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# Asia's Frontier Economies
# Plenty of Alpha

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Bangladesh
Cambodia
Lao P.D.R.
Mongolia
Myanmar
Pakistan
Sri Lanka
Vietnam

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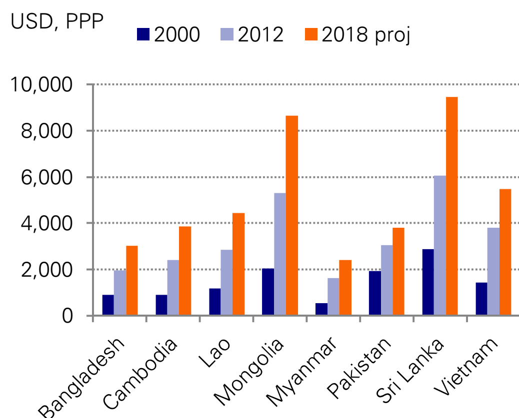
## Asia's Frontier Economies: Plenty of Alpha

What is a frontier economy, and how and when does it join the club of more scrutinized emerging market economies? The answer, for the purpose of this special publication, is as follows: frontier economies in Asia are considered to be those with the scale and/or potential to be comparable to emerging market economies, but presently lacking in sufficient economic and financial market depth to be suitable for large institutional participation in its financial markets.

In this report, we focus on eight selected economies of Asia that hold promise for a better tomorrow, not just for their population but for investors seeking alpha in an increasingly correlated world. The global financial crisis and the subsequent recovery have shown that financial markets have been beset with cross-border transmission of shocks, making diversification difficult. Frontier markets, because of their early stages of development and lack of market depth, are by and large uncorrelated to global markets.

The countries in this study, Bangladesh, Cambodia, Lao P.D.R., Mongolia, Myanmar, Pakistan, Sri Lanka, and Vietnam have seen fairly strong growth and impressive gains in income in recent years. Around the year 2000, in current prices, all countries were characterized by per capita income of less than $1000, while today incomes are higher by 2 (Bangladesh and Pakistan) to 8 (Mongolia) times. In purchasing power parity terms, the gains are smaller, but still impressive (2 to 3 times, as seen in chart below).

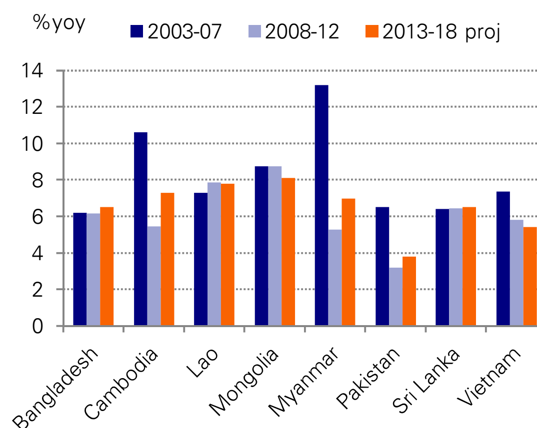
Per capita income is rising briskly, with a few countries heading into EM-comparable levels




*Source: IMF, Deutsche Bank. Gross domestic product based on purchasing-power-parity (PPP) per capita GDP, expressed in current international dollar*

Indeed, real GDP growth has been robust among these economies, by and large exceeding 6%, although Pakistan has experienced a sharp slowdown lately. Mongolia is a classic commodity boom story, while Cambodia, Lao, and Myanmar reflect low hanging fruits of opening up the economy. Sri Lanka shows tremendous promise as it shrugs of the drag from decades of civil conflict, and as per IMF forecasts, could be heading to the middle income cohort by the end of this decade.

With the exception of Pakistan, real GDP growth rate has been robust

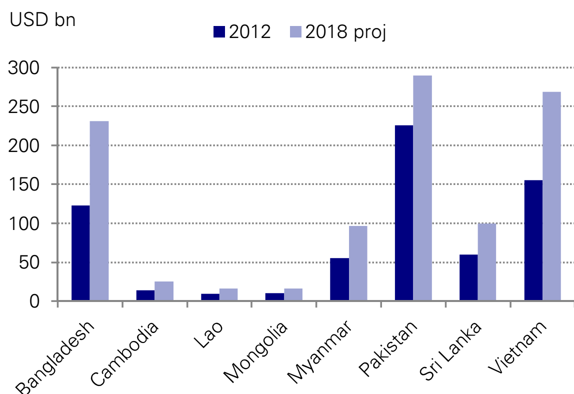



*Source: IMF, Deutsche Bank*

The economies in this study vary widely in size, but three already have nominal GDP amounting to more than USD100bn, namely Bangladesh, Pakistan, and Vietnam. Indeed, these three economies have a combined GDP of nearly half a trillion dollars and population of half a billion. These are hefty figures even by EM standards, and the scale alone is sufficient to keep investors interested in the coming years.

Two other economies in this study, Myanmar and Sri Lanka, offer potential scale (both likely to become USD100bn economies by 2018) and fast growth rates. The former is coming out of decades in economic seclusion, while the latter is recovering from a multi-decade civil war. Myanmar, if governed prudently, offers exciting opportunities for investors given its large population (64 million), extensive natural resource base, and low wages. Sri Lanka, already endowed with some of the most educated work force in the region and world class tourist destinations, could well be on the cusp of a sharp acceleration in growth, provided governance improves and the security situation remains stable.

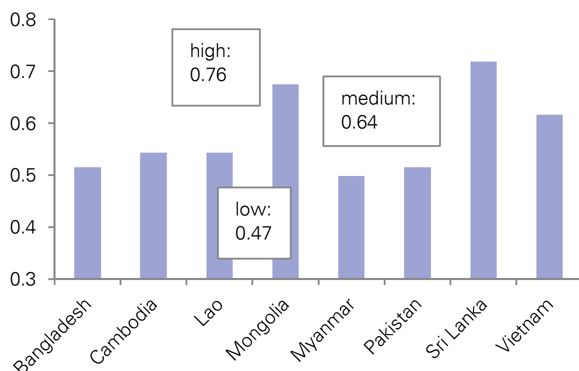
Three economies already in the USD100bn+ GDP club




*Source: IMF, Deutsche Bank*

Asia's frontier economies have their work cut out with regards to improving the living conditions of their population. Latest reading from the United Nations Human Development Index, which is a composite of life expectancy, education, and income indices, finds no country in the study in the high cohort, although Sri Lanka is on the cusp of joining that. Mongolia also ranks in the middle cohort comfortably as its per capita GDP and education attainment levels have risen sharply in recent years. Indeed, Mongolia recently overtook the Philippines in HDI scores, and is fast converging on Thailand. Among the rest, Bangladesh has seen a steady rise in recent years, outpacing its peers, while Pakistan has seen some setback as both the economy (especially income inequality) and the security situation has worsened.

Human Development Indicators; all have transitioned from low to medium level of development

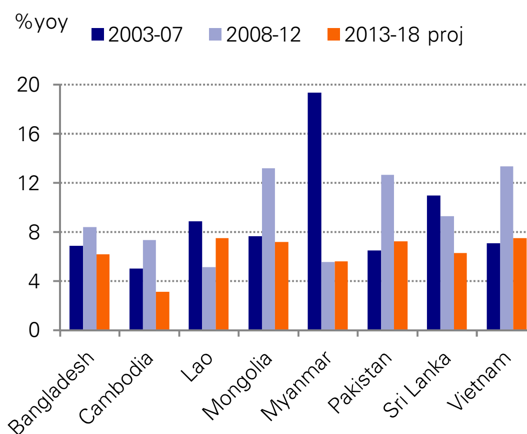



*Source: United Nations 2013 Human Development Index, Deutsche Bank*

While the countries in this study have grown substantially recently, with potential for more in the coming years, their key challenge is to assure macroeconomic stability while moving forward. Take for instance, the current account position of these economies. With the exception of Bangladesh and Vietnam, all countries in this study have been running sizeable current account deficits, ranging from -2% of GDP in Pakistan to a staggering -33% of GDP in Mongolia. Both Pakistan and Mongolia are presently experiencing difficulties in financing their imbalances, seeing their currencies weaken as a result.

Strong growth, if not managed through prudent counter-cyclical fiscal and monetary policies, can be readily associated with high rates of inflation. The chart below shows that frontier economies tend to struggle in this area, with all countries in our study experiencing inflation rates of 6% or higher in the past 5 years. Given that these economies have large swaths of population at or below the poverty level, and inflation tends to hurt the poor the most, the authorities need to work hard at bringing inflation down if they are serious about reducing poverty and inequality.

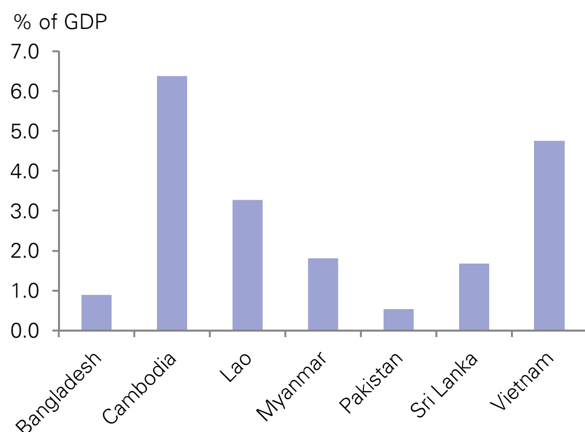
Track record with inflation has been broadly poor




*Source: IMF, Deutsche Bank*

Partly due to macro-economic volatility and limited market access, until recently there was little investor participation in most of the economies in this study. Change is underway, however. A few countries have already managed to attract sizeable foreign direct investment, with Cambodia, Mongolia, and Vietnam particularly notable. Mongolia's tremendous mining potential has begun to be realized as global energy giants have poured in money; indeed, in recent years FDI has amounted to nearly half the nominal GDP. Cambodia and Vietnam are receiving considerable attention from China in their apparel (Cambodia) and manufacturing (Vietnam) sectors. Lao, Myanmar and Sri Lanka have begun attracting considerable investment as well. The track record of Bangladesh and Pakistan, however, has been poor.

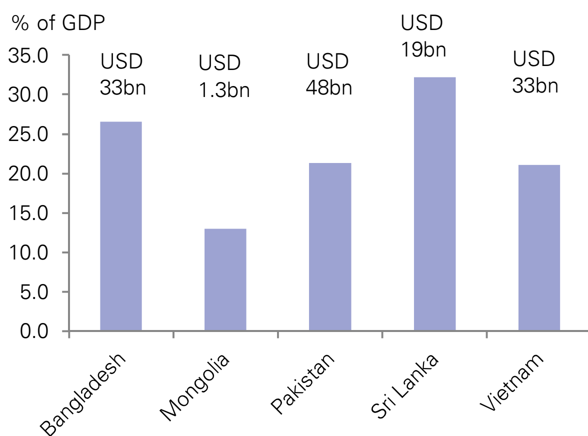
## Only a few are drawing sizeable FDI




*Source: World Bank, Deutsche Bank. This chart excludes Mongolia as adding it would distort the presentation. Mongolia received about 45% of GDP worth of FDI last year., almost all if it in mining.*

Beyond FDI, the prospect for portfolio flows has improved as markets have opened up. ETFs on Bangladesh, Mongolia, Pakistan, Sri Lanka, and Vietnam are available, while equity market capitalization in Bangladesh, Pakistan, and Vietnam are in the USD30-50bn range, making them interesting as far as scale is concerned.

## Stock market capitalization




*Source: CEIC, World Bank, Deutsche Bank*

Returns have been handsome as well. Pakistan's Karachi Stock Exchange, for example, is up 160% over the last five years, impressive gains even after the 30% depreciation of the rupee against the USD is taken into account. Investors in Bangladesh and Vietnam have seen, despite considerable volatility, net returns of 60-80% during this period.

External bond markets for some frontier countries have become active. While most external debt issued by these countries are multilateral or bilateral concessional loans, and local currency debt markets are by and large off limits to foreign investors, there have been a few sovereign and sovereign-backed issuances in recent years (see table below).

## Outstanding bonds

| USD bn | Sovereign | Sovereign-backed |
|---|---|---|
| Mongolia | 1.50 | 0.58 |
| Sri Lanka | 3.50 | 1.75 |
| Vietnam | 1.75 | -- |

*Source: Deutsche Bank*

Finally, the most compelling reason to invest in frontier countries, beyond their growth potential and associated dynamic, is their lack of correlation with the global economic cycle.[1] Below we present a set of growth regressions with G2 growth as the explanatory variable. This simple framework has proven to be useful in tracking EM Asia's growth path in recent decades. Extending the analysis to our set of frontier countries, we see that most offer little beta to the G2, with most their growth rates captured in the intercept of the regressions. Investors looking for low or negatively correlated trades in a world of increasingly common shocks will find looking at the countries in this study useful, in our view.

## Growth relationship with G2

| | Alpha | Beta |
|---|---|---|
| Bangladesh | 5.8 | 0.0 |
| Cambodia | 5.8 | 1.4 |
| Lao | 7.4 | 0.0 |
| Mongolia | 6.6 | 0.8 |
| Myanmar | 7.6 | 1.4 |
| Pakistan | 3.3 | 0.7 |
| Sri Lanka | 4.7 | 0.4 |
| Vietnam | 6.1 | 0.3 |

*Source: CEIC, IMF, Deutsche Bank. Growth beta regressions are run with individual country real growth as independent variable and GDP-weighted US/EU growth as the dependent variable. Alpha is the intercept while beta is the estimated coefficient on G2 growth.*

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[1] We present a set of macro data tables and demographics projection charts in the appendix of this publication.

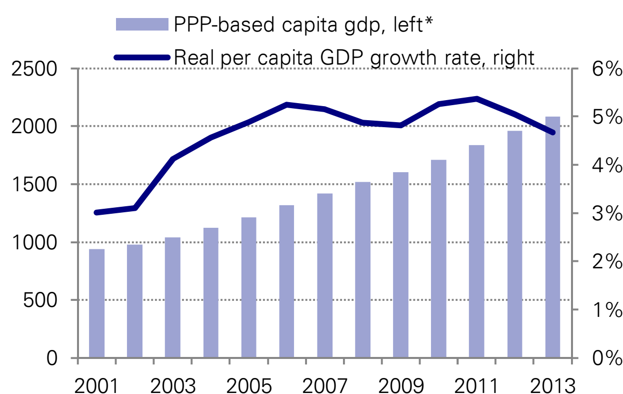
## Bangladesh—rising against the odds

*Despite constraints such as limited land, risks from climate change and high frequency of natural disasters, severe energy shortage, poor infrastructure, periodic political crises, and grave shortcoming in governance, Bangladesh's gains in economic growth and social indicators in recent decades have been remarkable. This trend is likely to continue.*

Bangladesh's track record defies its stereotypical image of an economy beset with repeated climate and governance related setbacks. Consider following:

- Real per capita GDP has risen, on average, by about 5% per annum for the past decade, with per capita GDP, on Purchasing Power Parity basis, rising to USD2100 this year.

Gains in nominal and real income over the past decade

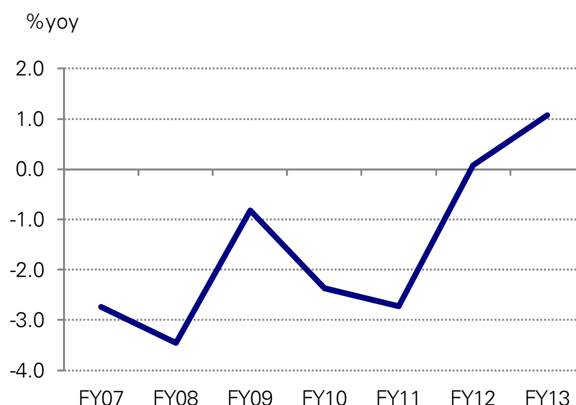



*Source: IMF, Deutsche Bank. Gross domestic product based on purchasing-power-parity (PPP) per capita GDP*

- While the present level of income still leaves the country in the cohort of the low income economies, there have been substantial gains in social and human development indicators:
  - Fertility rate has declined to 2.7 from 3.5 in the 1990s (used to be 6-7 in the 1970s);
  - Infant mortality has improved to 50 per 1000, from 146 in 1990-95;
  - Life expectancy has risen to 67; a sharp rise from 55 in 1990;
  - Gender disparity in primary and secondary education has been eliminated. Indeed, Bangladesh has made striking progress in reducing gender inequality, ranking considerably higher than India and Pakistan in areas such as women's reproductive health, empowerment and participation in economic activity.
  - The country is on track to meet the Millennium Development Goal of halving the proportion of people living below the poverty line between 1990-95 and 2015.

