

**MACROECONOMIC DETERMINANTS OF ECONOMIC GROWTH IN  
INDOCHINA COUNTRIES: A PANEL ANALYSIS**

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## **ABSTRACT**

### **Macroeconomic Determinants and Economic Growth in Indochina Countries:**

#### **A Panel Analysis**

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This study examines the main macroeconomic determinants of economic growth in Indochina countries, namely Cambodia, Laos, Myanmar, Thailand and Vietnam over the period of 1980 to 2009 where the sample period is dictated by data availability. Various econometric methodologies like Levin, Lin and Chu (LLC), Im, Pesaran and Shin (IPS) and Fisher-type (Fisher-ADF and Fisher-PP) panel unit root tests, Pedroni's cointegration test and Hausman test are conducted in this study. The result shows that there is non-existence of long run relationship between the macroeconomic determinants and economic growth in Indochina countries. Besides, this study found that the most significant macroeconomic determinant contributes to the economic growth in Indochina countries is inward Foreign Direct Investment (FDI). The negative relationship between inward FDI and economic growth imply that FDI-led growth hypothesis is not valid in Indochina countries which violated the endogenous growth theory.

## **ABSTRAK**

### **Faktor Penentu Makroekonomi dan Pertumbuhan Ekonomi di Negara-negara Indocina: Sebuah Analisis Panel**

**Oleh**

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Kajian ini dijalankan untuk mengkaji faktor penentu makroekonomi utama bagi pertumbuhan ekonomi di Negara-negara Indocina, iaitu Kemboja, Laos, Myanmar, Thailand dan Vietnam dalam tempoh 1980 hingga 2009 di mana tempoh sampel ditentukan oleh kesediaan data. Pelbagai jenis metodologi ekonometrik seperti ujian kepegungan panel *Levin, Lin and Chu (LLC)*, *Im, Pesaran and Shin (IPS)* and *Fisher-type (Fisher-ADF and Fisher-PP)*, ujian kepengamiran *Pedroni* dan ujian *Hausman* diaplikasikan dalam kajian ini. Hasil kajian ini menunjukkan bahawa faktor penentu makroekonomi dan pertumbuhan ekonomi tidak mempunyai hubungan jangka panjang di negara-negara Indocina. Di samping itu, kajian ini mendapati bahawa pelaburan langsung asing (PLA) masuk merupakan faktor penentu yang signifikan terhadap pertumbuhan ekonomi di negara-negara Indocina. Pelaburan langsung asing masuk yang berpengaruh secara negatif terhadap pertumbuhan ekonomi menunjukkan bahawa hipotesis pertumbuhan pacuan PLA tidak berlaku di negara-negara Indocina di mana ia melanggar teori pertumbuhan endogen.

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# CHAPTER 1

## INTRODUCTION

### 1.0 Introduction

A country's economic growth may be defined as a long-term rise in capacity to supply increasingly diverse economic goods to its population, this growing capacity based on advancing technology and the institutional and ideological adjustments that it demands (Kuznets, 1973). The three main components of economic growth are capital accumulation, population growth and technological progress. By overcoming the diminishing returns to physical capital accumulation, human capital has been used to determine growth (Lucas, 1988; Jones and Manuelli, 1990; Rebelo, 1991; Stokey, 1991) and knowledge accumulation has been used to perpetuate growth, either through learning by doing (Romer, 1986; Stokey, 1988; Young, 1991) or Research and Development (R & D) (Romer, 1990; Grossman and Helpman, 1991; Aghion and Howitt, 1992).

Increasing of economic growth can bring numerous advantages to a country, which are boost the average standard of livings; increase output which generate new job opportunities and thus reduce unemployment; boost household wealth with the good news for shares and the housing market; boost tax revenues for government as growth provides fiscal dividend; improve business confidence as it becomes attractive to foreign investment inflows; increase investment due to higher consumer demand; and spur to introduction of new technology (virtuous circle of growth) which spur further innovation (tutor2u, 2010).

As a result, forecasting the future evolution of Gross Domestic Product (GDP) growth is central concern for monetary policies and assessment of future state of the economics. Policymakers and economic analysts can either adapt their theoretical analysis of economic conditions regarding to the GDP growth forecasts or even probably make use of them as a justification of their theoretical analysis. Thus, better forecast performance for GDP growth will bring to better decisions (Guegan and Rakotomaroahy, 2010).

