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MYANMAR

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August 14, 2015

Approved By
Asia and Pacific Department

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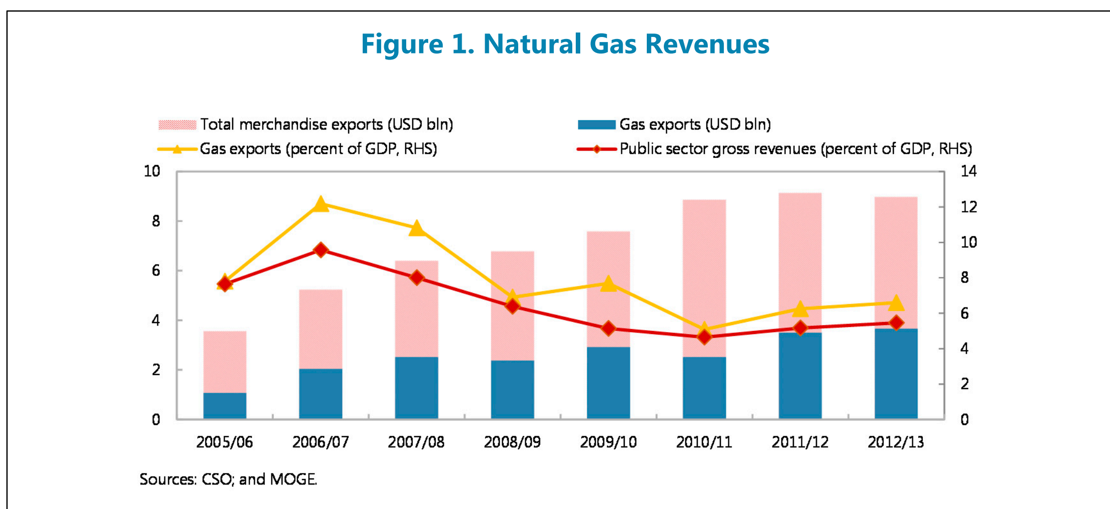
MANAGING NATURAL RESOURCES FOR PEOPLE'S DEVELOPMENT

Myanmar's natural resource endowments provide much needed national wealth to finance the country's development, including addressing wide infrastructure and human capital gaps. Given Myanmar's low tax revenue, mobilizing resource revenues is particularly important in the current macroeconomic environment of widening fiscal and current account deficits, inflationary pressures and exchange rate depreciation. However, natural resource wealth can be a mixed blessing if it is not well managed and there are difficult challenges related to transforming natural resource wealth into other productive assets that support sustained development. This paper provides a conceptual approach to identifying and addressing these challenges, and points to the directions in the reform of Myanmar's natural resource management. In particular, the government should consider revising the fiscal regime for natural resources and introducing a resource rent tax to maximize the revenue stream in an efficient way, possibly with IMF technical support. To better manage the impact of volatile resource revenues on the budget, consideration could be given to anchoring fiscal policy on an expenditure rule over the medium term. The financial requirements for SOEs involved in collecting natural resource revenues should also be revised to ensure that a fair share of revenue from national wealth accrues to the government. Structural reforms to improve transparency, accountability and capacity in public financial management should be accelerated.

A. Overview of Myanmar Extractive Industry Sector

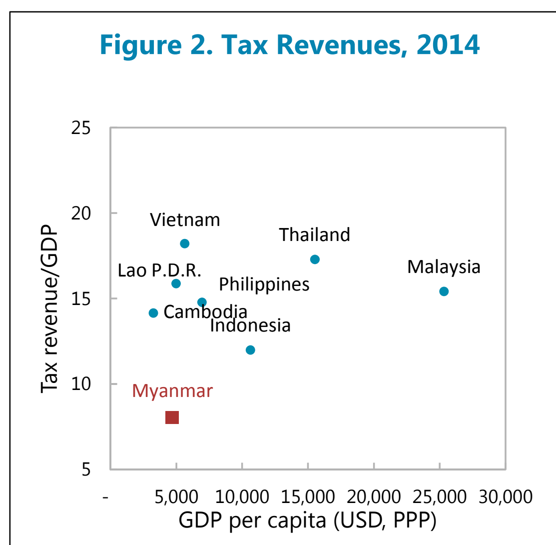
1. Myanmar is one of Southeast Asia's most natural resource-rich countries. Its natural resources include gems, jade, industrial minerals, logs, oil and natural gas. Natural resource exports accounted for 70percent of national exports, or about 11percent of GDP in2012 /13, with natural gas alone making up 40percent of the total (US$3.6billion) (Figure1). Natural resources are the country's prime source of foreign exchange earnings and a major attraction for FDI, and contribute significantly to the government budget. With 10trillion cubic feet of proved gas reserves in 2014, Myanmar ranks 38th in the world (US Energy Information Administration) and is the largest natural gas exporter in Southeast Asia. The recently completed onshore and offshore oil and gas bidding rounds bode well for future production.

2. Multiple agencies and government levels are responsible for the regulation and management of the natural resource sector. State-owned enterprises have important responsibilities for issuing licenses and collecting resource tax and non-tax revenue. Each sector is



regulated by one or more SOEs under the respective ministries and departments, according to sector-specific and largely obsolete laws. Regulating SOEs typically also carry commercial business activities without clear separation of functions. Although there are important differences by sector and contract, natural resource revenues contribute to the budget directly through tax revenues and one-off proceeds, and indirectly through the financial contributions of regulating SOEs to the union government. Non-tax payments are deposited in the accounts of the regulating SOEs with Myanma Economic Bank (MEB) and only partly transferred to the government.

3. The exact share of revenues derived from natural resources is difficult to estimate. There are pervasive data gaps on prices and extraction volumes; the division of responsibility for revenue collection and appropriation between ministries and SOEs is unclear; payments are deposited in multiple bank accounts; and information on production volumes and payments is not publicly disclosed. All these factors make it particularly challenging to accurately estimate revenue flows. Additional sources of uncertainty include the largely informal extraction and payment practices (especially in non-gas sectors); extensive tax holidays; the involvement of military-owned companies; and parallel administration of some resources by subnational entities.



4. There is substantial scope for improving Myanmar's natural resource management. Given Myanmar's extremely low tax yield compared to peer countries (Figure2), natural resource revenues represent a vital source of income for the country. In order to realize the revenue potential of this endowment, there is a need to review current practices to identify weaknesses and address them based on international best practices. In particular, the fiscal regime for natural resources

should be revised to maximize the stream of net government revenues; the fiscal framework should ensure a smooth and sustainable path of public investment in development; and the institutions and procedures in support of these efforts should ensure transparency, accountability and good governance to minimize revenue leakages.

B. Fiscal Regimes: raising natural resource revenues[1]

5. A fiscal regime for natural resources is a set of laws and regulations that govern the allocation of economic benefits derived from natural resource extraction. A distinct fiscal regime for natural resources is justified by key tax-relevant characteristics of the sector. These include: (i) potentially sizable rents, which are an attractive tax base on both efficiency and equity grounds; (ii) pervasive uncertainty due to highly volatile commodity prices and unknown reserves; (iii) asymmetric information between the resource owner and the contractor; (iv) high sunk costs that create time consistency problems; (v) extensive involvement of multinationals and SOEs; and (vi) the exhaustibility of natural resources, with a key opportunity cost of extraction today being foregone extraction in the future.

6. The main objective of a fiscal regime is to maximize the total revenue potential of natural resources and allocate a fair share of benefits to the host country. A well-designed fiscal regime provides predictable and stable revenue stream starting from the early years of production, and captures a greater share of the revenues during periods of natural resource windfalls. It should be easy to administer for the government, and easy to comply with for taxpayers, and minimize discretionary and negotiated elements. It should also provide incentives to maximize efficient production and avoid distortions, such as disincentives and sub-optimization. Such objectives have important implications for fiscal regime design.

7. Although no one fiscal regime is ideal for all countries, combining ad valorem royalty, CIT and resource rent tax has a considerable appeal for developing countries. While the specific fiscal regime should be tailored to country characteristics, the recommended approach include the following components, with their balance being determined by the relative ability to bear risk and the government's tolerance for delays in receiving revenue:

- An *ad-valorem royalty* on gross revenue, ensures some revenues whenever production is ongoing, including the very early stages of production;
- *A standard corporate income tax* (CIT) ensures that normal return to equity is taxed at corporate level as in other sectors;
- *A resource rent tax* exploits the distinct revenue potential of extractive industries and targets the excess profits resulting from the non-renewable and exhaustible nature of natural resources.

[1] This section draws on IMF (2012a)

There may also be scope for other instruments, such as bonuses, which can also serve as a bid variable in competitive allocation of licenses or contracts.

8. A resource rent tax ensures progressive revenues to the government while minimizing incentive distortions to production and investment. A rent tax is similar to a CIT but only applies to profits in excess of the normal return to capital (i.e., revenue minus expenditure minus a normal return to the investor). Since it taxes the full return to investors, including the required return to equity holders, the CIT is a blunt instrument for extracting rents because a high CIT rate can discourage investment by increasing the required pre-tax return. Other tax instruments, such as royalties, also cause distortions whose effect is to erode the value of pre-tax rents. A rent tax is non-distortionary as it taxes rents after the investor has already received a normal rate of return. As a result, it preserves the total pre-tax value of the resource rent with the objective of transferring a substantial part of it to the government.[2]

9. A wide range of mechanisms is used in practice. There is considerable variation in the design of fiscal regimes for extractive industries. Tax/royalty systems dominate in mining, while contractual schemes are common in the oil and gas sectors, often in combination with a royalty/tax regime. Some countries use state ownership to capture rents but this approach can result in mismanagement, corruption and waste of resources, particularly in countries where the rule of law is lacking and transparency, accountability, and management of SOEs are weak. Table1 presents data on revenue instruments used by countries from surveys of the oil and gas, and mining sectors.

10. Myanmar fiscal regime is a hybrid between a contractual scheme and tax/royalty system. Although there are important variations by sector, production sharing contracts regulate the allocation of profits between the relevant SOEs and private contractors. In addition, royalties and commercial taxes on domestic sales and exports are also levied at different rates depending on the sector, along with CIT and specific additional entitlements and fees. Tax revenues are transferred to the Internal Revenue Department (IRD) via line ministries. The amount of tax revenues are typically lower than those accruing to SOEs based on production sharing contracts (Lynn and Oye, 2014) and only20 percent of SOEs profits is transferred to the union governments as an annual dividend. Myanmar does not have a resource rent tax, suggesting that the government may be foregoing an important source of non-distortive tax revenues.