Also, despite high population density and land constraints (both quantity and quality), food production has kept pace with demand, keeping the economy largely self-sufficient. As GDP growth rate has remained steady, Bangladesh's growth differential with its largest neighbor, India, has narrowed markedly.

Growth differential with India has reversed




*Source: CEIC, Deutsche Bank. The above chart plots the difference between Bangladesh's real GDP growth rate with that of India.*

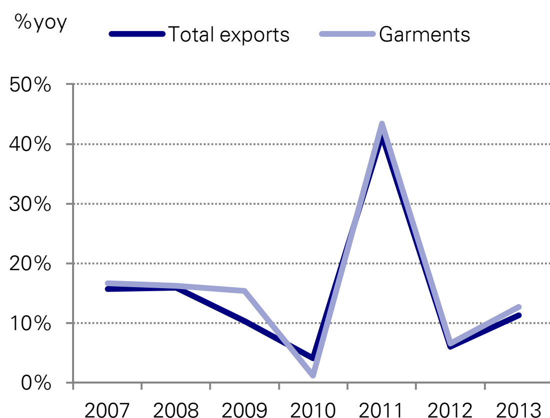
Bangladesh's 6%+ growth record in recent years, with a striking lack of variation regardless of the state of the global cycle, and a comfortable balance of payments position has been supported by three pillars:

### Pillar 1: Earnings from readymade garments

The economy has a large (second largest in the world) and efficient readymade garment sector that caters to the demand for reasonably priced, essential clothing in the US and EU. This segment of the clothing industry has a largely inelastic and substantial demand, as borne out by the resiliency of orders during the 2008/09 global financial crises. The industry's success (accounting for nearly one-fifth of GDP and at USD16bn last year, 80% of exports) has also been driven by the EU's Generalized Scheme of Preferences (GSP), under which it enjoys considerable tariff relief (unlike its competitors India, Pakistan, and Sri Lanka). Bangladesh-produced garments make up 8% and 10% of the US and EU markets, respectively.

Ample, low wage-workers have kept costs low, underscoring Bangladesh's comparative advantage. Recent worker protests for better working conditions and wages have led to sizeable increase in minimum wage, but as long the GSP stays in place in EU and no major sanctions are imposed by the US, Bangladesh will continue to offer competitive pricing and scale to the largest global vendors.

Exports: it's all about garments




Source: CEIC, Deutsche Bank

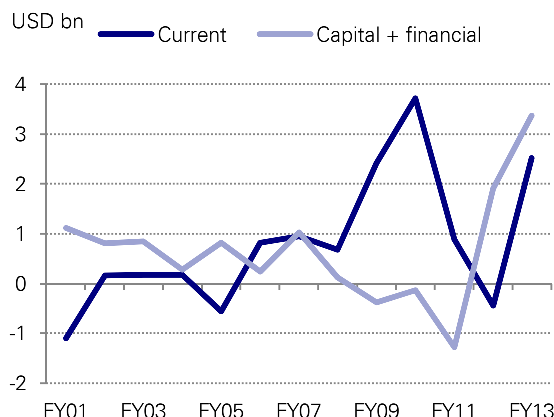
## Pillar 2: Resilient flow of remittances

Around 10 million Bangladeshi overseas workers, with a majority in the Middle-East, remit substantial, macro-stabilizing flows. The amount remitted each year has grown substantially over the past decade, from USD2.5bn (5% of GDP) in 2002 to USD14.5bn (10% of GDP) in 2012. Annual growth rates of remittances have been consistently positive, ranging from 6% to 32%, providing a valuable cushion to the balance of payments. Remittance did not suffer during the global financial crisis, and there seems to be no easing of demand for workers in the Middle East and East Asia in the near- and medium-term.

## Pillar 3: Self-sustaining domestic demand dynamic

With the external sector well supported by earnings from garments exports and remittance from overseas workers, Bangladesh's large population has also become a source of resilient domestic demand. Goods and services needed for the 160mn population generate considerable activities; in particular food production, construction, transportation, telecommunication, banking, retail trade, have flourished.

Broadly comfortable external position

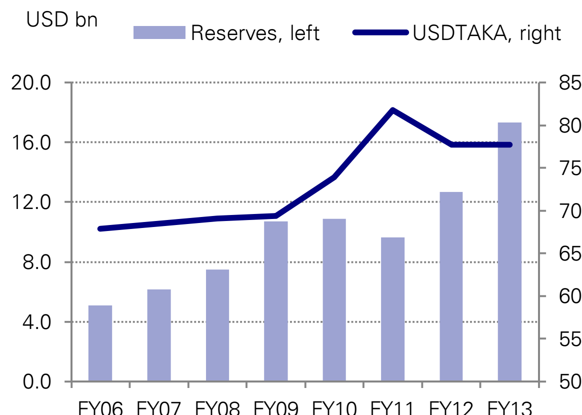



Source: CEIC, Deutsche Bank

Building atop these three factors, Bangladesh displays fairly low degree of macro-economic vulnerability. Among key vulnerability indicators, the following ones stand out:

- Gross external debt, mostly borrowed in concessional terms, is 19% of GDP;
- Current account deficit has been 1-2% of GDP in recent years and is projected to move into a surplus this year;
- Portfolio flows are minimal (USD100-200mn), which makes them of little consequence for the external account;
- Fiscal deficit has been around 4% of GDP and public sector debt is 41% of GDP and falling;
- Gross external financing requirement over the next few years are adequately covered under conservative inflows assumptions, as per the IMF;
- State-owned banks are under-capitalized but are being reformed under a program with the IMF. In particular, the banking system's capita-asset ratio has risen to around 10 as of end-2012.
- While the exchange rate has appreciated lately reflecting the improvement in balance of payments, it is not considered misaligned or uncompetitive.

Reserve accumulation and currency appreciated

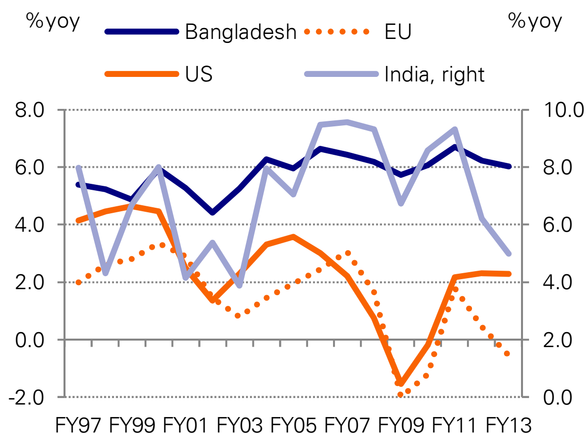



*Source: CEIC, Deutsche Bank*

All in all, the economy has proven to be resilient and appears set in a macroeconomic comfort zone at present. A continuation or perhaps even an improvement of the present trend can be expected the coming years, notwithstanding the well known constraints and impediments.

Most importantly, macroeconomic dynamics have been impervious of the global cycle. Growth and trade were interrupted marginally during the deep global downturn in 2008/09, proving wrong fears that garment demand and remittance flows would be affected substantially. The chart below illustrates the lack of link to the growth cycles of US/EU/India over the past decade and a half. Indeed, growth correlation with the US and EU have been negative 0.1 during this period. This attribute, if maintained, could make the country's assets a useful source of diversification for investors.

Not a beta to US/EU/India's growth cycle




*Source: CEIC, Deutsche Bank*

## Microcredit revolution

Another aspect of the economy that has helped, if not directly contributed to macro stability, is Bangladesh's flourishing micro finance institutions (MFIs). With banks penetrating only a fraction of the population (there are 5 bank branches per 100,000 adults), and widespread incidence of poverty, institutions specializing in uncollateralized lending to the poor in the informal sector have expanded rapidly in the past three decades.

Led by world famous Grameen Bank and BRAC, the MFIs have helped generate financial credit and employment for millions of Bangladeshis. As per government estimates, 35mn Bangladeshis (20% of the population), both individually and as part of small businesses, have received micro financing amounting to about 3% of GDP. Loans go to finance durable consumption, self employment, agriculture activity, short-term income loss due to seasonality, and to recover from natural disaster related shocks to income and employment.

While the government of Bangladesh deserves credit in orchestrating large campaigns to improve health and education access and standards, the salutary role played by the NGOs is a key part of the Bangladesh's story of resilience in recent decades. Studies show that (i) microcredit helps smooth consumption among the recipients; (ii) reduces financial distress among the very poor on a sustained basis; and (iii) complements significantly other programs to improve the well being of the poor.

## A broadly cohesive macroeconomic framework

Under a three-year Extended Credit Facility program with the IMF, the third review of which concluded in November 2013, Bangladesh is implementing a series of reforms to consolidate its recent macroeconomic gains. Doubling of international reserve levels from the lows in late 2011 is considered to be a major achievement under the program, and ongoing efforts to carry out fiscal consolidation are helping reduce macroeconomic uncertainty ahead of an election year (due in early 2014).

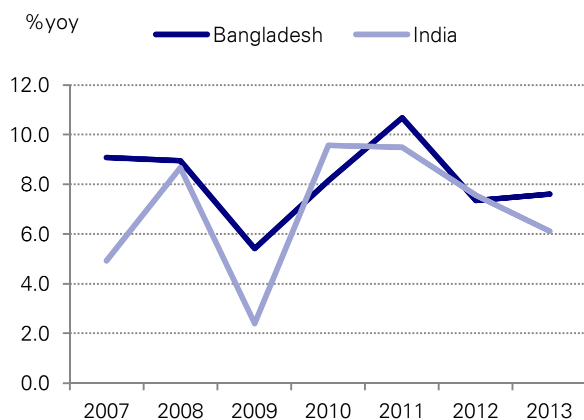
On the fiscal side, the authorities are committed to a budget deficit target of 4¼% of GDP, with a focus on increasing tax collections by strengthening tax administration capacity. This effort is expected to raise the space necessary to boost social spending while carrying out fiscal consolidation. Automation of tax identification numbers for income tax has been

implemented, and a new value-added tax regime is being put in place. With respect to spending, the operational efficiency and financial management of state owned enterprises is under focus, especially transparent reporting and safeguards for transfers of central government resources to SOEs. The government's social safety programs are also under modification to ensure greater transparency and accountability. Periodic fuel price and electricity tariff adjustments have kept subsidy spending under check.

### Monetary and financial sector policy

Barring a global oil price shock, inflation risks seem well contained. Monetary policy has been geared toward achieving an inflation target of 7% in 2013/14, and policy rates have been unchanged since the beginning of the year (when the repo rate and reserve requirement ratio were cut by 50bps). The inflation dynamic of neighboring India has major impact on Bangladesh, as seen in the chart below. Likely decline in inflation pressure in India in the coming year, helped by a forthcoming harvest that is expected to be a record breaking one, and ongoing easing of global commodity prices, bodes well for Bangladesh's inflation outlook.

Bangladesh's inflation tracks India's price shocks




*Source: CEIC, Deutsche Bank*

As noted earlier, foreign exchange reserves have grown substantially during the last couple of years thanks to ample export earnings and remittances. Bangladesh Bank has periodically intervened to smooth the appreciation pressure on the currency. Nevertheless, the Taka has bucked the regional trend by appreciating by 3% against the USD this year.

With respect to financial market policies, a concerted effort is being made to improve the financial health of the state-owned commercial banks (SCBs), long a source of substantial loss to the taxpayer and major lapses in governance. The authorities are enhancing the regulatory and supervisory powers of Bangladesh Bank under the amended Bank Companies Act. Measures to nudge the SCBs toward improvement include enforcement of stronger corporate governance, credit risk management, and internal audit and controls, complemented by gradual recapitalization.

### Political risk

With Parliamentary elections scheduled for early 2014, there is considerable concern that the two large political parties would once again engage in widespread, disruptive, and damaging demonstrations and confrontation. Indeed, violence has surged this year, and could well continue in the coming months. But political conflict is a recurring phenomenon in Bangladesh, with the data showing that over two decades of periodic political conflagration, the economy has managed rather well, with minimal and expeditiously reversible setbacks. When work days are lost due to strikes, firms work overtime to meet delivery deadline; when one mode of transpiration disruption hurts delivery, enterprising traders find another mode. Repeated shocks and a multitude of constraints have made Bangladeshis intrepid problem solvers. This explains the remarkable of lack of variation in the growth outturn in recent decades.

### Conclusion

While economic progress would have been considerably better had there been better infrastructure and less frequent bouts of natural disasters and political unrest, the Bangladeshi economy's track record despite such constraints speaks volumes about its potential. Regardless of the risks involving the political cycle, progress and major reforms have proven to be one-way, and broad macroeconomic stability looks ensured for the near term, with considerable upside for the medium term.

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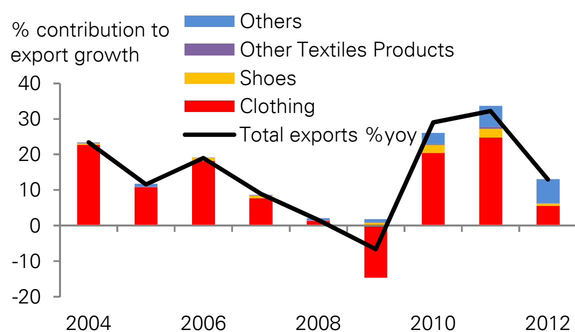
## Cambodia: clothing the West

*Cambodia is an export-driven economy, dependent on the US and EU for its textile and footwear exports, while its neighbors finance its fiscal and current account deficits.*

Cambodia began its economic reform in 1995, transforming its planned economy to a market-driven one. Since then, it has posted strong growth, with the exception of the 97/98 Asian financial crisis (complicated by civil unrest and political instability) and the 2008 global financial crisis period, averaging 7.7% since 2005.

As a result of its relatively early decision (compared to its peers in the region) to open up its economy, becoming a member of the WTO in October 2004, Cambodia's exports' share of GDP has risen rapidly, by 20ppt, to around 75% in the five-year period ending 2011. At the same time, as an export-driven economy, it remains highly vulnerable to external shocks and thereby its growth remained relatively volatile.

Clothes the west




*Sources: CEIC, Deutsche Bank*

Cambodia's exports are heavily concentrated, both in terms of goods and destination. To be specific, Cambodia remains highly vulnerable to any shocks in the US and the textile industry. Clothing and shoes constituted about 82% of total exports last year, with 75% for clothes and 5% for shoes, and the rest for textiles. Cambodia's share of the world's textile/fibre trade stood at 3%, vs. China's 35% in 2012. According to the garment manufacturing association in Cambodia (GMAC), for clothing/textiles, the US remains its most important destination, with a share of exports at 51%, followed by the EU's 29% and the rest of the world's 20% in 2011.

Despite the recent global slowdown, Cambodia benefitted from the new Rule of Origin for the EU GSP scheme (starting in 2011) that gave duty-free access to its market for garments made in Cambodia. Also, Cambodia's garment industry's adherence to the labor standards of the US continued to support its access to the market. For footwear, the EU share was high, at 63%, followed by Japan's 13% and ROW's 24% in 2011. Within the manufacturing sector, which stood at 20% of GDP in 2010, textiles/garments dominate, with their share of GDP at 15%.

According to GMAC, foreign firms dominate the textile industry, with Taiwan's ownership share topping the rest, at 28%, followed by China's 19%, Hong Kong's 17% and South Korea's 13% – not surprising considering that Asian countries topped the list of source of FDIs for Cambodia.

### FDI helping to finance current account deficits

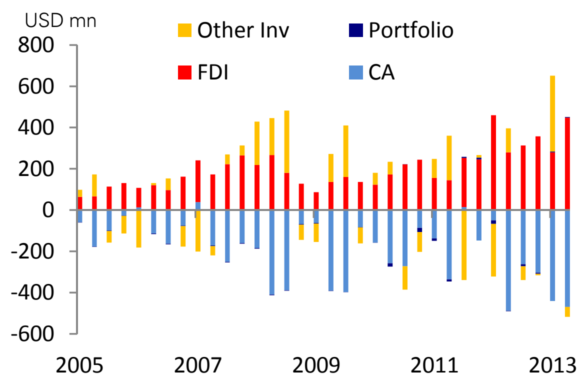
Foreign firms continue to dominate the country's industrial development via FDI. On a cumulative basis, Cambodia's tourism sector attracted the most FDI by 2010, with its share at 50%, followed by infrastructure's 22% and industry's 21%, while agriculture's share was relatively low, at 7%.