### **1.1 Background of Country**

Indochina is former federation of states in Southeast Asia. It is also known as Mainland Southeast Asia, comprised of Cambodia, Laos, Myanmar, Thailand and Vietnam. This region lies roughly east of India and south of China. This region lies roughly east of India and south of China, receives varying degrees of cultural influence from China and India. The cultures of Cambodia, Laos, Myanmar and Thailand are more heavily influenced by culture of India with a minor influence from culture of China while Vietnam is on contrary (Wikipedia, 2011). Due to lack of industrialisation, almost all Indochina countries are very interesting destination for tourists as it rich in cultural and fantastic natural sceneries, thus tourism has been a key factor in economic development especially Cambodia (Accom365, 2011).

Indochina is one of the least urbanized realms in the world where most of the countries live in rural areas but cities are growing in population. Agriculture is the major source of wealth in Indochina as the Mekong River supplies plentiful water to support farming and provide home to its citizens. Besides that, the tropical and

subtropical climates as well as fertile soil enable farmers to grow rice as a major food crop (Frederick & Leinbach, 2011). After all Indochina countries joined into Association of Southeast Asian Nations (ASEAN) by 1999 (Bank of Japan, 2011), the industry and services sector become increasingly important as the ASEAN economies adopted industrialization policies and structured towards growth in these two sectors.

As a result, the Thailand has been included in newly industrialized countries as it traditionally experienced high economic growth and commonly recognized as a well-established developed country. Vietnam also has been experiencing economic boom as it is notably making steady progress in developing their industrial sectors. For the rest of Indochina countries, Cambodia, Laos and Myanmar that still rely heavily on agriculture are economically lagged behind (Destination Asia, 2011).

Since the four Indochina countries, namely Cambodia, Laos, Myanmar and Vietnam are the least developed among the ASEAN members (Masaki, 2005), therefore the macroeconomic determinants of economic growth are important for policymakers to suggest appropriate policy such as trade liberalization to boost up the economic growth of these countries simultaneously with Thailand. The review of the economic growth background of each of Indochina countries are shown below.

### **1.1.1 Cambodia**

Cambodia is a low income economies with a range of income \$995 or less, coming under the East Asia and Pacific Region as to the classification made by the World Bank on the basis of income and region for the year 2011 (World Bank, 2011). The Cambodian economy is primarily agriculture based, whereas the second most

contributing industry is tourism and it also driven by garments and construction as well. Other major contributors to the GDP in the Cambodia industry sectors are beverages, food and beverage, and wood processing (Economy Watch, 2011).

**Table 1.1: The GDP, Constant Prices in Cambodia from 1986 to 2015\* (2008 est.)**

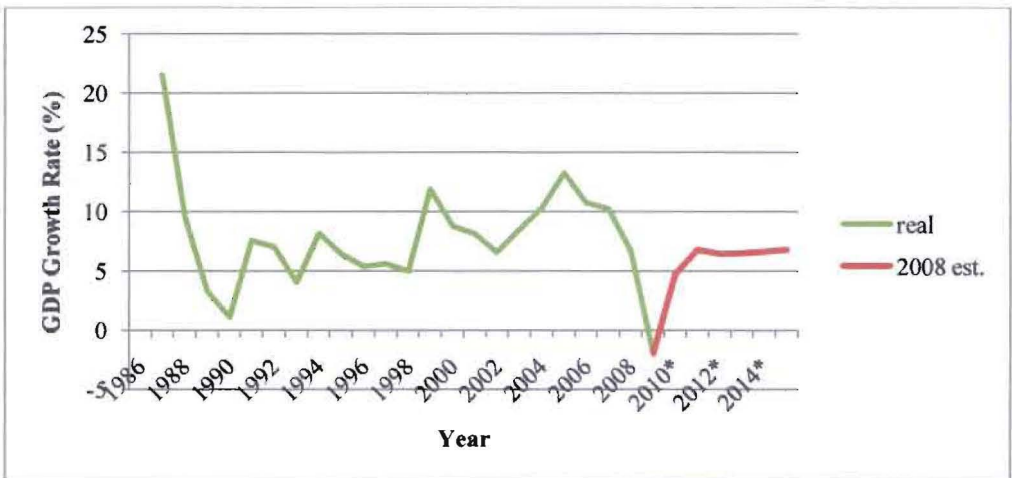
Year	GDP (Billions of Riels)
1986	5,151.40
1987	6,260.58
1988	6,862.60
1989	7,090.92
1990	7,170.19
1991	7,714.55
1992	8,259.91
1993	8,593.78
1994	9,296.87
1995	9,895.86
1996	10,431.46
1997	11,017.69
1998	11,569.57
1999	12,947.47
2000	14,082.64
2001	15,230.15
2002	16,232.13
2003	17,612.82
2004	19,434.07
2005	22,009.11
2006	24,379.73
2007	26,869.52
2008	28,667.52
2009*	28,106.60
2010*	29,446.10
2011*	31,453.16
2012*	33,488.66
2013*	35,663.53
2014*	38,029.25
2015*	40,606.01

