Executive Summary

Countries in the Mekong sub-region (Cambodia, Laos, Thailand and Viet Nam) face a dramatic challenge in promoting sustained growth and creating better employment opportunities for their young and growing populations, which live mainly in rural areas, where poverty rates are particularly disappointing. Implementation of far-reaching reforms, the opening up of their economies and better access to OECD-country markets has fuelled considerable dynamism in recent years. Their annual GDP growth of about 6 per cent over 2000-04 was above the regional average. However, growth is not on a firm footing yet, as it is largely driven by footloose sectors, such as clothing and electronics assembly, whose international competitiveness may be jeopardised by the ongoing restructuring of international production networks.

This study contributes to the international policy debate on how to promote private sector development and strengthen trade capacities in developing countries, by critically reviewing the experiences of governments and enterprises in the Mekong sub-region. How can governments and the private sectors work together to enhance competitiveness and meet the challenges of globalisation? How can donors effectively support these efforts? To what extent is the experience of the Mekong sub-region useful (and replicable) for other low-income countries? These are some of the questions this study tries to answer. More specifically, it analyses how local firms can get involved in international production networks (or global value chains), access distant and more profitable markets and, through their relationships with customers, upgrade their capabilities. It also considers how these firms are adjusting to the changing geography of trade and investment flows and governance structures of global value chains. In this way, the study seeks to draw 'bottom up' policy conclusions from firm- and industry-level analyses in specific country settings about how best to support private sector development in developing countries.

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These challenges are not unique to the Mekong sub-region. Many low-income countries have experienced a slow and unsatisfactory response to international trade liberalisation and are struggling to diversify their productive structures and increase value addition. On the one hand, high transaction costs and poor regulatory environments, often the result of earlier ill-conceived industrialisation strategies, exacerbate structural weaknesses in the productive sector and limit the opportunities created by dismantling trade and investment barriers. On the other, complex rules of origin and technical barriers to trade contribute to reducing the potentially positive impact of preferential market access initiatives.

The four neighbouring countries considered here share common problems, such as infrastructure bottlenecks and lack of regulatory harmonisation affecting cross-border trade and investment. The ongoing process of regional integration could help tackle these obstacles more effectively. At the same time, each country faces its own constraints, reflecting their different levels of development. In Cambodia, Laos and Viet Nam, the unfinished transition to a full market economy and the burden of past conflicts, which impoverished these economies and contributed to their falling off the radar screens of international trade and investment, still linger. Implementation of large-scale reforms and the granting by industrialised countries of preferential access to their markets spurred a surge of investment, pushing industry value-added growth to about 10 per cent a year between 2000 and 2004. This is progress, but these countries are still lagging behind. In Viet Nam, the most advanced in the catching-up process, per capita income is still only one-fifth of Thailand's (one-third in PPP terms).

The end of the Multifibre Arrangement (MFA), restructuring of the global electronics industry, rapid deforestation and depletion of natural resources in Southeast Asia, adoption of more stringent food safety requirements by importing countries, as well as frequent dumping allegations against Asian exporters, are among the biggest challenges these countries face. How are they adjusting to these phenomenal changes? What can governments do to sustain the adjustment and industrial restructuring process? Is there a role to play for donors?

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What are the Main Findings?

The study identifies five major findings:

1) One of the biggest changes in international trade over the last two decades is the emergence of a new form of international production sharing, moving from a structure centred on vertically integrated multinational enterprises towards one based on tiered networks of independent firms linked by market transactions. Given that they control key assets such as technology, design or brand name, lead firms can co-ordinate and control complex global-scale production systems without direct ownership. The personal computer industry is a case in point. Production processes have become increasingly interconnected along global value chains that stretch across many countries, with each country specialising in particular stages of an item's production sequence. Improvements in information and communication technology, combined with the search for lower-cost locations, better logistics, preferential market access and ways to circumvent trade barriers, brought about this geographical fragmentation of the production process.

2) Linking up to foreign partners creates opportunities for developing-country producers to escape their domestic constraints by offering them access to distant markets, knowledge and upgrading possibilities. Participation, however, is neither easy nor a guarantee of successful upgrading. Often firms in developing countries lack the capacity to comply with lead firms' requirements and remain at the bottom end of the value chain, performing simple and low-value-added assembly tasks. Lead firms generally invest to upgrade their suppliers' capabilities, but supplier-oriented upgrading has its inherent limits. Lead firms tend to provide selective support to improve the capacity to accomplish production and delivery tasks, as opposed to strengthening other potentially more rewarding capabilities such as design or marketing. The competitive and regulatory environment has also changed quite substantially. Latecomer firms face more competitive and sophisticated suppliers offering a wide range of services, far beyond assembly, and more stringent standards, affecting the structure of rewards along the value chain and the possibilities for industrial upgrading. The textile and clothing and the electronics sectors best epitomise this complex situation. Buyers' assistance to their suppliers has contributed to impressive upgrading of their productive capabilities. At the same time, rationalisation of buyers' sourcing strategies and the complex requests they make to their suppliers are raising the bar for entry thus favouring horizontal concentration of suppliers. In other industries, such as food or wood products, participation relies on availability of natural