Tourism's share of GDP stands at 15%, again highlighting the importance of external demand for the economy. Most of the tourists are from Asia, with the ASEAN share highest, at 43% in 2012, followed by East Asia's 28%, Europe's 17% and the US's 7%. Within Asia, tourists from Vietnam dominated, with their share at 22%, vs. South Korea's 11%, China's 9%, Laos's 7% and Thailand's 6%. The US's share stood at only 5%.

ASEAN also provides the most FDI, with its share (on a cumulative basis) at 31%, followed by the US's 30%, Taiwan's 11%, China's 10%, the EU's 5% and South Korea's 4%. During the three-year period ending in 2010, ASEAN remained the top provider of FDI, with its average share at 27%, followed by China's 21%, Taiwan's 9% and S Korea's 8%. In contrast, the US's importance declined sharply, to 3%, from around 30% in the late 1990s.

Moreover, sectors that received most FDI also changed, with the tourism and infrastructure sectors receiving less, with their shares at 17% and 7%, respectively, vs. the industry and agriculture shares of 24% and 51%, respectively. This change also reflected the government's efforts to support the expansion of other industries, such as automotive parts and agricultural product processing, among others.

External flows




Sources: CEIC, Deutsche Bank

FDI inflows continue to help finance Cambodia's current account deficits, which stood high at 5.5% of GDP in 2011. Imported intermediate goods tend to be substantial, with textile/garments/footwear imports making up about 60% in recent years, largely to be processed for exports. Private consumption share of GDP stood high, at around 80%, supported further by high credit growth of 34.2% in 2012.

Sustained rapid credit, however, remains a source of concern. A relatively stronger import growth of 15%, vs. export growth of 14% in 2012, reflected not only a surge in imports of petroleum, but in vehicle sales and construction materials. Meanwhile, investment share of GDP stood relatively at around 20%. While official FX reserves at USD3.5bn cover 3.7 months of imports, their coverage of FX deposits has steadily deteriorated.

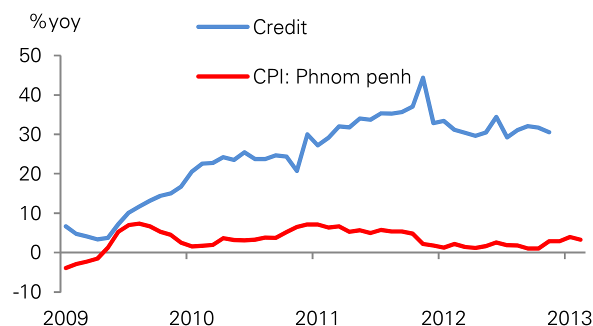
### Continued efforts in fiscal consolidation are needed

The government continues to fund its deficit with external grants and loans, while avoiding non-concessional borrowing. As such its debt risks remain "low" according to the International Monetary Fund (IMF) and World Bank (WB)'s debt sustainability analysis. After narrowing its fiscal deficit to 5.3% of GDP in 2012 from 9.6% in 2011 – with its expenditure lowered to 19.7% of GDP in 2012 from 22.8% in 2011 while revenue increased to 14.4% from 13.2% in the same period – the WB expect it to hover around that level for this year and the next. Further efforts are necessary in tax revenue collection, which stood lowest in the CLMV region after Myanmar.

### Inflation remains low, albeit rising, while high credit growth poses risks

With food and transportation constituting about 45% and 12% of the CPI basket, inflation fell to 2.5% in 2012, from 5.5% in 2011, as both food and transportation inflation fell. However, inflation began its upward trend this year, and the WB expects it to average 5%, due to higher food prices. Meanwhile, sustained surge in credit (hovering around 30% growth) poses a serious risk to the economy, highlighting the need for stronger financial supervision, despite its benefits to construction and agriculture. The latter sector's share of total credit doubled to 10% by end-2012 in three years. Despite the authorities' efforts to encourage the usage of riel, the economy remains highly dollarized, with 95% of the broad money supply in USD. With the riel pegged to the dollar, the National Bank of Cambodia's (NBC) control over the monetary conditions remains very limited.

Inflation and credit growth




Sources: CEIC, Deutsche Bank

### Outlook

Recovery in the G2 economies will bode well for Cambodia, as they support exports. Political uncertainties following elections pose risks to this outlook. Strong growth, however, has "outstripped the level that can be justified by normal financial deepening," according to the IMF, which has recommended macro prudential measures to slow down credit growth. At the same time, its high dual deficits leave Cambodia highly vulnerable to fluctuation in investor sentiment and capital inflows.

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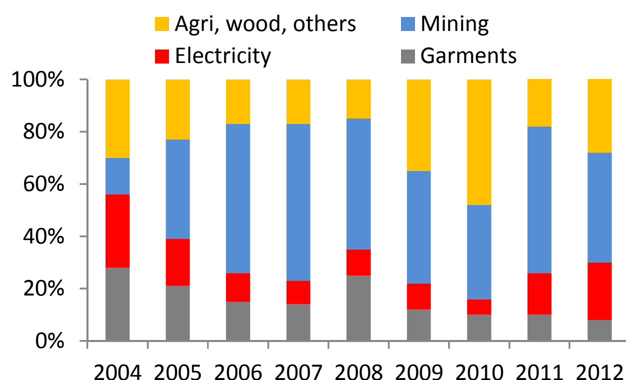
## Lao P.D.R. – extracting and electrifying

*Lao's economy is heavily geared to Thailand's growth, due to its reliance on the latter for exports, in both goods and services.*

Lao P.D.R. began its economic reform – de-centralizing control and encouraging private enterprise – in 1986, prompting average growth of 6.3% per year from 1988-2008, except during the 1997/1998 Asian financial crisis. It became a WTO member this February. Although Lao has only about 6.4m people, its per capita GDP stood relatively high at USD1281 in 2011, thanks to its rich natural resources – copper, hydropower, timber, gypsum, tin, gold, gemstones.

Reflecting Lao's heavy reliance on its natural resources for growth, mining products and electricity dominate, constituting about 42% and 22% of total exports, respectively, in 2012, followed by agri goods share at 10%. In fact, the mining and utilities sectors shares of GDP stood relatively high, at 7% and 5%, respectively, in 2011, constituting almost a half of the industry sector share of 27%. Meanwhile, the agriculture share stood at about 30%.

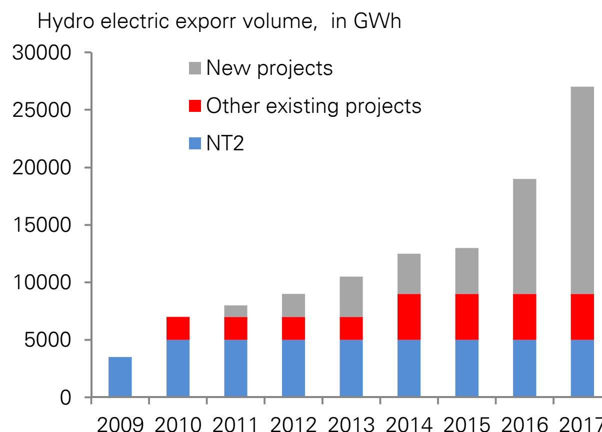
Natural resources dominate (share of exports)




Sources: CEIC, Deutsche Bank

Thailand remains the most important trading partner for Lao. About 50% of Lao's imports and exports came from and went to Thailand during three years ending 2011, hence, the importance of the local currency's (kip) cross rate with the THB. The Bank of Lao continued with its managed float exchange rate regime for the kip, with market rates not allowed to move within +/-0.25% against the US dollar and +/-0.5% against the THB.

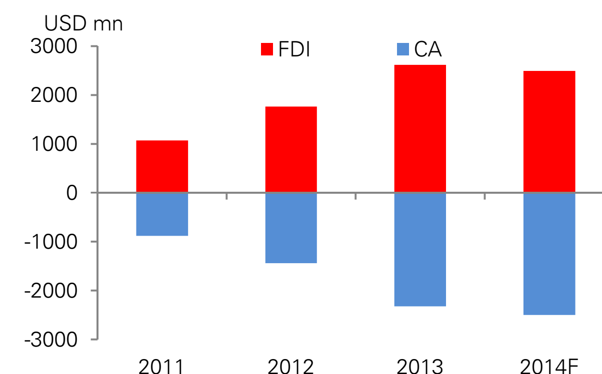
Changes to come




Sources: IMF, Deutsche Bank

Tourism is also an important contributor to the economy, with its revenue share of GDP at 5.2% in 2011. Thailand again stood out in this regard, with Thai tourists constituting about 58% of the total, followed by Vietnam's 21%, China's 6%, and Europe and the US's share at only 7% and 3%, respectively

FDI financing its external deficits




Sources: World Bank, Deutsche Bank

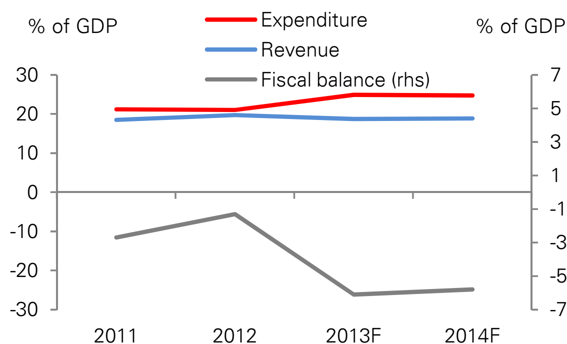
### FDI continues to finance large current account deficits

Since 2000, Lao has received about USD19bn in FDI, with its neighbors dominating as the source of those funds. On a cumulative basis, FDI from Vietnam, China and Thailand topped the list, with the first two overtaking Thailand since 2008. Vietnam focused on energy, banking, insurance, plantations of industrial crops, commercial services and urban development, while China focused more on agriculture, mining, hydropower, timber and real estate.

In contrast, hydropower remained Thailand's focus. By sector, on a cumulative basis, most of FDI was channeled towards mining and fuel, followed by hydropower and agriculture. During the past three years, however, the order of importance changed, even though mining remained at the top, followed by services and agriculture.

FDI helped to finance Lao's large current account deficit of 15.3% of GDP in 2012, which worsened from 10.3% in 2011, due to a surge (42% yoy rise) in consumption goods imports. Consumer goods constituted 47% of total imports in 2012, vs. 36% in 2011, while investment goods share fell to 48% from 60% in the same period. With relatively low FX reserves, USD530m in June 2013, covering only 1.6 months of goods and services of imports, there are obvious concerns about the local currency.

Deterioration in fiscal deficit calls for tightening




*Sources: World Bank, Deutsche Bank*

## Rising fiscal risks

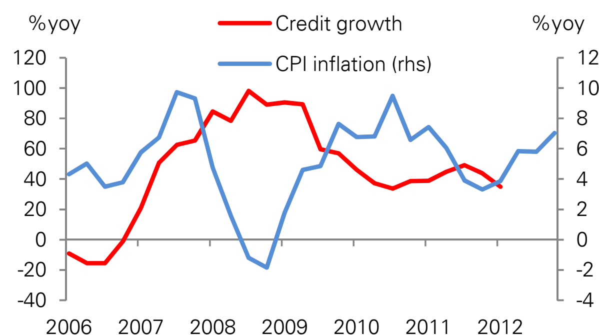
Lao has fared better fiscally than its peers, with a deficit of 1.3% of GDP in 2012. However, the World Bank expects it to deteriorate sharply to 6.1% of GDP in 2013, due to increases in expenditure as a result of public sector wages/benefits hikes and falling commodity prices which weighed on revenue. There are also concerns about local governments' privately-financed public infrastructure projects. Its growing reliance on non-concessional debt is of a concern.

Although the IMF and WB categorized Lao's debt risk as "moderate" in its debt sustainability analysis, some concern was expressed as the government is pushing ahead with large infrastructure projects. Meanwhile, deterioration in both fiscal and external accounts calls for macroeconomic policy tightening, also in light of rising inflation.

## Inflation rises, while high credit growth remains a risk

After falling to 4.3% in 2012, from 7.6% in 2011, inflation has trended upward this year, averaging 6.3% ytd in September, led by increasing meat and vegetable prices, which prompted the government to suspend livestock exports. Food constitutes 37% of the CPI basket, while transportation and communication made up 24%. With the dollarization of the economy at about 44% of M2, traditional monetary policy responses remain inadequate for Laos, requiring direct intervention instead, such as reduction in lending for infrastructure and slowing registration of new banks by the central bank. Strong domestic demand was supported by a surge in credit of 43.2% growth in 2012, vs. up further from 37% in 2011. Although weaker, credit growth remained strong at 28.2% in June 2013, posing risks to overall stability of the economy.

Strong credit growth, albeit slower than before




*Sources: CEIC, Deutsche Bank*

## Outlook

While completion of major power projects in 2014 will to contribute to growth ahead, there are increasing concerns about stability of the economy, due to large fiscal and external deficits, amid low FX reserves. Also, rising inflation also calls for tightening macroeconomic policies, especially as credit growth remains high. Given such outlook, the WB expects growth to moderate slightly to 7.7% in 2014 from 8% in 2013. At the same time, we underline downside risks related to uncertainties with regards to Thailand.

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## Mongolia—managing the resource windfall

*A small country population-wise (2.9mn in 2012), Mongolia is endowed with an exceptionally rich natural resource base. Estimates of the country's endowments have been repeatedly revised upward, drawing considerable FDI. Managing resource extraction in a prudent and sustainable manner, while minimizing damaging boom-bust cycles, is the key challenge.*

Mongolia is emerging as a significant participant in the global mineral resource producers' club. Already proven to have rich deposits of oil, coal, copper, molybdenum, tungsten, phosphates, tin, nickel, zinc, fluorspar, gold, silver, iron, and uranium, it is likely that more resource deposits will be identified as exploration continues in the coming years. Among the wide ranging natural resources, three are key presently:

- Coal. Government estimates suggest Mongolia has proven reserves of 18bn tons of coal, which is about a tenth of the world's reserves. 17 producing mines are in operation presently, making the extraction and export of coal the most important activity for the economy, Indeed, coal exports, which is largely destined for China, amount to nearly half of total exports.
- Copper. Mongolia has substantial copper (estimated reserves are about 80 million tons), and has long relied on its exports (currently about 20% of total exports).
- Gold. One of the top-10 gold producing nations in the world, Mongolia's mines are estimated to contain about 2400 tons of gold.

If properly extracted and managed, mining revenues could amount to 50% of GDP by the end of this decade, which would help generated considerable wealth and well-being for the people of Mongolia, a third of whom still live in informal and semi-nomadic conditions.

Mongolia's emergence as a mining giant in the past decade initially coincided with the global commodity boom. As the boom consolidated, it appeared that the economy was set to grow by leaps and bounds. Even now, exports of copper and coal are set to rise significantly over the coming years as more extractive and transportation capacity is added. Some details about the operations of two major mines in this context are of crucial importance:

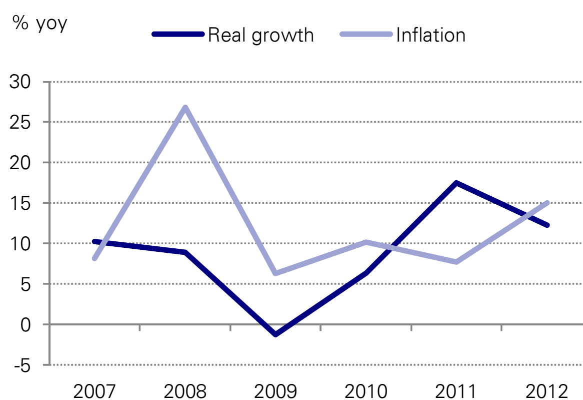
- The Oyu Tolgoi (OT) mine, located in Southern Mongolia, near the Chinese border, is already one of the largest copper and gold mines in the world. The government owns a third of the mine, and the rest is owned by Turquoise Hill Resources (Canada), in which Rio Tinto (UK) has a 51% stake. Production and export started in mid-2013.
- Tavan Tolgoi (TT), also located in southern Mongolia, is one of the world's largest coal deposits with estimated reserves of about 7bn tons. Erdenes Tavan Tolgoi LLC, a subsidiary of a 100 percent state-owned enterprise, has the mining license. An operating contract with foreign companies for the eastern block was concluded in October 2011.

As operations in OT and TT pick up, export earnings and fiscal revenues are expected to rise substantially in the coming years. Under conservative assumptions of production and world price, mining exports could amount to USD7bn by 2020. As for the government of Mongolia, the windfall will be minimal at the initial stage as it will have to settle its liabilities that were accrued during the construction phase. But within 4/5 years fiscal revenues could be substantial, perhaps as much 4 times the current level by 2018.

