FOR AGENDA

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November 14, 2007

To: Members of the Executive Board

From: The Secretary

Subject: **Myanmar—Selected Issues**

This paper provides background information to the staff report on the 2007 Article IV consultation discussions with Myanmar (SM/07/347, 11/5/07), which is tentatively scheduled for discussion on **Wednesday, November 28, 2007.** At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of Myanmar indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Mr. Hori, APD (ext. 39513), Ms. Wong, FIN (ext. 34153), and Mr. Lönnberg, MCM (ext. 35331).

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Monday, November 26, 2007; and to the Asian Development Bank, the Food and Agriculture Organization, and the United Nations Development Programme, following its consideration by the Executive Board.

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MYANMAR

Selected Issues

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Approved by Asia and Pacific Department

November 14, 2007

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I. MYANMAR—MODERNIZING THE EXCHANGE RATE SYSTEM [1]

A. Introduction

1. **Myanmar's multiple exchange rate system creates various distortions and should be unified to benefit from more efficient allocation of resources, increase market confidence, and attain higher growth**. This chapter describes the current multiple exchange rate system, presents the case for exchange rate unification, and highlights key policy actions required to bring about a smooth unification.

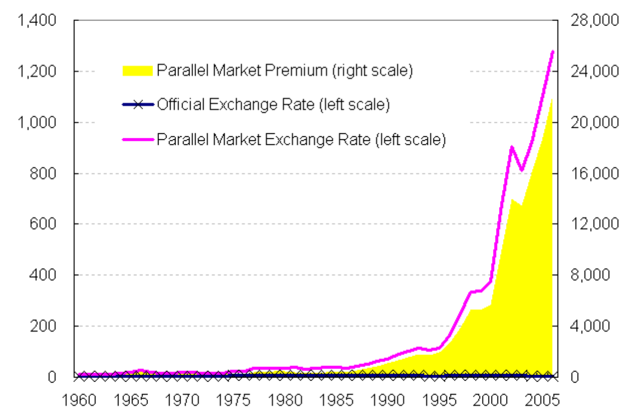
2. **Cost and benefit analyses indicate that the current multiple exchange rate system imposes considerable distortions and welfare losses on the Myanmar economy.** Exchange rate unification would bring large long-term benefits, while negative consequences over 1–2 years are likely to be limited and manageable as the private sector, accounting for more than 90 percent of the economy, is already operating at the market-determined exchange rate. Recent positive developments in the external sector and the corresponding increase in foreign exchange reserves also provide a good opportunity to implement the exchange rate unification from a position of relative strength. In addition, experiences of other countries in exchange rate unifications could serve as useful examples for Myanmar.

3. **Exchange rate unification could be implemented without causing major immediate disturbance through a sequenced set of measures.** The official exchange rate could be abolished together with the introduction of a system of explicit taxes and subsidies that would be phased out in a later stage. A comprehensive and well sequenced policy package should be adopted to mitigate the short-run disturbances and maximize the benefits of unification.

B. Description of the Current Exchange Rate System

4. **Myanmar maintains a multiple exchange rate system which consists of an official exchange rate that coexists with black market exchange rates. The official exchange rate is pegged at 8.5 kyat per SDR since 1977.** The authorities also issue U.S. dollar equivalent Foreign Exchange Certificates (FEC) which currently trades at a market-determined rate of around 1,300 kyat per FEC. In addition, there is a large "illegal" parallel market that exchanges U.S. dollars with kyats at a slight premium

Figure 1. Myanmar: Dual Exchange Rates and Parallel Market Premium, 1960-2006



[1] Prepared by Masahiro Hori and Yu Ching Wong.

over the FEC rate (Box 1). With the continued depreciation of the market-determined rate, the official rate is grossly overvalued with the parallel market premium at slightly more than 23,000 percent as of August 2007 (see Figure 1).

Box 1. Myanmar: The Multiple Exchange Rate System

The multiple exchange rate system consists of an official exchange rate and informal parallel market exchange rates.

The official rate has been pegged at 8.50847 kyat per SDR since 1977. Its valuation is allowed to differ within a margin of +/- 2 percent. The official rates of the kyat for the euro, Indian rupee, Japanese yen, Pakistan rupee, pound sterling, Sri Lanka rupee, Singapore dollar, Swiss franc, and the U.S. dollar are determined on the basis of the daily calculations of the value of these currencies against the SDR. The exchange rates for other currencies are determined on the basis of respective cross rates in the Singapore market.

The market-determined foreign exchange certificate (FEC) rate was about 1300 kyat per U.S. dollar in August 2007. FECs are issued by the Central Bank of Myanmar since 1993 at a rate of 1FEC=1 US$. FEC may be exchanged for kyats at a fixed rate at FEC exchange centers but such transactions appear to be limited as the centers' rates are typically set below the market rate, currently at around 450 kyat per dollar. Holders of FECs and residents with foreign currency earnings may open foreign currency accounts.

U.S. dollars are exchanged with kyats at a premium over the FEC rate in illegal parallel markets. The U.S. dollar was traded at around 1,320 kyat in August 2007. In addition, the Hundi system of exchange is widely used for settling payments for unrecorded trade, repatriation of profits, and for U.S. dollar cash remittances. The Hundi exchange rate is closely related to the parallel U.S. dollar rate but at a deduction of about 1 percent for commissions. The popularity of the Hundi system stems from the fact that it operates through an extensive informal network and this helps to evade 10 percent taxes collected at the state-owned banks on export receipts and remittances.[1] The market determined U.S. dollar exchange rate, together with the Hundi exchange rate, is the main exchange rate for current and capital account transactions.

1/ Export earnings are subject to a commercial tax of 8 percent and an income tax of 2 percent.

5. **The official exchange rate applies only in the public sector, which represents about 7 percent of value added in the economy.** The official exchange rate is used more for accounting purpose, and its use in public sector transactions is rationed by the Foreign Exchange Budget.[2] The foreign exchange budget is about US$ 1.4 billion in FY2006/07 (with about US$1.2 billion allocated for trade expenditure, US$100-150 million for debt

[2] The Foreign Exchange Budget is managed by the Ministry of Finance and Revenue. Foreign exchange revenues are obtained from export receipts of exporting SEEs, export taxes, income tax on inward remittances, utilities charges paid by foreign companies for public sector services, and the sales of FECs. Foreign exchange expenditures consist mainly of import payments of SEEs and for servicing of external debt of the public sector.

