other preferential trading agreements have driven reforms. Despite these achievements, the trade policy reform agenda remains incomplete. It is important for the GMS members of AFTA to multilateralize their preferences in order to avoid trade diversion and deflection, and remain open to global trade. This should also be the objective of the various ASEAN+1 bilateral free trade agreements (FTAs). Retaining a multiple-tier tariff system is unlikely to mitigate revenue loss, but could unnecessarily burden an already stretched bureaucracy, or lead to more rent-seeking. In order to reduce vulnerability to external shocks, diversification of both export commodities and markets are being considered. Intra-sectoral diversification of export commodities is likely to be more viable and less costly than inter-sectoral diversification. It is unlikely, however, that any rebalancing of growth from foreign to domestic demand would be required in the GMS countries in order to increase resilience to external shocks.

Keywords: Greater Mekong Subregion (GMS); Cambodia; the Lao People's Democratic Republic (Lao PDR); Myanmar; Thailand; Viet Nam; trade and investment; regional economic integration; regional trade agreements; economic diversification

JEL Classification: F15, F59, O53

1. Introduction

The Greater Mekong Subregion (GMS) is often described as one of the most successful stories of economic transition and integration among developing countries.¹ For much of the 1970s and early 1980s, while the rest of Asia was busy growing and integrating with the global economy, the GMS remained extremely poor and isolated—the outcome of years of conflict and central planning in Cambodia, the Lao People’s Democratic Republic (Lao PDR), Myanmar, and Viet Nam. Beginning in the mid-1980s, however, the “CLMV” countries began a gradual process of reform and liberalization.

The CLMV countries’ transition towards a market-based system has allowed the GMS to reinvent itself as one of the most dynamic subregions in the world. In the last 20 years, the GMS has grown at a faster pace than the whole of East Asia and the Pacific, with much of this growth coming from the CLMV countries. While Thailand and the rest of Asia reeled from the impact of the 1997/98 Asian financial crisis, the CLMV countries continued to post positive growth, given their limited connection to global financial markets at the time (Figure 1). While these countries were not as immune to the more recent global financial crisis (GFC), with sharp drops in growth that have begun to reverse only recently, this underlies a decade of growing openness and integration with the global economy. The sustained economic growth leading up to the GFC has been accompanied by a gradual shift away from agriculture, which has traditionally accounted for the biggest share of value added in the CLMV countries. Across the subregion, industry, manufacturing, and services now account for a bigger share of value added (Table 1).

This economic progress has translated into marked improvement in human development outcomes across the subregion (Table 2). Gross domestic product (GDP) per capita in constant 2000 \$ has more than doubled in Cambodia, the Lao PDR, and Viet Nam since the early 1990s. Infant mortality rates have declined rapidly in the last 20 years, while literacy rates have shown gradual improvement since 2000. Prior to the GFC, poverty rates—the poverty headcount ratio at \$1.25 a day at purchasing power parity— were also falling dramatically across the subregion, but 2009 data from Thailand suggests that poverty rates may have increased temporarily in the wake of the crisis.

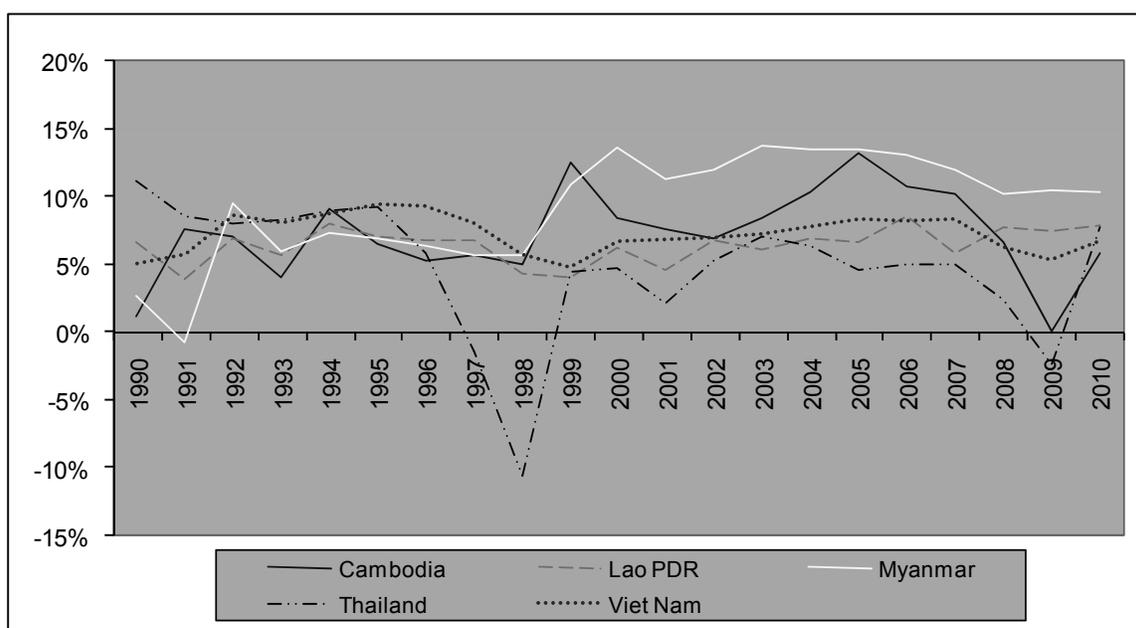
Strong rates of economic growth have been fueled in part by increased trade and investment in the subregion. Since the beginning of the 1990s, increased trade has played a huge part in spurring growth in the GMS, with exports playing a critical role in the subregion’s recovery after the 1997/98 Asian financial crisis. Just as trade has increased throughout the region, foreign direct investment (FDI) inflows have also risen dramatically over the last 2 decades.

¹ The Greater Mekong Subregion Economic Program was initiated by the Asian Development Bank (ADB) in 1992. The original members of the GMS program were Cambodia, Lao PDR, Myanmar, Thailand, Viet Nam, and Yunnan Province of the People’s Republic of China (PRC). In 2004, Guangxi Zhuang Autonomous Region of the PRC also joined the GMS. Due to the lack of provincial data for Yunnan and Guangxi, this paper focuses on the five member countries of the GMS.

These positive developments notwithstanding, a number of critical challenges continue to limit the subregion's potential to reap gains from trade and investment. This paper explores these challenges and identifies key elements of the unfinished policy agenda that need to be addressed.

The paper is organized into five sections. Following the introduction, Section II looks at the evolution of trade and investment policy and economic cooperation in the GMS countries, highlighting policy changes that have helped spur trade and investment growth. Section III brings together available data to examine the changing structure of trade and investment in the GMS. Section IV examines remaining challenges and identifies key elements of the unfinished policy agenda. A final section concludes.

Figure 1: GDP Growth in the Greater Mekong Subregion, 1990–2010



Lao PDR = Lao People's Democratic Republic.

Source: Asian Development Bank Statistical Database System (SDBS).

Table 1: Economic Growth and Restructuring in the Greater Mekong Subregion

Country/ Region	Real GDP growth (% constant \$ 2000)													
	1990- 1994		1995- 1999		2000- 2004		2005- 2008		2009		2010			
	Agriculture		Industry		Manufacturing		Services							
Cambodia	-	6.9	8.5	9.9	1.9	6.7	49.6	35.3	14.8	22.6	9.5	15.0	35.6	42.0
Lao PDR	6.1	6.4	6.0	7.7	7.5	8.4	55.7	34.7	19.2	28.2	14.3	9.3	25.1	37.1
Myanmar	5.1	7.2	12.9	13.2	-	-	60.0	48.3	9.9	16.2	6.9	11.6	30.1	35.4
Thailand	9.0	1.5	5.1	4.3	2.3	7.8	9.5	11.6	40.7	43.3	29.9	34.1	49.7	45.1
Viet Nam	7.3	7.5	7.2	7.8	5.3	6.8	27.2	20.9	28.8	40.2	15.0	20.1	44.1	38.8
East Asia & Pacific (developing)	9.5	3.6	4.1	5.2	7.4	9.6	19.3	11.3	44.3	45.0	30.9	31.7	36.5	43.4

Lao PDR = Lao People's Democratic Republic.

Note: ¹ Data for Lao PDR are for 2008.

Source: World Bank World Trade Indicators 2009/10 and World Development Indicators Online, April 2011.

**Table 2: Socioeconomic and Poverty Indicators
in the Greater Mekong Subregion, 1990–latest**

Country/Region	GDP per capita (constant 2000 \$)		Infant mortality rate (per 1,000 live births)		Literacy rate, adult total (% of people ages 15 and above)		Poverty headcount ratio at \$1.25 a day (PPP, % of population)	
	1990	2010	1990	2009				
Cambodia	209.8 ¹	550.9	85.3	68	67.3 (1998)	77.6 (2008)	48.6 (1994)	28.3 (2007)
Lao PDR	224.2	532.9	108.3	45.8	60.3 (1995)	72.7 (2005)	55.7 (1992)	33.9 (2008)
Myanmar	-	-	83.6	53.8	89.9 (2000)	92 (2009)	-	-
Thailand	1,400.3	2,751.5	26.5	12	92.7 (2000)	93.5 (2005)	5.5 (1992)	10.84 (2009)
Viet Nam	226.9	711.1	39.1	19.5	90.3 (1999)	92.8 (2009)	63.7 (1993)	13.1 (2008)
East Asia and the Pacific (developing)	484.4	2,103.9	41.3	21.4	90.8 (2000)	93.5 (2008)	50.8 (1993)	16.8 (2005)

GDP = gross domestic product, PPP = purchasing power parity.

Note: ¹ Cambodia data for 1993.

Source: World Bank World Trade Indicators Online, 2009/10, World Bank Development Indicators Online, April 2011.

2. Evolution of Trade and Investment Policy and Economic Cooperation in the Greater Mekong Subregion

With the exception of Thailand, the GMS were closed off to external markets until the late 1980s. Since that time, trade and investment reforms have been an integral part of the CLMV's efforts to move away from central planning and toward a market-based economy. The trade and investment regimes of the three countries have gone through several changes as part of the ongoing policy of transition toward market-oriented economies. The GMS has also been quick to seize opportunities for economic cooperation, and has been actively engaged in negotiations of preferential trade agreements.

2.1. Trade and Investment Policy: Early Unilateral Reforms

The opening up of Cambodia, the Lao PDR, and Viet Nam to trade and investment occurred almost concurrently in the late 1980s. Cambodia's government was the first to embark on a market-oriented reform process in 1985. The Cambodian government abolished the state monopoly for foreign trade in 1987 and allowed the private sector to engage in foreign trade in 1989 (ADB 2006). The government also promulgated a liberal foreign investment code in July 1989, and a National Investment Council was set up in 1991 with the task of reviewing all foreign investment applications.

The outcome of these reforms was somewhat lackluster, however, and perhaps unsurprising given continued warfare within the country. As an outcome of the United Nations (UN)-led peace process, elections were held in July 1993 and a multi-party democratic government was established in September 1993. This helped accelerate the process of economic reform in Cambodia. The foreign investment regime in Cambodia underwent an overhaul in 2003. The revised Law on Investment came into force on 27 September 2005, and represented a major attempt to equalize incentives for foreign and local investors, achieve greater transparency in incentives provided, and minimize distortions and delays arising from policymaker discretion. Meanwhile, quantitative restrictions on trade were abolished and import tariffs were progressively streamlined.