### Potential versus reality

Mongolia is a classic case of an economy struggling to manage its resource windfall, with the accompanying tensions occasionally outweighing the economic benefits. While real GDP has grown, on average, by 9% since 2007, causing per capita income to double during that period to USD3500, the economy is characterized by substantial inequality (Gini coefficient of 0.37), poor infrastructure and connectivity, and manifestly worrisome macroeconomic imbalances.

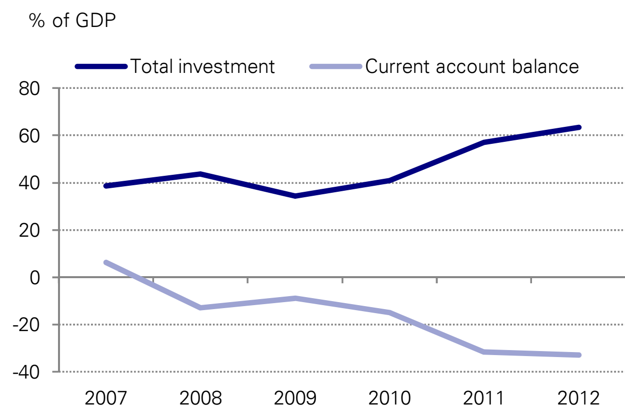
High growth and high inflation




Source: IMF, Deutsche Bank

In order to implement the mega mining projects, Mongolia has undergone an enormous investment binge in recent years, with investment as a share of GDP crossing 60% in 2012. With domestic savings hovering around 30% of GDP, this has caused enormous current account deficits, ranging from 10% to 30% of GDP in recent years.

Rising mining investment, ballooning current account deficit




Source: IMF, Deutsche Bank

The current account deficit was initially funded by FDI from mining companies, but lately has necessitated issuance of external bonds, bringing in portfolio flows. Consequently, the economy has become vulnerable to uncertainties stemming from investor appetite, global market conditions, and regulatory risk.

The mining boom has given rise to macro traits that reflect poor economic management in dealing with such large-scale inflows and activities:

- Poor handling of supply side factors have given rise to chronically high inflation, averaging about 12% per annum since 2007. Attempt to subdue inflation was carried out through an unconventional "Price Stabilization Program," which commenced in late 2012. Under this program, the authorities effectively imposed price controls while providing discounted loans to select industries in exchange for promises to keep prices stable. Both the likelihood of success (investment is needed to unlock the structural bottlenecks in the supply chain) and the justification of the program (financed off-budget, amounting to 4% of GDP last year) are open to question.
- In order to expedite infrastructure spending, the authorities have increasingly resorted to off-budget means (using the Development Bank of Mongolia to carry out borrowing and spending on its behalf). Taking such spending into account, the fiscal stance remains highly expansionary at a time when inflation is high, current account deficit is substantial, and the exchange rate is under pressure (due to capital flow volatility). Public spending amounts to nearly 47% of GDP, and the World Bank estimates that the consolidated fiscal deficit will be about 12% of GDP in 2013. Despite strong growth, revenue collection has lagged targets, and the spending side is beset with inefficiencies and control problems.
- Monetary policy is accommodating, with the central bank injecting liquidity though various programs. As a result, there has been a boom in bank lending and property prices. With credit growing by 40-50%yoy, loan-to-deposit ratio of the banking system has reached 130%. Risks associated with such rapid growth was reflected earlier this year, when Savings Bank, the fifth largest bank in the country, was deemed insolvent by the regulators and put into receivership. Poor corporate governance and defaults on insider loans were the main reasons behind the bank's failure.
- The biggest risk is however the financing of the gaping external imbalances. While Mongolia's mining potential is undeniable, foreign investor enthusiasm has waned lately with the softening of the global commodity markets. Since the end of 2012, portfolio flows have dwindled while there have been delays in FDI flows, pushing down reserves (loss of close to USD2bn this year) and causing the currency to weaken (the Mongolian Tugrik has depreciated by about 25% this year).

Perhaps more importantly, a series of missteps by the Mongolian authorities with respect to mining regulation has dampened investor sentiment. The 2012 adoption of the Law on Foreign Investment and substantial uncertainty around the government's negotiations with existing mining projects were deemed as unfavorable by foreign investors.

To their credit, the authorities are trying to correct the course. A new, streamlined, Law on Investment, prepared with technical assistance from the World Bank and IMF, was approved in October 2013, abolishing private sector FDI approval requirements and incorporating a tax stabilization clause. A Law on Investment Fund has also been approved, which is aimed at opening up the economy to institutional investors.

Mongolia is also striving to make it easier to do business. In the past year or so; company registration requirements have been eased considerably and permits and utility connection for businesses have become easily accessible.

As the economy liberalizes, capital flows are bound to return, in our view. Mongolia is a pure commodity play; the challenge for the authorities is to ensure that the economy has sufficient flexibility and safeguards in place to smooth out the inevitable gyration of the global commodity cycle.

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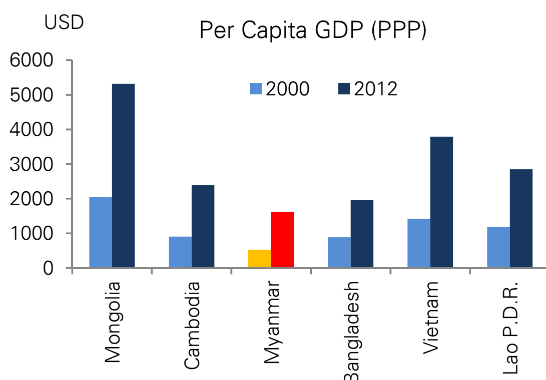
## Myanmar – setting the ground for balanced growth

*Myanmar is seeking an ambitious development strategy that aims to achieve both high and balanced (inclusive) growth. To this end, it has started laying the building blocks - physical, legal and institutional infrastructure, although much work remains*

Since Myanmar has undertaken meaningful economic and political reforms, fuelling the international community interest in and enthusiasm over the country's growth potential, given its abundant (about 61m), reasonably well educated (adult literacy rate of 92%) and cheap (GDP per capita of about USD900) labor force and rich natural resources (natural gas, timber, precious stones, minerals, freshwater, arable land and marine resources, among others).

Low income means low labor cost



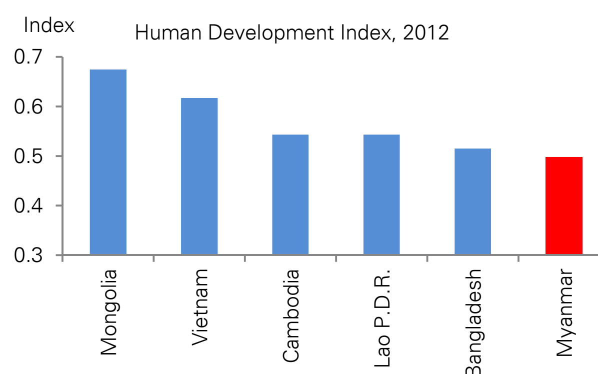

Sources: CEIC, Deutsche Bank

Helped by normalization of relationship with the rest of the world, tourism surged in 2012, adding another pillar to growth. Number of tourists rose by more than 33% in 2012, vs. 3% in 2011, led by growth in tourists from the UK (147%), Japan (122%) and the US (114%).

At the same time, the government's economic development plan suggests that it is trying to save the country from the Dutch Disease that many natural resource rich countries have suffered from – as it does not benefit the population at large and instead risks significant environmental degradation. Instead, the government has set a multi-dimensional development goal of achieving higher growth, via industrialization and agriculture development, while ensuring such benefits are well balanced across the region and shared by the entire population. Such a comprehensive growth strategy is rather unique for a country at such an early stage of development.

With the agriculture/forestry/fisheries sectors constituting 38% of GDP in 2011 (vs. services' 37%, industry's 20% and construction's 4%) and 70% of the labor force, it is not surprising that the government has underlined the importance of agricultural development as a part of a means to achieve balanced, inclusive growth and reduction in poverty. Myanmar is the poorest country in the CLMV region with the highest poverty rate of 25.6% (in 2010) in Southeast Asia. Again, Myanmar's human development index remains the worst among its CLMV peers.

Trying to improve social well-being




Sources: CEIC, Deutsche Bank

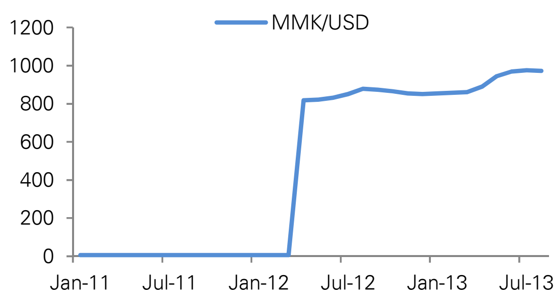
While the authorities have passed a new law on land (which gave title to farmers) and micro finance laws (to improve their access to finance), more work needs to be done to improve their ability to exercise their rights in this regard. Moreover, for inclusive growth, the authorities have provided more resources to health and education, albeit from very low levels, to improve human resources.

For balanced (regional) development, the government is also seeking improvement in connectivity (with provision of basic infrastructure) and pushing for border development, for which special economic zones (SEZs) will play a critical role, including attracting the necessary foreign capital and promoting Myanmar as a part of the production network in the region. To facilitate investment, the authorities have also passed a foreign investment law in 2012, although some restrictions remain, while reviewing laws on SEZs (like Dawei, Thiawa and Kyaukpyu) and smaller industrial zones and small and medium enterprises. Incentives to invest in SEZs may include five-year tax holiday; five-year 50% tax relief on export income; five-year tax relief on reinvested export profits; five-year customs duty exemption on selected products; and granting of 30-year land leases.

Myanmar's economic reform also included progress in all areas of macro policies, including FX, although there remain still formidable challenges. Last year, in April, Myanmar de-pegged its currency and adopted a managed floating system, allowing the reference rate to be determined by an auction system. This was followed by enactment of a foreign exchange management law in August 2012 and removing almost all restrictions on current transactions and payment on invisibles.

Also, private banks were allowed to offer foreign exchange operations at par with state banks, although the latter continued to dominate the FX market. Foreign Exchange Certificates (FECs) will also be phased out, to eliminate multiple currency practices (MCP), retention for which the IMF approved until mid-2014. These changes have not only helped to bring the reference and market rates closer together – when the government de-pegged the kyat it also devalued it by 152 times against the US dollar, in line with the unofficial market rate – but also helped to reduce high transaction costs (which also discouraged international trade and FDIs) and informal activities.

FX reform, adjusting the kyat



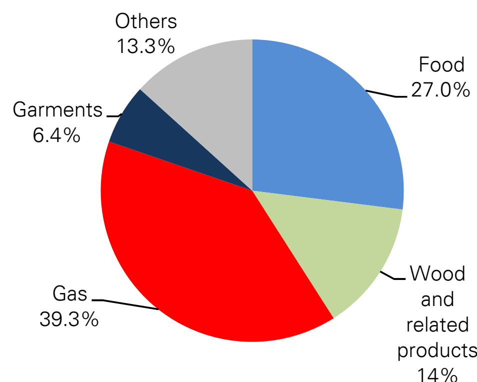

*Sources: CEIC, Deutsche Bank*

Relaxation related FX restriction (that allowed FX purchase by importers with export earnings only, removal of requirement for trade licensing, reduction of import taxes all contributed to relatively strong rise in imports. While exports rose only 5.5% in 2012, imports rose relatively rapidly, by 14.9%, due to strong investments. In particular, the machinery and non-electrical and transport equipment share of total imports overtook refined oil's (20%), at 25% in 2012.

The rise in imports mainly reflected stronger investment. Indeed, capital goods imports surged 90% in 2012, with their share of total imports overtaking others at 40%, vs. intermediate goods' 34% and consumer goods' 25%. For imports, Myanmar relied heavily on China, with its share of total imports at 29%, followed by Singapore's 27% and Thailand's 8%.

Relative strength of imports (17%yoy ytd in 1H 2013), vs. exports (0.6%) in turn pointed to trade deficit (of USD3.8bn) and thereby guiding the Myanmar kyat weaker in 1H, by about 14%.

Exports dominated by commodities




*Sources: CEIC, Deutsche Bank*

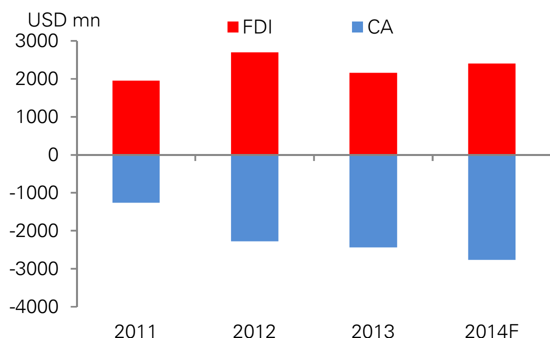
Exports were dominated by commodities, with natural gas constituting about 40% of total exports. Thailand stood out as Myanmar's largest export market, constituting 43% of total exports, followed by China's 25% and India's 12% in 2012. Myanmar's reengagement with the international community suggests changes ahead for exporters. For example, Myanmar's access to global export markets have improved significantly, with reinstatement of trade preference under the EU's Generalized System for Preferences for least developed countries.

Although exports share of GDP stood relatively low at 11% in 2011, economic reform and liberalization and reengagement by the international community point to their increasing importance ahead. By demand, consumption share stood high at 80%, with 70% for private and 10% for government, followed by investment share of GDP at 19%. With the urbanization rate at only 32.7% in 2011, industrialization also points to its rise ahead.

FDI funding external deficits

FDI in manufacturing is substantial 28% of total), followed by power (26%), oil/gas (22%) and hotel/tourism (21%). Until recently, power and oil/gas dominated, with their cumulative share of total FDI since 2005 at 56% and 34%, respectively. Mining's share stood at 7% vs. manufacturing's and hotel/tourism at only 2% and 1%, respectively, during the same period. In terms of source, China stood out as the top FDI investor, with its share of total FDI (cumulative basis since 2005) at 41%, followed by HK at 17%. They also stood as the largest FDI source in Q2 2012 to Q1 2013.

FDIs financing CA deficits




*Sources: CEIC, Deutsche Bank*

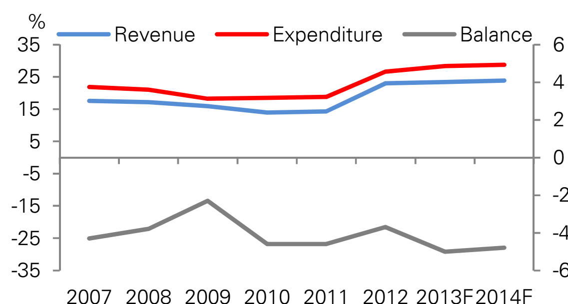
FDIs continued to help to finance Myanmar's current account deficits, which stood at around 4% of GDP in 2012 and the WB expects it to hover around that level for some time. Meanwhile, Myanmar's FX reserves stood at about USD4.6bn in 2012, slightly less than four months of imports. While the authorities are gradually transferring identified official FX reserves from state banks, the Central Bank of Myanmar (CBM) has also taken steps on its own, raising FX reserves via daily FX auctions.

According to the IMF and WB's debt sustainability analysis, Myanmar is assessed to be at "low" risk of debt distress following the clearance of its external arrears. Myanmar's external debt position also improved, to below 24.8% of GDP from 27.3% in 2012, followed the resolution of arrears this year. This included clearance of arrears to the WB and ADB in the amount of approximately USD1bn and the resolution of USD10bn in arrears to Paris Club creditors, which includes a 50% write-off, with the rest being restructured.

### Manage fiscal deficit, while addressing welfare needs

To limit fiscal deficits, the government has taken steps to simplify the tax system, broaden the tax base and move towards a VAT system to ease dependence on natural resources, which provided 23% of revenue. Indeed, as a result of stronger rise in revenue, the World Bank sees a smaller fiscal deficit of 3.7% of GDP in 2013, vs. 4.6% in 2012, despite higher expenditure. Apart from higher civil servants salaries, greater resources for health and education, respective budget shares of which will rise by 4 and 2 times, respectively, to 0.9% and 1.8% from 2012 to 2014, also contributed to the increase in expenditure. At the same time, the government's efforts to reduce monetization of its fiscal deficit also contributed to lower inflation.