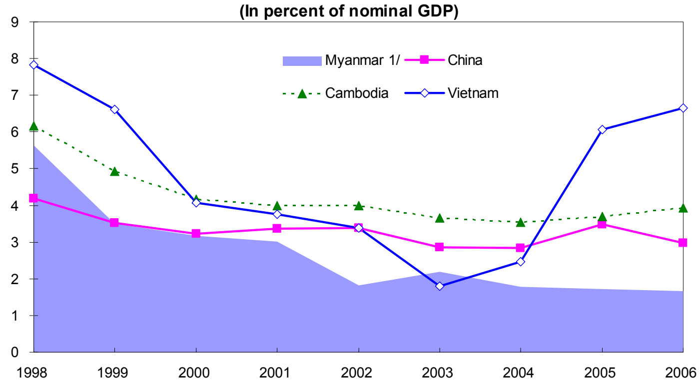
services payment, and US$ 65–70 million for expenditure such as those on diplomatic missions). It is expected to increase to about US$ 1.5-2.0 billion in FY2007/08.

6. **The authorities have effectively allowed private transactions at the informal market-determined rate** (Box 2). As an example of the gradual move towards de facto exchange rate unification, while custom valuation rate is fixed at 450 kyat per U.S. dollar from June 2004, the rate applied to border trade has been adjusted in accordance with the market rate since February 2007. Almost no private agent, unless forced to, sells U.S. dollars at the official rate, and it appears that even public agents will accept the informal rate when access to foreign exchange at the official rate is constrained.

7. **The current system has been supported by various foreign exchange controls to limit the use of foreign exchange.** For instance, private imports require a license and are restricted by the level of export earnings. In addition, Myanmar maintains exchange restrictions which impose a limit on the purchase of foreign exchange by residents for foreign travel, the transfer of the remittable portion of wages by nonresidents, as well as on payments and transfer relating to invisible and other current international transactions.[3]

C. Costs and Benefits of Exchange Rate Unification

Figure 2. Myanmar: Foreign Direct Investment Inflows, 1998-2006
(In percent of nominal GDP)



Sources: IMF, International Financial Statistics; World Economic Outlook; and staff estimates.
1/ In percent of staff estimate GDP.

8. **Under the current multiple exchange rate system, government purchases of foreign exchange from state economic enterprises (SEE) exporters at the official rate serves as implicit taxes while the sales of foreign exchange to SEE importers serves as implicit subsidies.** These quasi-fiscal taxes and subsidies distort comparative advantage, which in turn distort production, consumption, and investment, and ultimately hinder economic growth. For example, FDI in Myanmar has remained very low as compared to other regional comparators due in part to the complexities of operating under the multiple exchange rate system (Figure 2). In addition, the current regime encourages profit seeking activities, typically involving the under-invoicing of exports, and over-invoicing of imports with official access to foreign exchange. Rent seeking

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[3] Residents (other than government officials) who have been granted an official permit to travel abroad are allowed to buy the equivalent of US$100-US$200, on presentation of FECs from their own foreign currency accounts. Government officials are allowed to purchase the equivalent of US$500 for foreign travel. All payments for invisible transactions and current transfer outside the public sector are subject to approval on a case-by-case basis. The maximum amount that may be remitted against FECs is US$10,000 per month or its equivalent.

and corruption are often significant costs to the economy that goes beyond easy quantification.

Box 2. Myanmar: The Foreign Exchange System in Practice

- There is basically a fixed official exchange rate for the settlement of public sector's external transactions and accounting purposes, and an informal foreign exchange market where the market-determined rate forms the basis for transactions. **These two regimes are effectively segmented**.
- **The use of the official rate is rationed even for the public sector.** The foreign exchange obtained at the official rate by the public sector is used solely for public sector imports. However, until recently when the exports of natural gas contributed to the accumulation of international reserve, access to foreign exchange at the official exchange rate was constrained by the limited supply of foreign exchange. Under the constraint, the public sector agents procured imported goods by though private importers at the market rate. Therefore, in these circumstances, even the public agents effectively accepted the use of the market exchange rate.
- **The private exporters can retain export earnings.**[1] For private sector transactions, there is no legal way to acquire foreign currencies other than the foreign exchange obtained through exports receipts. Foreign exchange demand and supply among private exporters and importers are typically intermediated through "brokers" and not through the banking system. A private importer buying US dollars from a private exporter with excess US dollars is "tolerated" but not "legal".
- **The use of FECs.** FEC are seldom used in transactions even though FEC issued by the central bank amounted to US$ 374 million as of end-March 2007. FECs are only used by residents as a substitute for foreign currency in domestic transactions since the use of foreign currencies in Myanmar is not legal for residents, even though, Myanmar nationals who earn foreign exchange are allowed to hold U.S. dollars or euro accounts.[2] The FECs are usually used by residents to pay for large value items such as the purchase of air tickets, and local employees of international/foreign organizations are commonly paid in FECs. Foreign firms are often required to pay for utilities in U.S. dollars or FECs.[3]
- **The value of the FEC has remained relatively stable suggesting that there are considerable public confidence in the FEC.** This could in part be supported by relatively stable local demand given the restrictions on the use of foreign currencies.

[1] Until 1988, foreign trade was monopolized by the public sector. From November 1988, the private sector was permitted to engage in foreign trade and retain 60 percent of exports earnings, later increased to 100 percent from March 1990 (Larkin and Thein (2001)).

[2] Funds from these accounts could be used in external transactions (such as foreign visits and medical treatment abroad) with prior approval (IMF (2007)).

[3] This practice increases the business costs for foreign firms. For example, foreigners are required to pay their telephone bills in dollars, e.g. US$166 (=1000/6), for a charge of 1,000 kyat.