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resources and barriers to entry are somehow less stringent for the bulk segment of the market, which however also offers lower margins. Ability to meet environmental and sanitary standards plays a crucial role, especially for the higher end of the market.

3) Reforms to promote the private sector have spurred growth and generated employment, helping to reduce poverty in all four countries. Still, poverty persists while the private sector remains fragile, beset by structural weaknesses and slowly improving regulatory frameworks. Analysis of specific sectors — agro-industry, textiles and clothing, wood products and electronics — suggests that domestic firms face substantial obstacles to guaranteeing reliable supply and meeting quality and safety standards. These difficulties reflect underlying flaws in the domestic supply chain, such as low productivity (stemming from low educational attainment and obsolete technology), poor quality control (reflecting the high cost of testing and lack of dedicated facilities) and limited vertical and horizontal linkages. Infrastructure bottlenecks and inefficient logistics, poor trade facilitation and shortcomings in the business environment (especially access to financing and efficient utilities) all push up costs and reduce the international competitiveness of these firms.

4) Private sector development has become part and parcel of government growth strategies, featuring prominently in national development strategies and poverty-reduction strategy papers. Governments have made great efforts to reform their policies and remove remaining anti-private sector or anti-export biases. Reforms are starting to bear fruit, mainly in Foreign Direct Investment (FDI) and export growth. Cambodia, Laos and Viet Nam have embarked on far-reaching programmes of economic liberalisation and sector-specific development. Thailand, which already had an open trade and investment policy environment, has taken further steps to establish itself as a major regional player in international production networks. In order to support industrial restructuring and upgrading, governments have resorted to dedicated interventions and incentive schemes to enhance risk taking and foster competitiveness. These interventions compensate for weak or missing markets and include financing for training programmes, technology support centres, testing laboratories, equipment upgrading and linkage-promotion programmes. The ongoing regional integration and WTO accession gave strong impetus to the reform process. Cambodia joined the WTO in 2001, while Laos and Viet Nam are still in the course of joining. The donor community has provided substantial technical and financial support to these efforts. Donors have channelled resources through both bilateral and, increasingly, co-

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ordinated multi-donor programmes, such as the Integrated Framework for Trade-Related Technical Assistance (IF) and the Mekong Private Sector Development Facility (MPDF).

5) The private sector is adjusting to domestic and international challenges, often through co-ordinated action and in partnership with government institutions. Available evidence points to some positive, though still limited, improvements. Some companies overcame their competitive disadvantages and established themselves as successful producers in the sectors reviewed. These companies frequently used the knowledge acquired as suppliers and original equipment manufacturers for foreign customers to develop their own products or diversify into new lines of business. Collaborative efforts with business associations and government agencies were often instrumental in addressing underlying drawbacks of the industry and responding to emerging threats, such as anti-dumping actions or food safety emergencies. Supplier-oriented upgrading remains crucial for building or strengthening manufacturing capacity. Lead firms often provide assistance for certification, training and technology transfer, as seen with coffee, wood products and electronics.

Conclusions and Policy Recommendations

Supply-side constraints and a high-cost business environment are major hindrances to private sector development and export growth in the four countries, as in many other low-income countries. An increasingly complex external environment aggravates those internal difficulties, with the web of trade and trade-related regulations set in multilateral, regional and bilateral agreements complemented by (sometimes stricter) standards enforced by private sector actors. These rules, which generally reflect best practices in industrialised countries, aim to create a transparent and predictable environment in which to conduct business. They also have the potential to induce economic restructuring. These rules, however, often carry considerable implementation costs and put an additional burden on already scant institutional resources in developing countries.

How can governments and the enterprise sector best address the underlying weaknesses that prevent productive diversification and value addition, in a situation of limited resources and constrained external

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environment? We think we have contributed to this policy debate in three ways. By discussing how policy interventions should be designed to promote private sector development more effectively, by considering how international development assistance can better integrate domestic efforts in this area and by discussing the concerns of many developing countries about the flexibility of the multilateral trading system (so-called "policy space") and its capacity to accommodate their various concerns.