Increase in revenue accompanied by expenditure rise

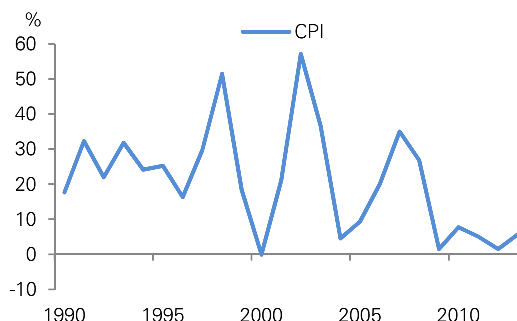



*Sources: World Bank, Deutsche Bank*

### Building a modern financial system and modernizing Central Bank

Lower commodity prices also helped to keep CPI inflation stable, at 2.8% in 2012, vs. 2.8% in 2011, despite the devaluation of the local currency. However, rising food prices, housing rental costs and fuel prices have driven inflation higher since mid year, the WB expects it to double to 5.6% in 2013.

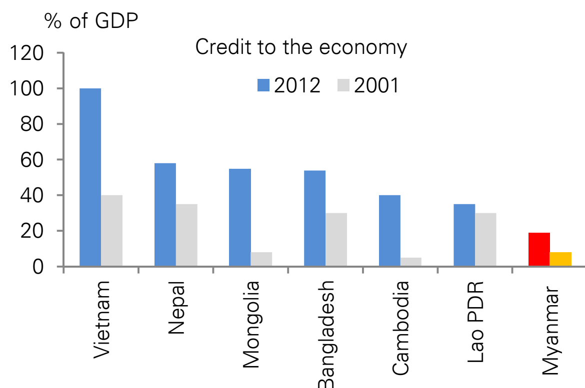
Great moderation in inflation




*Sources :UNCTAD, CEIC,WB, Deutsche Bank*

Meanwhile, there are obvious concerns over rapid increase in credit – commercial bank lending to the private sector rose 50% in 2012 after rising 60% a year prior – albeit from underdeveloped levels. Myanmar's credit market remained small, with credit to the private sector at only 8% of GDP.

Though rapidly rising, credit market remains underdeveloped




*Sources :IMF, CEIC,WB, Deutsche Bank*

To develop the financial sector, the authorities have liberalized deposit rates (within a fixed range) and easing restrictions on eligible collateral for loans, although the lending rate remains fixed. They have also lifted the deposit-to-capital ratio, which discouraged deposit growth, with deposit taking by private banks limited to 10 times of paid-up capital, and allowed private banks to open foreign currency accounts.

Meanwhile, the government has also taken steps to provide the Central Bank of Myanmar with independence, as well as arm it with core central bank functions, which have been given to state banks before. The CBM Bill was approved by the legislature in March 2013, although there are still uncertainties with respect to its budgetary and operational autonomy. The CBM operates under a budget appropriated by parliament, which constrains its expenditure on open market operations. Regulations to establish effective reserve requirement have yet to be issued, but a formal interbank market has been established.

## Outlook

Sustained economic reform, increasing trade, and increasing gas production (gas fields coming on-stream) will sustain strong growth. The World Bank expects growth to rise from 6.5% in 2012 to 6.8% and 6.9%, respectively, in 2013 and 2014, although political uncertainties pose risks. There are concerns that the 2015 election may detract Myanmar from continuing with its reform agenda. Meanwhile, in the near term, a rebound in growth in G3 economies, China in particular, bodes well for Myanmar's growth ahead, although Thailand risks have risen.

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# Pakistan – a new innings

*Pakistan is endeavoring to transition to economic and political stability. In the aftermath of an orderly election, a fresh engagement with the IMF, and some recent measures taken by the authorities, the hope is that better days are ahead.*

The situation, however, is perilous. Economic growth has averaged 2.9% over the past five years while inflation has soared during the same period (averaging 13%), external position has weakened (rupee has depreciated by 12% in the last 12 months), reserves have fallen to critical levels (lower than 1½ months of imports cover), and government's fiscal position has worsened (fiscal deficit rose to 8.0% of GDP in FY13). Add to these problems such as prevailing fragility in the security situation, a power shortage crisis, severe shortcoming in governance, and forthcoming withdrawal of support from the US, Pakistan's challenges appear daunting.

Macro snapshot

| Indicators | Unit | FY13 | 5-year avg. |
|---|---|---|---|
| Real GDP growth | %yoy | 3.6 | 2.9 |
| Gross fixed investment | %yoy | 0.8 | -2.6 |
| CPI inflation | %, annual avg. | 7.4 | 12.9 |
| Fiscal balance | % of GDP | -8.0 | -6.9 |
| Public debt/GDP | % of GDP | 63.2 | 60.8 |
| Current account balance | % of GDP | -1.0 | -2.1 |
| Net FDI | % of GDP | 0.5 | 1.0 |
| FX reserves | USDbn | 6.0 | 10.7 |
| PKR/USD depreciation | % | 8.4 | 9.4 |

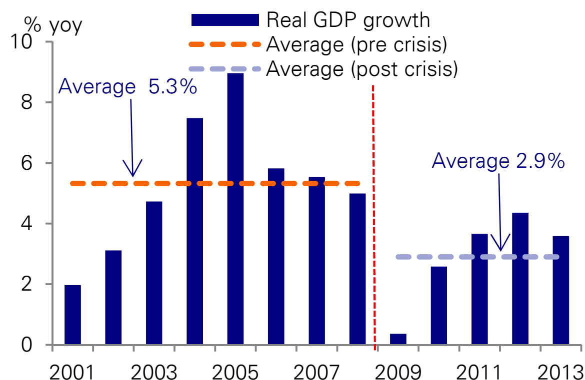
*Source: National Sources, CEIC, Deutsche Bank. Note: Financial year starts from 1 July and ends on 30 June of the following year*

## Reforms need to endure to lift growth

In the last five years, growth has averaged just 2.9%. A sharp deceleration in investment momentum (private investment has moderated to 8.7% of GDP in FY13, from 13% of GDP prior to the GFC), is primarily responsible for the secular slowdown in growth. Energy sector problems have complicated matters further. Official estimates suggest that power outages are responsible in lowering Pakistan's growth by 2%ppt each year.

Near term growth outlook is not encouraging. Given the current IMF macro stabilization program, fiscal and monetary impulses are likely to be negative in this fiscal year (2.0% of GDP worth reduction in primary deficit and 250bps of likely policy rate hike), which will exert a downward pressure on growth. Government consumption, which was the biggest contributor to growth last year, will moderate sharply, led by a substantial fiscal compression and private consumption growth is also likely to decelerate as monetary policy is tightened further.

Post-crisis growth recovery has been weak

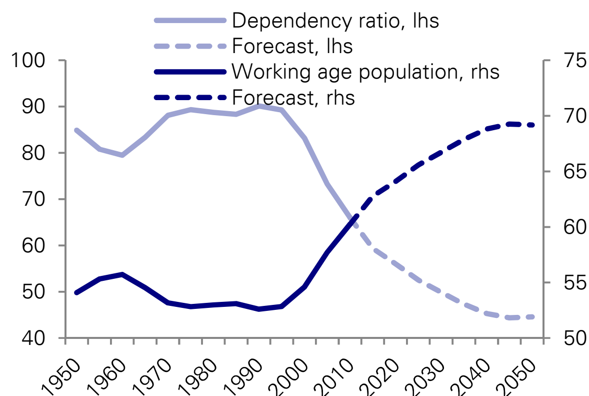



*Source: SBP, CEIC, Deutsche Bank*

Tight monetary policy and high inflation will keep investment momentum weak, while net exports will likely contribute lesser to growth in FY14 compared to the previous year. Overall, we expect real GDP growth to slow down to 3.0% in the current fiscal year (FY14), from 3.6% in FY13. Getting growth back on track would require serious supply side reforms, which are time-consuming and politically unpopular. The authorities have taken a few bold steps to reform the power sector, but much more needs to be done. As imbalances start to ease, power sector reforms gain pace and consumer and business confidence rises, growth should pick up. We expect a modest recovery from next year onward, contingent on the authorities pursuing with the IMF macro stabilization program.

Pakistan's population dynamic remains positive in the coming decades, which ought to increase the long term growth potential of the economy, but this advantage could well turn into a handicap, if enough jobs are not generated to absorb the rising labor force.

Positive demography ought to help but can also hurt

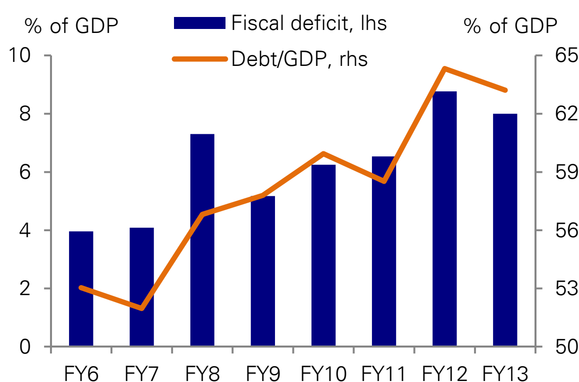



*Source: United Nations Population Database: the 2012 revision, Deutsche Bank*

## Fiscal consolidation a key priority

A poor mix of low growth, narrow revenue base and sticky expenditure has worsened Pakistan's fiscal position in recent years. Pakistan's consolidated fiscal deficit was 8.0% in FY13, somewhat better than the outturn in FY12 (8.8% of GDP), but still considerably higher than its past average. The sharp spike in fiscal deficit in FY12 and FY13 is mainly on account of the government's decision to settle a large part of the power sector circular debt, but lower tax collection and higher government expenditure also influenced the outcome to a large degree.

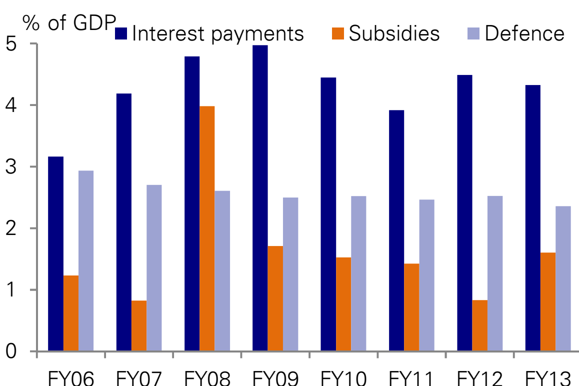
Fiscal deficit has worsened in recent years




*Source: Ministry of Finance, SBP, Deutsche Bank.*

Federal Board of Revenue (FBR) tax collection registered a growth of 2.9%yoy in FY13, the lowest since FY02. The lower tax collection is mainly due to a slowdown in direct taxes (1.1%yoy) and import related sales tax (-0.2%yoy). On the expenditure front, apart from settlement of circular debt, higher interest and subsidy payments (relative to budget estimates) were responsible for putting pressure on the fiscal deficit.

Interest, subsidies, defense constitute 39% of total exp




*Source: Ministry of Finance, SBP, Deutsche Bank*

In the last two years, the debt/GDP profile has also worsened considerably, rising to 64.3% in FY12 (from 58.5% of GDP in FY11) and thereafter moderating slightly to 63.2% in FY13. Domestic debt as a % of total public debt has steadily increased to 65.7% in FY13 (from 50.5% in FY09), with interest sensitive short-term/floating debt constituting 55% share of that. This trend is worrisome, as a sharp increase in interest rates could increase the debt burden further and pose a threat to macroeconomic stability.

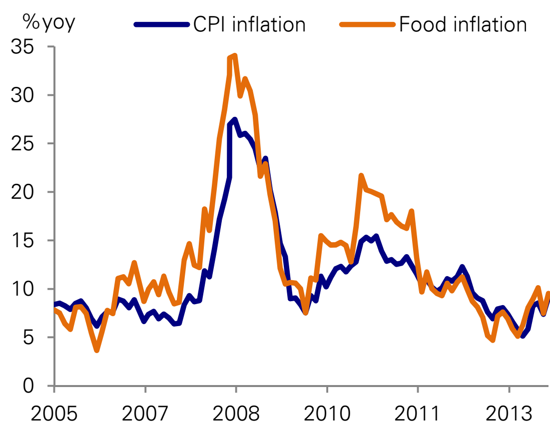
Debt-sustainability analysis indicates that primary deficit needs to be brought down below 2% of GDP (from 3.7% of GDP currently) to avoid further increase in the debt/GDP ratio. This is indeed challenging but not impossible. With a prudent mix of tax reforms and expenditure compression measures, it is possible in our view to reduce the primary deficit below 2% of GDP, but we expect this to be achieved in FY15 rather than in FY14 (in FY14, we expect the fiscal deficit to moderate to 6.5% of GDP from 8.0% in FY13). The IMF's involvement will be a big help, in our view, as it will keep the pressure on the authorities to continue with the fiscal consolidation agenda, till a sustainable level of deficit is achieved. We note the negative fiscal impulse will impact growth in the near term but ought to improve the medium term outlook, as lesser dis-savings will help crowd-in private investment and make monetary policy transmission more effective.

## Inflation to rise to double digits; more tightening ahead

Pakistan continues to suffer from high inflation, despite weak growth. In the last five years, CPI inflation has averaged 13%, while real GDP growth has averaged about 3% in the same period. Persistent deficit financing, weather related disruptions in food supply, infrastructure bottlenecks and spillovers from oil price shocks have kept inflation elevated in Pakistan, thereby impacting investment sentiments severely. Inflation volatility has also been high in recent years, although it eased somewhat in the last fiscal year.

Food (36%) and energy/transport (14%) components together constitute 50% weight in the CPI basket and therefore any large swing in these two components tends to impact the headline inflation number readily. Inflation has bottomed in 2013 and has started rising, led by higher food prices. Going forward, even if food price pressure eases, we expect pressure on CPI inflation to persist on account of four factors: i) first and second round impact of electricity tariff hike; ii) spillover from food to non-food inflation; iii) adverse base effect; and iii) FX pass-through to prices. Overall, we expect CPI inflation to average 11.0% in FY14, about 350bps higher than the previous year.

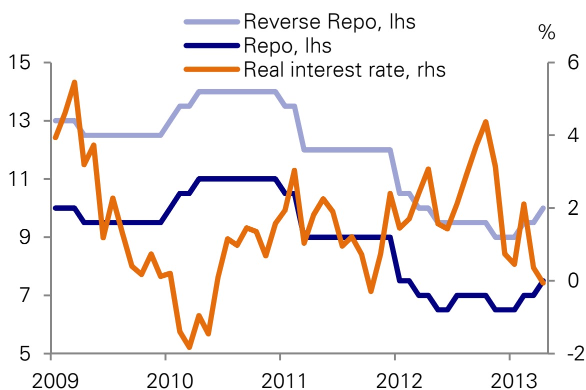
Inflation has bottomed in the first half of 2013




Source: CEIC, Deutsche Bank

More rate hikes are in store. With inflation likely to hit double digits in the coming months, the SBP preemptively increased the policy rate by 50bps to 9.50% in its September monetary policy review. In mid November, the policy rate was hiked by another 50bps. Historically, the SBP has tried to maintain a positive real interest rate (Reverse repo rate – CPI inflation) of 0-2% through its monetary policy actions. Our calculation shows, that without any further monetary policy tightening, real interest rate will fall deeply into the negative territory, as CPI inflation touches double digits in the months ahead. According to our forecast, CPI inflation will average 11.5% in the next twelve months. To keep real interest rates neutral, the policy rate needs to be raised by at least 150bps from current levels. We think the SBP will hike the reverse repo rate by another 150bps in the first half of 2014, pushing up the terminal reverse repo rate to 11.50% by mid-2014.

Policy rate and real interest rate movement

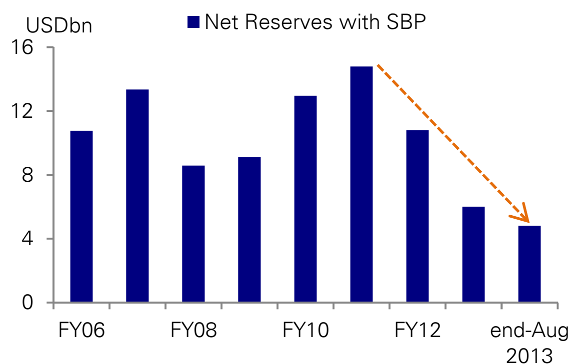



Source: CEIC, Deutsche Bank

External financing crisis has been averted for now, but risks remain

Despite having a relatively modest current account deficit (1% of GDP in FY13), Pakistan's FX reserves depleted sharply in the last 12 months to critical levels, due to large repayment obligations to the IMF, FX intervention by the central bank and a sharp slowdown of FDI inflows into the country, leading the authorities to negotiate a bailout program with the IMF. On September 4, the IMF approved a USD6.6bn loan to Pakistan under a 3-year Extended Fund Facility (EFF) program. Pakistan received USD544.5mn initially, while the residual amount will be evenly distributed over the next three years, subject to meeting the conditions of the program.