9. **Unifying the exchange rates could eliminate the negative consequences above, and lead to better allocation of resources between the public and private sectors.** Exchange rate unification could also have short to long-run implications on fiscal balance, the banking system and inflation. The following sub-section first examines net welfare losses caused by the multiple exchange rate system, follows by an accounting analysis on the

impact of exchange rate unification on the measurement of national accounts, fiscal balance, the banking system, and inflation.[4]

Cost of the current regime—net welfare loss estimates

10. **Net welfare losses in the public export sector due to the multiple exchange rate could be as high as 10 percent of GDP**. The requirement for exporting SEEs to surrender their export earnings to the Foreign Exchange Budget at the official exchange rate serves as a disincentive to export, resulting in lower production which decreases producer surplus. With fewer goods exported, more goods are available for domestic consumption which increases consumer surplus. Government revenues are collected in the form of implicit taxes on exporters. The net welfare effect of the above three factors is shown as negative, and by assuming a simple functional form for the supply of exports, net welfare losses can be expressed as a function of implicit tax revenues (i.e. implicit tax rate multiplied by export value) and export elasticities. The net welfare losses as a percent of GDP increase with implicit tax rate and export elasticities (Table 1). The above results suggest that even at very low export elasticities (as the SEEs are likely to be unresponsive to price changes), the net welfare loss could be significant, ranging from about 1 to 10 percent of GDP.[5] In addition, net welfare losses have increased in the last few years with a higher implicit tax rate owing to widening parallel market premium.

11. **Net welfare losses in the public import sector are also estimated to be significant.** Importing SEEs' access to foreign exchange at the official exchange rate provides a strong incentive to import. However, domestic producers incur loses under the current exchange rate system due to lower demand for domestically produced products, while the government incurs loses due to the implicit subsidy given to importing SEEs. On the other hand, consumer surplus increases as more imported goods can be consumed at lower prices. The net welfare effect again turns out to be negative, with net welfare loses increasing with implicit subsidy rate and import elasticities. Even at low import elasticities, net welfare losses in the public import sector are sizable ranging from about 0.5 to 5 percent of GDP, and these loses have increased during the past few years (Table 2).[6]

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[4] While a number of informal parallel market exchange rates exist, estimates in this chapter focus on the comparison between the official exchange rate and the market exchange rate of kyat per U.S. dollar.

[5] As an extreme case, it is possible to assume the price elasticity of SEE production to be zero. However, even then, the elasticity of exports should be positive, since the elasticity is also affected by the elasticity of domestic demand by private sectors. In sum, the elasticities assumed here (between 0.01 and 0.1) for our calculations are very small if compared with assumptions (usually from 0.5 to 2) used in similar calculations for other countries.

[6] Following standard literature, the welfare loss calculation here assumes that importing SEEs have unlimited access to foreign exchange at the official rate. This assumption is not far from the current conditions governing foreign exchange budget, since the gas exports are leading the rapid accumulation of foreign reserves in recent years. More generally, however, the availability of foreign exchange to importing SEEs at the official rate could be rationed.

Table 1. Myanmar: Net Welfare Losses on Export Markets due to the Multiple Exchange Rate System
(In percent of GDP)

	2003/04	2004/05	2005/06	2006/07
Ad valorem tax rate	134.8	160.3	188.0	217.2
Export Elasticity (1/ β)				
0.01	0.45	0.58	0.62	0.91
0.05	2.45	3.19	3.40	5.01
0.10	5.48	7.15	7.65	11.32

Source: Fund staff calculations.

Note: This calculation used the FEC rate as an estimate of the equilibrium rate.

Net welfare losses are calculated using the following equation:

$$\frac{NWL_X}{\frac{tax}{1+tax}P_{FT}^{X}X_{tax}}=\frac{1+tax}{tax}\frac{\beta}{1+\beta}(1+tax)^{\frac{1}{\beta}}-\frac{\beta}{1+\beta}\frac{1}{tax}-1$$

where β is 1 divided by export elasticity. Ad valorem tax rate is defined as

$$tax=\frac{P_{World\ Price}}{P_{Domestic\ Price}}-1=\frac{E_{Equiribrium}}{E_{official}}-1$$

Table 2. Myanmar: Net Welfare Losses on Import Markets due to the Multiple Exchange Rate System
(In percent of GDP)

	2003/04	2004/05	2005/06	2006/07
Ad valorem subsidy rate	0.99	0.99	0.99	1.00
Import Elasticity (1/ α)				
0.01	0.48	0.48	0.51	0.68
0.05	2.22	2.20	2.34	3.10
0.10	4.03	3.97	4.22	5.56

Source: Fund staff calculations.

Note: This calculation used the FEC rate as an estimate of the equiribrium rate.

Net welfare losses are calculated using the following equation:

See Rosenberg and Zeeuw (2000) for derivation.

$$\frac{NWL_M}{subP_{FT}^{M}M_{sub}}=1-\frac{1-sub}{sub}\frac{\alpha}{1-\alpha}\left[1-\left(\frac{1}{1-sub}\right)^{\frac{\alpha-1}{\alpha}}\right]$$

where α is 1 divided by export elasticity. Ad valorem subsidy rate is defined as

$$sub=1-\frac{P_{Domestic\ Price}}{P_{World\ Price}}=1-\frac{E_{Official}}{E_{Equilibrium}}$$

12. **Including the dynamic effects would increase the estimated net welfare losses**. There may be factors that are not taken into account in the above static analysis and could work to reduce the estimated net welfare losses in our analysis. For instance, if tax evasion is prevalent, the implicit tax and subsidy rates would effectively be lower and has the effect of reducing net welfare losses. However, dynamic effects will increase net welfare losses and such an increase is expected to be larger than that caused by other factors. As trade and capital inflows bring new goods and technology, the welfare loss of the multiple exchange

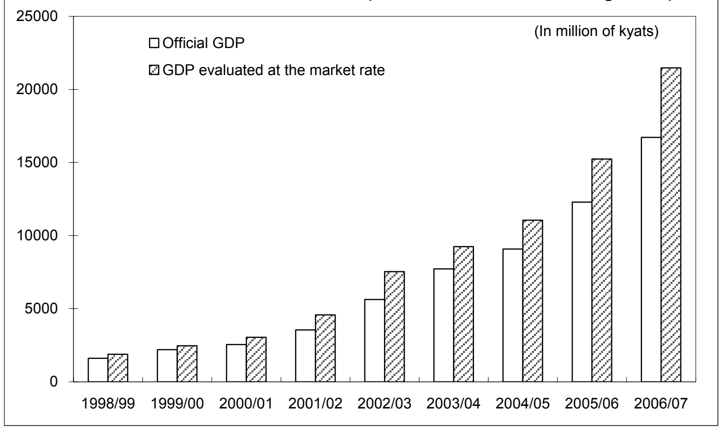
rate system could therefore be much larger as a large and unquantifiable cost is how the current system discourages trade and investments.[7]