In the Lao PDR, the process of transition to a market-oriented economy began in 1986 with the implementation of the New Economic Mechanism, a major program of economic reforms. Tariffs were lowered soon after the reforms were adopted. A major reduction was implemented in 1995 when a complex multiple tariff rate system with a 150% maximum rate was replaced by a simpler six-band structure (ADB 2006). A Foreign Investment Code was passed in July 1988 and the Foreign Investment Management Committee (FIMC) was set up under the direct purview of the prime minister to act as the apex agency responsible for approving, monitoring, and promoting FDI. At the initial stage, the prime objective of the FDI policy in the Lao PDR was to engage foreign investor participation in restructuring state-owned enterprises. The Investment Code was supplanted by the Law on Promotion and Management of Foreign Investment in July 1994, which was again substantially revised in October 2004.

Foreign investment is permitted in all business sectors, with 100% ownership allowed in most sectors, except in mining and energy projects in which the Government contributes to share capital or retains the right to buy a pre-agreed share of equity. In joint ventures, foreign equity participation is required to be at least 30% of total invested capital.

The opening of the economy to FDI was part of Viet Nam's *doi moi* (renovation) reforms initiated in 1986. Procedures for the approval of investment projects were streamlined and fresh investment incentives were granted under the Law on Foreign Investment enacted in 1996.

Meanwhile, in the area of trade reform, Viet Nam enacted the Law on Import and Export Duties in 1988; in 1992, it replaced the original import tariff schedule with a detailed, consolidated schedule based on the Harmonized System of tariff nomenclature. The tariff structure was progressively fine-tuned, and the maximum tariff rate was reduced from 200% in 1997 to 113% in 2004. Viet Nam also abolished quantitative restrictions and converted to tariff rate quotas for some products (ADB 2006).

2.2. Membership in Economic Cooperation and Trade Agreements

The adoption of these unilateral policy reforms set the stage for increased trade and investment in the GMS. However, recognition of the fact that these unilateral efforts could only achieve so much provided an important impetus for GMS countries to engage in economic cooperation agreements. These agreements have increasingly been used as a tool for overcoming constraints in infrastructure development and trade facilitation, as well as providing leverage for pursuing further economic reforms.

2.2.1. The Greater Mekong Subregion Program

The earliest of these agreements was the GMS Economic Program initiated by the Asian Development Bank (ADB) in 1992. The original members of the GMS program were Cambodia, the Lao PDR, Myanmar, Thailand, Viet Nam, and Yunnan Province of the People's Republic of China (PRC). In 2004, Guangxi Zhuang Autonomous Region of the PRC also joined the GMS.

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

As a program of market-based integration, the GMS agenda has concentrated on the provision of physical infrastructure with public good characteristics (e.g., cross-border infrastructure). Indeed, essential infrastructure of all types remains underdeveloped in most of the GMS economies, and the GMS program has focused on overcoming this constraint. Initiatives such as the East–West, North–South, and Southern economic corridors are creating a network of roads that connect the region, reducing the cost of transporting goods and people from one corner of the region to the other. Options for

interconnecting power transmission and developing fiber optic transmission links—both covered through the GMS flagship programs on power and telecommunications—also fall within the geographic scope of these corridors.

Apart from hardware in the form of physical infrastructure, the GMS program has also tried to address complementary software issues. A key initiative towards this end is the Cross-Border Transport Agreement, a comprehensive multilateral instrument that supports a range of measures to facilitate trade and investment, which in turn promotes integration. These include:

- (i) one-stop customs inspection;
- (ii) cross-border movement of persons (e.g., visas for persons engaged in transport operations);
- (iii) transit traffic regimes, including exemptions from physical customs inspection, bond deposit, escort, and phytosanitary and veterinary inspection;
- (iv) eligibility requirements for road vehicle cross-border traffic;
- (v) exchange of commercial traffic rights; and
- (vi) infrastructure, including road and bridge design standards, road signs, and signals (ADB 2009a).

Emerging transport networks and economic corridors in the subregion are transforming its economic geography. Enhanced connectivity, along with cooperation in transport and trade facilitation, has been associated with an eleven-fold increase in intra-regional trade since the Program's inception in 1992. Priority infrastructure projects worth around \$10 billion have either been completed or are being implemented. As connectivity between GMS countries improves, their linkage with the region as a whole is also enhanced. For example, when the economic corridors are completed, it should be technically feasible for goods to be transported by land from Singapore through Malaysia to anywhere in the subregion.

While the availability of cheap and trainable labor in the GMS has been a key factor for promoting trade and FDI, it is not the only determining factor. The availability of a wider array of complementary inputs, including better trade facilitation and high-quality infrastructure and logistics, are critical in making the trade and investment environment efficient by world standards.

Despite the achievements of the GMS program in this area, a lot more remains to be done. Tables 3 and 4 reveal considerable variation in trade facilitation and logistical performance across the GMS countries, with Thailand and Viet Nam performing better than the CLM countries.

Table 3: Export and Import Costs and Documentary Requirements, 2005–2010

Indicator	Country	2005	2006	2007	2008	2009	2010
Cost to export (\$ per container)	Cambodia	736	722	722	732	732	732
	Lao PDR	1,420	1,420	1,750	1,860	1,860	1,860
	Myanmar	–	–	–	–	–	–
	Thailand	848	848	615	625	625	625
	Viet Nam	468	468	468	533	555	555
Cost to import (\$ per container)	Cambodia	816	852	852	872	872	872
	Lao PDR	1,690	1,690	1,930	2,040	2,040	2,040
	Myanmar	–	–	–	–	–	–
	Thailand	1,042	1,042	786	795	795	795
	Viet Nam	586	586	586	606	645	645
Documents to export (number)	Cambodia	8	11	11	11	11	10
	Lao PDR	11	11	9	9	9	9
	Myanmar	–	–	–	–	–	–
	Thailand	9	9	7	4	4	4
	Viet Nam	6	6	6	6	6	6
Documents to import (number)	Cambodia	12	11	11	11	11	10
	Lao PDR	15	15	10	10	10	10
	Myanmar	–	–	–	–	–	–
	Thailand	12	12	9	3	3	3
	Viet Nam	10	9	8	8	8	8

Lao PDR = Lao People's Democratic Republic.

Source: World Bank World Development Indicators Online, April 2011.

Table 4: Logistical Performance Index of the Greater Mekong Subregion, 2009

Indicator	Country	2009
Logistics performance index: Ability to track and trace consignments (1=low to 5=high)	Cambodia	2.50
	Lao PDR	2.45
	Myanmar	2.36
	Thailand	3.41
	Viet Nam	3.10
Logistics performance index: Competence and quality of logistics services (1=low to 5=high)	Cambodia	2.29
	Lao PDR	2.14
	Myanmar	2.01
	Thailand	3.16
	Viet Nam	2.89
Logistics performance index: Ease of arranging competitively priced shipments (1=low to 5=high)	Cambodia	2.19
	Lao PDR	2.70
	Myanmar	2.37
	Thailand	3.27
	Viet Nam	3.04
Logistics performance index: Efficiency of customs clearance process (1=low to 5=high)	Cambodia	2.28
	Lao PDR	2.17
	Myanmar	1.94
	Thailand	3.02
	Viet Nam	2.68
Logistics performance index: Frequency with which shipments reach consignee within scheduled or expected time (1=low to 5=high)	Cambodia	2.84
	Lao PDR	3.23
	Myanmar	3.29
	Thailand	3.73
	Viet Nam	3.44
Logistics performance index: Overall (1=low to 5=high)	Cambodia	2.37
	Lao PDR	2.46
	Myanmar	2.33
	Thailand	3.29
	Viet Nam	2.96
Logistics performance index: Quality of trade and transport-related infrastructure (1=low to 5=high)	Cambodia	2.12
	Lao PDR	1.95
	Myanmar	1.92
	Thailand	3.16
	Viet Nam	2.56

Lao PDR = Lao People's Democratic Republic.

Source: World Bank World Development Indicators Online, April 2011.

2.2.2. Membership in the Association of Southeast Asian Nations, World Trade Organization, and Free Trade Arrangements

Soon after the launch of the GMS program, the CLMV countries sought membership in the Association of Southeast Asian Nations (ASEAN) and the World Trade Organization (WTO).² Viet Nam became a member of ASEAN in 1995, the Lao PDR and Myanmar joined in 1997, and Cambodia joined in 1999. Myanmar, Cambodia, and Viet Nam became members of the WTO in 2004 and 2007, respectively. Meanwhile, the Lao PDR is at an advanced stage in negotiations for WTO accession.

As members of ASEAN, the GMS countries are also parties to the ASEAN Free Trade Agreement (AFTA). Unlike the GMS program, AFTA is designed to pursue institutional, as opposed to market, integration. In essence, AFTA is a free trade agreement (FTA) based on a legal agreement that prescribes tariff reductions on a purely discriminatory basis. The centerpiece of the AFTA proposal is the common effective preference tariff (CEPT). It differs from an FTA in that its approach is essentially by sector, making it more comprehensive and less cumbersome than the item-by-item approach of an FTA. The objective of the CEPT scheme is to lay the foundation for the creation of a single ASEAN market. Under the revised AFTA plan, tariffs of products in the CEPT Inclusion List³ were to be reduced to 20% within a time frame of 5–8 years (beginning in January 1993) before they were cut to 0–5%. This target has already virtually been realized among the six original members of ASEAN, including Thailand.

The CLMV countries are also far along in the implementation of their CEPT commitments, with almost 80% of their products having been moved into their respective CEPT Inclusion Lists. Of these items, about 66% already have tariffs within the 0-5% tariff band (ASEAN Secretariat 2010). The CLMV countries were granted extensions on phasing in sensitive products. All quantitative restrictions on sensitive products must be eliminated by 1 January 2013 in Viet Nam; 1 January 2015 in the Lao PDR and Myanmar; and 1 January 2017 in Cambodia (ASEAN 1999).

In addition to the AFTA, GMS countries are also increasingly becoming parties to bilateral trade agreements, which have risen as multilateral trade talks at the WTO have stalled. Table 5 provides a summary of each GMS country's participation in FTAs as of July 2011. As expected, Thailand has been the most active in pursuing FTAs among the GMS countries with 24 in total, 11 of which are currently in effect. Viet Nam follows with 15 FTAs, 7 of which are in effect. Thailand's FTAs involve a more diverse mix of trading partners, while the CLMV countries' FTAs mainly involve countries within the Asia–Pacific region (see Annex A for a full list of FTAs). Table 6 presents a summary of the major FTAs to which the GMS countries are signatories, primarily as members of ASEAN.

² Myanmar has been a member of the WTO since 1995.

³ Products excluded from the CEPT Scheme are specified in the Highly Sensitive List (e.g., rice) and the General Exception List.

Table 5: Greater Mekong Subregion Free Trade Agreements, as of July 2011

	Concluded	Under Negotiation	Proposed	Total	Intra-Asia and the Pacific
Cambodia	6	1	2	9	8
Lao PDR	8	1	2	11	10
Myanmar	6	2	2	10	9
Thailand	11	7	6	24	17
Viet Nam	7	3	5	15	11

Lao PDR = Lao People's Democratic Republic.

Source: ADB Asian Regional Integration Center (ARIC) Free Trade Agreement Database for Asia.