FX reserves fell to critical levels by end-August 2013




Source: SBP, Deutsche Bank

The IMF's USD6.6bn Extended Fund Facility program has helped Pakistan avoid a BOP crisis and increased the scope of securing financial assistance from other multilateral institutions such as ADB (USD500mn assistance expected in FY14), the World Bank (USD500mn) and Islamic Development Bank (USD330mn). According to the IMF program assumptions (see table below), financial assistance from multilateral organizations (totaling USD12.4bn) can potentially help Pakistan to meet its gross financing requirement over the next three years, and enhance gross official reserves to USD18.5bn (3.6 months' of imports) by end FY16 from USD6bn now.

It is clear from the table below, that without financial support from IMF and other official creditors, Pakistan would be unable to meet its external financial obligations in the years ahead. Even if Pakistan manages to secure external assistance, gross FX reserves may not increase to the projected levels, if current account deficit turns out to be higher and if inflows from FDI and privatization receipts fall short of the target.

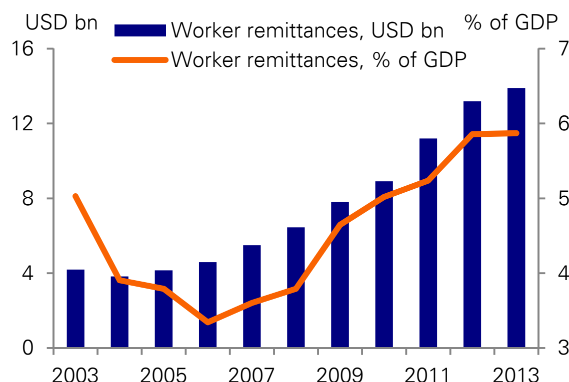
## Gross financing requirement and sources (USDbn)

| IMF program assumptions | FY14 | FY15 | FY16 |
|---|---|---|---|
| **Gross external financing requirement** | **7.1** | **5.9** | **6.3** |
| Current account deficit | 1.3 | 1.7 | 2.7 |
| o/w: Coalition Support Fund | 1.2 | 1.2 | 0.6 |
| Amortization of MT & LT debt | 5.1 | 3.7 | 3.3 |
| Maturing ST debt | 0.7 | 0.5 | 0.3 |
| **Available financing** | **3.8** | **1.5** | **1.6** |
| o/w: Net FDI (including privatization receipts) | 2.3 | 3.2 | 4.0 |
| **Reserve Assets** | **2.1** | **3.9** | **5.1** |
| | | | |
| **Remaining financing gap to be met through program financing** | **3.3** | **4.5** | **4.7** |
| Borrowing from IMF | 2.2 | 2.2 | 2.2 |
| Loans and grants from other donors | 1.1 | 2.3 | 2.4 |
| o/w: WB | 0.5 | 0.8 | 0.9 |
| ADB | 0.3 | 0.5 | 0.5 |
| Bilateral & other | 0.4 | 0.9 | 1.0 |
| **Gross official reserves** | **9.6** | **13.4** | **18.5** |
| Months of import cover | 2.2 | 2.8 | 3.6 |

*Source: IMF, Deutsche Bank estimates*

In spite of the current IMF program, the risks to external sector financing remain high in the years ahead. Volatility in global financial markets, oil price shock, and political unrest could prevent significant improvement in the external financing dynamic, despite the best efforts of the Pakistani authorities, in our view.

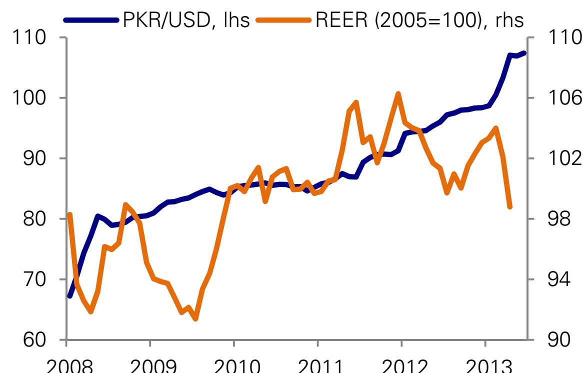
## Worker remittances are strong but flattening out




*Source: CEIC, Deutsche Bank*

Given that risks to the external sector are still high, we remain cautious about the outlook on the rupee. According to our calculation, the rupee remains overvalued by at least 5% and has scope to depreciate further in the months ahead. With Dollar likely to strengthen globally and given SBP's requirement to buy Dollars to shore up FX reserves, we see little support for the rupee in the months ahead. We expect the rupee to continue depreciating against the USD, touching 113 by end-June 2014.

## Rupee remains under pressure; further depreciation likely




*Source: CEIC, Deutsche Bank*

## Conclusion

Pakistan faces numerous near-term and structural challenges, which require swift policy responses from the authorities. Growth momentum remains weak, fiscal deficit and inflation are persistently high, exchange rate depreciation continues unabated and Balance of Payments risks are serious. Attaining external sector stability, improving the fiscal & debt dynamic and energy sector reforms are clearly the need of the hour to avoid a further deepening of the economic crisis, and help ease the various supply side constraints that impede the economy from operating at its full potential. The IMF's new macro stabilization program will be a big positive for Pakistan in this regard, as it is likely to help fast track the reforms process, which is what is urgently required to restore investor confidence. A stable political environment is however necessary to carry out the various structural reforms in an uninterrupted manner. The newly elected PML(N) government enjoys a strong majority at the centre, which should help the reforms process for now, but some degree of caution is warranted, given Pakistan's history of frequent political unrest.

If the reforms momentum is sustained for the next couple of years under a stable political environment, growth could rise by an additional 100bps or more from current levels aided by a better performing energy sector, lower inflation and fiscal deficit and a stable external environment. The long term potential for growth is even higher, in our view, given Pakistan's favorable demography and geo-strategic location (ideal for boosting trade), but achieving this will require political stability, more friendly ties with neighboring countries, greater financial and economic liberalization, and last but not the least, policies oriented toward easing cost of doing business and facilitate foreign investments into the country.

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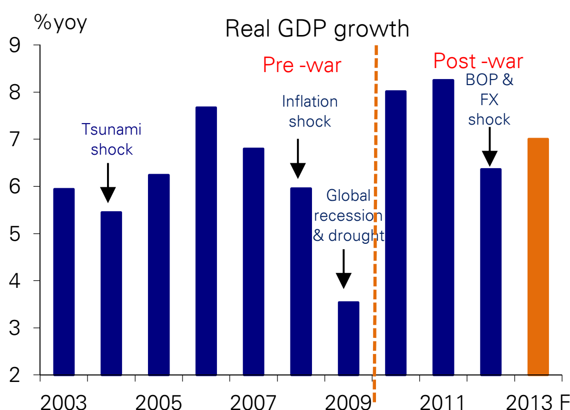
## Sri Lanka – strong potential despite negative demographics

*The macroeconomic landscape of Sri Lanka has undergone a dramatic transformation, since the termination of the three decade long internal strife in 2009. Easing of security concerns and restoration of stability in governance are paving the way for improved growth prospects*.

Historically, the Sri Lankan economy has shown a high degree of resiliency through various crises. Even when Sri Lanka was engaged in a brutal civil war, real economic growth had remained fairly strong despite various endogenous and exogenous shocks.

A resilient economy



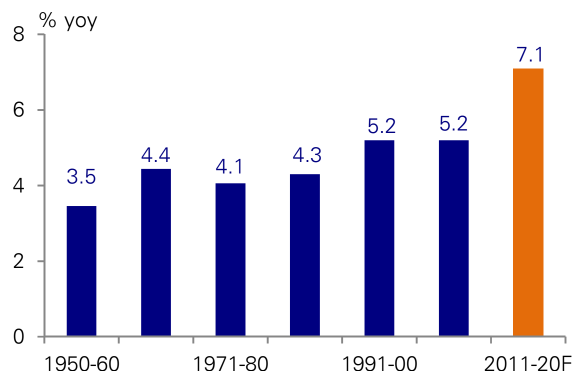

Source: CEIC, CBSL, Deutsche Bank

### Growth outlook positive despite negative demography

The end of the civil war in 2009 and the ensuing "peace dividend" has improved Sri Lanka's long-term growth outlook meaningfully. Farm sector growth prospects have risen, as the agricultural rich province of the North and East (which were affected by the war) are now expected to generate more output than before. Tourism and post-conflict reconstruction activities should also benefit from the end of hostilities. In the current decade (2011-2020), we forecast Sri Lanka's growth to average around 7.0%, almost 200bps higher than the 5.2% growth recorded in the last two decades.

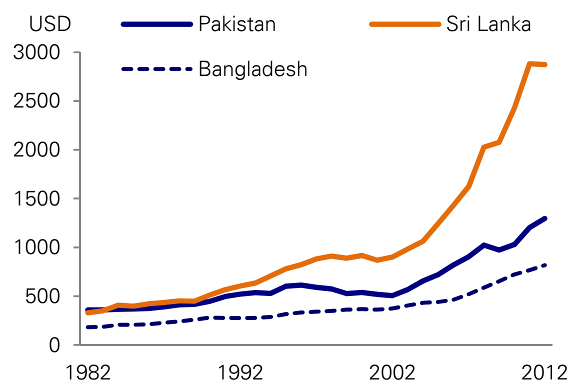
This has the potential to boost Sri Lanka's per capita income (which is significantly higher than comparable countries such as Bangladesh and Pakistan) above USD7,000 by 2020, from an estimated USD3,100 in 2013, in our view.

Real GDP growth – decadal average




Source: CEIC, Deutsche Bank

Sri Lanka's per capita income higher than its peers

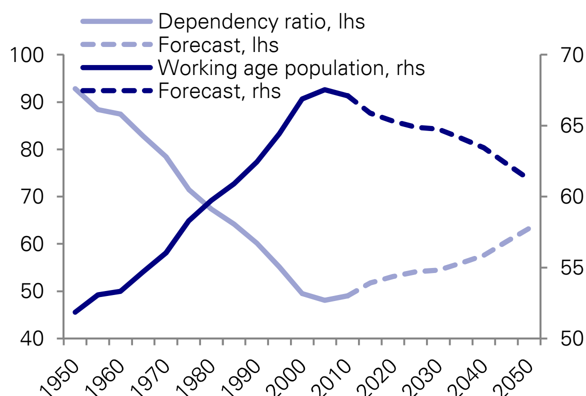



Source: IMF, Deutsche Bank

**Sri Lanka's growth potential could have been higher, if not for the negative population dynamic.** Using projections from the United Nations population database, we find that the Sri Lankan economy will be aging at a rapid pace in the next forty years, with proportion of population over 65 years age likely to rise from 7.8% in 2010 to 20.1% by 2050. The speed with which the population aging is likely to occur is indeed worrisome. To put numbers in perspective, while it took 45 years for the proportion of population above 65 years age to double from 3.9% in 1965 to 7.8% in 2010, the next doubling will likely take place in just a span of 25 years (to 16% in 2035).

A lower birth rate and rapid rise in aging will likely result in working age population (population within the age group of 15-64) to fall from 67 in 2010 to 61 by 2050, while dependency ratio (number of children aged 0-14 and elderly (age 65+) per 100 people in the workforce age 15-64) is likely to rise from 49 in 2010 to 63 by 2050.

Working age population and dependency ratio




*Source: United Nations Population Database, Deutsche Bank*

This adverse population dynamic is likely to exert a negative influence on the real economy. A shrinking working age population will tend to depress savings, investment and consequently overall economic growth while potentially push up costs related to welfare, health and pension on the fiscal side. The end of the longstanding civil war will probably help to offset some of this negative impact as the ensuing 'peace dividend' will allow the economy to operate at a fuller potential, but overall the economy would have to push itself extra harder with each passing year.

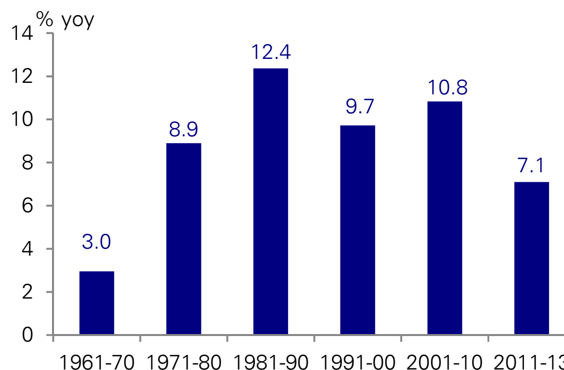
Therefore while the near-term growth prospects remain promising, propelling the economy to a sustained 7.0-8.0% growth trajectory will be challenging and will depend on the government's willingness and ability to carry out far-reaching economic reforms, in our view. Key areas where steady improvement is required are:

- Fiscal consolidation. Given the challenging demographic outlook, it is imperative that the government continues with its fiscal consolidation drive, as it will help to reduce public dissavings and add to the total savings pool of the economy.
- Improving the business climate and ease of doing business in Sri Lanka. Sri Lanka ranks 81st out of 183 countries in the World Bank's "Ease of doing Business Index", while the "World Competitiveness Index" lists Sri Lanka at 68th place out of 144 countries. A marked improvement on this front is essential to attract much needed growth critical foreign investments into the country, in our view.
- Focus on strategies, which incentivize shifting Sri Lanka's trade dynamic in favor of Asian countries, and away from US and EU, where growth prospects are expected to remain significantly poor relative to its Asian peers for many years to come. Currently US and EU combined constitute 55% of Sri Lanka's total exports compared to only 6% for India.
- Focus on improving productivity to raise the savings/investment ratio to 30-35% of GDP, from the current 25-30%, to support a non-inflationary 7.0% growth trajectory on a sustained basis.

## Inflation needs to be anchored at mid single digit levels

The Sri Lankan economy has a history of high inflation. CPI inflation has averaged 11% in the last three decades (1981-2010), with food and fuel price shocks being the main catalysts behind past inflation spikes. Food and fuel together constitute close to 42% of the total CPI basket, and any supply shock therefore readily affects the inflation trajectory (as was the case in 2008 when a spike in global fuel prices pushed up CPI inflation to 22.5% that year).

Long term inflation trend



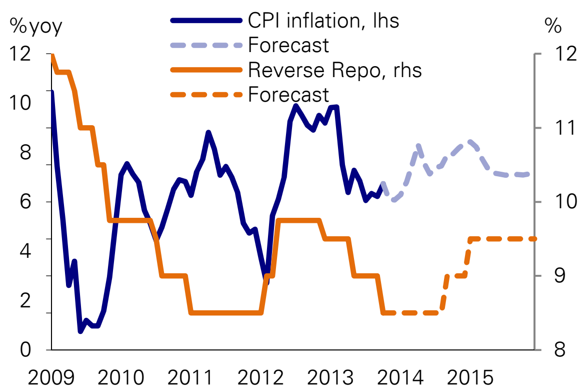

*Source: CEIC, Deutsche Bank*

The persistence of high inflation in Sri Lanka is due to a host of factors including, i) structural bottlenecks; ii) heightened vulnerability to supply side shocks; iii) periodic overheating of the economy due to inadequate tightening of monetary policy; and iv) high fiscal deficit. Clearly, the improvement in inflation dynamic requires coordinated policy responses from both the monetary and fiscal authorities. In order to reduce structural inflation, the government needs to focus on policies, which foster competition, raises productivity, incentivizes investment, reduces wasteful fiscal expenditure and unclogs supply-chain bottlenecks. The monetary authorities on their part should put more emphasis towards controlling inflation and inflation expectations and in the process seek to enhance the Central Bank of Sri Lanka's inflation fighting credibility.

The CBSL's inflation fighting track record is poor. The central bank's inherent bias towards supporting growth, has often led to policy errors in the past (2010-11 episode) and posed a risk to macroeconomic stability. Swift and aggressive monetary tightening could have prevented building up of imbalances in the past but would have also led to a slower growth outturn, which the authorities were not willing to accept. Overall, the CBSL prefers to be reactive rather than be proactive in

tackling inflation, while being ready to support growth at every possible opportunity.

Inflation is close to bottoming out



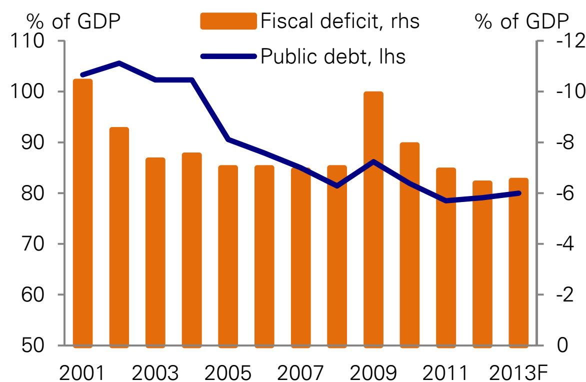

Source: CEIC, Deutsche Bank

The CBSL, in our view, should endeavor to keep inflation anchored in the 5-6% range, if it wants to achieve an investment-led stable growth outturn on a secular basis. High inflation not only reduces real income of households but also erodes investor confidence and pares down the medium term growth outlook by creating all sorts of distortions in the economy. In our view, Sri Lanka would benefit in the long term if the authorities put increased focus on achieving some sort of stability in the growth-inflation dynamic, rather than continuing with their obsession of achieving over ambitious growth targets, which leads to repeated boom-bust cycles in the economy.