Impact of exchange rate unification—An accounting analysis[8]

Measurement of national accounts

13. **The use of the market exchange rate for accounting would increase nominal GDP estimate by close to 30 percent**. International transactions are currently recorded at the official exchange rate in national account statistics although a large part of these transactions are taking place at the market-determined exchange rate. International transactions are therefore undervalued by the extent of the parallel market premium, and results in an overall underestimation of GDP if these transactions were consolidated into GDP statistics. Our estimates indicate that nominal GDP (in kyat) is about 30 percent larger at market exchange rate after valuation adjustments (Figure 3).[9]

Figure 3. Myanmar: GDP estimates:
Official GDP vs. Staff GDP Estimate (Evaluated at Maket Exchange Rate)



Sources: Mayanmar authorities; and Fund staff estimates.
Notes: Staff estimate GDP evaluated at the market rate is derived as follows:
Staff estimate GDP (in Kyat)
= Domestic Demand for Domestically Produced Goods (in Kyat) + Adjusted Final Imports (in Kyat) + Adjusted Exports (in Kyat) - Adjusted Imports (in Kyat)
= Domestic Demand for Domestically Produced Goods (in Kyat) + Adjusted Exports (in Kyat) – Adjusted Intermediate Good Imports (in Kyat).
Where:
Adjusted Exports (in Kyat) = Exports (in Kyat) in Official Statistics /Official Exchange Rate * Market Exchange Rate
Adjusted Imports (in Kyat) = Imports (in Kyat) in Official Statistics /Official Exchange Rate * Market Exchange Rate
Adjusted Intermediate Imports (in Kyat) = Imports of Intermediate (in Kyat) in Official Statistics/Official Exchange Rate *Market Exchange Rate

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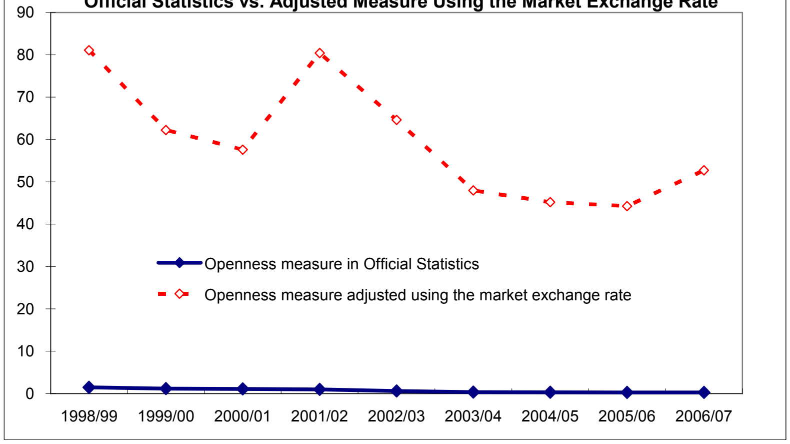
[7] Romer (1994) provides us an illustration of the importance of new goods brought by international trade. In his numerical example, the cost of an ad valorem tax of 25 percent is 47 percent of GDP in his model with new goods, and 6 percent of GDP in the standard model without new goods.

[8] While the short-run impact on GDP estimates, fiscal balance, banking sector soundness, and inflation are also dependent on the behavior of economic agents as well as changes in accounting valuation, our analysis only focused on the latter as behavioural reactions are difficult to predict and quantify. However, the long-run implications of the changes in economic behaviors would appear significant as indicated by the welfare analysis in the previous sub-section.

[9] Unless noted otherwise, GDP figures used in this chaper are staff's estimates with valuation adjustment using market exchange rate.

14. **Measures of trade openness would also be significantly higher at about 50 percent of GDP.** This is much higher than 0.2–0.3 percent calculated at the official exchange rate, suggesting that Myanmar is more exposed and integrated into the global markets (Figure 4). Trade openness, measured at market exchange rate, is however declining over the past decade, reflecting perhaps the trade reduction effects of the current exchange rate regime.

Figure 4. Myanmar: Trade Openness: Official Statistics vs. Adjusted Measure Using the Market Exchange Rate

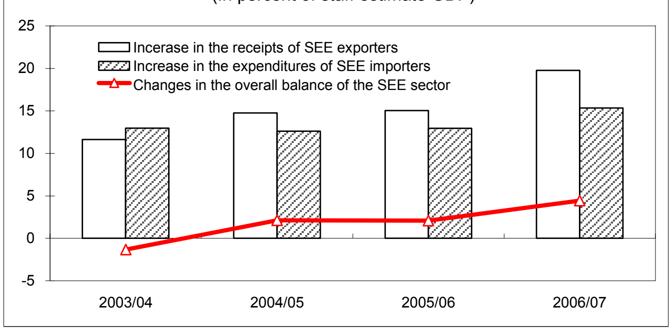


Sources: Myanmar authorities; and staff estimates.
Notes: Openness measure = (Exports in official statistics + Imports in official statistics) / GDP in official statisitcs
Adjusted openness measure = (Adjusted Exports + Adjusted Imports)/Staff estimate GDP

Fiscal implication

15. **Exchange rate unification, or the use of the market exchange rate for accounting, could improve the overall public sector balance by 2–4 percent of GDP**. Exchange rate unification would eliminate implicit taxes and subsidies, while increasing substantially both the receipts of SEE exporters and the expenditures of SEE importers. Reflecting the trade surplus in the public sector since 2004 due to buoyant gas exports, exchange rate unification have a net positive effect of improving the total balance of the SEE sector by up to 2–4 percent of GDP (Figure 5).[10]

Figure 5. Myanmar: Impact of Exchange Rate Unification on the Overall Balance of the SEE Sector
(In percent of staff estimate GDP)



Sources: Fund staff estimates.
Notes:
SEE receipts at the market rate = SEE receipts at the official rate + Public sector exports in US$ *(Paralell exchange rate - Official exchange rate)
SEE expenditures at the market rate = SEE expenditures at the official rate + Public sector imports in US$ *(Paralell exchange rate - Official exchange rate)
Increase in the receipts of SEE expoters = SEE receipts at the market rate - SEE receipts at the official rate
Increase in the expenditures of SEE importers = SEE expenditures at the market rate - SEE expenditures at the official rate

16. **Exchange rate unification could also improve the fiscal balance directly through increased custom revenues of about 0.2 percent of GDP.** While the official exchange rate was initially used in valuing imports for the assessment of customs duties, the customs assessment rate of 100 kyat per U.S. dollar introduced in June 1996 has been increased gradually to 450 kyat per U.S. dollar since June 2004 while the rate for border trade is now

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[10] To keep our estimation simple, the transfers from the SEE to the Union Government of Myanmar are assumed to be constant, irrespective of the increased profits in the SEEs. More realistically, all the profits of SEEs are transferred to the Union Government; however, the transfer does not affect the fiscal balance of the consolidated public sector, the focus of our analysis.

close to the market rate. Exchange rate unification could improve the fiscal balance, by about 0.2 percent of GDP, through higher custom revenues (Table 3). The impact is relatively minor as the parallel market premium is small with the unification process already underway and the relatively low custom tariff rates.