Table 6: Summary of Major Free Trade Agreements Involving the Greater Mekong Subregion

	ASEAN FTA	ASEAN–PRC FTA	ASEAN–Republic of Korea FTA	ASEAN–Japan EPA	ASEAN–India FTA	ASEAN–CER (Australia and New Zealand)
Date in Effect	1 Jan 1993	1 Jul 2005	1 Jun 2007	1 Dec 2008	1 Jan 2010	1 Jan 2010
Date Signed	28 Jan 1992	21 Nov 2004	24 Aug 2006	14 Apr 2008	13 Aug 2009	27 Feb 2009
Negotiation Period (start of formal negotiations to FTA signing)	2–3 years (Oct 1990–Jan 1993)	2–3 years (Nov 2002–Nov 2004)	1–2 years (Feb 2005–Aug 2006)	4–5 years (Oct 2003–Apr 2008)	5–6 years (Oct 2003–Aug 2009)	4 years (Feb 2005–Feb 2009)
Trade in Goods Liberalization	Inclusion list: 99% of tariff lines at 0-5% (of which 60% are duty-free) for ASEAN-6 by 2010; 88% for CLMV by 2015 Sensitive track: (0.2% of tariff lines remaining among ASEAN-6 (Philippines and Indonesia)	Normal track: Tariff elimination on 90% of products for ASEAN-6 and PRC by 2010 (flexibility up to 2012); for CLMV by 2015 (flexibility up to 2018). Sensitive track: Tariff reduced to 0-5% by 2018 for ASEAN-6 and PRC; 2020 for CLMV	Normal track: Tariff elimination on 95% of products by 2010 (flexibility for 5% of tariff lines for Philippines and Indonesia up to 2012) Sensitive track: Maximum of 10% of tariff lines where tariff reduced to 0-5% by 2016	Normal track: Tariff elimination within 10 years upon entry into force Sensitive track: Tariff reduction to 0-5% in 10 years	Normal Track: Coverage of 80% of tariff lines (NT1/NT2) by 2013/2016 for ASEAN-5 and India; 2018/2019 for Philippines and India; 2018/2021 for CLMV. Sensitive Track: 10% of tariff lines. At least 50 tariff lines at MFN 5% will be at standstill;	Normal track: Tariff elimination on 90% of products by 2013 for Australia, New Zealand, and ASEAN-6, with (flexibility for Indonesia and Thailand). SL1: 6% of tariff lines by 2020. SL2: 3% of tariff lines with 20% margin of preference by 2020.

	ASEAN FTA	ASEAN–PRC FTA	ASEAN–Republic of Korea FTA	ASEAN–Japan EPA	ASEAN–India FTA	ASEAN–CER (Australia and New Zealand)
		Highly sensitive track: Tariff rate reduced to below 50% by 2015 for ASEAN-6 and PRC, and 2018 for CLMV			reduction to 4.5% from entry to 4% by 2016 for ASEAN 6 and India (special arrangements for Indonesia and Thailand; and 2019 for Philippines). India identified crude and refined palm oil, coffee, black tea and pepper as highly sensitive.	Longer tariff elimination: Cambodia, Lao PDR, Myanmar, and Viet Nam (2020–2024)
Notes	ASEAN Economic Community Blueprint in November 2007 sets out concrete steps for services by 2015. ASEAN has concluded seven Mutual Recognition Agreements (MRAs) in services; comprehensive investment Agreement was signed 26 February 2009.	Services agreement entered into force in July 2007 (first package of services liberalization). Agreement in trade in services in effect as of July 2007 and on investment signed in August 2009.	Services agreement signed in November 2007. Investment agreement signed 2 June 2009. Thailand signed the ASEAN–Republic of Korea FTA on 27 February 2009.	Bilateral EPAs and BITs commitments will apply. As of Feb 2009, seven countries (Japan, Singapore, Malaysia, Brunei Darussalam, Viet Nam, the Lao PDR, and Myanmar) have implemented the ASEAN–Japan EPA. To negotiate liberalization on services and investments.	The ASEAN–India FTA Trade In Goods Agreement was signed on 13 August 2009. As of 1 January 2010, India, Singapore, and Malaysia have implemented this agreement. The Trade in Services and Investment Agreement is expected to be approved by ASEAN in late 2011.	Services and investments agreement included. ASEAN–Australia–New Zealand FTA is the most comprehensive FTA has concluded in a single undertaking. Enacted into force on 1 January 2010 for Australia, New Zealand, Brunei Darussalam, Malaysia, Myanmar, Philippines, Singapore, and Viet Nam.

ASEAN = Association of Southeast Asian Nations; CER = Closer Economic Relations; CLMV = Cambodia, Lao People's Democratic Republic (Lao PDR), Myanmar, Viet Nam; EPA = Economic Partnership Agreement; FTA = free trade agreement; MFN = most favored nation; PRC = People's Republic of China.

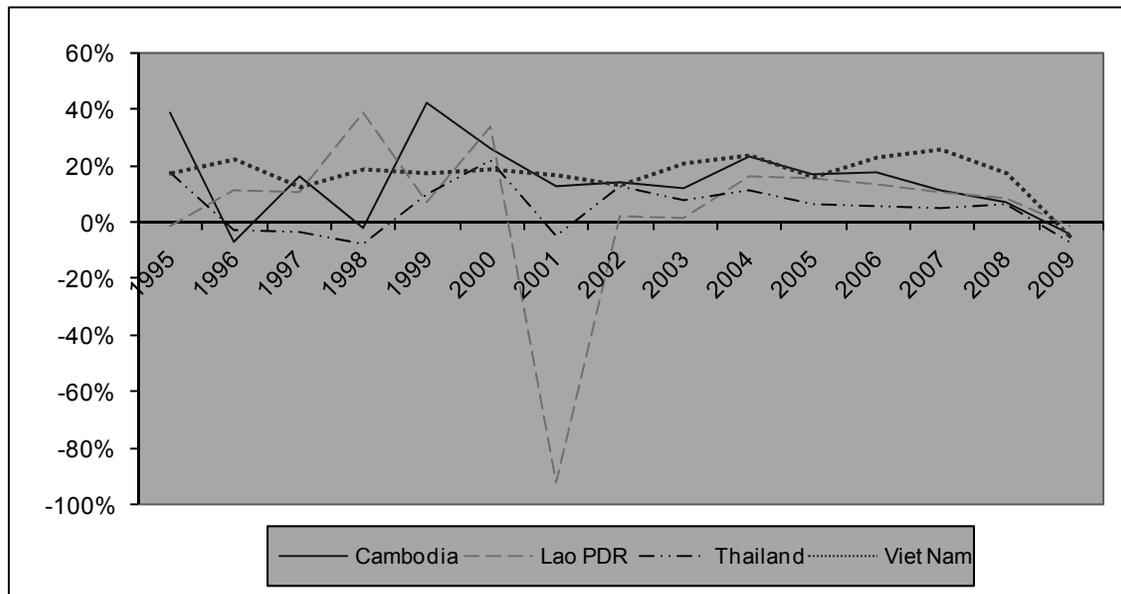
Source: ADB Asian Regional Integration Center (ARIC), Philippine Information Agency, 2011.

3. Changing Patterns of Trade and Investment in the Greater Mekong Subregion

3.1. Overall Trends in Trade and the Changing Structure of Exports

Although trade growth contracted in real terms in 2008 and 2009 as a result of the GFC, in general, unilateral policy reforms and greater economic cooperation have led to positive trade growth in the GMS. This is true particularly for Cambodia and Viet Nam, where real trade growth has been higher than the average growth of trade for East Asia and the Pacific. The Lao PDR's trade contracted in real terms in 2000–2002, but rebounded in 2004 (Figure 2). With the exception of Myanmar, trade openness has increased throughout the region, with trade as a percentage of GDP above 100% in Cambodia, Thailand, and Viet Nam (Figure 3).

Figure 2: Real Trade Growth in the Greater Mekong Subregion, 1995–2009
(constant 2000 prices)

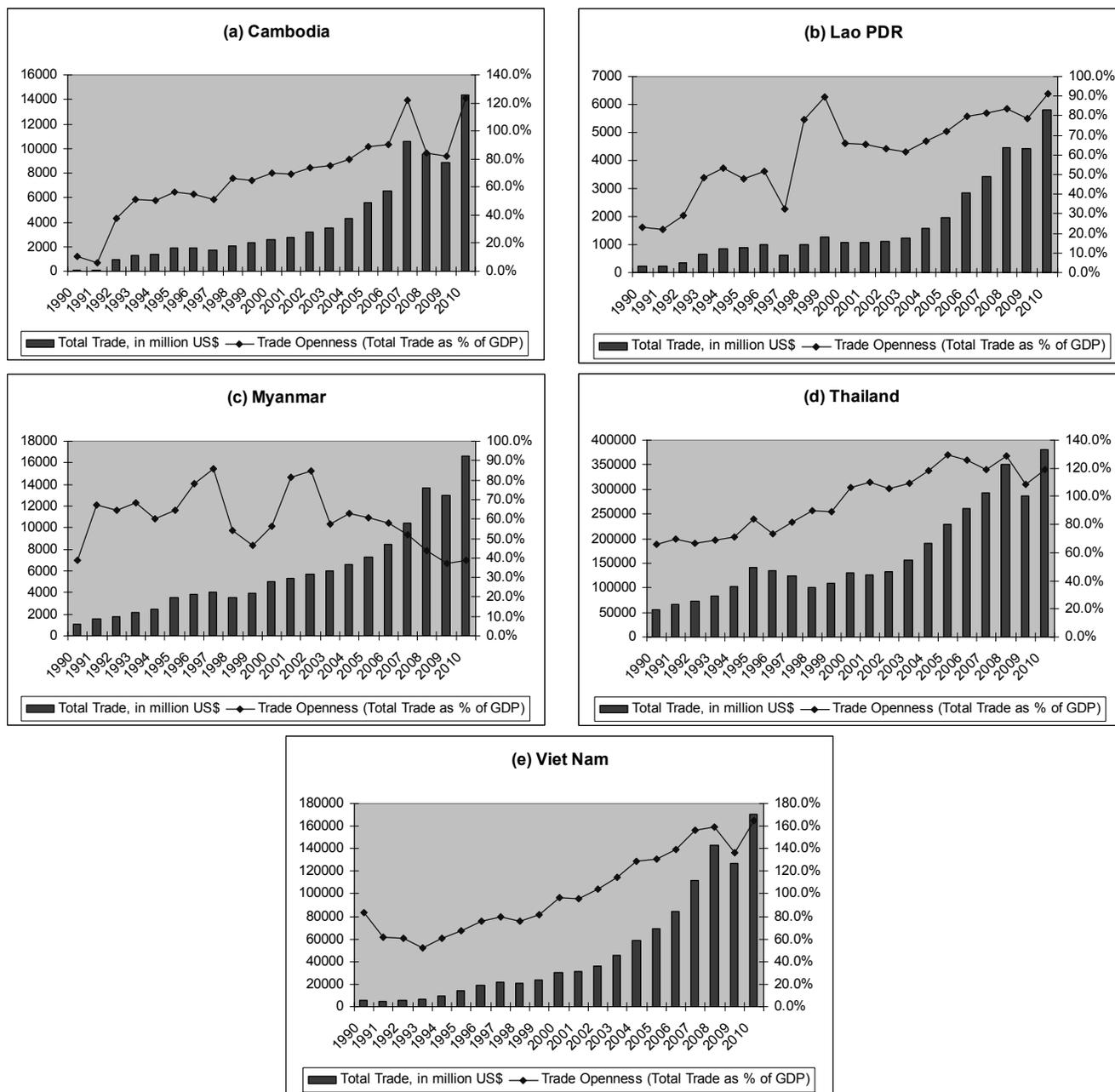


Lao PDR = Lao People's Democratic Republic.

Note: data not available for Myanmar.

Source: World Bank World Trade Indicators, 2009/10.