## Twin deficits – key source of weakness

Sri Lanka's high twin deficits have been a source of concern for many years now. Sri Lanka has always struggled to keep fiscal deficits under check. Consider the following statistics. The lowest fiscal deficit achieved since 1980 was 5.8% of GDP in 2013. In the last two decades (1991-2000 and 2001-2010) fiscal deficit/GDP has averaged 8%, which is however an improvement over the 1981-1990 decade, when the government ran deficits of 10% on an average. Given weak fiscal metrics, naturally the debt dynamics also has been a perennial source of concern for Sri Lankan authorities. In the last two decades, debt-GDP ratio has averaged 94%, worsening the most during 2001-04 (debt/GDP ratio stayed above 100% in these four years).

High fiscal deficit and debt despite some moderation

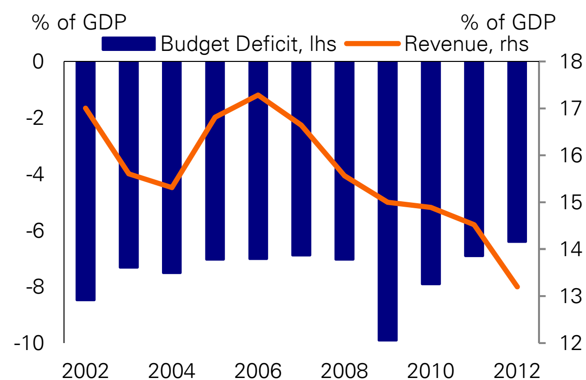



Source: CEIC, Deutsche Bank

It is therefore hardly surprising that when Sri Lanka decided to tap the IMF-SBA loan facility in 2009, the IMF officials prescribed fiscal consolidation as one of the key deliverables for the Sri Lankan authorities to be eligible for the full amount of the loan (USD2.5bn). The progress on the fiscal and debt front has been encouraging in recent years. Under IMF's surveillance, the authorities managed to bring the budget deficit down to 6.4% of GDP by the end of 2012 (in 2013, fiscal deficit is likely to have improved further to 5.8% of GDP), from 9.9% in 2009. Consequently, the debt/GDP ratio has also improved to 79% in 2012, from 86% in 2009. Despite some improvement in recent years, Sri Lanka's fiscal deficit however remains high when compared with its regional peers.

In the last few years, the improvement on the fiscal front was achieved by lowering expenditure (mainly recurrent expenditure), rather than through an increase in the revenue/GDP ratio. In fact, revenue/GDP ratio has been trending down each year since 2006. What is striking is that this downward trend was maintained even in the high growth years of 2010/2011.

Revenue/GDP ratio on a downtrend



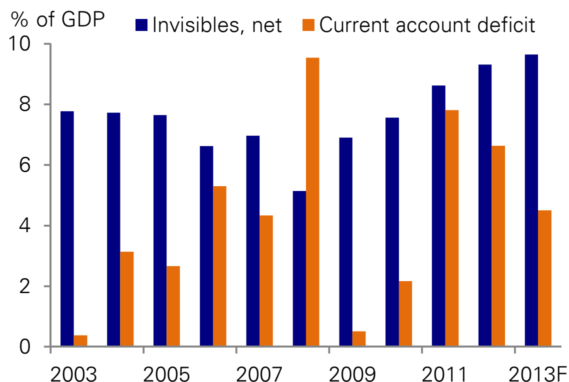

Source: CEIC, CBSL, Deutsche Bank

Sri Lanka has a long way to go before it achieves some sort of stability in its fiscal balances, but the authorities seem committed so far to carry on with the fiscal consolidation effort. Bold tax reforms initiated in the 2011 budget should start paying dividends in the years ahead, thereby helping narrow the budget deficit further, but caution should be maintained, given Sri Lanka's poor track record of maintaining low fiscal deficits in the past.

Since 2001, Sri Lanka has faced four BOP crises (2001, 2004, 2009 and 2012). The last BOP shock occurred in 2012, led by a spike in CAD to 7.8% of GDP and a sharp drop in FX reserves. The authorities announced tough measures in early 2012 to check the imbalances which have worked well so far. CAD is expected to narrow to 4.1% of GDP in 2013 (and further to 3.1% in 2014), led by a lower trade deficit and robust invisibles but the external position still warrants caution.

Most of the pipeline FDI is tied with developments in the hotel and tourism sector, which is seen as one of the key drivers of growth. However such FDI is generally lumpy in nature and takes time to materialize, leading to large swings in the capital account position. If FDI flows disappoint next year (we estimate at least USD1bn in 2014), the BOP and exchange rate will remain under pressure. Potential volatility in global financial markets (related to Fed-tapering) could complicate matters further.

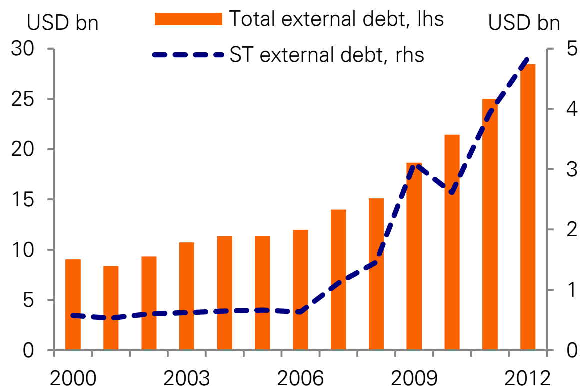
Current account deficit high despite robust invisibles




Source: CEIC, Deutsche Bank

The other source of concern is external debt. At end-December 2012, Sri Lanka's external debt was USD28.4bn, a 103% increase from pre-crisis 2007 levels. The short term component of the external debt has risen more rapidly, touching USD4.8bn by end-Dec 2012 (70.3% of gross official reserves), from USD1.1bn in 2007 (+335%). Combination of a large current account deficit and rising short-term external debt makes the economy vulnerable to any potential external shock, which could eventually pose a risk for financial system stability.

External debt has increased rapidly and substantively




Source: CEIC, Deutsche Bank

Year to date, the Sri Lankan rupee has depreciated by 2.8%. While we are not factoring in a trend depreciation of the exchange rate next year (given our baseline forecast of a narrowing CAD and stable inflow assumptions), we expect depreciation pressure intermittently, led by US tapering related uncertainty. Given the experience of 2011-12, we do not expect the central bank to intervene actively in the FX market, but we do expect the authorities to step in from time to time to smoothen out volatility.

## Conclusion

With the end of the three-decade long civil war in 2009, Sri Lanka has begun to attract the attention of the investor community but sustaining the interest would be contingent on the government's willingness and capability of continuing with growth supportive and productivity enhancing economic and financial reforms. The 'peace dividend' following the end of the longstanding war with LTTE rebels in May 2009 is likely to enhance the growth potential of the economy in the medium term but over a slightly longer horizon, a negative demography could offset much of the positive gains. Fiscal and external sector dynamic continues to be weak and needs to be dealt with urgently to create a conducive climate for investment. Fast tracking the reforms momentum could potentially boost growth-critical foreign investment into the country, given Sri Lanka's relatively high growth potential (despite the adverse demography), locational advantage (port and tourism), skilled yet cheap labor force and likelihood of further widening and deepening of the domestic capital markets in years to come. It is up to the authorities to seize this golden opportunity.

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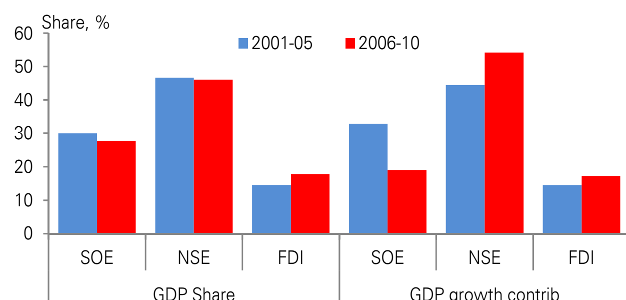
## Vietnam- from volatility to reform, Doi Moi #2

*After years of boom and bust cycles, the government prioritized stability for two years and is about to embark on its second reform push, with the Trans-Pacific Partnership as a catalyst for comprehensive change.*

Vietnam has gone through a couple of boom and bust economic cycles since its entry into the WTO in 2007, with the global financial crisis amplifying the volatility. Meanwhile, the authorities have prioritized stability over growth and now we think they are ready to take Vietnam one step further in development, by taking on broader structural reform and liberalizing the economy. We think their efforts will be more comprehensive, not restricted to only banks but also including SOEs (gradually) and the private sector. As Vietnam develops and integrates further into the global economy, we see it increasing its support for fair competition and opportunities for all economic agents, which will be positive for the non-state (private) sector. Naturally, a removal of restrictive barriers to business and investment activities would effectively level the playing field and make the business environment friendly for all types of enterprises – SOEs, non-state enterprises and FDIs alike – and better improve the link between FDIs and local suppliers.

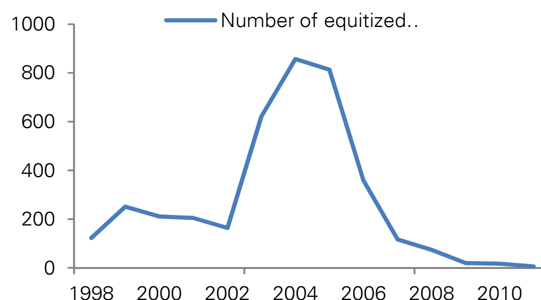
Poor SOE performance




Sources: CEIC, Deutsche Bank

We think Vietnam is ripe for its second Doi Moi and we expect the National Assembly to consider a more decisive step in this regard when it meets later this year to carry out the midterm review. Considering the non-state sector's relative outperformance in boosting Vietnam's growth, we think that a general policy move to support the "private" sector, while improving SOE efficiency/productivity, will contribute greatly to Vietnam's balanced growth agenda. In recent months, the government has taken a more decisive step in bank reform, with bad debt resolution via VAMC (Vietnam Asset Management Company) and the reform of SOEs. The authorities have asked the Finance Ministry to submit a plan for SOE bad debt resolution and have ordered SOEs to pull away from peripheral activities and focus on the core instead. For example, the government announced a plan to reduce its stake in the national airline and ordered it to completely divest its capital in non-core businesses by late 2015. The authorities are also encouraging joint ventures/strategic partnerships between FDIs/non-state enterprises (NSEs) and SOEs/SOCBs. According to local news reports, the national airline (SOE) plans to select a strategic investor, by end-year. The authorities are also preparing to increase foreign investment limits. According to local news reports, for selected industries the limit may be increased from 49% to 59%, to be proposed by the State Securities Commission (SSC). We see changes in Vietnam to improve its competitiveness as inevitable as it seeks to move up the global value chain while broadening its presence in international trade.

SOE equalization efforts to gain stronger momentum




Sources: ADB, Deutsche Bank

### TPP could be a turning point for Vietnam

According to a study by Petri and Plummer[2], Vietnam's potential gains from freer trade by joining Trans-Pacific Partnership are the largest of any country, with a boost to national income of about 11-14% (with exports increasing about 28-37%) by 2025, depending on whether it is TPP-12 or TPP-13.[3] Note that TPP-12 represents about 40% of the world's population and 33% of the world's GDP (PPP) (38% nominal). For Vietnam, the TPP-13 would represent about 50% of its total exports, while China/HK represents about 14% and ASEAN together about 15%. Also, TPP-13 is significant in terms of Vietnam's move up the value chain, given South Korea's importance (via FDI) in Vietnam's high tech sector and related exports.

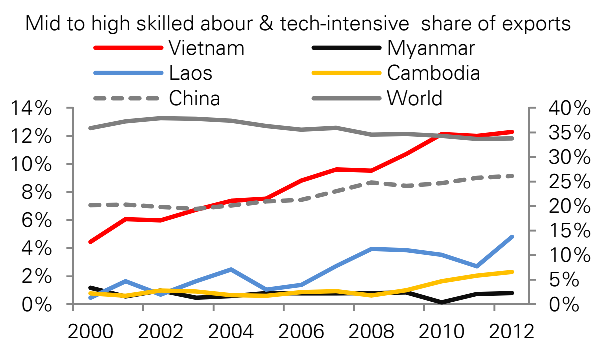
At the same time, by joining the TPP, Vietnam will commit itself to economic policy reform, although the

[2] The Trans-Pacific Partnership and Asia-Pacific Integration, by Peter A Petri, Michael Plummer, and Fan Zhai, published on 24 October 2011.

[3] TPP-12 includes the US, Australia,Canada, Chile, Mexico, New Zealand, Brunei, Japan, Malaysia, Singapore and Vietnam, while TPP-13 includes South Korea. The latter has not yet formally joined the TPP negotiations.

speed may be negotiated. There are obviously difficult details to be negotiated, related to rules of origin, anticompetitive policies, labour rights, intellectual property and agricultural products, among others. In particular, the TPP would require its members to ensure "competitive neutrality of policy with respect to government enterprises" as well as "national treatment and enforcement authority," among other things. Vietnam is pursuing the TPP while it continues its work on the FTA with the EU and ASEAN Economic Community (AEC).

Good lead vs. its neighbors in moving up the value-chain but still a long way to go




*Sources: UNCTAD, Deutsche Bank*

Vietnam's TPP membership may obscure its ASEAN agenda, as the former may better support Vietnam's efforts to improve its competitiveness and move up the supply chains. ASEAN is pursuing a single production/market base (ASEAN Economic Community), which would ensure the free flow of goods, services, investment, capital and skilled labour. ASEAN is also seeking a Regional Comprehensive Economic Partnership (RCEP), a FTA that extends to Australia, China, India, Japan, South Korea and New Zealand. While TPP does not include other CLMV (Cambodia, Laos, Myanmar, Vietnam), AEC does include them. With TPP presenting Vietnam with significant gains in the areas of apparel and footwear, this may be particularly challenging to Cambodia. There are, however, rising political risks to the TPP, largely from the US front.

### Government targets stronger growth in 2014

While the Vietnamese government has proposed a realistic goal of achieving GDP growth of 5.8% in 2014, there are concerns about its ambitious debt proposal. The Vietnamese government's economic targets for 2014 include GDP growth of 5.8% (vs. its target of 5.3% in 2013); inflation of 7% (unchanged from this year's 7%); a budget deficit of 5.3% of GDP (unchanged from this year); and social investment of 30% of GDP (vs. 29.1% in 2013). Despite the modest increases in debt and social investment next year, the government's debt issuance plan for the next three years poses risks to its debt sustainability and price stability. The plan calls for another VND170tr (USD8.1bn, about 5% of 2012 GDP) of debt issuance, in addition to the original proposal of VND75tr (USD3.5bn, about 2% of 2012 GDP), largely to fund infrastructure projects.

From 2011 to Q3 2013, Vietnam's GDP growth averaged 5.5%, vs. the medium-term 2011-2015 GDP growth target of 6.5%-7%. This growth target, however, will be missed, unless Vietnam achieves GDP growth of about 10% in 2015, which we do not expect. And, we see any attempt to push a strong growth agenda by public investment, financed by debt, pose risks to not only to prices – CPI inflation averaged about 12% in 2011-October 2013, vs. the medium-term target of 5-7% –but also the dong.

Meanwhile, the State Bank of Vietnam (SBV) is looking for means to limit speculative flows and de-dollarise the economy. For the former, the SBV may ban FX deposits by non-residents. On the other hand, it may allow FDI investors to open multi-currency accounts and use their dong income in Vietnam for reinvestment. At the same time, the SBV has accumulated enough FX reserves to cover about 12 weeks of imports, vs. 10 weeks at end-2013 and six weeks at end-2011, although the improvement in the external balance was partly due to sustained FDI inflows and weakness in domestic demand. The latter has resulted in a trade deficit of less than USD200m ytd in October (vs. the five-year average deficit of USD10.5bn in 2012). Meanwhile, Vietnam has continued to enjoy large FDI inflows. By October, FDI stood at USD9.6bn (vs. the five-year average of USD10.7bn in 2012), while the newly registered level stood at USD19.3bn (vs. the five-year average of USD29.3bn in 2012), suggesting improved implementation. However, the Fed's tapering and normalization of global rates pose risks to the dong.