[2] See IMF (2012a) and references therein for a detailed discussion of rent taxation, leading schemes and main differences.

Table1. International Experience with Fiscal Regimes for Extractive Industries, 2012

Oil and gas: survey of 67 countries

Fiscal Instrument	No. of Countries
Signature bonus	16
Production bonus	10
Royalties	50
Resource rent taxes	9
Additional income taxes	3
Production sharing	34
State participation	27
Social investments/infrastructure	6

Mining: survey of 25 countries

Fiscal Instrument	No. of Countries
Signature bonus	1
Production bonus	0
Royalties - Specific	2
Royalties – Ad Valorem	21
Royalties – Other	2
Resource rent taxes	5
Variable Income Tax	3
Additional income taxes	1
State participation	5
Social investments/infrastructure	1

Source: IMF staff.

C. Fiscal Policy Frameworks: spending natural resource revenues[3]

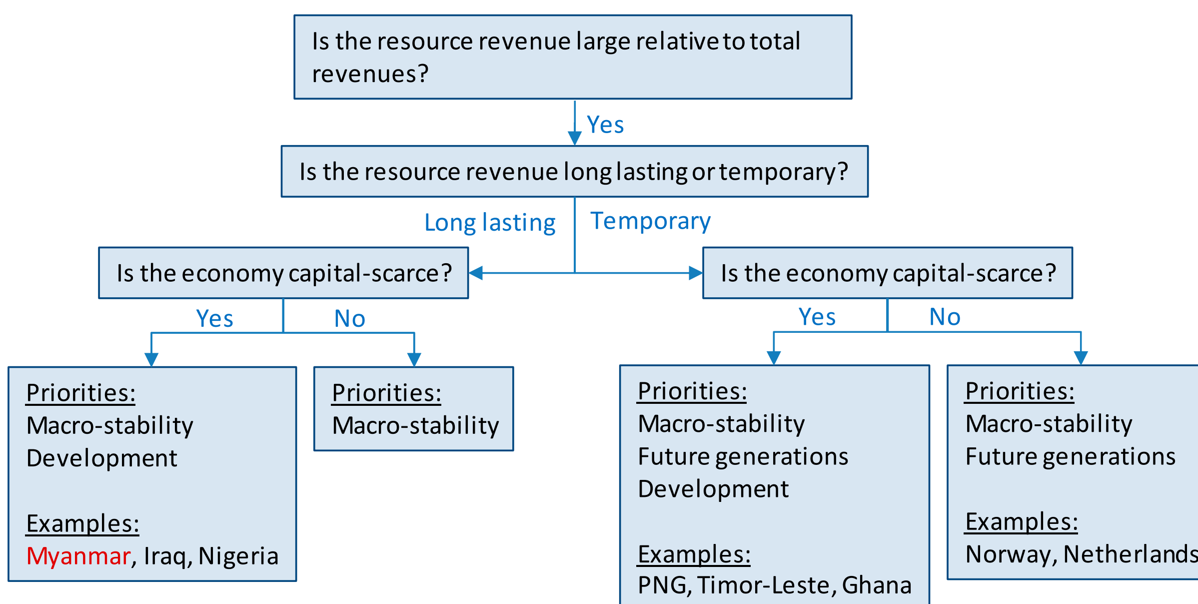
11. The volatility, uncertainty and exhaustibility of resource revenues pose challenges in the design of appropriate policy framework in resource-rich countries. A fiscal framework is a set of fiscal rules that determines the level and composition of government spending. Commodity price volatility complicates fiscal planning because revenue variability makes it difficult to ensure a stable level of public expenditure. Moreover, the uncertainty over natural resource reserves and its exhaustibility raise issue of spending sustainability and intergenerational equity. Additional challenges arise because government spending financed through natural resource windfalls has an expansionary impact on the economy as it injects revenues into the economy without reducing the purchasing power of the private sector through taxation.

[3] This section draws on Baunsgaard and others (2012) and IMF (2012b).

12. As in other countries, a well-designed fiscal framework needs to address issues of demand management and sustainability. In resource-rich countries, this implies ensuring (i) macro-fiscal stability in the face of revenue volatility; (ii) adequate accumulation of precautionary savings; (iii) fiscal sustainability if resource revenue flows are temporary; (iv) scaling up growth-enhancing expenditure for developing countries. The precise weight assigned to each of these objectives should reflect country-specific characteristics such as the degree of resource dependence and the reserve horizon. For countries with temporary resource revenues, the key issue should be to accumulate sufficient financial savings for future generations and avoiding the need for massive fiscal adjustment once resource wealth has been depleted. Countries with long-lasting resource revenues should focus on managing volatility and achieving macro stability. If the economy is capital scarce, the fiscal framework should give a greater weight to investing revenue domestically to build up infrastructures and improve conditions for non-resource growth (Figure1).

13. Since Myanmar is a capital-scarce economy with long-lasting resource revenues, the key issue is ensuring macro-stability while scaling up public investment. There is a need to limit the pro-cyclicality of public spending by delinking expenditures from resource revenue volatility. Given pressing development needs there is also scope for frontloading investment to generate growth and improve the living standards for current generations. The Myanmar government has adopted an overall deficit target of 5percent of GDP. Although this target has helped strengthen fiscal discipline, latest debt sustainability analysis suggests that a lower target, of about 4½percent of GDP, would be more appropriate for keeping public debt on a low risk of distress over the long run. Moreover, an overall deficit target does not adequately address the issue of resource price volatility and it subjects the economy to a procyclical fiscal policy. Under this fiscal rule, expenditure tends to be higher whenever revenue is higher, and vice versa.

Figure 3. Fiscal framework priorities



Source: Baunsgaard and others (2012).

14. **Structural balance rules can be used to delink expenditure from resource price volatility.** This approach mitigates the transmission of externally driven resource price volatility by linking expenditures to structural resource revenues based on a reference price. Commodity reference prices can be calculated by formulas or, as in Chile, by an independent committee. Price formulas can be a moving average either of past prices or, as in Mexico and Trinidad and Tobago, of past spot and futures (markets) prices. If the economic cycle is well defined, an additional adjustment to non-mineral revenue for the economic cycle is typically applied. The choice of price formula implies a trade-off between smoothing expenditures and a need to adjust to changes in price trends. In the current environment of falling international commodity prices, however, using a backward looking formula would result in overestimated resource revenues. In this respect, an expenditure rule may be more appropriate given recent trends in international commodity prices.

15. **An expenditure rule can limit the growth of government spending in nominal or real terms or in percent of non-resource GDP.** Such a rule is desirable when scaling up expenditure in the presence of absorption constraints (Berg and others, 2012) and if the volatility of resource windfalls requires precautionary saving (van der Ploeg, 2011). Relative to a simple structural balance rule, the increase in spending would be more gradual, and buffers would be built up in good times, when revenue windfalls can make spending pressures difficult to resist (Ayuso-i-Casals, 2012). These countercyclical properties make an expenditure rule particularly attractive for Myanmar where the economic cycle is not well defined (Cordes and others, 2015). By reducing incentives for spending overruns, expenditure rules can lead to better prioritization and greater efficiency in spending (Debrun, 2014). Adjustments to the expenditure growth limits should ideally be informed by an

analysis of absorption capacity. To accommodate a preference for investment expenditure, growth limits could be set higher for capital expenditures than for current expenditures.

16. Given institutional and absorptive capacity constraints in Myanmar, the pace of expenditure scale-up needs to be gradual. At the macro level, spending resource windfalls domestically can significantly increase demand on the non-resource sector, leading to higher inflation, especially of non-tradables, and a real appreciation of the kyat (effect commonly known as Dutch disease) although this risk is moderate in Myanmar given the low level of wages and high unemployment. At the micro level, domestic supply constraints and shortcomings in institutional capacity increase the cost and reduce the efficiency of public investment. A gradual approach to scaling up public investment is also warranted by the limited fiscal space if an unsustainable debt trajectory is to be avoided.

D. Structural Policies: supporting resource management

17. Well-designed fiscal institutions are necessary to support macro-fiscal frameworks and the scaling up of public investment. Sound fiscal institutions are essential to ensure transparency and accountability in the collection and utilization of natural resource revenues. Strong public financial management (PFM) capacity is critical to provide reliable revenue forecasting and credible medium-term budget planning. Ensuring that higher spending will yield the expected growth benefits requires strong capability in appraisal of project proposals, good implementation capacity, and sound procurement practices.

18. As part of Myanmar's economic and political transition, the government has announced a commitment to greater transparency. Myanmar has joined the Extractive Industries Transparency Initiative (EITI) (Box 1). Implementation of the EITI will improve transparency and good governance in the management of natural resources and it is important that Myanmar meets the January 2016 deadline for the submission of the first EITI report according to the agreed terms of reference. However, broader measures are needed to ensure public and regular disclosure of information and systematic audits of SOEs operations.

19. A resource fund can be a useful tool in support of macro-fiscal management in the long term. A resource fund could help meet medium-term fiscal stabilization and long-term saving objectives as well as enhance the transparency and credibility of fiscal policies. However, resource funds are complementary policy tools, not a substitute for sound fiscal policy rules, and can complicate fiscal policy management in the presence of weak PFM frameworks. Funds should be integrated into the budget and saving be derived from fiscal surpluses. Considering Myanmar's developing PFM framework and limited fiscal space at present, establishing a resource fund should be seen as longer-term objective.