Table 3. Impacts of Exchange Rate Unification on Custom Valuation

	Definition	2003/04	2004/05	2005/06	2006/07
Custom Duties (actual amount in million of kyat)	[a]	4,031	21,131	17,894	31,963
Relative to total imports at official rate (percent)	[b]=[a]/Official Imports	30.1	186.4	155.4	189.9
Relative to total imports at FEC rate (percent)	[c]=[a]/Adjusted Imports	0.22	1.16	0.82	0.85
Changes in customs valuation rates	[d]	100-180	450 from June 2004		850 from June 2006 (only on border trade)
FEC exchange rate	[e]	809	921	1,104	1,280
Custom duties to total imports under the FEC equivalent custom valuation rate (estimated)	[f]=[c]*[e]/[d]	1.79	2.37	2.02	2.12
Estimated custom duties after unification (in million of kyat)	[g]=[f]*Adjusted Imports	32,598	43,267	43,904	79,623
Impacts of Unification (in million of kyat)	[h]=[g]-[a]	28,567	22,136	26,009	47,660
Relative to staff estimate GDP	[i]=[h]/Adjusted GDP	0.31	0.20	0.17	0.22

Sources: Myanmar Central Statistical Organization, Selected Monthly Economic Indicators; and staff estimations.

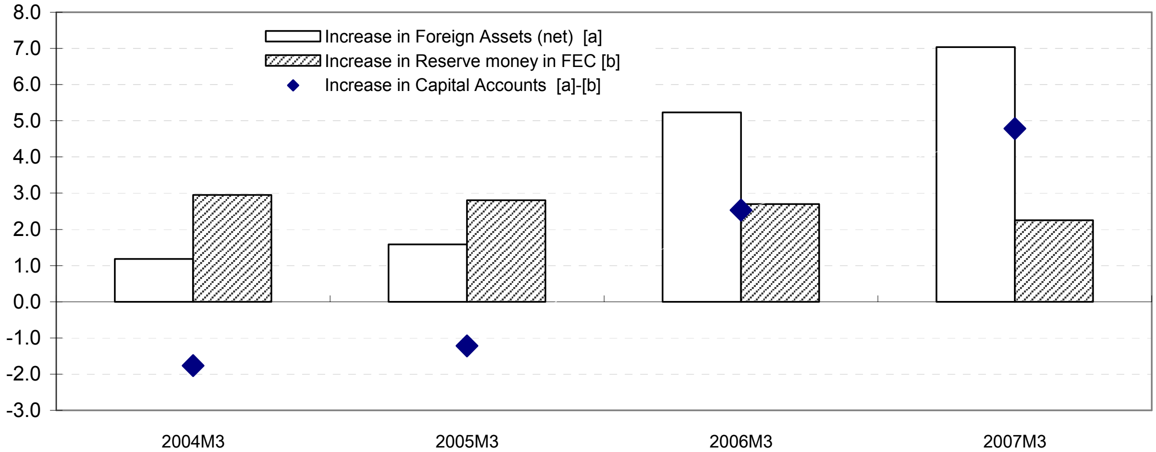
17. **In addition, exchange rate unification could have a one-off positive effect on the government balance sheet through valuation adjustments of foreign currency denominated asset and liability items of the public sector.** Foreign currency denominated assets and liabilities are currently recorded in the public sector balance sheet at the official exchange rate. A revaluation of these asset and liability positions in kyat terms after unification could result in net gains or loses depending on the net foreign currency exposure. Exchange rate unification would result in a net profit for the central bank due to evaluation gain when foreign currency components are valued at the market exchange rate. Based on available information, this could be as large as 3–5 percent of GDP (Figure 6).

Impact on the banking sector

18. **Exchange rate unification could have implications on the soundness of the banking sector through banks' balance sheets.** In the event that state-owned commercial banks with a net exposure to foreign liabilities need to be recapitalized due to large equity losses, this would represent a fiscal cost to the government. Private banks have no foreign currency exposure.

19. **The impact of exchange rate unification on the banking sector is expected to be limited as only one bank has large foreign currency exposures.** Our preliminary estimates suggest that the combined net foreign assets of the three state-owned commercial banks would increase to about 4 percent of GDP from almost negligible if the banks' balance

Figure 6. Myanmar: Impact of Exchange Rate Unification on the Balance Sheet of the Monetary Authorities
(In percent of staff estimate GDP)



Sources: IMF, International Financial Statistics; Myanmar authorities; and staff estimates.
Notes: Impacts on the balance sheet of monetary authorities through US$/FEC denominated assets and liabilities.
Increase in Capital Accounts (in kyat) = Increase in Foreign Assets (net, in kyat) - Increase in FEC denominated reserve money.
= Foreign Assets (net, in kyat at market rate) - Foreign Assets (net, in kyat at official rate)
- (FEC issued (net, in kyat at market rate) - FEC issued (net, in kyat at official rate))
= Foreign Assets (net, in kyat at official rate)/Official Exchange Rate* Market Exchange Rate -Foreign Assets (net, in kyat at official rate)
- (FEC issued (net, in kyat at official rate)/Official Exchange Rate*Market Exchange Rate - FEC issued (net, in kyat at official rate))

sheets are revaluated at market exchange rate (Table 4). However, one state-owned commercial bank could incur an equity loss equivalent to about 0.1 percent of GDP after exchange rate unification due to its net foreign currency exposure from external debt contracted at the official exchange rate.[11]