Figure 3: Total Trade and Trade Openness of the Greater Mekong Subregion, 1990–2010
(\$ million, % of total GDP)



GDP = gross domestic product, Lao PDR = Lao People's Democratic Republic.

Sources: IMF Direction of Trade Statistics 2010; IMF World Economic Outlook database (downloaded from ADB Asian Regional Integration Center database)

The direction of trade over the past two decades suggests a marked expansion in GMS' countries trade not only with the world, but especially among themselves (Figure 4). Cambodia's direction of trade may be the only exception to this general trend. In the 1990s, Cambodia's trade with the subregion accounted for about one-third of its total trade, on account of log and timber exports. However, this share has since declined, largely as a result of a ban on log exports and the growing importance of the United States (US) and the European Union (EU) as export destinations. The PRC is also fast emerging as a major source of imports. The increase in Cambodia's intra-GMS trade in the latter part of the 2000s could have been mainly the result of falling demand for Cambodian exports in the US and the EU, as a result of the GFC.

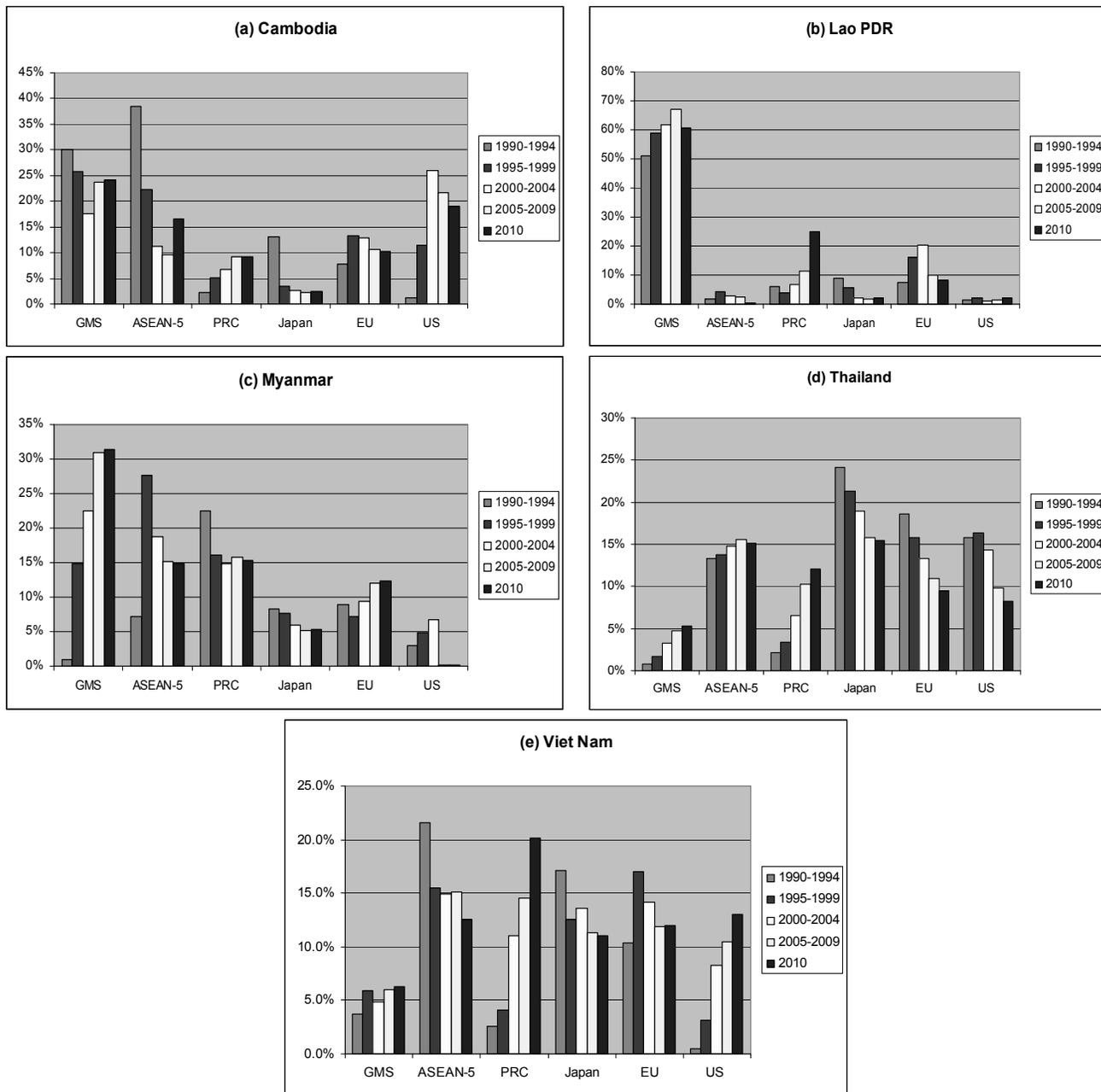
The larger GMS countries, Thailand and Viet Nam, have shown modest increases in subregional trade. As might be expected, these countries trade predominantly with the rest of the world and therefore have more diversified partners. Japan continues to be Thailand's biggest trading partner, although Japan's share has been steadily declining in recent years and is likely to soon be overtaken by the PRC. The PRC is already Viet Nam's leading trading partner, accounting for roughly 20% of its trade in 2010.

The share of intra-GMS trade in total trade has traditionally been higher for the subregion's smaller countries—the Lao PDR and Myanmar—reflecting both transshipment arrangements and limited commercial penetration beyond the immediate neighborhood. Between 2005 and 2009, trade within the subregion made up more than two-thirds of total trade in the Lao PDR, and more than one-third of total trade in Myanmar. These countries trade the most intensely with Thailand. During the same period, Thailand accounted for 83% of the Lao PDR's total intra-GMS trade; this was even higher in the case of Myanmar at 98% (Table 7).

Nonetheless, a significant portion of trade among the GMS economies is informal, involving small merchants or traders, and therefore not recorded. The nature of this type of trade makes it difficult to know its magnitude, but estimates range from about 30%–50% or more of total recorded trade (ADB 2006).

Changing demand for export products has helped transform the structure of exports from the subregion. In Cambodia and Thailand, there has been a shift away from primary commodities to labor-intensive manufactured goods. In Viet Nam, primary commodities still make up close to 30% of total exports, but there is a clear shift towards a more diversified export base. In the Lao PDR and Myanmar, there was a similar shift away from primary commodities in 2000. However, this trend has since reversed due to increased external demand for primary commodities, particularly ores and metals in the case of the Lao PDR, and natural gas in the case of Myanmar (Figures 5, 6).

Figure 4: Direction of Trade, 1990–2010



GMS = Greater Mekong Subregion; ASEAN-5 = Brunei Darussalam, Indonesia, Malaysia, Philippines, and Singapore; PRC = People's Republic of China; EU = European Union; US = United States.

Sources: IMF Direction of Trade Statistics, 2010 (data for 1990-1994); UNCTADStat, August 2011 (data for 1995-2010)

Table 7: Intra-Greater Mekong Subregion Trade Flows in 2005–2009
(\$ thousand, share of total intra-Greater Mekong Subregion trade in brackets)

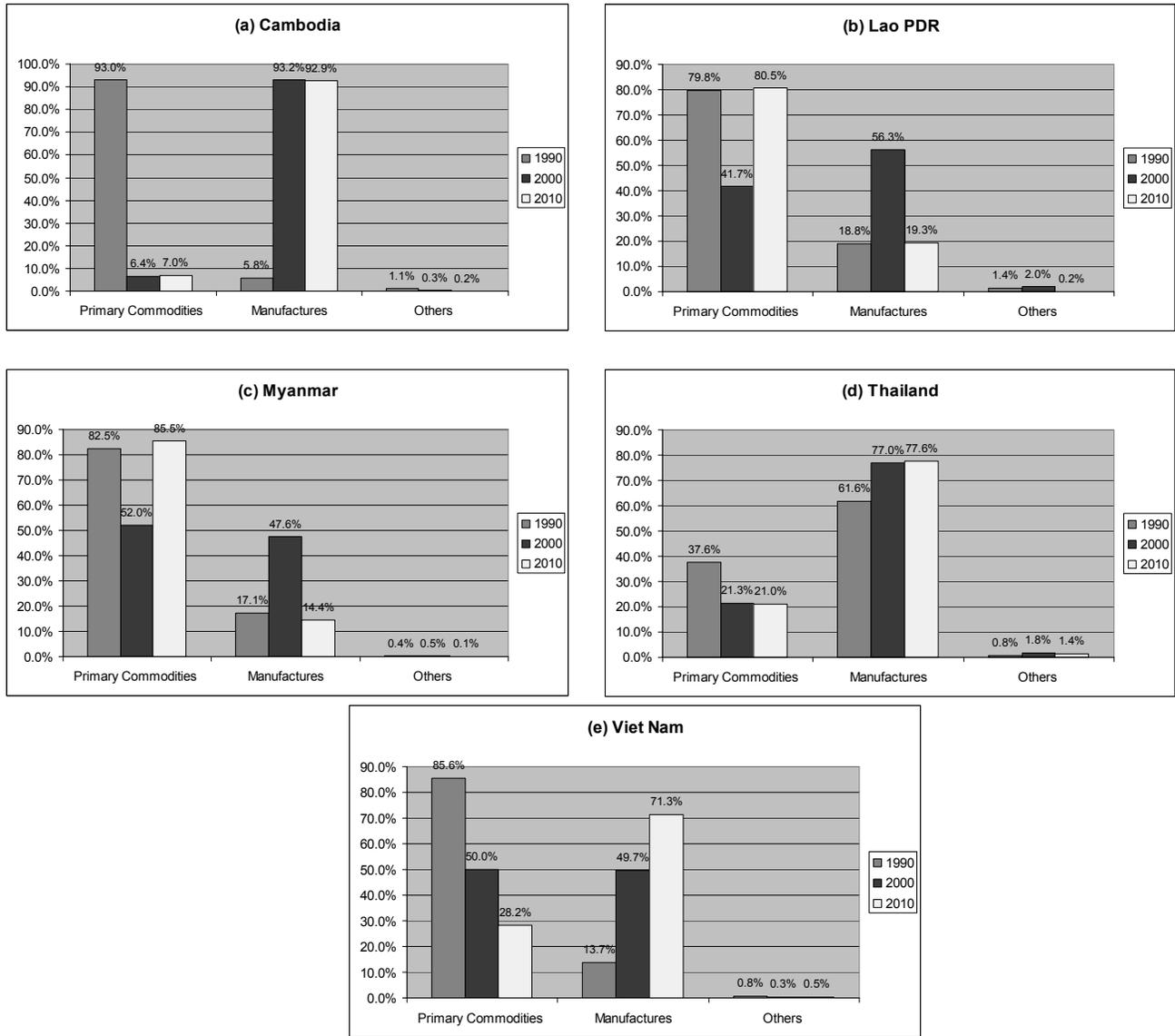
ECONOMY	PARTNER					Total
	Cambodia	Lao PDR	Myanmar	Thailand	Viet Nam	
Cambodia		4,574.3 (0.04%)	3,019.9 (0.03%)	5,962,341.6 (55.96%)	4,684,913.9 (43.97%)	10,654,849.73 (100.00%)
Lao PDR	559.1 (0.01%)		0.0 (0.00%)	5,738,012.4 (83.15%)	1,162,376.7 (16.84%)	6,900,948.29 (100.00%)
Myanmar	4,646.9 (0.03%)	0.0 (0.00%)		14,541,620.3 (98.55%)	209,493.3 (1.42%)	14,755,760.48 (100.00%)
Thailand	7,400,939.6 (10.91%)	8,775,583.1 (12.94%)	17,879,321.7 (26.36%)	8,979,088.2 ¹ (13.24%)	24,789,476.3 (36.55%)	67,824,408.94 (100.00%)
Viet Nam	6,021,979.6 (18.82%)	1,614,675.9 (5.05%)	437,349.0 (1.37%)	23,922,797.5 (74.77%)		31,996,802.04 (100.00%)

Lao PDR = Lao People's Democratic Republic.