Box 1. The Extractive Industry Transparency Initiative (EITI)

The Extractive Industries Transparency Initiative (EITI) is a global Standard to promote open and accountable management of natural resources. It seeks to strengthen systems of revenue management in governments and companies, inform public debate, and enhance trust. In each implementing country it is overseen by a multi-stakeholder group of government, company and civil society representatives. Countries implement the EITI Standard to ensure full disclosure of taxes and other payments made by oil, gas and mining companies to governments. These payments (taxes, royalties, etc.) are disclosed—companies report their payments to the government and the government reports what it has received. The information is then compiled and reconciled by an independent auditor chosen by the country, and published in the annual EITI report. The report allows citizens to see for themselves how much their government is receiving from their country's natural resources. Myanmar was accepted as an EITI candidate at the International EITI board meeting on July 2, 2014. Since achieving candidate status in July 2014, nine multi-stakeholder group meetings have been held. Three sub-committees have been established to take forward the work on reporting, outreach and communications, and work plan and governance. Progress has been made in agreeing on the scope and Terms of Reference for the first EITI Report, which is due on January 2, 2016 and will cover data from FY 2013/14. The report will be produced in accordance with the EITI Standard. The scoping study which is being undertaken to prepare for the report will include an assessment of the feasibility to disclose contractual terms relevant to the EITI, explore mechanisms for disclosure of the beneficial owners of extractive companies operating in Myanmar, and overview artisanal extractive activities.

Source: https://eiti.org/Myanmar

E. Summary of Policy Recommendations

21. Myanmar needs to capitalize on its resource endowments to meet its development needs. Myanmar's richness in natural resources presents the government with an opportunity to raise revenues to finance the country's large development needs. Mobilizing revenues is particularly important to create fiscal space in the current macroeconomic environment characterized by inflationary pressures, a widening current account deficit, and a depreciating kyat. In order to maximize the revenue potential from natural resources, the current fiscal regime for extractive industries should be reviewed and reformed with a view to meeting international best practices and improve transparency and accountability. In this respect, the government should consider imposing a resource rent tax on super-normal profits from the extraction of exhaustible natural resources.

22. There are significant challenges involved in spending natural resource revenues, including how to achieve short-term macro-stabilization objectives. In order to minimize vulnerabilities to external shocks the fiscal framework should be anchored on an expenditure rule that delinks expenditure from volatile resource revenues thus avoiding pro-cyclical policies. Coordination with monetary and external sector policies is also essential to avoid macroeconomic imbalances and inflationary pressures from domestic spending of natural resource revenue windfalls. Structural reforms to improve efficiency of non-resource sector will also be important. This would help accelerate the process of economic diversification to avoid enclave effects of resource extraction and mobilize non-resource revenues.

23. The financial requirements for transfers to the Union Government of those SOEs collecting and retaining natural resource revenues should be revised in the context of the ongoing reform of the sector. Since these SOEs are responsible for collecting the nation's resource revenue, their financial requirements in terms of profit transfers to the Union Government should be different from the rest of the sector. Alternatively, the current collection and retention model should be reformed to ensure that all revenues automatically accrue to the budget.

24. The IMF stands ready to provide technical assistance to build capacity and improve Myanmar's natural resource management framework. The IMF helps countries undertake general tax policy reviews and provides tax policy advice with focus on oil, gas and mining sectors. It also helps countries to improve tax administration, PFM, asset and liability management and statistics. Since 2006, over 130 missions have been carried out in around 40 countries, with a strong focus in Africa and the Asia-pacific regions. Such TA activities are delivered in partnership with the Norwegian Agency for Development (NORAD), which is already assisting the Government of Myanmar in developing an oil and gas framework. However, IMF TA is demand driven and it is only initiated upon country governments' request.

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THE ROLE OF FOREIGN BANKS IN DEVELOPING A MODERN BANKING SECTOR IN MYANMAR

A. Introduction

1. **The entry of foreign banks this year is rapidly changing the landscape of Myanmar's banking sector.** Eight foreign banks have started their branch operations since April, and one more will join them by end September.[1] With a combined regulatory capital of about 1 trillion kyat (or about US$1billion), the entry of the nine foreign banks will double the capital size of the Myanmar banking system and increase the number of banks by about one-third. This will introduce competition between the domestic and foreign banks although operations by foreign bank branches will initially be limited to wholesale banking. The entry of the foreign banks is taking place at a time when the number of domestic banking institutions, particularly policy banks, is also increasing. Moreover, with economic liberalization since 2011, credit to the private sector has been growing on average by 50 percent per year, largely driven by the expansion of domestic private banks while state-owned banks[2] (SOBs) are struggling to find their place in a rapidly changing economic environment. In the meantime, the Central Bank of Myanmar (CBM), which was made autonomous only in 2013, is still in early stages of modernizing its regulatory framework and building supervisory capacity.

2. **The entry of foreign banks thus poses considerable challenges to the regulators and domestic banks as well as provides great opportunities for the development of Myanmar's banking sector.** Creating an efficient, competitive, and stable financial market is one of the key goals of the government under its Framework for Economic and Social Reforms (FESR), a development plan that outlines Myanmar's reform priorities. One of the key pillars of the framework is financial sector reforms, under which the authorities envisage the development of the banking sector and promotion of competition among the private banks in order to improve their services and making other financial instruments available to the public. In particular, improving access to

[1] The nine foreign banks were granted preliminary restricted banking licenses on October 1, 2014 by the Foreign Bank Licensing Committee, which has nine representatives from the CBM, the Ministry of Finance, the Union Attorney General's Office, and other experts. The nine banks comprise three Japanese banks (Bank of Tokyo-Mitsubishi UFJ (BTMU), Mizuho Bank, and Sumitomo Mitsui Banking Corporation (SMBC)), two Singaporean banks (Oversea-Chinese Banking Corporation (OCBC), United Overseas Bank (UOB)), and one bank each from Australia (Australia and New Zealand Banking Group Limited (ANZ)), China (Industrial and Commercial Bank of China (ICBC)), Malaysia (Malayan Banking Berhad (Maybank)), and Thailand (Bangkok Bank). ANZ will be the last of the nine banks to apply for the full license.

[2] The Myanma Agriculture Development Bank (MADB), the Myanma Economic Bank (MEB), and the Myanmar Foreign Trade Bank (MFTB) are state-owned and were established in April 1976 under the reorganization of the Union of Burma Bank. The fourth SOB, the Myanma Investment and Commercial Bank (MICB), was set up in 1990 to provide specific financing for agriculture, foreign trade and investment. MEB, MFTB and MICB are 100 percent owned by the Ministry of Finance and should be supervised by the CBM under the 1990 Financial Institutions of Myanmar Law, but the current responsibilities are unclear. The MADB with 206 branches is controlled by the Ministry of Agriculture and was established under a separate act to support agricultural and rural development.

credit is considered to be indispensable for private sector development and poverty reduction, and maintaining financial sector stability is needed to realize the goal of sustained economic growth. In this context, the government hopes that the entry of foreign banks would help promote the modernization and development of the banking sector.

3. The scope of operations by foreign bank branches is expected to gradually expand. Foreign banks are approved to do wholesale banking and not retail banking. They will operate as a branch with one place of business which is permitted to serve only foreign corporations and domestic banks and that will take deposits and extend loans in both foreign currency and Myanmar Kyat. Each foreign bank branch requires a minimum (paid-in) assigned capital of US$75 million, of which $40million is to be deposited at the CBM. In the future the permitted scope of operations of the new foreign bank branches may be expanded to include conducting business with domestic corporations.[3]

4. It is crucial that the authorities quickly move to put in place policies that will help prepare domestic banks for increasing competition, including upgrading the CBM's regulation and supervision framework to cater for more complex banking operations, before further liberalization of the banking sector occurs. Implementing sound policies will help mitigate the risks in a relatively shallow and yet rapidly expanding market under a still developing regulatory framework and weak supervision. To support steps to be taken by the authorities, this paper presents some considerations on the near- to medium-term prospects for Myanmar and its challenges to benefit from the entry of foreign banks. The next section provides an overview of the current state of the banking sector (Section B), followed by a stock-take of the authorities' current objectives for foreign bank entry (Section C). Priority tasks for the CBM to undertake in the short–to-medium term are discussed in Section D before the paper concludes.

B. The Current State of the Banking Sector

5. Myanmar's financial system is still at an early stage of development. Myanmar is a largely cash-based economy where less than 20 percent of the population has access to formal financial services. Despite rapid growth in recent years, the banking system remains small, with deposits equivalent to 32.5 percent of GDP and credit to the private sector amounting to only 16 percent of GDP in FY2014/15. As of end-March 2015, Myanmar's domestic banking sector comprises 4 SOBs and 23 private banks, of which 7 are partly government owned (i.e. by government ministries and municipalities).

6. The SOBs account for slightly more than half of total banking sector assets but they have been losing market share to the fast growing private banks. The SOBs' share in total banking sector assets had declined to 52 percent in March 2015 from 67 percent just two years ago. The assets held by SOBs are mostly government securities and foreign exchange (FX) assets. Among SOBs, the Myanma Economic Bank (MEB) has the largest domestic presence with 306 branches and

[3] It was noted in the invitation to submit an expression of interest for a bank license that the CBM will consider this extension of the scope of the license within 12–24 months after the initial entry of the foreign bank branch to Myanmar.

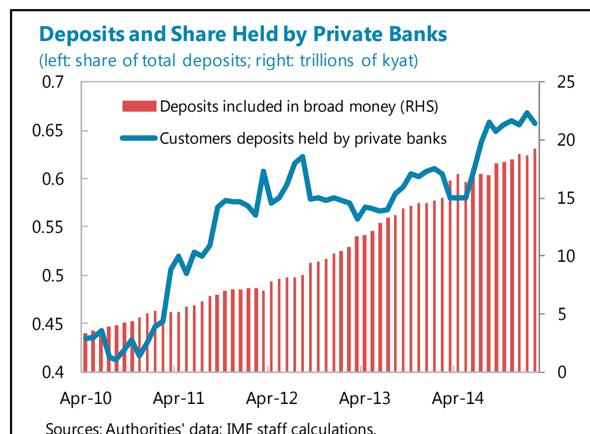
the second largest deposit base (after Kanbawza Bank, a private bank) at 6 percent of GDP, and accounts for 50 percent of total SOB deposits or 18 percent of total bank deposits in March 2015. The share of private banks in banking sector total assets has surged to 48 percent and now accounts for almost two-thirds of total deposits and about 80 percent of total loans. The private banks, many of which were established after 1992, are dominated by five banks, namely, Kanbawza Bank (35.4 percent of total assets), Ayeyarwaddy Bank (11.3 percent), Co-operative Bank (10.7 percent), Myawaddy Bank (7.3 percent), and Myanma Apex Bank (6.8 percent). These five banks collectively account for 72 percent of the total assets of the private banks and 48 percent of the total deposits in the domestic banking system.