Table 4. Myanmar - State-owned Commercial Banks's Total Foreign Currency Exposure
(In billions of kyat, as of September 2006)

	Before unification			After unification 1/		
		(In percent)	(In percent of GDP) /2		(In percent)	(In percent of GDP) 3/
Total Assets	4,033	100.0	24.1	9,106	100.0	42.4
Assets in kyats	4,011	99.4	24.0	4,011	44.0	18.7
Assets in foreign currencies	23	0.6	0.1	5,095	56.0	23.7
Total Liabilities	4,027	100.0	24.1	8,217	100.0	38.3
Liabilities in kyats	4,008	99.5	24.0	4,008	48.8	18.7
Liabilities in foreign currencies	19	0.5	0.1	4,209	51.2	19.6
Capital	7		0.0	889		4.1
Net open foreign exchange position	4		0.0	887		4.1
Capital to assets ratio		0.2			9.8	

Sources: IMF, International Financial Statistics; and staff estimations.
1/ Foreign currencies components are converted to kyats by multiplying market exchange rate/official exchange rate as of end FY2006/07.
2/ In percent of offical nominal GDP (FY 2006/07) before unification.
3/ In percent of staff estimate GDP (FY2006/07) evaluated at the market exchange rate after unification.

Impact on inflation

20. **Exchange rate unification could have implications on inflation through two main channels: temporary price hike due to a sudden withdrawal of implicit subsidies to**

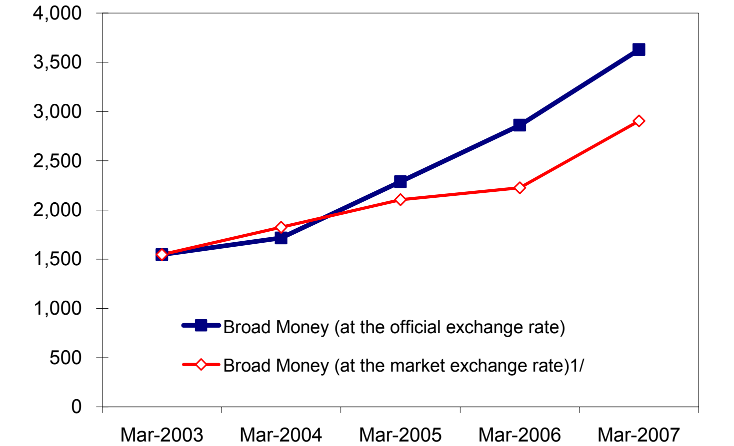
[11] Largely due to long-term borrowing of the government from Japan OECF. Recapitalization would require a capital injection equivalent to about 1.4 percent of GDP to reach a capital adequacy ratio of 8 percent.

importing SEEs and a medium-term effect through a lower money supply due to improved fiscal balance.

21. **A sudden withdrawal of implicit subsidies to importing SEEs may result in a temporary price hike of about 6 percentage points due to higher import costs**. Our estimate indicates that exchange rate unification could increase the cost of the SEE sector by about 80-90 percentage points. However, as the share of SEE in Myanmar's total value added is only about 7 percent, the overall inflation increase could be around 6 percentage points. This estimate could be seen as the upper bound as some forms of administrative price controls may limit the pass-through effect of higher import costs to consumers. Compression of profit margin for SEEs that are already pricing at similar level as the private sector could also help to mitigate the inflationary impact.

22. **Exchange rate unification is also expected to have a medium-term effect of lowering broad money growth by about 7 percentage points due largely to improved fiscal balance**. If the exchange rate unification took place in end-March 2004, the estimated average annual growth rate of broad money for the period 2003-2007 would decrease from 24 percent to 17 percent (Figure 7). On the one hand, there is a one-off revaluation at market exchange rate at the point of unification which results in a large expansion of net foreign assets and hence broad money. However, the offsetting effect from lower fiscal deficit lowers broad money growth.

Figure 7. Myanmar: Impact of Exchange Rate Unification on Broad Money



Sources: IMF, International Financial Statistics; and staff estimations.
1/ Assume that the exchange rate is unified on end-March 2004.

D. Country Experiences

23. **Compared with other countries' experiences with the dual/multiple exchange rate, Myanmar's system stands out for its very high parallel market premium of 23,000 percent**. Based on a cross-country historical dataset prepared by Reinhart and Rogoff (2004),[12] among 77 countries with dual/multiple exchange rate regime, 23 countries have experienced a parallel market premium of more than 1,000 percent but only four have a

[12] There are limited data on parallel exchange rates since they are often illegal rate for which official data are not available. According to the dataset examined, 77 countries out of the total 110 countries in the dataset have some experiences of dual/multiple exchange rate regime (with more than 10 percent parallel market premiums) in the period 1970-1998. More than half of the countries, however, have graduated from the dual/multiple exchange rate regime in their modernization process, with only 27 countries still remaining as of 1998.

parallel market premium of more than 10,000. Since a parallel market premium is a good proxy for the economic loss or inefficiency of the system, exchange rate unification is one of the key components in the modernization of the Myanmar economy.

24. **Experiences of other countries in exchange rate unification could serve as useful examples for Myanmar**. In examining the modernization of exchange rate arrangements, we identified 22 episodes of exchange rate unification attempts with large premiums of more than 400 percent.[13] The sample episodes are then divided into four categories based on two criteria: (1) whether the unification process (or process to reduce the parallel market premium) was rapid or gradual, and (2) whether the unification attempt was successful based on the criterion that the authorities could keep the premium below 10 percent for five years. Among 12 episodes of gradual unification attempts, eight episodes could be considered successful, while four episodes failed. For the remaining ten episodes of rapid unification attempts, six have been successful (Table 5).