Note: ¹ Re-imports

Source: UNCTADStat, August 2011

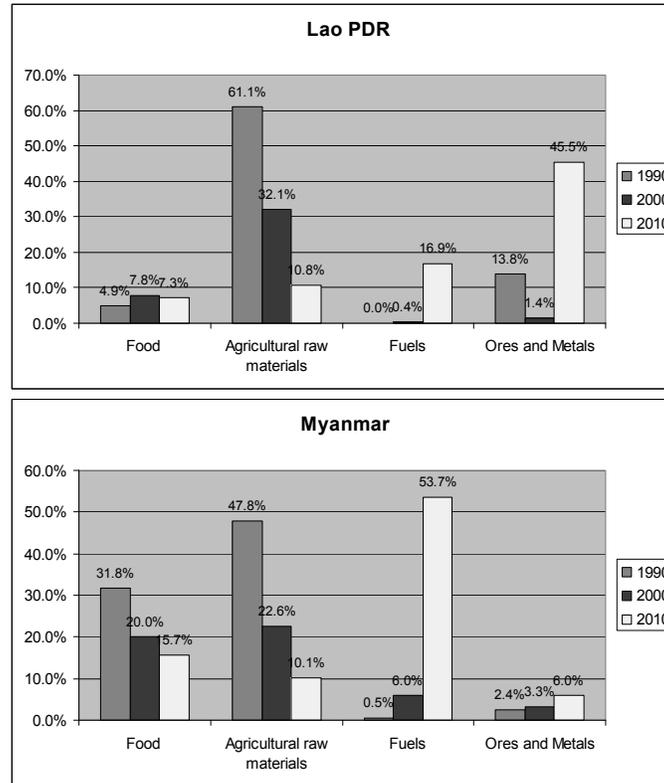
Figure 5: Composition of Greater Mekong Subregion Exports in 1990, 2000, and 2010



Lao PDR = Lao People's Democratic Republic.

Source: UNCTAD COMTRADE database.

Figure 6: Major Primary Commodities in Total Exports of the Lao People's Democratic Republic and Myanmar in 1990, 2000, and 2010



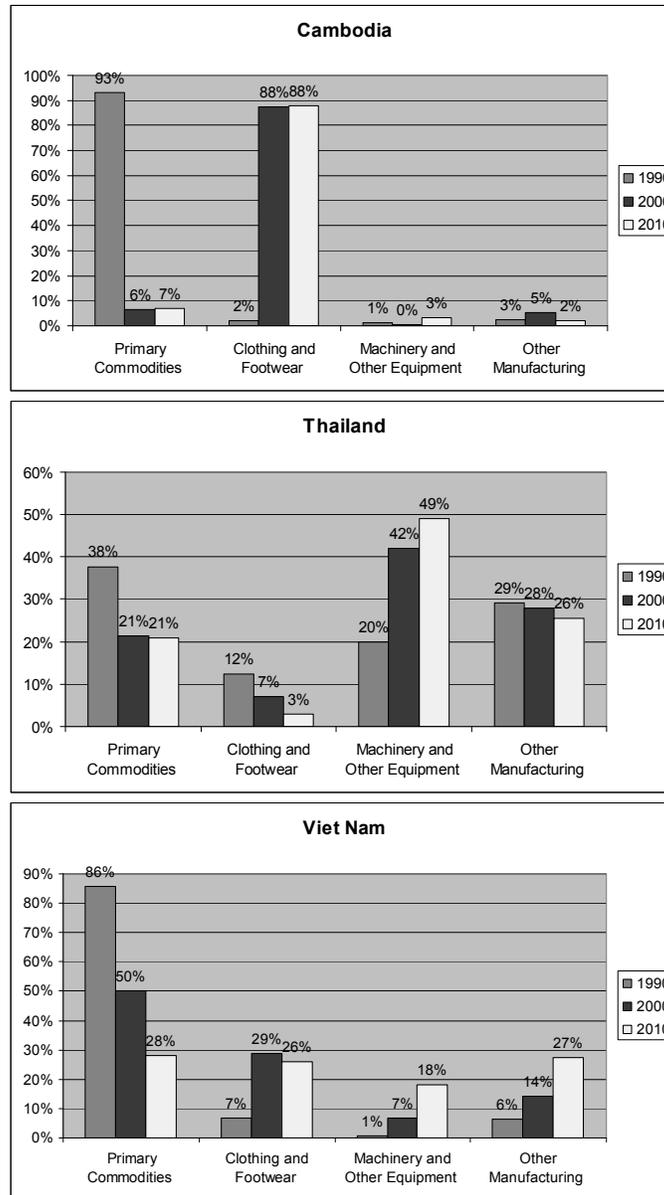
Lao PDR = Lao People's Democratic Republic.

Source: UNCTAD COMTRADE database.

The shift towards manufactured export products has been most pronounced in Cambodia, where textiles and garments quotas from the US and EU led to the emergence of an extremely narrow export base dominated by clothing and footwear. In 2010, clothing and footwear accounted for 88% of Cambodia's total exports (Figure 7), with the bulk of clothing and footwear exports (80%) going to the US and EU markets.

In Thailand, trade in machinery and other equipment comprised almost half of total exports in 2010. Production fragmentation trade has become a critical part of Thailand's export dynamism. There are indications that Viet Nam is following suit, as the share of machinery and equipment in Viet Nam's total exports has risen to 18% in 2010. At present, however, clothing and footwear and other manufacturing continue to make up the bulk of Viet Nam's manufactured exports, accounting for 26% and 27% of total exports in 2010, respectively (Figure 7).

Figure 7: Major Manufactured Products in the Total Exports of Cambodia, Thailand, and Viet Nam in 1990, 2000, and 2010

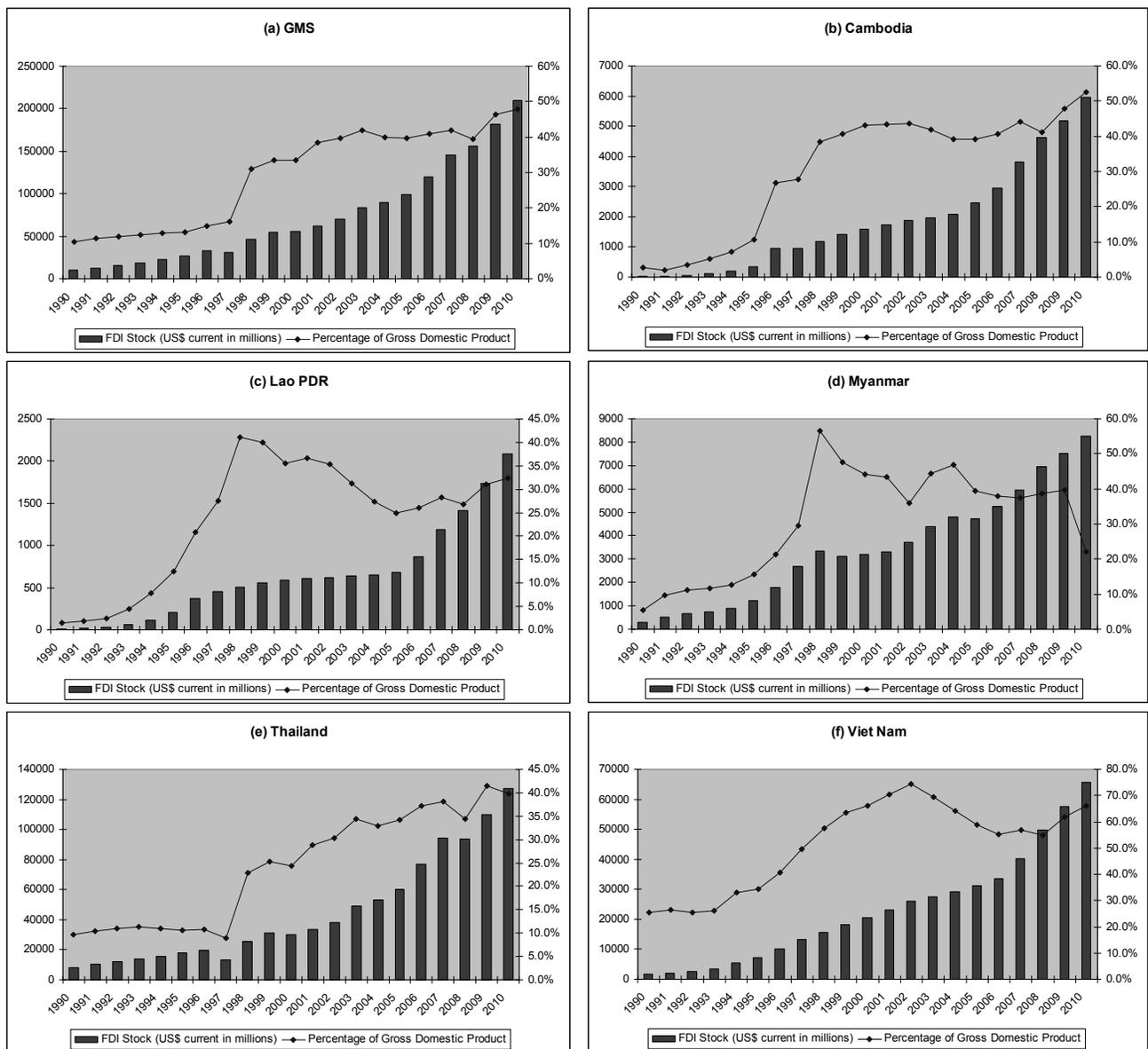


Source: UNCTAD COMTRADE database.

3.2. Overall Trends in Foreign Direct Investment

Along with trade, FDI to the subregion has also risen over the last 2 decades. In 2010, total FDI stock amounted to \$209 billion, or 48% of total GDP. Cambodia and Viet Nam have FDI stock-to-GDP ratios well above the subregional average, with Thailand's just slightly below it. In contrast, Myanmar's openness to FDI has declined since 1998. Historically, Thailand has been the largest FDI recipient in the region, but Viet Nam has been catching up in the last several years (Figure 8).

Figure 8: Foreign Direct Investment and Foreign Direct Investment Openness in the Greater Mekong Subregion, 1990–2010



FDI = foreign domestic investment, Lao PDR = Lao People's Democratic Republic.