Myanmar: Structure of the Banking System
(As of March 2015)

	Domestic Total	State-owned Banks	Private Banks	
	(A)+(B)	(A)	(B)	Share of Total (In percent)
No of banks	27	4	23	85
		(In billions of kyat)		
Assets	34,669	17,953	16,716	48
o/w: Loans	11,351	2,298	9,052	80
Deposits	20,985	7,498	13,487	64
		(In percent of GDP)		
Assets	55	29	27	
Loans	18	4	14	
Deposits	33	12	21	

Sources: Central Bank of Myanmar; and IMF staff calculations.

7. Myanmar banks are relatively weak and uncompetitive. Currently, the range of banking products and services is limited, and lending is collateralized by real estate or other immovable assets. The dominance of the SOBs is waning and their prominent role in retail deposit-taking has been overtaken by private banks. The SOBs, as part of the government, tend to focus on helping implement development mandates of the government as opposed to undertaking profit orientated commercial activities. Overall, SOBs are vulnerable due to their low risk management capability, weak corporate governance, and high dependence on government subsidies to fulfill their development objectives along with their commercial banking activities. On the other hand, private banks are expanding rapidly partially reflecting government policies to develop the private sector and promote FDI. However, their weak funding and equity base, combined with their limited risk management and banking capacity, leave them vulnerable to competition from their more sophisticated and modern international counterparts. The continued development of private banks in the face of increased competition will require a significant modernization of their banking technologies and upgraded risk management capacity. An overhaul of the regulatory and supervisory framework governing the banking sector will help strengthen the sector and allow it to develop further while maintaining financial stability.



8. The regulatory framework governing banks and the supervisory capacity of the CBM are at an embryonic stage of development. Many elements of Myanmar's regulatory framework

are outdated and require modernization, including those associated with the management of risks of modern banking operations. The CBM has made considerable progress, including the preparation of the draft Banks and Financial Institutions Law (BFIL), which is currently tabled at parliament for approval. Enactment of the law is urgently needed and will become the basis for upgrading prudential regulations further. Nevertheless, the regulatory environment will be in a state of transition for years to come and the authorities will face a constant challenge to improve the regulatory environment. At the same time, the CBM faces a steep learning curve to move from compliance-based to risk-based bank supervision. As the CBM only has a limited number of experienced bank supervisors, it will take years and considerable effort to develop a strong capacity to conduct on-site and off-site examinations to globally recognized standards.

9. Transparency standards in the banking system are low. The complex ownership structure of the private banks can mask their vulnerabilities making it difficult for bank supervisors, shareholders and customers to easily monitor and understand the operations of banks and their underlying financial position. As accounting and auditing standards are yet to be rigorously defined and implemented the task is still more difficult. This may mean that risks in the banking system are underestimated and explains why public confidence in the banking sector remains weak after the banking crisis in 2003.

10. Current macroeconomic policy settings are adding to the challenge of maintaining financial stability in the face of foreign bank entry. Loose financial conditions as a result of expansionary monetary and fiscal policies have led to rapid credit growth over the past three years. Although foreign banks are not allowed to lend directly to domestic firms at the moment, their lending to domestic banks could give another impetus to domestic credit expansion. At the same time, domestic constraints on raising capital and mobilizing funding make offshore borrowing more attractive to domestic banks and firms, particularly given the relatively high nominal interest rates with rising inflation. To manage these risks Myanmar needs to maintain capital controls to mitigate risks associated with volatile capital flows as the financial and corporate sector only has a weak capacity to manage such volatility.

C. Myanmar's Objectives for Foreign Bank Entry

11. The authorities expect foreign banks in Myanmar to contribute to the development of the domestic banking sector. Foreign banks are required under their licensing commitments to participate in the interbank market, including by lending to domestic banks to support their financing activities of domestic firms, and engaging in foreign exchange businesses. They are also expected to increase the availability of banking products such as cash management and trade finance. Moreover, foreign banks are expected to transfer modern banking techniques and practices and increase competition in the banking sector, which would help uplift operational efficiency for local banks, benefit their customers, and support economic activities.

12. The entry of foreign banks is also expected to support Myanmar's export-oriented development strategy. The authorities value the role of foreign banks in better serving the needs of foreign investors and facilitating their operations in Myanmar by providing readily accessible

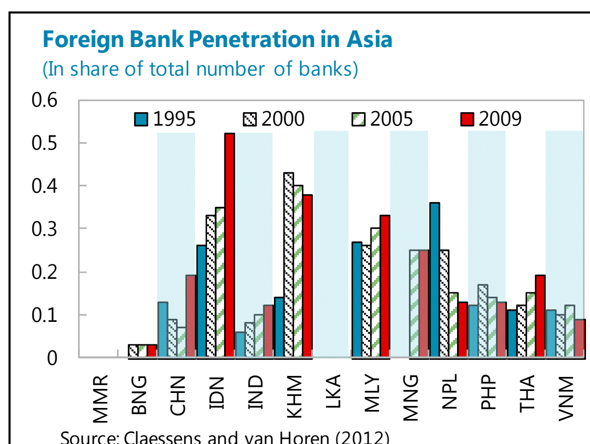
funds. From a strategic perspective, reputable regional and global banks can also bring their trade and investment networks and knowhow, greatly helping Myanmar gain access to global financial markets.

13. In addition, the opening up of the banking sector to foreign banks helps demonstrate Myanmar's commitment to the ASEAN Economic Community (AEC). Until recently, Myanmar was the only ASEAN member with no operating foreign bank branches or subsidiaries. The AEC is expected to achieve a freer flow of goods, services, investment, capital, and skilled labor between its member countries. Going forward, Qualified ASEAN Banks (QABs) will gain greater cross-border market access to expand their operations within the AEC under the ASEAN Banking Integration Framework. However, the QAB criteria for cross-border market access will be established on the basis of bilateral reciprocity between ASEAN countries. Against this background, Myanmar, along with other ASEAN countries, will need to implement sound principles of regulation and supervision that are consistent within the AEC.

14. Foreign bank branches with restricted banking activities serve Myanmar well at the current juncture. Given the high cost and risks of entry, foreign banks are entering the Myanmar market with a long-term perspective. As most foreign banks are expected to follow their international clients in the Myanmar market, in the initial stage of development, setting up a branch allows for quick local establishment and benefits from the full financial and management support of the parent banks. On the other hand, with their extensive branch networks and knowledge of the local business, local banks are largely shielded from direct competition with the foreign banks, which gives them time to improve their services and capabilities before the full liberalization of the banking sector for foreign banks' participation.

D. Reaping the Benefits and Mitigating the Risks

15. To achieve its objectives for foreign bank entry, it is important that Myanmar set specific goals in managing the entry of foreign banks as part of its overall strategy to modernize the banking sector. In this respect, Myanmar can also learn from other countries' experience with foreign bank entry (Box 1). Essentially, countries have allowed foreign bank entry at different stages of economic and financial market development while considering their development priorities. The legal infrastructure and regulatory frameworks in which foreign banks operate is also varies across countries. This poses different challenges and shapes the extent of foreign bank entry, as partly reflected in the different degrees of foreign bank penetration across countries. The speed of foreign bank entry has important implications for financial stability, which should be an important consideration for Myanmar in managing the risks. Hence, specific considerations need to



Foreign Bank Penetration in Asia
(In share of total number of banks)
Source: Claessens and van Horen (2012)

be given to Myanmar's context in designing an appropriate policy framework, and policy options need to be assessed against a set of key criteria that reflect Myanmar's medium-term goals for the banking and financial system:

- *Better access to financial services*. This encompasses both a wider range of products and better technology as well as better access to financial institutions outside of the main urban areas. This requires facilitating technical transfer from foreign banks to local Myanmar banks, introducing new banking products, improving banking sector efficiency, and raising service standards in ways that can be extended throughout the country.

- *A safer and more stable financial system*. The banking sector should become more resilient to shocks (internal and external) through the application of stronger risk management and hedging practices, in which case the participation of foreign banks could help bring best practices through knowledge transfers or spillovers.

- *Stronger regulatory capacity and framework.* The framework should be consistently applied, dovetail with those used in ASEAN partners and well monitored by expert regulators. Crisis management capacity should be strong and the regulatory framework should be consistent with the desired capital flow management and FX regime. As foreign banks will be a new and important conduit for foreign capital into the country, it will be important that their entry does not undermine the capital flow management regime and raise the risk of an unmanageable reversal of capital flows in the future.

- *Developed financial markets.* Myanmar would hope to develop well-functioning and liquid interbank money, FX and hedging markets that will enable maturity transformation and credit, interest rate and exchange rate risk management. The skills and experience of new foreign players should be leveraged off to jumpstart the development of these key markets. Foreign banks should add to the liquidity of the interbank money and FX markets and complement rather than dominate domestic private banks.

- *Locally owned banks should be an important and strong component of the banking system.* While some consolidation of the domestic banks is likely inevitable, those that remain should be key players in the banking sector given that international experiences show that locally based banking systems tend to be more resilient to external and internal shocks. In this context, foreign bank entry should not trigger unmanageable consolidation pressures among domestic banks or threaten confidence. The process of integrating foreign banks into the system should be orientated around the development of a consistent set of regulations governing the entire banking sector with capacity of regulators to monitor and enforce regulations.

16. In the short term, the authorities need to allow foreign banks into key markets to facilitate banking sector modernization. Providing foreign bank branches with authorized FX dealer licenses will allow them to participate in the FX markets. Opening a door for foreign banks to

invest in new Treasury bills at auctions can facilitate interbank money market development since the safe liquid assets can be used as collateral. The authorities can also adjust the regulatory framework to allow for the FX forward and swap markets that will facilitate risk and liquidity management for domestic and foreign customers alike.

17. The medium-term goal is to manage the entry process such that benefits are realized without risks to the financial system. This can be achieved by:

- *Managing competition risks.* Excessive competition is a key risk to a well-managed consolidation of the domestic banking system and hence the pressure to issue more foreign branch licenses and to allow the scope of operation of foreign banks to broaden should be resisted until the existing crop of entrants is well bedded in.