Table 5 Identified Episodes of Exchange Rate Unification from High-Premium (>400) Dual Exchange Rate Ragime (1970-1996)

		Before the Unification				Unification		After the Unification		Classification	
	Country	Month of Peak Premium	Peak Premium in the Dual Regime	1-year Average Premium before the Unification	Premium 1-month before the Unification	Month of the Unification 1/	Premium in the Month of the Unification	5-year Average Premium after the Unification	Premium 60-months after the Unification 2/	Rapid or Gradual 3/	Failure or Success 4/
		(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)
(1)	Bolivia	Aug-1985	2022.7	604.8	2022.7	Sep-1985	-4.3	6.1	1.6	R	S
	Bulgaria	Dec-1989	1422.5	60.4	18.0	Sep-1994	6.2	9.4	4.1 *	R	S
	Peru	Aug-1988	1066.7	92.3	18.2	Mar-1991	7.1	6.4	3.8	R	S
	Poland	Dec-1970	4400.0	369.0	95.4	Jan-1990	5.3	7.9	0.5	R	S
	Sierra Leone	May-1988	1594.7	72.9	16.2	Jan-1992	10.0	5.1	-5.4	R	S
	Vietnam	Aug-1985	19820.3	290.8	500.0	Mar-1989	6.7	0.5	1.0	R	S
(2)	Ghana	Dec-1982	4263.6	17.9	10.5	Jul-1990	8.9	4.0	1.7	G	S
	Guinea	Dec-1985	1423.0	18.4	10.1	Mar-1987	9.8	8.8	-0.6	G	S
	Guyana	Sep-1986	1109.3	15.1	12.3	Jan-1995	9.9	4.2	3.3 *	G	S
	Lao P.D.R.	Aug-1985	1071.4	43.4	10.2	Jun-1989	6.3	9.9	0.7	G	S
	Nicaragua	Jan-1988	71328.6	36.6	10.0	Apr-1994	8.5	1.3	0.2 *	G	S
	Tanzania	Mar-1986	713.0	21.2	15.7	Jul-1993	3.0	4.3	6.8	G	S
	Uganda	Apr-1987	1185.7	11.1	10.4	Jan-1996	9.3	8.3	5.4 *	G	S
	Zimbabwe	Jun-1977	437.0	16.1	11.2	Dec-1994	8.6	9.4	6.7 *	G	S
(3)	Nigeria	Jul-1984	401.1	66.4	13.2	Oct-1987	1.7	35.5	34.4	R	F
	Suriname	Apr-1994	8583.5	5567.6	8023.3	Jul-1994	-0.3	11.6	69.6 *	R	F
	Ukraine	Apr-1994	693.0	316.9	103.6	Oct-1994	8.1	5.7	19.6 *	R	F
	Zambia	Jun-1989	1221.5	55.0	13.0	Aug-1992	1.9	14.0	35.7	R	F
(4)	Chile	Aug-1973	5312.8	13.0	11.5	Dec-1977	2.6	7.0	14.2	G	F
	El Salvador	Dec-1985	472.0	26.7	23.9	Apr-1991	9.8	14.1	10.8	G	F
	Romania	Oct-1990	807.2	28.5	15.6	Jul-1993	7.7	19.1	6.1	G	F
	Uganda	May-1981	2109.9	32.7	23.4	Nov-1984	3.4	257.7	158.3	G	F

Sources: Episodes selected by staff from Reinhart and Rogoff dataset.
1/ The month of the unification is identified by selecting months in which parallel premium fall below 10 % for at least 3-months for the first time after a high premium period.
2/ An asterisk (*) in this column means (g) and (h) are calculated for the period until 1998M12 (not until 60 months after the unification month), being constrained by the data availability.
3/ (i)=R if (c)>50 and/or (d)>25, otherwise (i)=G.
4/ (j)=S if (g)<10 and (h)<10, otherwise (j)=F.

[13] The identification is based on staff's subjective judgments.

25. **Unification attempts appear to bring benefits without causing major macroeconomic disorder in both successful and failed episodes.** While there are some cases of temporary growth slowdown and inflation acceleration especially for sharp unifications, growth rate picked up and inflation declined in the medium term. In addition, current account balance also improved, resulting in higher foreign reserves coverage of monthly imports (Table 6). For most cases, these improved performances are supported by relatively tight monetary and fiscal policies. In sum, experiences of these countries suggested that exchange rate unification is most likely to bring benefits in the medium to long-term if implemented against the backdrop of sound macroeconomic policies, while the short-run adverse effects were, in most cases, manageable.

Table 6. Changes in Macroeconomic Variables from Dual Exchange Regime Period to Post-Unification Period (Averaged by 4 Categories)

	Classification	Number of Episodes	Real GDP Growth			CPI Inflation			Stock of Reserves		
			Dual Regime (Average from T-3 to T-1)	Unification Year T	Post-Unification (Average from T+1 to T+3)	Dual Regime (Average from T-3 to T-1)	Unification Year T	Post-Unification (Average from T+1 to T+3)	Dual Regime (Average from T-3 to T-1)	Unification Year T	Post-Unification (Average from T+1 to T+3)
(1)	Succesful Rapid Unification	6	-0.9	-3.9	1.4	1490.7	240.5	97.9	2.3	3.5	3.8
(2)	Succesful Gradual Unification	8	3.2	5.4	6.5	149.3	26.4	16.0	2.8	3.1	3.5
(3)	Failed Rapid Unification	4	-3.6	1.3	0.6	643.7	163.8	46.0	1.9	1.7	4.4
(4)	Failed Gradual Unification	4	-1.1	5.1	6.8	109.0	77.9	74.5	2.4	1.7	3.5

	Classification	Number of Episodes	Broad Money Growth			Government Balance			Parallel Rate Premium		
			Dual Regime (Average from T-3 to T-1)	Unification Year T	Post-Unification (Average from T+1 to T+3)	Dual Regime (Average from T-3 to T-1)	Unification Year T	Post-Unification (Average from T+1 to T+3)	Dual Regime (Average from T-3 to T-1)	Unification Year T	Post-Unification (Average from T+1 to T+3)
(1)	Succesful Rapid Unification	6	1090.7	86.5	63.0	-8.8	-4.4	-5.0	215.7	11.8	5.8
(2)	Succesful Gradual Unification	8	99.7	51.9	28.2	-3.4	-5.7	-4.6	146.8	7.7	7.0
(3)	Failed Rapid Unification	4	266.6	75.9	51.3	-7.1	-1.5	-1.1	459.5	20.1	15.0
(4)	Failed Gradual Unification	4	80.7	60.9	79.6	-3.2	-1.2	-1.7	127.0	14.3	85.1

E. Conclusions

26. **In sum, the results of our accounting analysis suggest that short-run impact of unification is manageable, and the long-term benefits to the economy will be substantial (Table 7).**

Table 7. Myanmar: Estimated Impacts of Exchange Rate Unification

Short-term impact	
Fiscal Deficit	
· Improvement in the overall public sector account	2-4 percent of GDP
· Increase in custom revenues	0.2 percent of GDP
Government Balance Sheet	
· Improvement in assets-liabilities position	3-5 percent of GDP
Banking Sector	
· Fiscal cost to recapitalize a state-owned bank with large equity losses due to net exposure to foreign liabilities	-0.1 percent of GDP
Inflation	
· Temporary price hike due to a sudden withdrawal of implicit subsidies to importing SEEs	6 percent points
· (Medium-term impact) Lower money supply growth due to improved fiscal balance	-7 percent points
Long-term benefits	
· Net welfare gain in the public export sector	1 - 10 percent of GDP
· Net welfare gain in the public import sector	0.5 -5 percent of GDP

Note: All numbers are relative to staff estimate GDP.