Supportive Policies

Improving the regulatory environment and the ease of doing business is important, but not enough. Successful upgrading often depends on knowledge acquired through linkages to strategic partners in global value chains. However, local firms encounter tough obstacles to qualify for entry into such productive relationships. Well-designed government interventions can raise the benefits and reduce the costs for foreign firms of using domestic suppliers by tackling market failures that discourage these lead firms from supplying locally and hamper the linkage formation process. At the same time, proactive policies can strengthen domestic firms' capabilities, by also involving foreign firms in financing training and skill formation that the country needs. Far from advocating a "picking winners" approach, we suggest government interventions should focus as much as possible on strengthening and expanding the range of firms' capabilities to produce more efficiently and engage in non-traditional activities. The kind of capabilities that need to be strengthened, as well as the regulatory bottlenecks to be streamlined, can only emerge from a regular and transparent dialogue with the private sector and civil society. Governments should also make sure they adopt a coherent set of policies and whole-of-government approaches in designing and implementing private sector development interventions. Efforts to alleviate supply-side bottlenecks would be useless if other policies perpetuate an anti-private sector bias and keep incentives for new risk-taking activities low.

What Role for Donors?

Developing-country governments, facing severe resource constraints and multiple pressing priorities in areas of basic human needs, might find it hard to finance interventions to support private sector development and adjustment costs associated with trade liberalisation and industrial restructuring. Trade-related international assistance, therefore, has an important role to play.

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Donors, who are already granting much-needed technical assistance and financing infrastructure, should opt as much as possible for co-ordinated, multi-donor approaches, aligned to priorities identified and endorsed by stakeholders in the beneficiary country. Allocating responsibilities among donors and securing adequate and predictable funding for implementation must be addressed upfront, to ensure the sustainability of these initiatives. Although increasing since the WTO Doha Ministerial, resources for trade-related assistance are insufficient, especially in the light of an expanding menu of activities and of countries that require financing. The need to scale up aid resources for trade (and trade-related adjustment) has often been reiterated by beneficiary countries and within the WTO. More resources would make little difference, however, if donor and recipient countries do not find ways to use them more effectively. The importance of linking the "aid for trade" debate to the broader aid harmonisation and effectiveness agenda is therefore crucial.

The Multilateral System and the Policy Space Debate

Policy makers should also reconsider the architecture of the multilateral trading system and acknowledge the need for greater differentiation. There are big differences between developing countries in terms of resource capacity and national priorities and a precondition for ownership and sustainability of the multilateral system is that signatory governments perceive that the benefits of these rules outweigh the costs. Cambodia's accession process to the WTO represented a unique opportunity for learning, adopting far-reaching reforms and catalysing trade-related assistance around well-defined goals. At the same time, despite the resources and efforts deployed, Laos, and especially Viet Nam, have still not become members. This shows the huge difficulties that developing countries face in creating domestic support for reform, upgrading their legislative and regulatory frameworks and abiding by international agreements. Developing-country governments claim that the international environment, though allowing some flexibility for developing countries ("policy space"), limits the possibility of using the policy tools that underpinned the development of the Asian tigers, such as local content requirements or subsidies contingent on export performance. Using such instruments is clearly more difficult today, but it is not certain they were the most fundamental force behind the phenomenal development of these countries. Their costs need to be closely evaluated and other polices affecting firms' competitiveness need to be considered. Moreover, the discussion risks overlooking the limits of the flexibility already built into the current system

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(single undertaking and special and differential treatment for the self-defined developing countries), which has proved quite ineffective in addressing these widely different interests and concerns. A new kind of flexibility should be introduced, which balances the need to ensure adoption of a core set of regulations by all members and full participation of developing countries in writing the rules, while offering them enough time and resources to learn and adopt new commitments.

It is often argued that trade-related technical assistance and capacity building should help developing countries to better identify their own trade interests and negotiation positions. Many observers have warned about the risk of inherent conflicts of interest, as donor-country governments eventually sit at the same negotiating table as the beneficiary of their assistance. Mechanisms can be devised to minimise risks and ensure that assistance is directed to areas relevant to the beneficiary country. The experience of most advanced countries shows that a country's trade and development interests only emerge through close interaction and learning between government, private sector and civil society. Adequate efforts should thus be made to promote entrepreneurship, while also strengthening the analytical and advocacy capacity of private sector and civil society organisations.

Promoting private sector activity calls for a mix of interventions, geared towards improving the policy framework and company-level capabilities. These two goals are largely complementary and need to be tackled in a complementary and coherent manner. Since their ultimate aim is empowering developing-country entrepreneurs to take advantage of opportunities created by the fall of barriers in local, regional or international markets, donors' trade-related and private sector development interventions should be closely linked in their design, implementation and evaluation.

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