- *Continuing to strengthen legal, regulatory and macro policy frameworks.* The regulatory framework needs to be urgently strengthened through upgrading existing prudential regulations and passing the new BFIL. Policies aimed at strengthening capital flow management and the risk of dollarization should be prioritized so that local banks do not rely on short-term wholesale FX funding from offshore and so that un-hedged FX risks do not grow in the corporate sector.

- *Mitigating cross-border contagion risks.* Cross border contagion risks naturally increases with the entry of foreign banks hence a robust assigned capital regime for foreign bank branches should be established. Foreign bank branches should be required to convert themselves into subsidiaries when practical (and certainly when retail deposit taking is allowed) as subsidiaries are better able to be influenced and managed by the authorities in a crisis situation.

- *Strengthening the rule of law and transparency arrangements.* Confidence will only be built when there is accountability and transparency around the banking sector. This requires modern and effective accounting and auditing standards to be applied throughout the industry. Basic legal protections for bank lending need to be improved through contract enforcement procedures so banks can effectively measure and manage the credit risks inherent in their businesses.

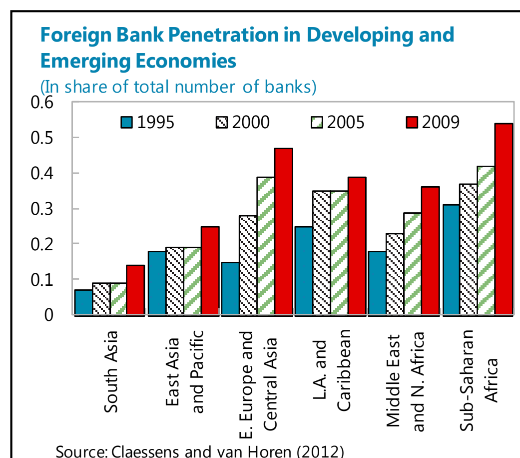
E. Conclusions

18. The entry of nine foreign banks in Myanmar has the potential to bring large benefits to the country, but the rapid pace of entry also poses challenges to maintaining financial stability. The entry of the foreign banks provides an unprecedented opportunity to develop a modern banking sector through introduction of new financial products and risk management techniques, and lending by foreign banks could become an important source of funding for private sector development. This requires a sound regulatory framework and strong capacity of supervision. Consolidation of the banking sector is likely necessary but this process should occur in a way that does not lead to a loss in confidence or financial stability.

19. The CBM should revamp its regulatory framework and strengthen its supervisory capacity. It should also develop and implement a financial sector reform program to consolidate and modernize the domestic banks, including with help from foreign banks, to improve and expand their services and enhance their capacity for risk management so that they are competitive and are able to meet global prudential standards. Meanwhile, the authorities should resist any pressure to allow further entry of foreign banks or broaden the scope of operation of existing foreign banks until they are well integrated into the domestic banking system under the existing entry arrangements. Even after completing the revamp of the regulatory framework, the focus should continue to be placed on managing risks in the banking system and improving the conditions for the foreign banks to play their part in modernizing Myanmar's banking sector.

Box 1. Foreign Bank Entry: some international experiences

The entry of foreign banks in Myanmar follows a global trend of rising foreign bank penetration, observed particularly in emerging and developing countries during the last two decades. Penetration in Asia is low relative to other regions. The entry of nine foreign banks in Myanmar brings its level of foreign bank penetration to the average in East Asia and the Pacific in 2009.



Rapid entry of foreign banks can lead to financial sector instability when supervisory capacity is low. Cambodia is a case in point. Following the liberalization of its banking sector in the early1990 s, the number of foreign banks in Cambodia multiplied, and the penetration ratio reached among the highest in Southeast Asia. The National Bank of Cambodia (NBC) issued a moratorium of new licenses during1994 –96, followed by the promulgation of a new central bank law in1996 and enactment of the Law on Banking and Financial Institutions in 1999. When the NBC required all existing banks to reapply for a new license under the Law, a number of banks could not meet capital adequacy requirements and were subsequently shut down, which led to loss of public confidence in the banking sector. It took Cambodia years to restore confidence through a series of measures to strengthen regulation and supervision with help from international development partners (IMF 2003).

Slow foreign bank penetration helps cushion domestic banks from excessive competition, but it is difficult to come up with an optimal pace of penetration. China's experience with foreign bank entry represents a gradual and cautious approach, similar to its overall approach to economic reform and opening up. Since 2004, while the number of foreign banking institutions more than doubled to over 400, the penetration of foreign banks remains limited at about 2percent of total banking assets in China. The regulations governing the establishment of foreign banks have remained quite stringent, and often expansion appeared to be constrained by slow approvals of new branches and financial products (Gopalan and Pajan2010; PWC 2013). Foreign equity participation limit in local banks has also helped to moderate expansion.

Experiences from other parts of the world suggest that the mode of foreign bank entry (subsidiaries or branches) has important implications on risks arising from funding sources. Research by Canales-Kriljenko et al (2010) has shown that the propagation of global financial shocks in Latin America was significantly more muted than in Eastern Europe because foreign banks' lending at their subsidiaries in the former was funded primarily by domestic retail deposits which were more stable during the crisis. This was also helped by the fact that about 60percent of foreign bank lending was denominated in local currency. In contrast, Emerging Europe experienced a deeper credit crunch in the wake of the shocks as foreign banks' branches were lending largely internationally sourced funds, and they were more vulnerable to sudden withdrawal of wholesale funding or parent bank funding.

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DEVELOPING A COMPETITIVE EXPORT SECTOR: CAN MYANMAR BE THE NEW GOOSE?

A. Introduction

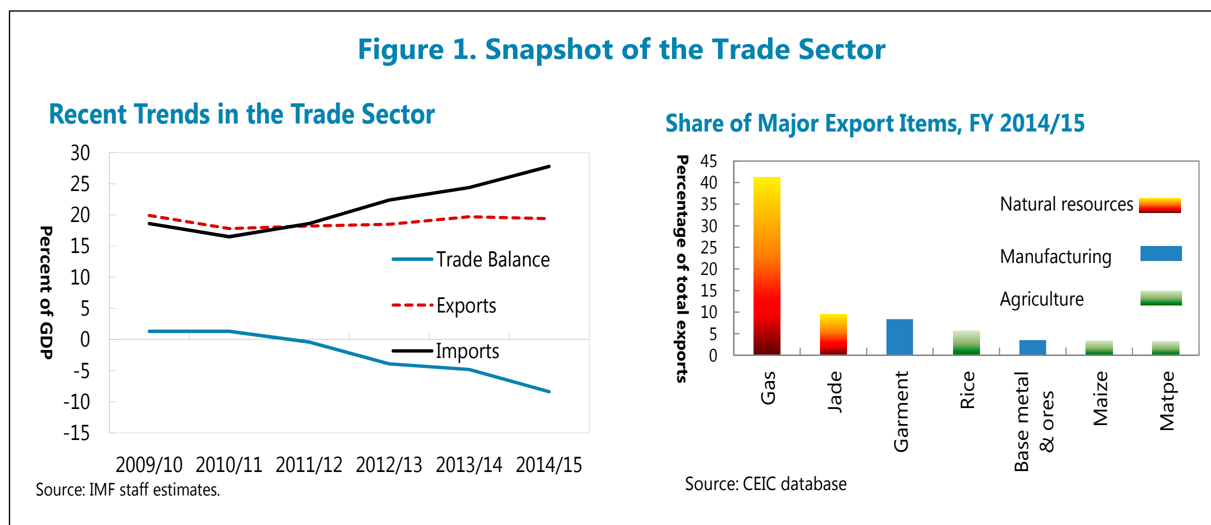
1. **Myanmar's external sector is undergoing a rapid structural change as the economy continues to open-up to rest of the world.** Prior to the 2011 reform, the "export first" policy, which required imports to be financed by export earnings, ensured that foreign trade was largely balanced. The termination of this policy and the release of pent-up demand following economic liberalization have led to a surge in imports while exports have been growing much less rapidly. As a result, the trade deficit has widened and foreign financing has become essential to sustain the rapid import growth. Over the last few years, an increase in Foreign Direct Investment (FDI) has been the main source of foreign financing, but most of the inflows have been in the resource sector, particularly the gas sector. With declining gas prices over the past few years, both export earnings from gas exports and FDI inflows into the sector are showing signs of slowing down. The trade imbalance has been exacerbated by loose macroeconomic conditions as reflected in rising inflation and rapid credit growth, two key factors driving the rapid import growth.

2. **While monetary and fiscal tightening will be needed to address the increasing external imbalance in the short run, Myanmar will need to expand its export capacity to meet the structural increases in imports in the medium to long run.** Capital inflows, both from private and official sources, will continue to play an important role in financing Myanmar's trade and current account deficits for a long time to come, given its low level of economic development. However, without a diversified export base, Myanmar will be vulnerable to external shocks and its export-oriented growth strategy will be unlikely to create the jobs and export earnings that are needed for sustainable growth and prosperity. Meanwhile, Myanmar's political and economic reforms have opened up markets for its exports to advanced countries, while the ongoing relocation of global manufacturing activities and the ASEAN Economic Community (AEC) initiative provide some unique opportunities for Myanmar to plug into the global and regional value chains. The key challenge for Myanmar is to move fast to seize these opportunities to facilitate the structural transformation of its export sector, and the economy in general.

3. **This paper aims to shed some light on how Myanmar can focus its reforms in key areas that are vital to improve its external competitiveness.** It begins with an overview of Myanmar's trade sector (Section I), followed by some considerations in Section II of its strategy to take advantage of its resource sector, upgrade its agricultural sector, and diversify the export base to manufacturing. Section III discusses global factors that provide Myanmar with unique opportunities for product and market diversification, and Section IV outlines domestic policies that are essential for Myanmar to capture these opportunities. The paper then concludes with a brief summary.