Source: World Economic Outlook (WEO), International Monetary Fund

Cambodia is one of the world's poorest economies, thus economic development is its highest priority. Much of its population is involved in subsistence farming with limited arable land. In addition, it suffered from the long period of civil strife and instability which adversely affected Cambodian economy in its human resource base and physical infrastructure (Encyclopedia of the Nations, 2011). The GDP in Cambodia at constant prices over the period of 1986 to 2015\*, where started from 2009\* until 2015\* is the forecast estimation in 2008 is illustrated in Table 1.1.

Although GDP in Cambodia shows an upward trending from 1986 to 2015\* in Table 1.1, it does not necessarily means that the GDP growth rate also having the same trend. The derivation of GDP growth rate in Cambodia from GDP at constant prices is presented in Figure 1.1. From the figure, the GDP growth rate shows an unstable trending from early 1986 to 2010\*, however it forecasted to have a sustainable growth onwards.

**Figure 1.1: Trend of GDP Growth Rate in Cambodia from 1986 to 2015\* (2008 est.)**



Source: World Economic Outlook (WEO), International Monetary Fund



According to Figure 1.1, the Cambodia's GDP growth rate has declined sharply from 21.5 percent in 1986/87 to 1.1 percent in 1989/90. During that time period, the First Five-Year Program of Socioeconomic Restoration and Development (1986-90) or First Plan was adopted by Kampuchean People's Revolutionary Party (KPRP). The plan was intended to open a new phase of the Cambodian revolution and gave highest priority to agricultural production, calling it "the first front line" by focussing on food, rubber, fishing, and timber sectors. However, the adverse weather conditions, insufficient numbers of farm implements and of draft animals, inexperienced and incompetent personnel, security problems, and government collectivization caused the agricultural sector performed poorly. All of these reasons contributed to low productivity and decreasing in GDP growth rate indirectly (Mongabay, 2010).

Since the early 1990s, Cambodia has enjoyed over a decade of high average economic growth of 7.1 percent, which is driven largely by construction and tourism, and a rapidly emerging garment sector since the late 1990s (World Bank, 2007). Cambodia has made great strides after Paris Peace Accords in 1991, when more than two decades of isolation and conflict ended and priorities turned to ensuring peace and security, rebuilding institutions, establishing a stable macroeconomic environment, and putting in place a liberal investment regime (Asian Development Bank, 2010).

After the starting point of transition period from socio-economy into market-oriented economy in 1993, the Cambodian economy was recognized as the economy based on foreign aid in 1994 as large amounts of foreign aid replaced the budget deficit financing by printing money and easing inflationary pressures. At the same

time, the enactment of Investment Law attracting large foreign direct investment (FDI) concentrated on the light industry particularly in garment manufacturing, mainly from ASEAN countries into Cambodia. With the market-oriented economy, Cambodia enjoyed its high level of economic growth until 1997 where the economy growth slowed to a low of 5 percent in 1997/98 due to the Asian Financial Crisis, civil violence and political infighting. During that time, the international aid was suspended and FDI fund was dramatically decreased. However, it has succeeded a rapid economic recovery as a result of relentlessness in local politics pressure and the historic joint with ASEAN in 1999. After the Cambodia's accession to ASEAN, the liberalization of Cambodian economy has gained momentum reaching a high growth of 11.9 percent in 1998/99 (Ty, 2011).