*Juliana Lee, Hong Kong, +852 2203 8312*

# Data appendix

## Bangladesh

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|
| Gross domestic product, current prices, USD bn | 74.0 | 84.5 | 94.9 | 106.2 | 114.1 | 123.0 |
| Population, mn | 146.5 | 148.0 | 149.5 | 151.1 | 152.7 | 154.3 |
| Gross domestic product, constant prices, %yoy | 6.3 | 6.0 | 5.9 | 6.4 | 6.5 | 6.1 |
| Inflation, average %yoy | 9.1 | 8.9 | 5.4 | 8.1 | 10.7 | 8.7 |
| Total investment, % of GDP | 24.3 | 24.3 | 24.4 | 24.8 | 25.9 | 26.7 |
| Gross national savings. % of GDP | 29.5 | 29.9 | 29.8 | 29.4 | 29.0 | 29.4 |
| Government revenue, % of GDP | 10.8 | 11.3 | 10.8 | 11.5 | 11.9 | 12.9 |
| Government spending, % of GDP | 13.4 | 15.9 | 14.5 | 14.6 | 16.0 | 16.3 |
| Current account, % of GDP | 0.8 | 1.4 | 2.8 | 0.5 | -1.4 | 0.7 |

*Source: IMF, Deutsche Bank*

## Cambodia

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|
| Gross domestic product, current prices, USD bn | 8.6 | 10.4 | 10.4 | 11.3 | 12.9 | 14.1 |
| Population, mn | 14.3 | 14.6 | 14.8 | 15.0 | 15.1 | 15.3 |
| Gross domestic product, constant prices, %yoy | 10.2 | 6.7 | 0.1 | 6.1 | 7.1 | 7.3 |
| Inflation, average %yoy | 7.7 | 25.0 | -0.7 | 4.0 | 5.5 | 2.9 |
| Total investment, % of GDP | 21.2 | 18.6 | 21.3 | 17.3 | 22.0 | 23.5 |
| Gross national savings. % of GDP | 19.3 | 13.0 | 16.8 | 13.4 | 13.9 | 12.5 |
| Government revenue, % of GDP | 13.7 | 15.9 | 15.8 | 17.0 | 15.6 | 17.2 |
| Government spending, % of GDP | 14.5 | 15.6 | 20.0 | 19.9 | 19.6 | 20.0 |
| Current account, % of GDP | -1.9 | -5.7 | -4.5 | -3.9 | -8.1 | -11.0 |

*Source: IMF, Deutsche Bank*

## Lao P.D.R.

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|
| Gross domestic product, current prices, USD bn | 4.2 | 5.3 | 5.6 | 6.9 | 8.2 | 9.2 |
| Population, mn | 6.0 | 6.1 | 6.3 | 6.4 | 6.5 | 6.6 |
| Gross domestic product, constant prices, %yoy | 7.8 | 7.8 | 7.5 | 8.1 | 8.0 | 7.9 |
| Inflation, average %yoy | 4.5 | 7.6 | 0.0 | 6.0 | 7.6 | 4.3 |
| Total investment, % of GDP | | | | | | |
| Gross national savings. % of GDP | | | | | | |
| Government revenue, % of GDP | 15.6 | 15.9 | 17.1 | 18.3 | 18.3 | 19.6 |
| Government spending, % of GDP | 18.0 | 18.6 | 22.4 | 23.0 | 20.4 | 22.2 |
| Current account, % of GDP | -15.7 | -18.5 | -21.0 | -18.2 | -15.5 | -28.4 |

*Source: IMF, Deutsche Bank*

## Mongolia

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|
| Gross domestic product, current prices, USD bn | 4.2 | 5.6 | 4.6 | 6.2 | 8.7 | 10.3 |
| Population, mn | 2.6 | 2.7 | 2.7 | 2.8 | 2.8 | 2.8 |
| Gross domestic product, constant prices, %yoy | 10.2 | 8.9 | -1.3 | 6.4 | 17.5 | 12.3 |
| Inflation, average %yoy | 8.2 | 26.8 | 6.3 | 10.2 | 7.7 | 15.0 |
| Total investment, % of GDP | 38.7 | 43.6 | 34.4 | 40.8 | 57.1 | 63.5 |
| Gross national savings. % of GDP | 42.1 | 31.9 | 26.0 | 27.1 | 28.0 | 30.7 |
| Government revenue, % of GDP | 37.9 | 33.1 | 30.3 | 37.1 | 40.3 | 35.5 |
| Government spending, % of GDP | 35.3 | 37.6 | 35.5 | 36.6 | 45.1 | 47.3 |
| Current account, % of GDP | 6.3 | -12.9 | -9.0 | -14.9 | -31.7 | -32.8 |

*Source: IMF, Deutsche Bank*

## Myanmar

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|
| Gross domestic product, current prices, USD bn | 23.3 | 34.6 | 38.1 | 49.6 | 56.2 | 55.3 |
| Population, mn | 57.6 | 58.8 | 60.0 | 61.2 | 62.4 | 63.7 |
| Gross domestic product, constant prices, %yoy | 12.0 | 3.6 | 5.1 | 5.3 | 5.9 | 6.4 |
| Inflation, average %yoy | 30.9 | 11.5 | 2.2 | 8.2 | 2.8 | 2.8 |
| Total investment, % of GDP | 14.6 | 13.1 | 14.7 | 16.0 | 14.9 | 20.1 |
| Gross national savings. % of GDP | 12.9 | 14.4 | 18.3 | 23.1 | 27.5 | 15.6 |
| Government revenue, % of GDP | 12.3 | 11.6 | 10.7 | 11.4 | 12.0 | 23.0 |
| Government spending, % of GDP | 15.5 | 14.0 | 15.6 | 16.9 | 16.6 | 26.6 |
| Current account, % of GDP | -0.7 | -4.2 | -1.3 | -1.9 | -2.4 | -4.4 |

*Source: IMF, Deutsche Bank*

## Sri Lanka

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|
| Gross domestic product, current prices, USD bn | 32.4 | 40.7 | 42.0 | 49.6 | 59.2 | 59.4 |
| Population, mn | 19.9 | 20.1 | 20.2 | 20.4 | 20.5 | 20.7 |
| Gross domestic product, constant prices, %yoy | 6.8 | 6.0 | 3.5 | 8.0 | 8.2 | 6.4 |
| Inflation, average %yoy | 15.8 | 22.4 | 3.5 | 6.2 | 6.7 | 7.5 |
| Total investment, % of GDP | 28.0 | 27.6 | 24.4 | 27.6 | 30.0 | 30.6 |
| Gross national savings. % of GDP | 23.6 | 18.0 | 23.9 | 25.4 | 22.2 | 24.0 |
| Government revenue, % of GDP | 16.6 | 15.6 | 15.0 | 14.9 | 14.5 | 13.2 |
| Government spending, % of GDP | 23.5 | 22.6 | 24.9 | 22.8 | 21.4 | 19.7 |
| Current account, % of GDP | -4.3 | -9.5 | -0.5 | -2.2 | -7.8 | -6.6 |

*Source: IMF, Deutsche Bank*

## Pakistan

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|
| Gross domestic product, current prices, USD bn | 152.5 | 171.2 | 169.7 | 177.6 | 213.7 | 225.6 |
| Population, mn | 158.2 | 164.7 | 168.2 | 171.7 | 175.3 | 178.9 |
| Gross domestic product, constant prices, %yoy | 5.5 | 5.0 | 0.4 | 2.6 | 3.7 | 4.4 |
| Inflation, average %yoy | 7.8 | 10.8 | 17.6 | 10.1 | 13.7 | 11.0 |
| Total investment, % of GDP | 18.8 | 19.2 | 17.5 | 15.8 | 14.1 | 14.9 |
| Gross national savings. % of GDP | 14.3 | 11.1 | 12.1 | 13.6 | 14.2 | 12.9 |
| Government revenue, % of GDP | 14.4 | 14.4 | 14.2 | 14.3 | 12.6 | 13.1 |
| Government spending, % of GDP | 19.5 | 21.4 | 19.2 | 20.2 | 19.5 | 21.5 |
| Current account, % of GDP | -4.5 | -8.1 | -5.5 | -2.2 | 0.1 | -2.1 |

*Source: IMF, Deutsche Bank*

## Vietnam

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|
| Gross domestic product, current prices, USD bn | 77.5 | 98.3 | 101.6 | 112.8 | 134.6 | 155.6 |
| Population, mn | 84.2 | 85.1 | 86.0 | 86.9 | 87.8 | 88.8 |
| Gross domestic product, constant prices, %yoy | 7.1 | 5.7 | 5.4 | 6.4 | 6.2 | 5.2 |
| Inflation, average %yoy | 8.3 | 23.1 | 6.7 | 9.2 | 18.7 | 9.1 |
| Total investment, % of GDP | 39.6 | 36.5 | 37.2 | 35.7 | 29.8 | 27.2 |
| Gross national savings. % of GDP | 30.2 | 25.0 | 30.7 | 31.6 | 29.7 | 33.0 |
| Government revenue, % of GDP | 26.1 | 26.6 | 25.0 | 27.2 | 25.2 | 22.9 |
| Government spending, % of GDP | 28.1 | 27.1 | 31.6 | 30.0 | 28.1 | 27.7 |
| Current account, % of GDP | -9.0 | -11.0 | -6.0 | -3.8 | 0.2 | 5.8 |

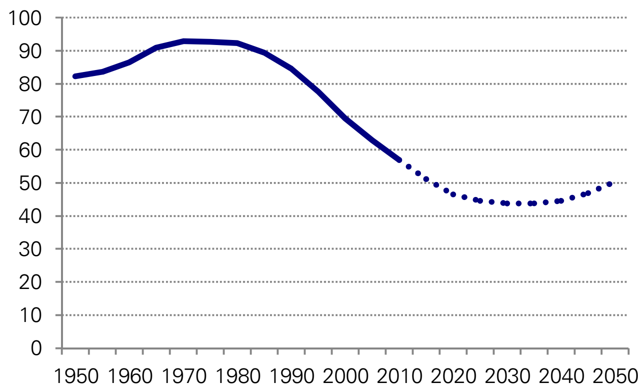
*Source: IMF, Deutsche Bank*

# Demographic dynamic

## Mostly favorable dependency ratio projection (Sri Lanka is an exception) bodes well for consumption, savings and potential growth for the medium- and long-term

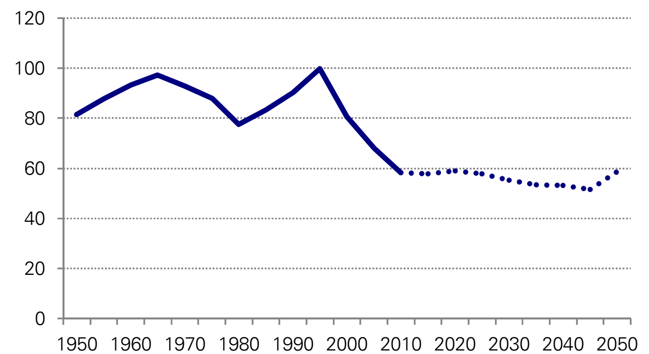
*Note: Total dependency ratio (<15 & 65+)/(15-64) by major area, region and country, 1950-2100 (ratio of population 0-14 and 65+ per 100 population)*

Bangladesh



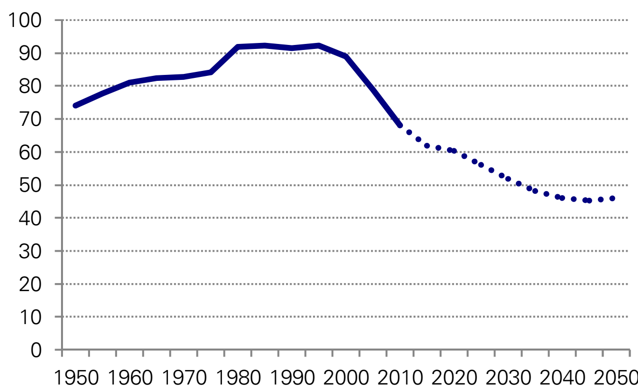

*Source: United Nations, Deutsche Bank*

Cambodia



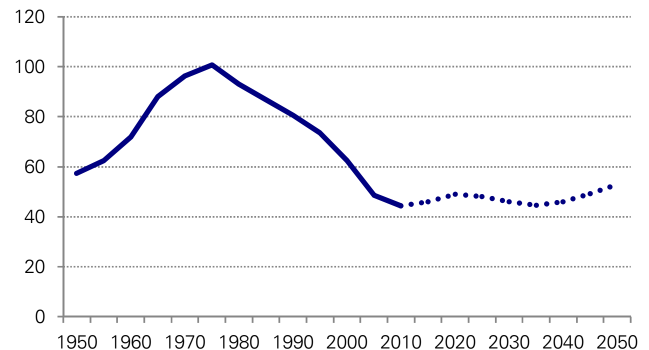

*Source: United Nations, Deutsche Bank*

Lao P.D.R.



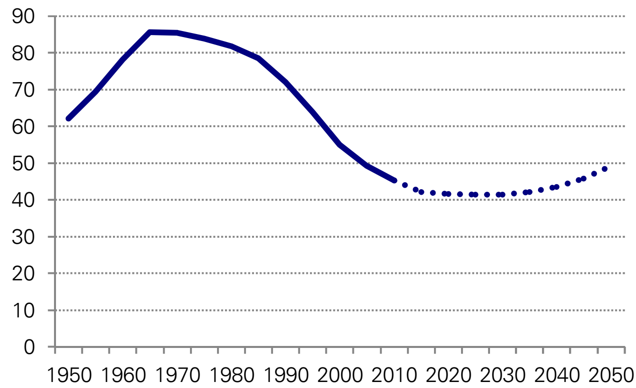

*Source: United Nations, Deutsche Bank*

Mongolia



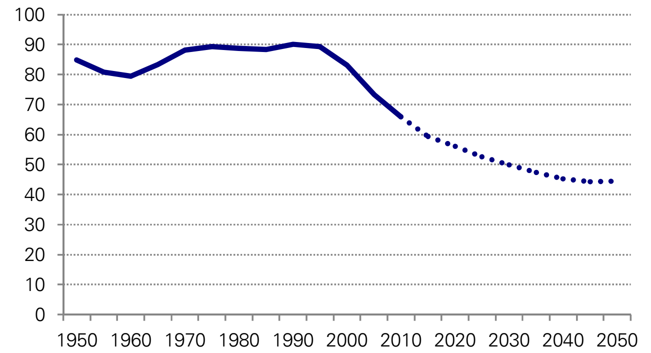

*Source: United Nations, Deutsche Bank*

Myanmar



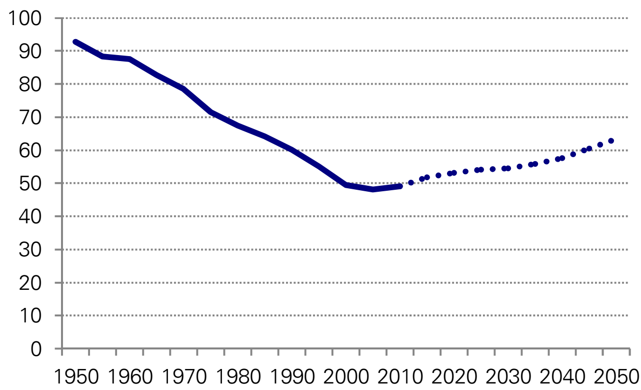

*Source: United Nations, Deutsche Bank*

Pakistan



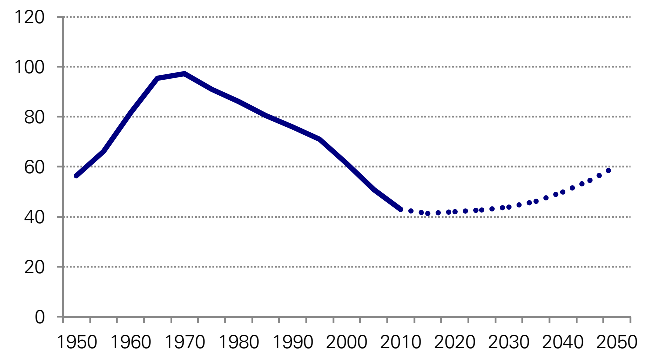

*Source: United Nations, Deutsche Bank*

Sri Lanka




*Source: United Nations, Deutsche Bank*

Vietnam




*Source: United Nations, Deutsche Bank*

# Appendix 1

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