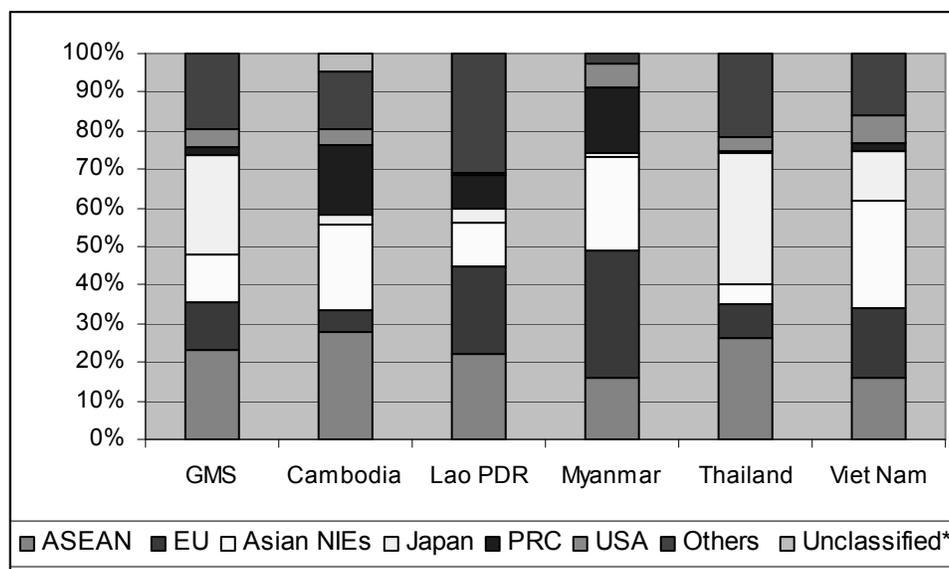
Source: UNCTADStat, August 2011.

The source country composition of FDI in GMS countries is characterized by a clear regional bias (Figure 9). Investors are predominantly from ASEAN, Japan, the PRC, and Asia's newly industrialized economies of Hong Kong, China; the Republic of Korea; and Taipei, China. In Cambodia, the Lao PDR, and Thailand, intra-ASEAN FDI flows made up roughly one-fourth of total flows between 2000 and 2008. Despite the predominance of ASEAN investors, however, the EU has also been an important source of capital for the Lao PDR (23%), Myanmar (33%), and Viet Nam (18%).

As for intra-GMS FDI flows, data for 1995–2005 suggest that these have been important sources of capital for the smaller GMS countries, particularly the Lao PDR, where they accounted for more than one-third of total FDI flows, originating mostly from Thailand (Figure 10).

That trade and investment are growing hand-in-hand in the subregion is no coincidence. Early signs of a trade–investment nexus are emerging whereby trade not only encourages investment, but investment, in turn, encourages trade. For instance, FDI in agriculture and forestry, mining, and hydropower projects has contributed significantly to export growth in the Lao PDR, while FDI in the garment industry has helped strengthen Cambodia's clothing and footwear exports (ADB 2006). These are examples of a virtuous circle comprising trade and investment that links back to economic growth.

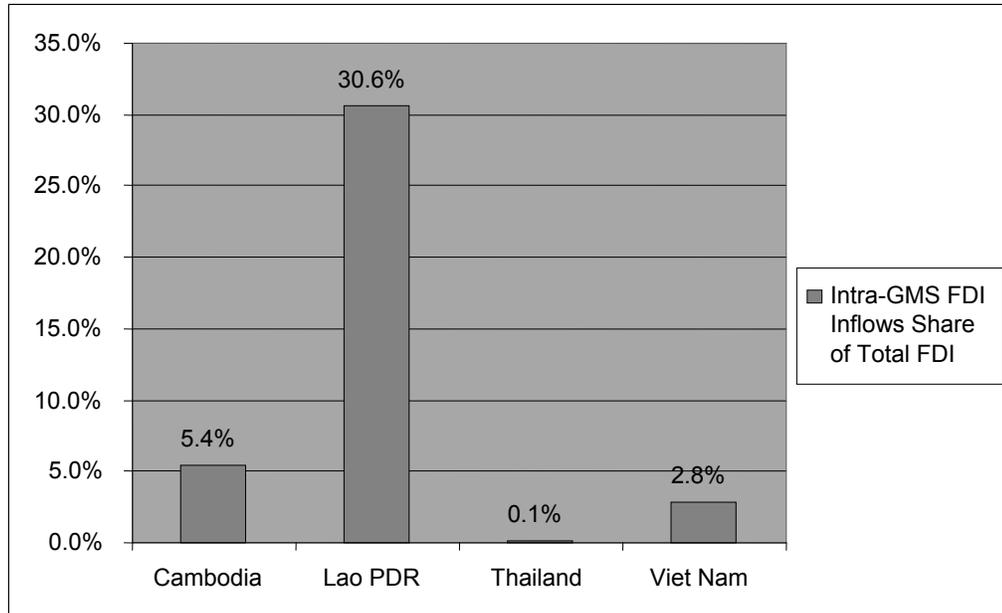
Figure 9: Foreign Direct Investment Inflows into the Greater Mekong Subregion by Source Country, 2000–2008



ASEAN = Association of Southeast Asian Nations, EU = European Union, FDI = foreign direct investment, Lao PDR = Lao People's Democratic Republic, NIEs = newly industrialized economies, PRC = People's Republic of China.

Source: ASEAN Statistical Yearbook 2008.

Figure 10: Share of Intra-Greater Mekong Subregion Inflows in Total Foreign Direct Investment, 1995–2005



FDI = foreign direct investment, GMS = Greater Mekong Subregion, Lao PDR = Lao People's Democratic Republic.

Source: ASEAN (2006). Statistics of Foreign Direct Investment in ASEAN, Eighth Edition.

4. Remaining Challenges and the Unfinished Policy Agenda

The foregoing discussion has highlighted considerable progress in enhancing trade and investment policies and outcomes in the GMS. These gains notwithstanding, a number of critical challenges continue to limit the subregion's potential for reaping further gains from trade and investment. Furthermore, the countries of the region have been subject to several external shocks recently, the latest being the GFC. How can these countries reduce their vulnerability and increase their resilience to such shocks?

4.1. Further Rationalizing Tariff Rate Structures

The biggest challenge facing GMS countries in improving their trade performance relates to accelerating trade facilitation reforms and dealing with a wide range of non-tariff barriers that continue to interfere with trade flows. The need to deal with these issues and reduce trade costs is now widely acknowledged, and measures are being put in place to address them. Nevertheless, the traditional area of tariff liberalization should not be neglected as the reform process is far from complete. Furthermore, the increasing number of FTAs presents new challenges in rationalizing tariff structures and creating a trade regime that ensures distortions do not peter away the gains from trade.

The opening up of the CLMV countries in the 1990s has led to significant tariff cuts. Table 8 presents the average CEPT and most-favored nation (MFN) tariffs, and the difference between the two, which is the margin of preference (MOP), since the year the CLMV countries entered AFTA.⁴ The data clearly show a general trend of declining MFN and preferential rates, although reductions in the average MFN tariffs seem to have stalled across all four countries since 2005. With the exception of Myanmar, MFN tariff rates in the GMS in 2007 remain higher than the 9.6% average for East Asia and the Pacific. In addition, the MFN tariff rates in Cambodia and Viet Nam were higher than the 12.5% average for low-income countries.

With CEPT rates continuing to fall in line with AFTA commitments, this has resulted in an increase in their respective MOPs since 2005. The MOP in 2007 was almost 15% in Viet Nam, and around 7–8% in Cambodia and the Lao PDR. Thus, the newer members of ASEAN have chosen to operate a two-tier tariff system, with two rates for each tariff line.

Table 8: Most Favored Nation and Preferential Tariffs in Cambodia, the Lao People’s Democratic Republic, Myanmar, and Viet Nam, 1998–2007

		1998	1999	2000	2002	2003	2004	2005	2006	2007
Cambodia	MFN	–	–	16.46	16.41	16.41	15.81	14.26	14.25	14.18
	CEPT	–	–	–	8.87	7.83	–	9.08	–	6.85
	MOP	–	–	–	7.54	8.58	–	5.18	–	7.33
Lao PDR	MFN	10.34	10.33	10.33	10.34	–	10.33	9.71	9.71	9.71
	CEPT	–	–	7.21	6.70	–	6.15	3.88	–	1.57
	MOP	–	–	3.12	3.64	–	4.18	5.83	–	8.14
Myanmar	MFN	5.54	5.51	5.49	5.51	5.51	5.51	5.60	5.60	5.60
	CEPT	–	–	–	4.81	4.81	4.26	4.29	–	3.36
	MOP	–	–	–	0.71	0.70	1.25	1.31	–	2.24
Viet Nam	MFN	4.47	12.43	13.08	15.80	16.03	16.81	16.81	16.81	16.81
	CEPT	3.71	7.39	7.54	6.86	6.57	5.50	4.08	2.27	2.35
	MOP	0.76	5.04	5.54	9.06	9.46	11.31	12.73	14.54	14.46

– = data not available, CEPT = common effective preference tariff, MFN = most-favored nation, MOP = margin of preference, Lao PDR = the Lao People’s Democratic Republic.

Source: Calvo-Pardo, Freund, and Ornelas, 2011.

This contrasts with the approach taken by the original members of ASEAN, which have opted to multilateralize the CEPT preferences for a large share of their tariff lines (Menon 2007). For Singapore, Malaysia, and Brunei Darussalam, more than 80% of tariff lines had been fully multilateralized as early as 2002. Indonesia and the Philippines had fully multilateralized more than 60% of their tariff lines by 2002. For the remaining tariff lines, the MOP was less than 10% in all of these countries (Feridhanusetyawan 2005). In a comparison of external tariffs of major FTAs, the World Bank (2005) finds

⁴ Data for Thailand is unavailable.

that only the North American Free Trade Agreement (NAFTA) has lower external tariffs than AFTA. The low MOPs are confirmed by the low utilization rate of preferences. A survey by JETRO (2003) found that in 2002, the rate was only 4% for Malaysia and 11% for Thailand.⁵

Why have the original member countries been multilateralizing most of their CEPT concessions? The main reason relates to the desire to minimize trade diversion. When preferences are fully multilateralized, the MOP is zero as is the potential for trade diversion. Even if it is not zero, the lower the MOP is, the less potential there is for trade diversion. This approach also reflects the long-standing commitment of the original ASEAN members to the concept of open regionalism.

Emulation of the approach taken by the original members would be in the interest of the new members of ASEAN. Indeed they will need to emulate this approach if they are not to be left behind, and if they are to succeed in deepening regional integration. Regionalism through ASEAN membership could provide the GMS economies with an opportunity to pursue multilateralism aggressively and thus allow regionalism through AFTA to be a building block, rather than stumbling block, toward free and open trade. This applies equally to the other ASEAN+1 FTAs that the GMS members of ASEAN will eventually participate in (Table 6), as well as the individual bilateral FTAs being pursued by each country (Annex A).

There are reasons apart from minimizing trade diversion for why the new member countries should emulate their predecessors in concurrently bringing down external tariffs. The freedom of members of an FTA to set their own barriers against trade with nonmembers raises the possibility of trade, production, and investment deflection. Trade deflection occurs when imports enter the area covered by an FTA via the member country with the lowest tariff on nonmember trade. Trade deflection distorts the region's trading patterns with the rest of the world and deprives the member country that eventually consumes the import of tariff revenue. In the case of the GMS and ASEAN, revenue is likely to be lost to a member like Singapore, which is virtually a free-trade port.

Production deflection will occur if the manufacture of products containing imported inputs shifts to countries that have lower tariffs on the inputs because differences in tariffs outweigh differences in production costs. This is detrimental to economic efficiency and welfare since the pattern of productive activity will be based on differences in duties rather than on comparative advantage. The deflection of production may also affect the pattern of international investment. If differences in tariffs outweigh differences in production costs, tariffs will dictate investment decisions. Investment deflection will reinforce detrimental effects on welfare and efficiency associated with production deflection. Although the GMS economies may not currently be subject to much production or investment deflection because most are still not developed enough to compete with other ASEAN members for the same types of investments, they could avoid it in the future by multilateralizing their AFTA tariff preferences.

⁵ To put this in comparative perspective, utilization rates of below 50% are considered low in European preferential trading agreements (see Augier et al. 2005).