During the second mandate of the Royal Government of Cambodia (RGC) (1999-2003), the strengthening of macroeconomic management and implementation of the fiscal reforms to maintain macroeconomic stability has resulted in an average annual GDP growth of 8 percent (Council for the Development of Cambodia, 2011). From 2004 to 2007, the Cambodian economy experienced rapid growth expanded by an averaged of 11.4 percent per annum, with the expansion in the garment sector, construction, agriculture and tourism driving the growth, and relative stability of inflation. This rapid growth also caused by the speedy increase in FDI which is 12-fold since 2004, as the sound macroeconomic policies, political stability, regional economic growth and government openness toward investment attract growing number of foreign investor. Moreover, US-Cambodia bilateral trade and Investment Framework Agreement (TIFA) was signed in 2006 (U.S. Department of State, 2010).

However, the GDP growth rate dropped below 7 percent in 2007/08 and probably contracted led to zero-growth in 2008/09\* as a result of the global economic slowdown where the global financial crisis weakened the demand of exports and construction is declining due to the shortage of credit (CIA World Factbook, 2011). Therefore, the long-term economic stability of Cambodia remains a serious challenge to achieve Cambodia Millennium Development Goals (CMDG) by 2015, which is essential to reducing poverty, improving livelihood and the quality of life of all Cambodians (Ministry of Planning, 2007). While recovery is forecasted for 2010, the GDP growth is anticipated to be much lower than the recent historical trend with an annual average growth of 6.6 percent over the period of 2010\* to 2015\*.

### **1.1.2 Laos**

According to World Bank (2011), Laos is similar with Cambodia classified as a low income economies with a range of income \$995 or less coming under the East Asia and Pacific Region on the basis of income and region for the year 2011. Laos is also one of the world's poorest economies, thus its main objective is to strengthen its economy and develop its own means to earn foreign exchange (Encyclopedia of the Nations, 2011). The Laos economy is dominated by agriculture where the subsistence rice farming is the support of the economy. Other major contributors to the GDP in the Laos industry sectors are timber, tin and copper mining, garments, construction, cement, gypsum mining and tourism (Economy Watch, 2011).

**Table 1.2: The GDP, Constant Prices in Laos from 1980 to 2015\* (2009 est.)**

Year	GDP (Billions of Kip)
1980	5,099.28
1981	5,881.09
1982	6,158.37
1983	6,343.13
1984	6,751.53
1985	7,367.37
1986	7,723.14
1987	7,649.02
1988	7,488.39
1989	8,229.21
1990	8,779.45
1991	9,130.51
1992	9,769.59
1993	10,342.75
1994	11,186.74
1995	11,974.84
1996	12,800.20
1997	13,684.30
1998	14,283.66
1999	14,874.29
2000	15,814.95
2001	16,546.06
2002	17,681.98
2003	18,780.00
2004	20,098.60
2005	21,458.60
2006	23,313.60
2007	25,141.97
2008	27,099.19
2009	29,156.14
2010*	31,414.87
2011*	33,770.21
2012*	36,251.39
2013*	38,566.61
2014*	41,486.93
2015*	45,352.83

Source: World Economic Outlook (WEO), International Monetary Fund

The major economic disadvantage of Laos has been that it is a landlocked country with an inadequate infrastructure and a largely unskilled workforce. The economic hardship is further exacerbated by low domestic savings, forcing Laos to heavily dependent on investment sources for economic development particularly foreign assistance and concessional loans (U.S. Department of State, 2010). The GDP in Laos at constant prices over the period 1980 to 2015\*, where started from 2010\* until 2015\* is the forecast estimation in 2009 is presented in Table 1.2.

As shown in Table 1.2, the Laos' GDP shows an upward trending starting from 1980 to 2015\* with the exception of small decline in GDP for the year 1987/88. The derivation of GDP growth rate in Laos from GDP at constant prices is presented in Figure 1.2, where it shows an unstable trending over the period 1980 to 2015\*.

**Figure 1.2: Trend of GDP Growth Rate in Laos from 1980 to 2015\* (2009 est.)**



Source: World Economic Outlook (WEO), International Monetary Fund

According to Figure 1.2, the Laos' GDP growth rate fell sharply from 15.3 percent in 1980/81 to a low of -2.1 percent in 1987/88 before staging a marked back

to 9.9 percent by 1988/89. As the tentative steps toward a continued market-oriented economy shifting away from socialist goals started in 1979, the First Five Year Plan (1981-1985) has been implemented to achieve self-sufficiency in food production and the collectivism of agriculture, and focus on developing industrial activity, increasing trade with Thailand, improving the shattered rural infrastructure and increasing export revenues. However, the Lao economy was showing signs of stagnation by the mid 1980s where the agricultural production was sluggish, low mobilization of domestic savings and few private enterprises (Mongabay, 2011).