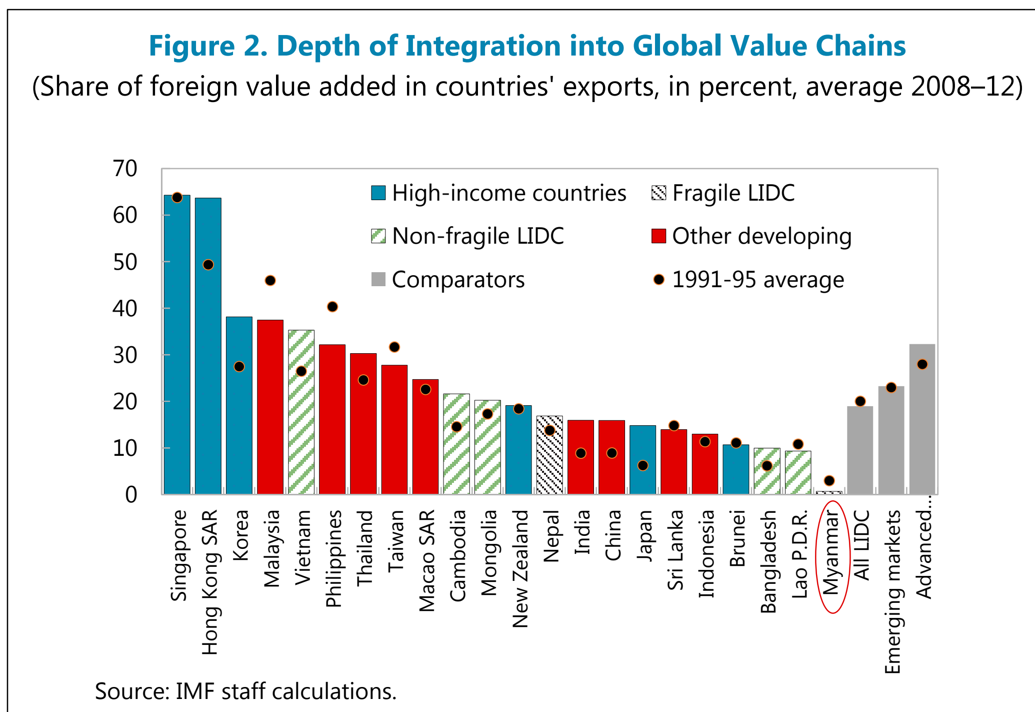
B. Current State of Play

4. Myanmar's external sector has undergone significant changes since it began to open up its economy in 2011. As restrictions on imports were lifted, imports of capital goods to meet investment and pent-up consumer demand rose sharply. While Myanmar's exports also grew, its growth was not as rapid as that of imports (Figure 1, left panel). Myanmar's exports, in fact, continued to be dominated by a few primary commodities with gas being the single most important export item, followed by jade, garment, and agricultural products. Myanmar has just started to branch out into manufactured exports (Figure 1, right panel).

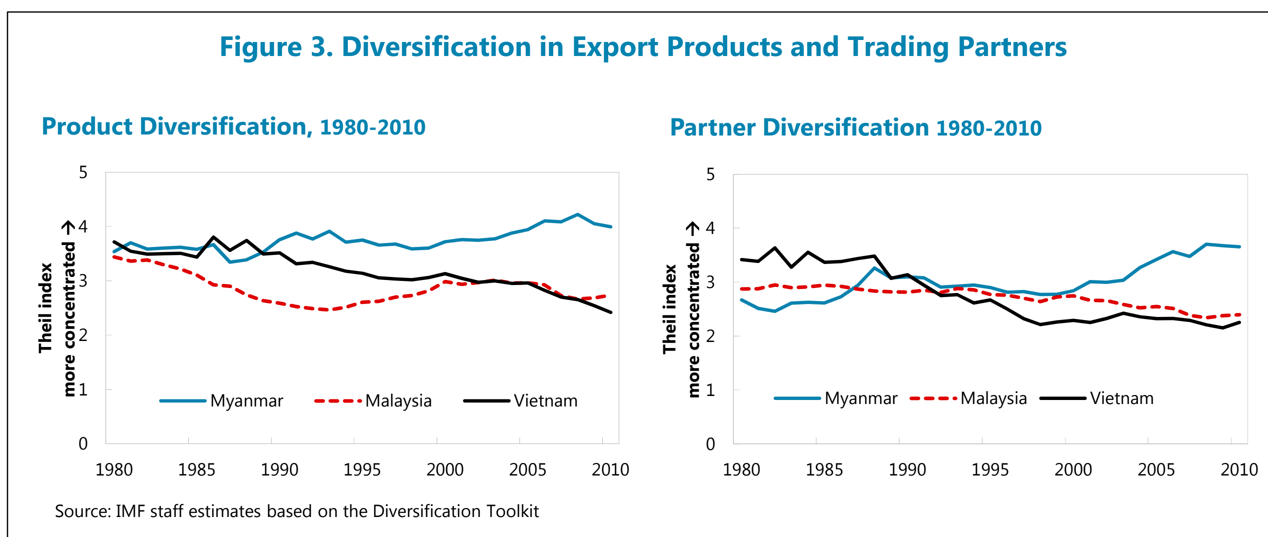


5. Myanmar's trading partners are also limited and mainly confined to its neighbors, reflecting their proximity as well as sanctions imposed by the West until recently. Myanmar's largest export markets (in terms of value) are China and Thailand, mainly driven by the export of gas and gems. About 70 percent of Myanmar's total exports went to these two countries in FY 2014/15. Other significant export partners include India, Japan, Malaysia, Korea, and Singapore. Myanmar's main sources of imports are China, Singapore, Thailand and Japan which accounted for over 75 percent of Myanmar's total imports.

6. Myanmar is not well integrated into the Global Value Chain (GVC). Through integration into the GVCs, countries can specialize in the production of specific parts and components, rather than entire final goods, drawing on their comparative advantages. Global experiences show that integration into the GVCs has provided an opportunity to develop the manufacturing sector, create employment and benefit from technology transfer. More than half of developing countries' exports in value-added terms now involves GVCs, and developing-countries' share in global trade in parts and components has quadrupled since the mid-1980s (IMF 2015). Myanmar, however, has yet to enjoy the full benefits as it has just begun to integrate into the GVCs (figure 2).



7. It is interesting to note that two of the region's widely known successful countries, Malaysia and Vietnam, were at the same starting point as Myanmar back in the 1980s. In the early 1980s, Myanmar, Malaysia and Vietnam had the same level of export concentration (Figure 3: left panel). Since then, however, both Malaysia and Vietnam have been able to successfully diversify into many products while Myanmar's exports have become more concentrated. While Malaysia is a resource-rich country, Vietnam is not despite its considerable oil endowments – indicating that diversification is possible for many types of countries. A similar pattern is observed in partner diversification where Myanmar has significantly increased concentration of trading partners (partly due to the trade sanctions), but both Malaysia and Vietnam have been able to trade with more partners over time (Figure 3: right panel).



C. Strategy for the External Sector

Given its abundant natural resources, Myanmar needs to continue to develop this sector. However, it will have to balance the exports of natural resources with high-quality agricultural goods and labor-intensive manufactured goods tapping on its comparative advantage of abundant and cheap labor, large potential domestic market, and strategic location.

8. The strategy for Myanmar would be to continue to expand its exports of natural resources while diversifying into manufactured products. Myanmar needs to capitalize on its abundance of many natural resources. Myanmar has a worldwide rank of 38th in 2014 based on proven natural gas reserves (US Energy Information and Administration). Myanmar also accounts for 90 percent of the global value of jade production and ranks among the top producers of gems including rubies and sapphires. The continued production and export of these natural resources will provide the country with much needed foreign exchange earnings as well as fiscal revenue. However, being too reliant on natural resources can hurt the economy through several channels: excessive reliance on a few commodities is likely to make the Myanmar vulnerable to fluctuations of commodity prices and external demand with adverse implications for foreign reserves and fiscal revenue.

9. Many natural resource-rich countries have successfully diversified into exports of non-commodity goods. Although there are many global examples of countries that have balanced exports of natural resources with other products and services (Norway or Botswana, for example), Malaysia is a success story within the region that may hold many lessons for Myanmar. Malaysia adopted an export-led growth strategy focusing on manufactured goods as well as natural resources through developing industrial clusters and free trade zones. Throughout this process, Malaysia was able to attract FDI for investment in the manufacturing sector as well as in infrastructure.

10. Given its abundant agricultural resources and cheap labor, Myanmar is in a good position to break into the wider international markets for agricultural and manufactured exports. Agriculture will have to be a clear priority in Myanmar's export plans. Myanmar is the 38th-largest country in the world by total area, but the 25th largest in terms of agricultural land and is blessed with a favorable climate for agriculture. Once famous for its rice and logging production, agricultural output in Myanmar has fallen far below its potential. Efforts to revive the sector would be well timed to take advantage of the rising global demand for food.

11. Development of the manufacturing sector in Myanmar can take place in stages. In the early stages of development, Myanmar may well focus on developing labor-intensive manufacturing that matches the country's current comparative advantages. The availability of low-cost labor and a large working-age population can work to its advantage. Candidates of labor-intensive manufactured goods include food and beverages, mineral-based products, textiles, footwear, furniture, jewelry, toys, and various rubber and plastic products. Over time, Myanmar can diversify and move up the manufacturing value chain following the example of Thailand, Malaysia, and many

other Asian economies by producing automotive parts and assembly, consumer electronics assembly, chemicals, petroleum refineries, electrical machinery, and communications equipment.

12. The National Export Strategy of Myanmar (2015–19) has appropriately identified a mix of agricultural and manufactured goods as priorities to support sustainable export-led growth. According to the strategy, the priority sectors in agriculture include rice; beans, pulses and oilseeds; fisheries; and rubber; while those in manufacturing include textiles and garments; and forestry products. Tourism is also identified as a priority export of services.[1] The main question is whether Myanmar is able to break into the export market for these goods. The answer lies in (a) whether the external environment is conducive for Myanmar to break into international markets for these commodities, and (b) whether Myanmar can adopt the appropriate policies to increase its external competitiveness.

D. Taking Advantage of Global Factors

Myanmar needs to seize the opportunities left by China in the production of low-end manufactured goods, by becoming another Asian country to join the "flying geese" of industrializing economies. Recent reengagement with the EU and anticipated establishment of single ASEAN market through the AEC initiative will also help broaden Myanmar's export markets.