To deal with potential trade, production, and investment deflection, AFTA imposes domestic ASEAN content requirements based on rules of origin (ROO). These rules limit regional trade preferences to commodities that incorporate a minimum of 40% domestic ASEAN content. The ASEAN+1 FTAs would have their own ROO, as would individual country bilateral FTAs. These different ROO, combined with other FTA-specific requirements, such as differing inclusion, exclusion, and sensitive lists, underlie the costs associated with the spaghetti-bowl effect of overlapping trade agreements. Furthermore, application of these rules can only limit, but not eliminate, trade, production, and investment deflection in AFTA. Krueger (1995) goes further to suggest that these rules can lead to the “export” of protection. This occurs when a member country deliberately purchases a higher-cost input from another member rather than the lower-cost alternative from a nonmember in order to satisfy ROO requirements and gain duty-free access for its end-product exports.

ROO are also notoriously difficult to police and the administrative burden can be substantial. Not only is the origin of a product difficult to determine in this era of increasing internationalization of production, but the transaction costs resulting from the extensive documentation associated with this cumbersome process can nullify any benefits coming from freer intra-regional trade. In many of the GMS economies, the administrative costs associated with implementing ROO or measuring domestic content could be crippling.

Adoption of the nondiscriminatory approach to regionalism by the new member countries would maximize the extent and pace of their integration with the global economy. It would also simplify implementation of the tariff reduction component of the various upcoming ASEAN+1 FTAs (Table 6), and the other FTAs that GMS countries have been pursuing (Annex A). This is underlined by the fact that the completion dates vary across FTAs. For instance, the CLMV countries have to complete their tariff reductions by 2015 for the ASEAN–PRC FTA, 2016 for the ASEAN–India FTA, 2018 for the ASEAN–Republic of Korea FTA, 2017 for the ASEAN–Japan FTA, and 2020 for the ASEAN–CER (Australia and New Zealand) FTA. Apart from avoiding trade diversion and deflection, the multilateralization approach would untangle them from the spaghetti bowl by doing away with the tedious and costly tasks of implementing ROO and measuring domestic content of their imports. This would be the best option.

So, why have the new member countries of ASEAN resisted the multilateralization approach? It appears that the main reason may relate to concerns over potential loss in government revenue. Indeed, the concern over loss of government revenue is perhaps the most significant issue associated with participating in AFTA for new ASEAN member countries. This is because these countries continue to derive a significant share of government revenue from trade taxes.

Retaining a multiple rate tariff regime is being pursued in an attempt to offset, or mitigate, the anticipated revenue losses associated with AFTA, as well as ASEAN+1 FTAs and other bilateral FTAs. What are the likely revenue impacts of the multiple-rate system compared with the one-rate system? To answer this question, we need to look at (i) the costs associated with administering each system, and (ii) the likely change in tariff revenue collections associated with each system. We need to consider both the costs of

administration and the change in tariff collections because the relevant variable is the change in government revenue (not just the change in tariff revenue) associated with each system.

The costs associated with administering the multiple-rate system are clearly going to be higher than with the one-rate system. If the multiple-rate system is going to be effective in practice, then customs authorities in new ASEAN member countries will have to measure the domestic content of all of their imports in order to determine which rate should apply. As we have already argued, measuring domestic content with accuracy is very difficult for any country, and it will be close to impossible for the new ASEAN members.

Additional tariff revenue will only be collected if non-member country imports are levied the higher MFN rate. If there is a significant difference between the two rates, there will be a strong incentive for trade deflection. With trade deflection, imports from outside ASEAN will enter new ASEAN member countries through a low tariff country (e.g., Singapore).

Creating a system whereby six or more tariff rates can apply to each tariff line, depending on the source, also increases the potential for rent-seeking behavior. It is an open secret that some portion of revenue associated with trade taxes is collected privately rather than publicly in the GMS countries. A higher MFN rate compared with the many preferential rates would provide a new avenue through which private rents are extracted, with no change to public customs revenue collections.

In conclusion, the multiple-rate system is a second-rate system compared with the one-rate system because it is more costly to administer, economically distortionary, and unlikely to produce a significant increase in government tariff revenue collections. It could also lead to increased rent-seeking behavior. Without a significant increase in tariff revenue collections, the increased costs of administration and the economic costs associated with trade diversion would produce an outcome that is inferior in welfare terms when compared to the one-tariff rate system.

Moreover, tariff escalation remains higher than the regional average for agricultural goods in the case of Cambodia and Viet Nam, and non-agricultural goods in the case of Cambodia, Thailand, and Viet Nam (Table 9). This creates an anti-export bias by raising the effective rate of protection on final goods produced for the domestic market.

In sum, there is an urgent need to rationalize tariff structures in order to address tariff dispersion as a result of the various FTAs so that trade diversion and tariff escalation can be minimized.

Table 9: Average Applied Tariffs and Tariff Dispersion

Indicators	Cambodia			Lao PDR			Myanmar			Thailand			Viet Nam			East Asia-Pacific		
	2000-2004	2005-2008	2005-2008	2000-2004	2005-2008	2005-2008	1995-1999	2000-2004	2005-2008	2000-2004	2005-2008	2005-2008	1995-1999	2000-2004	2005-2008	1995-1999	2000-2004	2005-2008
MFN applied tariff - Simple average - All goods (%)	16.40	14.25	9.59	9.70	5.51	5.60	23.05	16.65	9.53	16.52	16.63	16.81	19.09	10.95	9.39			
MFN applied tariff - Simple average - Agricultural (AoA) goods (%)	19.44	18.10	18.99	19.46	8.51	8.66	38.48	31.04	19.91	23.05	23.71	24.15	25.08	15.89	12.40			
MFN applied tariff - Simple average - Non-agricultural goods (%)	15.93	13.66	8.17	8.22	5.05	5.14	20.81	14.57	8.59	15.52	15.56	15.70	18.21	10.22	8.97			
MFN applied tariff - Dispersion - All goods (%)	0.83	0.76	0.83	0.84	1.15	1.12	0.73	0.89	1.26	1.13	1.25	1.12	1.27	1.29	1.04			
MFN applied tariff escalation (diff, finished-row) - All goods (%)	-	7.57	-	-2.68	-	1.39	-	6.42	0.79	-	-	7.54	-	2.22	1.84			
MFN applied tariff escalation (diff, finished-row) - Agricultural (AoA) goods(%)	-	14.01	-	1.61	3.50	5.48	-	11.37	2.97	-	-	16.10	-	4.99	9.69			
MFN Applied tariff escalation (diff, finished-row) - Non-agricultural goods (%)	-	6.74	-	2.08	1.80	1.54	-	9.20	9.32	-	-	9.27	-	3.24	2.51			
MFN Applied tariff escalation (% change, finished-row) - All goods (%)	-	69.39	-	20.56	-	26.02	-	81.88	6.71	-	-	55.83	-	46.92	21.96			
MFN Applied tariff escalation (% change, finished-row) - Agricultural (AoA) Goods(%)	-	128.8	-	8.30	47.30	89.25	-	82.63	13.19	-	-	95.48	-	80.72	80.81			
MFN Applied tariff escalation (% change, finished-row) - Non-agricultural goods (%)	-	61.50	-	30.04	42.86	33.69	-	221.3	250.5	-	-	90.06	-	78.68	66.97			

- = data not available, Lao PDR = Lao People's Democratic Republic, MFN= most favored nation.

Source: World Bank World Trade Indicators 2009/10.

4.2. Reducing Vulnerability to External Shocks: Issues of Diversification and Rebalancing

There is a widespread perception among government officials and policymakers that the GMS countries remain highly vulnerable to external shocks. This concern manifests itself in calls for diversification of the export commodity base and export markets, and more recently, growth rebalancing. The GFC has simply hastened such calls. What, if anything, should the CLMV countries do to reduce this vulnerability? How valid are the proposals on diversification and rebalancing being put forward, and how should the region respond?

It is true that exports from the CLMV countries are still concentrated in a small number of goods and markets. The data on the composition of exports presented in Section III-A and Table 3 bear this out. It is also true that these concentrations make the CLMV countries highly vulnerable to sudden changes in external demand, as the recent GFC demonstrated. Therefore, the increasing calls to diversify and therefore reduce reliance on a narrow range of export commodities and markets are not surprising. But how should the GMS countries go about diversifying their economies?

First, how should countries go about diversifying their export commodity base? In answering this question, it is useful to distinguish between intra-sectoral versus inter-sectoral specialization. In other words, should the diversification take place by shifting resources toward new activities within sectors, or through inter-sectoral resource movements? Inter-sectoral diversification would involve changes to the shares of GDP accounted for by the key sectors—agriculture, manufacturing, and services—while intra-sectoral diversification could leave these shares relatively unchanged.

In this context, it is important to recognize that there is a gradual process of diversification at the macro level that is already taking place naturally as part of the process of economic development. This is evident in the changing shares of GDP accounted for by the three key sectors over time, particularly the reduction in the share accounted for by agriculture and the corresponding increases in manufacturing and services (Table 1). The question then is the extent to which government policy should intervene to control or direct this process, or to hasten it. In this regard, pursuing inter-sectoral diversification would require a greater level of government intervention—in the form of subsidies as part of a package of industry policy incentives—than intra-sectoral diversification. This is because the artificial relative price changes required to induce resources to shift across sectors would be larger than those required for intra-sectoral reallocations.

There are a number of reasons why intra-sectoral specialization is to be preferred in pursuing a policy of diversification. First, the adjustment cost associated with intra-sectoral specialization is likely to be much lower than inter-sectoral specialization (Menon and Dixon 1997). This is because intra-sectoral specialization does not require inter-sectoral factor movements. It is likely that factors of production can be moved more easily across activities within a sector, with greater similarity in factor intensities, than they can across sectors, where factor intensities are likely to vary more widely. Trade expansion through inter-sectoral specialization is more likely to require factor transfer from

export-oriented industries to import-competing industries, whereas trade expansion through intra-sectoral specialization might only require factor transfer within export-oriented industries.

This is already being recognized by leaders and policymakers in the region. In a recent interview, Prime Minister Abhisit Vejjajiva of Thailand highlighted the need for intra-sectoral specialization within agriculture and services, downplaying calls to diversify into heavy industry, stating that "(t)he strengths of our economy lie in agriculture and the country's beauty, which attracts tourism." He added that "it is (not) necessary that the country has everything from upstream to downstream industries. Some people say the automobile industry will have a problem if we don't have a steel industry. But I don't think this holds true, given the benefits of ASEAN cooperation."⁶ In short, there is room to diversify into a range of activities related to traditional sectors that should be pursued first. That is, it would be more sensible economically to consider activities related to agro-processing such as rice milling, for instance, before venturing into the manufacture of automobiles or airplanes.

Apart from diversification of the export commodity base, there may also be a need to diversify export markets, so that there is less reliance on demands from a small number of countries. In this respect, the experience of GMS countries during the GFC does highlight the risks associated with significant dependence on extra-regional demand for exports, especially the US and EU markets. Although increasing the number of markets that GMS countries export to will reduce these risks, the GFC did nothing to invalidate the outward-looking, export-oriented growth strategies that GMS countries have been pursuing. This policy has delivered rapid and continuous economic growth, and resulted in substantial improvements in living standards and significant reductions in the incidence of poverty. Thus, the subregion should maintain its vital trade links with the industrialized countries and the rest of the world.