As a result, the Second Five Year Plan (1986-1990) was endorsed in 1986 where the new reform policy called as New Economic Mechanism (NEM) attempt to stimulate economic recovery. It has been introduced to transform a planned economy system to that of free market forces and prices without sacrificing the nation's goal of food self-sufficiency, aims to provide greater incentives to increase economic performance and productivity (Encyclopedia of the Nations, 2011). This market-oriented reforms began to decentralized government control, encourage private enterprise as well as foreign investment. Despite of the success in carrying out many reforms during the late 1980s, the poorer results in Laos since 1986 can be ascribed to the severe drought in 1987 and 1988, thus the Second Five Year Plan ended with economic performance lagging well behind planned achievements where the sustained self-sufficiency in food had not been met (Bourdet, 2000).

The Lao economy grew fairly fast at an annual average rate of 6.7 percent from 1988 to 1998 with the exception during the short-lived drop caused by the Asian financial crisis that began in 1997. Although Lao economy has been gaining momentum opportunities with large foreign capital inflows after joined into ASEAN,

however the crisis has bring significant impact on the economy where GDP growth fell to below 4 percent in 1998 and 1999 due to the currency devaluation and hyperinflation. Despite this rapid growth, Laos still remains saddled by a distinct lack of infrastructure as well as internal and external telecommunications even the continued progress has been made under the previous two plans by the Third Five Year Plan (1991-1995) through the strategy in improving the country's infrastructure, promoting exports and encouraging import-substitution industries (Mongabay, 2011).

The adoption of stabilization program and several reform programmes in public expenditure management, banking, state-owned enterprises (SOEs), forestry, trade and the private sector contribute to the improvement in the GDP growth which resumed to around 6.3 percent in the early 2000s (Davading, 2010). Due to the impact of global financial crisis, the GDP growth rate has been slowed down from 7.9 percent in 2007/08 to 7.6 percent in 2008/09. The reliance on Foreign Direct Investment (FDI) instead of small quantum of domestic savings in assistance for the development in hydropower, mining and construction has been delayed with the happening of global financial crisis in the late 2008 (Economy Watch, 2011).

With the expected global recovery, the Lao economy is projected to rebound to 7.7 percent in 2009/10\* and to sustain at this annual average rate over the period of 2010\* to 2015\*. The future growth is anticipated to benefit from the recovery of tourism, implementation of large hydropower projects and increase in demand of natural resources from neighbouring countries (Davading, 2010). The Millennium Development Goals could be achievable by Laos to sustain a high economy growth of about 8 percent by 2015 and create favourable conditions for Laos graduating

from United Nations (UN) Development Program's list of least-developed countries by 2020 (Economy Watch, 2011).

### **1.1.3 Myanmar**

Myanmar, which is also known as Burma, is one of the poorest economies in Southeast Asia, but the largest country in Indochina. Among the world's poorest nations, it counted as the least open economy in Asia. Although Myanmar is a wealthy nation rich with natural resources, but its economy experienced incredible poverty due to the poor government control (Economy Watch, 2011). Thus, Myanmar is similar with Cambodia and Laos classified as a low income economies with a range of income \$995 or less coming under the East Asia and Pacific Region on the basis of income and region for the year 2011 (World Bank, 2011).

The Myanmar economy is a resource-rich country with strong agricultural base and dependent on its export trade to generate revenue. The major industrial sector in Myanmar is mineral industry while other industries are agriculture processing, garments, wood and wood products, pharmaceuticals, fertilizer, oil and natural gas, jade and gems, and cement and construction materials (Economy Watch, 2011). The military-run state enterprises controlled the key industries in Myanmar and the black market permeated every aspect of economic life where the prices are shooting up due to official price controls (World Desk Reference, 2011). In addition, Myanmar has an issue with imbalances on the economic front which bring numerous problems particularly inflation, overvalued multiple exchange rates, financial deficits, unreliable statistics and inability to reconcile national accounts as well as the determination of correct GDP (Economy Watch, 2011).