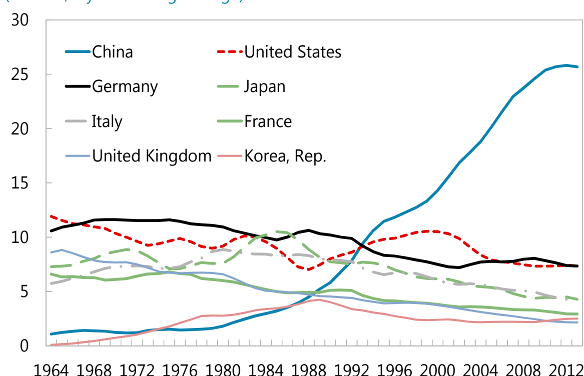
Stepping into Chinese Shoes

13. China's shift in the GVC provides a unique opportunity for Myanmar's export diversification. There is growing evidence that increasing labor costs may be pushing China out of low-end, labor-intensive manufactured goods (Figure 4). This opens up export opportunities for Myanmar as well as many other low-labor cost countries. This "flying geese" phenomenon whereby a "lead" economy moves up the value chain and creates opportunities for other economies to step into the lower ladder of the value chain is a well-known phenomenon that has been exploited by many of the Asian countries. It started with Japan moving up the value chain creating opportunities for Korea and Taiwan Province of China to fill in its previous position. They were followed by the ASEAN tigers and then China which is now moving up the value chain making room for other low-income economies like Myanmar to move into the production of low-end manufactured goods.

[1] Although this selected issues paper does not cover tourism, the policy recommendations for the development of the trade sector equally hold for the tourism sector.

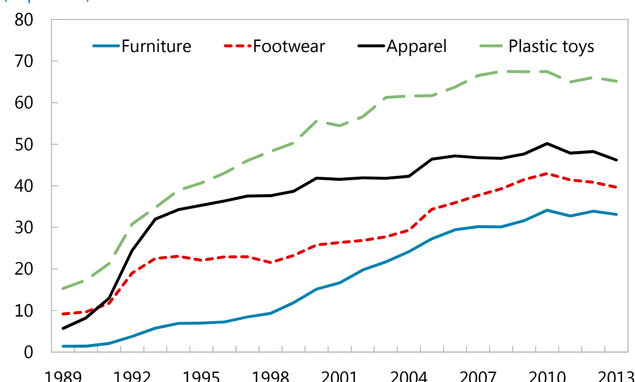
Figure 4. China moving out of Labor-intensive Manufacturing Exports

Global Market Share in Labor Intensive Exports
(Percent, 3 year moving average)



Sources: IMF 2015; UN Comtrade; and IMF staff calculations.

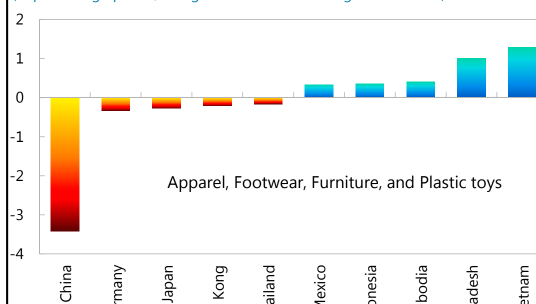
Chinese Market Share in Labor Intensive Final Goods
(In percent)



Sources: IMF 2015; UN Comtrade; and IMF staff calculations.

14. Myanmar needs to exploit this unique opportunity created by China's move into the manufacturing of more sophisticated goods. Already, many countries have begun to fill the vacuum created by China in recent years, with Vietnam, Cambodia, and Bangladesh (among others) increasing their market share in major low-end goods. Myanmar also needs to take advantage of this opportunity as it offers a huge potential to increase manufactured exports.

Change in Market Share in Major Low End Goods
(In percentage points; 5 largest and smallest changes since 2010)



Sources: IMF 2015; UN Comtrade; and IMF staff calculations.

Re-engagement with EU: Generalized Scheme of Preferences

15. Myanmar has entered an active phase of negotiations with the EU to reinstate its eligibility for the EU's Generalized Scheme of Preferences (GSP). The GSP, with enhancement of the *Everything But Arms* initiative, gives Least Developed Countries (LDCs) duty-free access to the EU market for the export of all products except arms and ammunition.[2]

16. While several countries in the EU have expressed interest in importing goods from Myanmar, the biggest obstacle would be to meet EU's standards on the quality of goods. Currently, Myanmar's trade with the EU is less than 3 percent of its total trade, with Myanmar running a small trade deficit. Myanmar's exports to EU are dominated by clothing and agricultural

[2] The gradual easing of sanctions by the United States and Canada has also helped increase investors' confidence in Myanmar.

products while its imports from EU are mostly machinery and transport equipment. The reinstatement of Myanmar's participation in the GSP is expected to boost current low level of trade between Myanmar and the EU. It should be noted, however, that the EU has stringent standards, particularly in areas of interest to Myanmar (for example, sanitary and phytosanitary measures for fishery products). The EU is also preparing to negotiate a Europe-wide investment agreement with Myanmar in an effort to promote investment from the EU to Myanmar.

Integrating into the single ASEAN market: Dynamic Economic Region

17. Myanmar also has a geographic advantage given its proximity to a fast-growing dynamic ASEAN region. Myanmar's transition is well timed to take advantage of the planned establishment of the ASEAN free trade zone. Myanmar's efforts to implement its commitments under the AEC initiative will greatly facilitate its integration into regional production networks and further global supply chains. An increasing number of labor-intensive and low-tech industries in other ASEAN countries are seeking relocation in search of lower labor cost and favorable business environment. In this context, the development of Special Economic Zones (SEZs) in strategic locations in Myanmar and ongoing efforts to improve legal and regulatory frameworks including the enactment of the new Investment Law and the amendment of the Company Law will help attract foreign investments including from other ASEAN countries. Plans for enhancing regional connectivity and fulfilling commitments for the liberalization of services and investment under the AEC initiative will help speed up Myanmar's reform.[3] Myanmar has made significant progress in fulfilling a majority of the commitments but further reforms will be needed to address low competitiveness, poor infrastructure, weak legal and regulatory frameworks, and delayed implementation of commitments to achieve a freer flow of capital.

E. Policies to Enhance External Sector Competitiveness

While a sound macroeconomic framework is critical to maintain a competitive real exchange rate conducive to export growth, structural reforms to raise productivity is key to improve external competitiveness.

Macroeconomic Policies

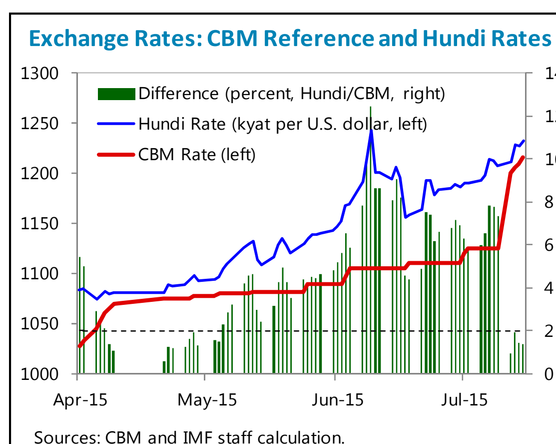
18. The Real Effective Exchange Rate (REER) is a broad measure of a country's currency value relative to its trading partners as adjusted for the effects of inflation.[4] In general, REER

[3] The four pillars of AEC are building (i) a single market and production base, (ii) a highly competitive economic region, (iii) a region of equitable economic development, and (iv) a region fully integrated into the global economy.

[4] The REER is defined as the trade weighted average of real exchange rate (RER). $RER= eP^*/P$, where e is the nominal exchange rate, P^* is the average price index in Myanmar's trading partner and P is the average price index in Myanmar. As can be seen, the REER is an index of domestic prices relative to foreign prices when the same currency is used to measure the prices of both domestic and foreign goods. The REER level depends on the level of nominal exchange rates and the relative price levels between the home country and its trading partners. Similarly, a change in the REER (depreciation or appreciation) depends on changes in nominal exchange rates and changes in relative prices between home country and its trading partners (i.e., inflation differentials).

appreciation that is not supported by a faster productivity increase than that in trading partners will make Myanmar's exports more expensive in foreign currencies (and imports cheaper in local currencies) and reduce external competitiveness. Hence, to keep the kyat REER stable, Myanmar needs to (a) make sure that its inflation is not higher than the average of its trading partners or (b) allow the nominal kyat exchange rate to depreciate to offset the positive inflation differential between Myanmar and its trading partners. Prudent fiscal and monetary policies to keep inflation low are therefore essential to avoid an inflation-depreciation spiral and to create a stable macroeconomic environment for export development.

19. The Central Bank of Myanmar's (CBM) recent decision to move its reference rate in line with the broad market rates was a bold step in the right direction that will also contribute to enhancing competitiveness. After a prolonged period of keeping the kyat/USD exchange rate more appreciated than the parallel market rates, the CBM in mid-July 2015 brought its reference rate in line with market rates (a 6.7 percent depreciation). In the short run, this move helped to balance the demand and supply in the foreign exchange market by increasing the willingness of exporters to sell their foreign exchange and reducing the demand for imports. Over the longer term, the exchange rate realignment will also help improve the competitiveness of the export sector.

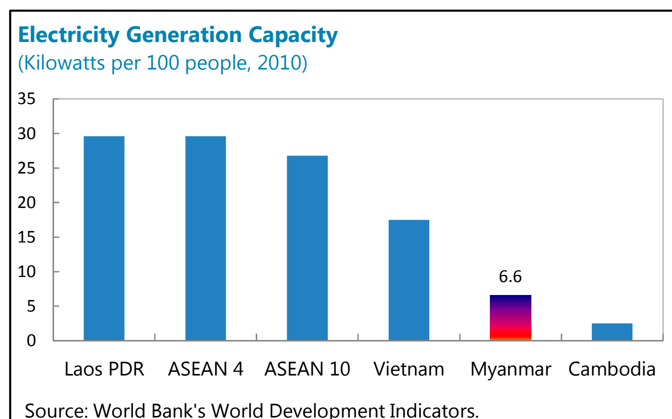


Sources: CBM and IMF staff calculation.

Structural Policies

Improve infrastructure, particularly electricity supply and transportation.