At the same time, however, the transformation of East Asia from a relatively stagnant, low-income region to a dynamic, middle-income one suggests that intra-East Asian trade offers the promise of a new source of demand and growth (Estrada et al. 2010). Strengthening intra-regional trade will enable the region's economies to exploit potentially large, but hitherto under-realized, gains from trade (ADB 2009b). Indeed, this is already happening for many of the GMS countries. In Figure 4, we can see this shift taking place. To a certain extent, the unexpectedly speedy and robust recovery occurring in the GMS countries reflects this shift in the geographical pattern of much of the region's exports. With the exception of Japan, East Asia is undergoing a near V-shaped recovery reminiscent of the region's rebound from the 1997/98 Asian financial crisis. Given the relatively high shares of intra-East Asian trade among most of the GMS countries, they are in a good position to ride this wave of recovery taking place around them.

The growth rebalancing literature suggests that a complementary strategy would be for each country to shift the sources of growth from foreign towards domestic demand (ADB

⁶ Reported in Diversity holds key to success, says PM. *Bangkok Post*. 11 October 2010. pp. 1.

Table 10: Product and Market Diversification

Indicators	Cambodia			Lao PDR			Myanmar			Thailand			Viet Nam		
	1995-1999	2000-2004	2005-2008	1995-1999	2000-2004	2005-2008	1995-1999	2000-2004	2005-2008	1995-1999	2000-2004	2005-2008	1995-1999	2000-2004	2005-2008
No. of products exported	58.67	66.60	73	118.6	160.6	188	176	144.4	114	253.2	240.2	254	218.4	236.8	250
No. of products imported	229.2	178.8	240	227.4	227	238	248.8	245.8	246	254.6	249.6	257.5	247	252	256.5
Export product concentration index	35.04	40.32	35.47	29.27	33.10	32.72	27.18	29.58	43.52	10.03	9.69	9.10	20.81	22.53	22.53
Share of top 5 export markets of total goods exports	-	-	78.76	-	-	62.60	-	-	77.36	-	-	44.77	-	-	52.75
Export market destination concentration index	-	56.82	53.65	-	-	31.87	-	-	47.07	29.82	28.13	21.47	22.61	27.36	24.77

Lao PDR = Lao People's Democratic Republic.

Source: World Bank World Trade Indicators 2009/10

2009c). There is certainly a case for the PRC to do this, as well as a number of other East Asian countries that continue to run large current account surpluses. As far as the GMS countries are concerned, however, almost all of them are net importers of capital and run current account deficits. Furthermore, the contribution of net exports to growth in most countries is either small or negative. These factors suggest that any policies in the GMS countries designed to shift sources of demand from foreign to domestic markets would be misplaced.

5. Conclusion

The GMS is one of the most successful stories of economic transition and integration among developing countries. Strong rates of economic growth since the early 1990s have been fueled by increased trade and FDI in the subregion. This economic progress has translated into marked improvements in living standards and human development outcomes, and dramatic reductions in poverty. Unilateral policy reforms and greater economic cooperation have led to positive trade growth in the GMS. These include participation in the GMS Program, AFTA, WTO, and various FTAs.

Despite these achievements, a number of critical challenges continue to limit the subregion's potential for reaping further gains from trade and investment. The trade policy reform agenda in particular remains incomplete. The biggest challenges facing GMS countries in improving their trade performance relate to accelerating trade facilitation reforms and dealing with a wide range of non-tariff barriers that continue to interfere with trade flows. It is important that more traditional areas of trade reform are not neglected either, especially with regard to rationalization of tariff structures following participation in AFTA and other FTAs. In this regard, the GMS members of AFTA should work towards multilateralizing their CEPT preferences in order to avoid trade diversion and deflection, and remain globally connected. This should also be the objective of the various ASEAN+1 bilateral FTAs, as well as each GMS country's bilateral FTAs. Retaining a multiple-tier tariff system is unlikely to mitigate revenue loss, but could unnecessarily burden an already stretched bureaucracy or create new avenues for rent-seeking behavior. There is also an urgent need to address growing tariff escalation to remove the anti-export bias.

The GMS countries have been subject to several external shocks in recent decades, the latest being the GFC. In order to reduce vulnerability to external shocks, diversification of both export commodities and markets are being considered. Intra-sectoral diversification of export commodities is likely to be more viable and less costly than inter-sectoral diversification. Trade expansion through inter-sectoral specialization is more likely to require factor transfer from export-oriented industries to import-competing industries, which would be difficult, whereas trade expansion through intra-sectoral specialization might only require factor transfer within export-oriented industries. Meanwhile, the growth rebalancing literature suggests that a complementary strategy would be for each country to shift the sources of growth from foreign toward domestic demand. It is unlikely, however, that any such rebalancing of growth would be required in the GMS countries in order to increase resilience to external shocks, given that most are capital importing countries and the contribution of net exports to growth is either small or negative.

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Annex

List of Free Trade Agreements Involving Greater Mekong Subregion Countries, as of July 2011

Cambodia

- ASEAN Free Trade Area (Signed and In Effect)
- ASEAN-Australia and New Zealand Free Trade Agreement (Signed and In Effect)
- ASEAN-EU Free Trade Agreement (Under Negotiation)
- ASEAN-India Comprehensive Economic Cooperation Agreement (Signed and In Effect)
- ASEAN-Japan Comprehensive Economic Partnership (Signed and In Effect)
- ASEAN-Korea Comprehensive Economic Cooperation Agreement (Signed and In Effect)
- ASEAN-People's Republic of China Comprehensive Economic Cooperation Agreement (Signed and In Effect)
- Comprehensive Economic Partnership for East Asia (CEPEA/ASEAN+6) (Proposed/Under consultation and study)
- East Asia Free Trade Area (ASEAN+3) (Proposed/Under consultation and study)

Lao People's Democratic Republic

- ASEAN Free Trade Area (Signed and In Effect)
- ASEAN-Australia and New Zealand Free Trade Agreement (Signed and In Effect)
- ASEAN-EU Free Trade Agreement (Under Negotiation)
- ASEAN-India Comprehensive Economic Cooperation Agreement (Signed and In Effect)
- ASEAN-Japan Comprehensive Economic Partnership (Signed and In Effect)
- ASEAN-Korea Comprehensive Economic Cooperation Agreement (Signed and In Effect)
- ASEAN-People's Republic of China Comprehensive Economic Cooperation Agreement (Signed and In Effect)
- Asia-Pacific Trade Agreement (Signed and In Effect)
- Comprehensive Economic Partnership for East Asia (CEPEA/ASEAN+6) (Proposed/Under consultation and study)
- East Asia Free Trade Area (ASEAN+3) (Proposed/Under consultation and study)
- Lao PDR-Thailand Preferential Trading Arrangement (Signed and In Effect)

Myanmar

- ASEAN Free Trade Area (Signed and In Effect)
- ASEAN-Australia and New Zealand Free Trade Agreement (Signed and In Effect)
- ASEAN-EU Free Trade Agreement (Under Negotiation)
- ASEAN-India Comprehensive Economic Cooperation Agreement (Signed and In Effect)
- ASEAN-Japan Comprehensive Economic Partnership (Signed and In Effect)
- ASEAN-Korea Comprehensive Economic Cooperation Agreement (Signed and In Effect)
- ASEAN-People's Republic of China Comprehensive Economic Cooperation Agreement (Signed and In Effect)
- Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) Free Trade Area ((FA) signed/FTA Under Negotiation)
- Comprehensive Economic Partnership for East Asia (CEPEA/ASEAN+6) (Proposed/Under consultation and study)
- East Asia Free Trade Area (ASEAN+3) (Proposed/Under consultation and study)

Thailand

- ASEAN Free Trade Area (Signed and In Effect)
- ASEAN-Australia and New Zealand Free Trade Agreement (Signed and In Effect)
- ASEAN-EU Free Trade Agreement (Under Negotiation)
- ASEAN-India Comprehensive Economic Cooperation Agreement (Signed and In Effect)
- ASEAN-Japan Comprehensive Economic Partnership (Signed and In Effect)
- ASEAN-Korea Comprehensive Economic Cooperation Agreement (Signed and In Effect)
- ASEAN-People's Republic of China Comprehensive Economic Cooperation Agreement (Signed and In Effect)
- Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) Free Trade Area ((FA) signed/FTA Under Negotiation)
- Comprehensive Economic Partnership for East Asia (CEPEA/ASEAN+6) (Proposed/Under consultation and study)
- East Asia Free Trade Area (ASEAN+3) (Proposed/Under consultation and study)
- India-Thailand Free Trade Area ((FA) signed/FTA Under Negotiation)
- Japan-Thailand Economic Partnership Agreement (Signed and In Effect)
- Korea-Thailand Free Trade Agreement (Proposed/Under consultation and study)
- Lao PDR-Thailand Preferential Trading Arrangement (Signed and In Effect)

- Pakistan-Thailand Free Trade Agreement (Proposed/Under consultation and study)
- People's Republic of China-Thailand Free Trade Agreement (Signed and In Effect)
- Thailand-Australia Free Trade Agreement (Signed and In Effect)
- Thailand-Bahrain Free Trade Agreement ((FA) signed/FTA Under Negotiation)
- Thailand-Chile Free Trade Agreement (Proposed/Under consultation and study)
- Thailand-European Free Trade Association Free Trade Agreement (Under Negotiation)
- Thailand-MERCOSUR Free Trade Agreement (Proposed/Under consultation and study)
- Thailand-New Zealand Closer Economic Partnership Agreement (Signed and In Effect)
- Thailand-Peru Free Trade Agreement ((FA) signed/FTA Under Negotiation)
- United States-Thailand Free Trade Agreement (Under Negotiation)

Viet Nam

- ASEAN Free Trade Area (Signed and In Effect)
- ASEAN-Australia and New Zealand Free Trade Agreement (Signed and In Effect)
- ASEAN-EU Free Trade Agreement (Under Negotiation)
- ASEAN-India Comprehensive Economic Cooperation Agreement (Signed and In Effect)
- ASEAN-Japan Comprehensive Economic Partnership (Signed and In Effect)
- ASEAN-Korea Comprehensive Economic Cooperation Agreement (Signed and In Effect)
- ASEAN-People's Republic of China Comprehensive Economic Cooperation Agreement (Signed and In Effect)
- Chile-Viet Nam Free Trade Agreement (Under Negotiation)
- Comprehensive Economic Partnership for East Asia (CEPEA/ASEAN+6) (Proposed/Under consultation and study)
- East Asia Free Trade Area (ASEAN+3) (Proposed/Under consultation and study)
- Japan-Viet Nam Economic Partnership Agreement (Signed and In Effect)
- Korea-Viet Nam Free Trade Agreement (Proposed/Under consultation and study)
- Trans-Pacific Partnership (TPP) ((FA) signed/FTA Under Negotiation)
- Viet Nam-Customs Union of Russia, Belarus, and Kazakhstan Free Trade Agreement (Proposed/Under consultation and study)
- Viet Nam-European Free Trade Association Free Trade Agreement (Proposed/Under consultation and study)

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Trade and Investment in the Greater Mekong Subregion: Remaining Challenges and the Unfinished Policy Agenda

In this paper, Jayant Menon and Anna Melendez examine the challenges that remain which limit the potential of the Greater Mekong Subregion (GMS) to reap further gains from trade and investment. Over the coming years, these countries will have to implement numerous ASEAN+1 bilateral free trade agreements. To minimize the administrative burden and maximize economic benefits, these countries should multilateralize their trade preferences, thereby avoiding trade diversion and deflection, and remaining open to global trade. However, any rebalancing of growth from foreign to domestic demand would unlikely be required in the smaller GMS countries in order to increase resilience to external shocks.

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