20. Improving Myanmar's weak infrastructure is crucial to creating a business-friendly environment and attracting investment. Stable electricity supply, for example, is a prerequisite for developing a competitive manufacturing industry, but Myanmar's electricity supply is insufficient and unreliable. Only 13 percent of the population in Myanmar has access to electricity, although major urban areas generally have higher access. Globally, Myanmar stands at 121 in the ranking of 189 economies on the ease of getting electricity, far behind its peer group (Doing Business 2015, Word Bank). Moreover, Myanmar's transport infrastructure (road, air, water) is poor and underdeveloped, hampering the movement of goods and people and constraining economic activities. For Myanmar,



Source: World Bank's World Development Indicators.

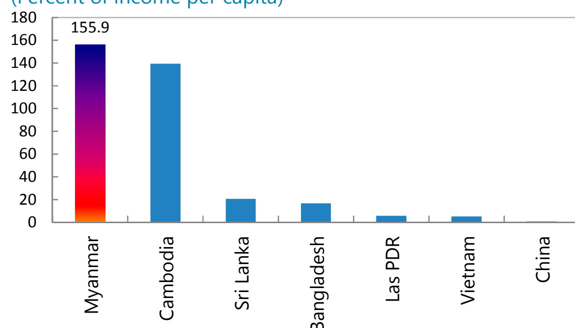
strengthening physical connectivity is a prerequisite for it to fully capitalize on its geographical advantage as a natural bridge between South and Southeast Asia. Myanmar should therefore focus its development efforts on mobilizing appropriate financing for investment in infrastructure, particularly the electricity and transport sectors.

Improve Business Environment to attract FDI

21. It is widely accepted that FDI inflows are conducive to trade due to its financing role in investment and the associated transfer of technology. Although FDI has significantly increased in Myanmar, much of it has flowed into the gas sector. To attract FDI into other sectors, particularly the budding manufacturing sector, it is essential to improve the regulatory and business environment in Myanmar. Currently Myanmar ranks the lowest globally in the criteria of "ease of starting a business" based on the *World Bank's Doing Business 2015*. Not surprisingly, its cost of starting a business is among the highest in the region while its regulatory quality is among the lowest.[5]

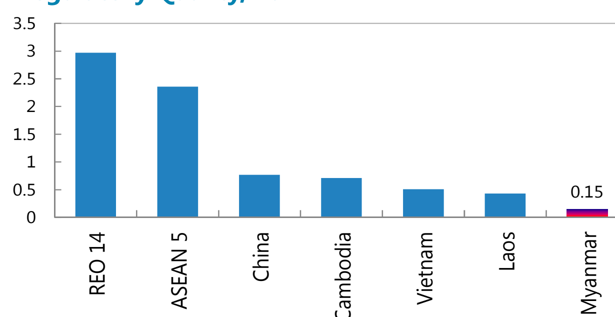
Figure 5. Selected Indicators of Impediments to FDI Inflows

Starting Business Cost
(Percent of income per capita)



Source: Doing Business 2015, World Bank

Regulatory Quality, 2012



Source : Worldwide Governance Indicators , World Bank

22. Specialized Economic Zones (SEZs) can partially address these shortcomings. It takes time to improve dilapidated infrastructure and the general business environment nationwide, but this can be done much more quickly in SEZ enclaves. Many countries including China, Bangladesh, Cambodia, and Vietnam have used this approach to attract FDIs (Lin, 2012). To improve country wide regulatory environment and attract FDI, an immediate step Myanmar can take is to approve the Investment Law and Company Law. Once regulations are set, rule-based administration would enhance transparency and predictability of administration, boosting investors' confidence. In addition, the CBM should speed up approval of foreign borrowings related to FDI projects while ensuring appropriate capital management measures (such as setting annual ceilings of new borrowings) are in place to safeguard financial stability.

[5] These indicators should be interpreted with caution due to a limited number of respondents, a limited geographical coverage, and standardized assumptions on business constraints and information availability.

Enhance Labor Productivity

23. While wages are low in Myanmar, the country needs to improve labor productivity to increase competitiveness and move up the value-added curve. On average, the value added of a worker in Myanmar is about US $1,500 per year, around 70 percent less than the average of seven other Asian countries (Figure 6, right panel). Overall, Myanmar lags behind its regional peers in labor productivity across all major sectors. For example, the labor productivity in Myanmar's manufacturing sector is about 50 to 75 percent lower than the weighted average of manufacturing labor productivity in China, India, Indonesia, Thailand, and Vietnam. Labor productivity in Myanmar's dominant agriculture sector is also low, at only about $1,300 per worker per year compared with about $2,500 in Thailand and Indonesia. This indicates that policy measures such as training and investment in human capital, technology and productivity-enhancing capital facilities can indeed boost labor productivity.

Figure 6. Labor Cost and Labor Productivity

24. Increasing investment in education, health and skills are particularly important in boosting labor productivity. Increasing investment in developing skills of Myanmar's labor force and improving the availability and the quality of education and vocational training are effective ways to reduce Myanmar's unit labor cost by increasing labor productivity.[6] While Myanmar has recently undertaken several initiatives[7], further investment in skills will be necessary to raise productivity and create greater value added per worker. The government can play a useful role in raising the supply of highly skilled workers to meet ever-increasing demand for them over the medium to long term by upgrading the training and education system.

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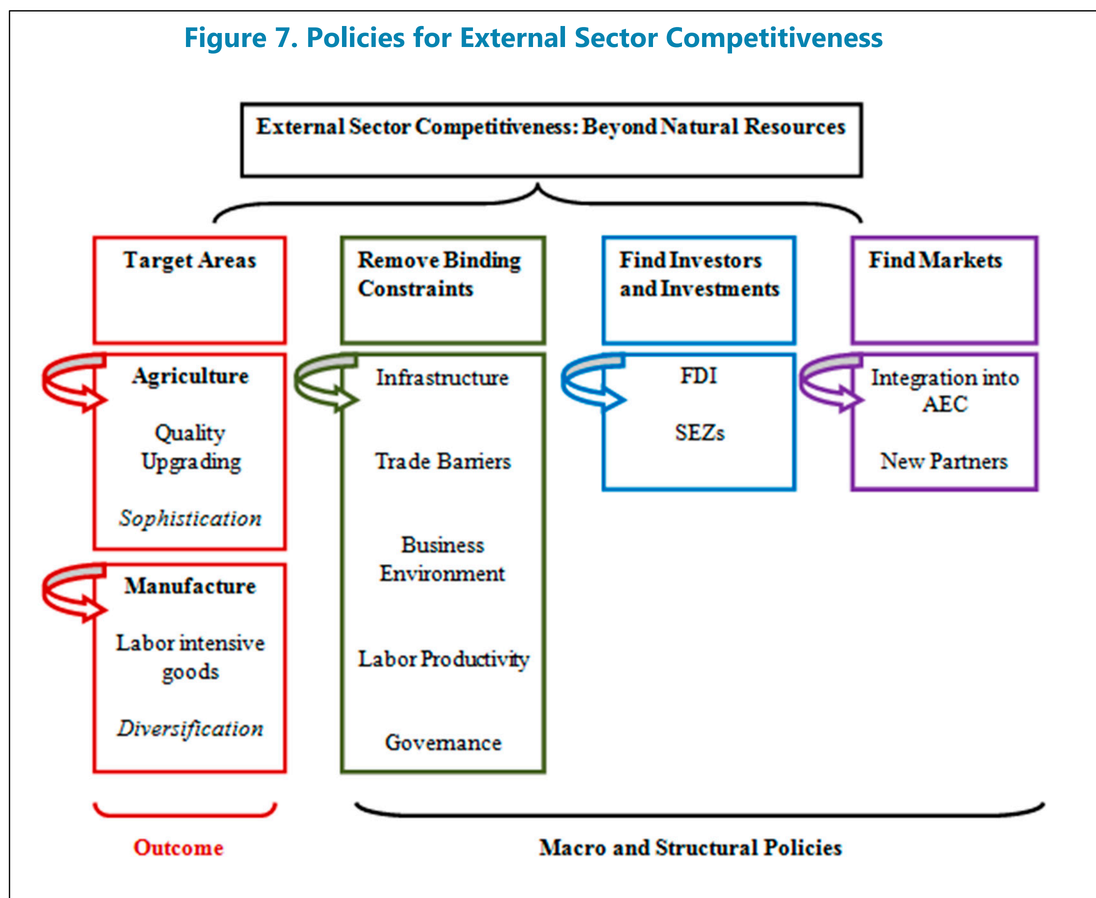
[6] Unit labor cost is defined as the average cost of labor per unit of output and are calculated as the ratio of total labor costs to real output.

[7] Myanmar is working with donors, in particular GIZ, to improve Technical and Vocational Education and Training (TVET) and skills building programs for industry and trade. The Ministry of Commerce recently established a Trade Training Institute in April 2013 and the Ministry of Commerce established a SME Development Centre which provides skills training.

Facilitate Trade through the elimination of tariff and non-tariff barriers

25. To remain competitive in the region, it will be necessary for Myanmar to eliminate tariff and non-tariff barriers under the AEC initiative. Myanmar will need to reduce import tariffs to zero percent by 2018 under the AEC initiative (as compared to most of the other ASEAN countries that need to bring down tariff rates to zero by end 2015). Even without the same urgency for fulfilling the commitment under the AEC initiative as other ASEAN countries, Myanmar's reforms of tariff and non-tariff barriers have become necessary in many sectors. For example, the export/import license scheme needs to be streamlined.

Figure 7. Policies for External Sector Competitiveness



F. Concluding Remarks

26. Myanmar is presented with unprecedented opportunities to pursue export-oriented growth as it continues to reform and open up its economy. Seizing these opportunities has the potential to allow Myanmar to achieve export diversification, increase value added of its exports, and promote stronger investment in the trade sector. Myanmar is beginning to expand its labor-intensive manufacturing sector just as China is shifting away from low-end and labor-intensive manufacturing. Myanmar is also strategically located between South and Southeast Asia and a dynamic Asian market. Moreover, the prospect for the reinstatement of eligibility for the EU's Generalised Scheme of Preferences (GSP) and continued implementation of ASEAN-level

agreements on trade, services and investment would improve market access for Myanmar exports. To seize these opportunities, Myanmar needs to focus its attention on the development of agricultural and manufactured exports in addition to natural resource exports. The former is a much more difficult task as it needs better infrastructure and a substantial improvement in the quality of the business environment to attract investment. There is no short-cut other than sustained structural reforms to create these conditions. Figure 7 provides a summary of policies that form such a reform agenda.

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