27. **Key steps to exchange rate unification and the eventual development of a foreign exchange market would include the following steps:** (i) putting in place the legal framework to allow foreign exchange transactions at the market exchange rate and the development of a foreign exchange market; (ii) using the market exchange rate in all accounting, (iii) unifying the exchange rate at the current market-determined exchange rate (which also terminates the public sector's access to foreign exchange at the official exchange rate); (iv) replacing implicit taxes and subsidies, if necessary, with explicit taxes and subsidies to SEEs which would be phased out over time; and (v) creating an interbank foreign exchange market. The next steps after unification would be to gradually liberalize restrictions on current account transactions, including restrictions under the Article VIII, and phasing out import and export licensing requirements.

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II. Banking and Financial Sector Issues[14]

A. Structure of the Banking Sector

28. **Banks dominate the financial system in Myanmar while the insurance sector and the securities market are nascent**. As of March 2007, total assets of the banking system stand at K 1,521 billion. The banking sector consists of 19 institutions of which four state-owned banks account for 55 percent of total assets (Table 1).

Table 1. Myanmar: Supervised Financial System, March 2007

Type	Number of Institutions	Assets (Millions of kyats)	Assets as Percent of GDP
Banks	19	1,521,447	9.10
Of which:			
State banks	4	838,514	5.02
Private banks	15	682,933	4.09
Insurance company 1/	1	...	...
Security exchange	1	...	...
Total	21	1,521,447	9.10

Source: Central Bank of Myanmar
1/ Premium income during 2006/07 were K 6,833 million.

29. **The state banks serve the specialized needs of the economy as indicated by their names**—Agricultural and Rural Development Bank, Economic Bank, Foreign Trade Bank, and Investment and Commercial Bank. They are complex financial institutions, which combine banking with directed lending and other quasi-fiscal operations and, in some cases, certain central banking and treasury operations. This is in part a result of the 1963 nationalization when 24 private commercial banks—14 domestically owned and 10 foreign-owned institutions—were taken over and merged into four state banks.

30. **Starting in 1992, private domestic banks were again allowed to operate in Myanmar**. After a period of strong growth, private banks used to dominate the banking sector before the 2003/04 banking crisis. As a result of the subsequent retrenchment; their market shares, in March 2006, were 41.9 percent of total deposits and 48.1 percent of total lending to the private sector (Figure 1). Several of the more important of the 15 private banks are strongly associated with trading companies, which are owned by ethnic or regional minorities. Foreign banks have not been allowed to resume operating branches or subsidiaries, although 13 institutions have been licensed to operate representative offices for information and marketing purposes. Draft legislation on the establishment of special economic zones is planned to permit foreign banks to operate in these zones.

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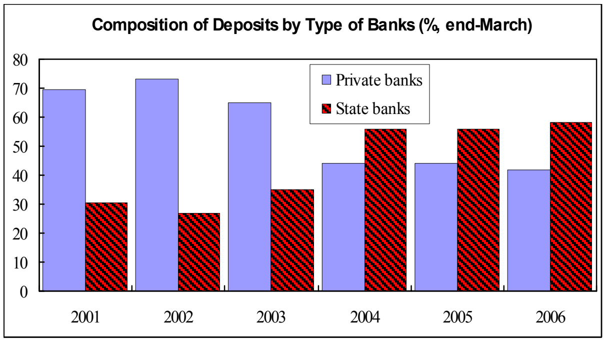
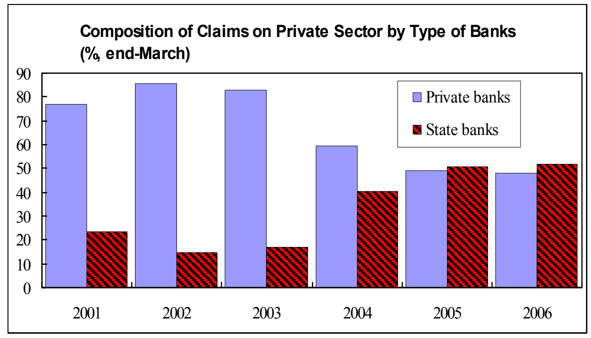
[14] Prepared by Åke Lönnberg .

Figure 1. Composition by Type of Banks





Source: Central Bank of Myanmar.

31. **The financial system appears significantly under-banked with about 600 bank offices for a population of some 55 million people in a vast and diverse country**. Again, the state banks dominate; the Economic Bank alone has some 260 branches while all private banks together has about 180 branches. Many private banks have ambitious plans to expand their branch networks.

B. Recent Performance

32. **During the last several years, the performance of the banking sector has been seriously affected by the major banking crisis that started in 2003.** The key points in the crisis are summarized in Box 1 below[15]

33. **The authorities' policy priority since the 2003/04 crisis has been to maintain financial stability even at the cost of the development of the banking sector**. Over time, the private banks have adjusted in some remarkable ways, with many of them being able to add significantly to their paid-in capital. With strong emphasis on liquidity, the banks' liquidity ratios have also strengthened. As a result, during 2006/07, the reported data on liquidity and capital ratios are very high (Table 2).[16]

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[15] For a more detailed discussion, see Myanmar—Selected Issues and Statistical Appendix (SM/05/100; 3/11/2005); Section III, prepared by Olivier Frécaut (MCM).

[16] Definitions used in Myanmar are not always in accordance with international standards and codes, thereby making international comparisons difficult.

Box 1. Summary of the Banking Crisis in 2003/04

- February 2003: Acute problems arose among illegal financial firms involved in pyramid schemes. A decline in public confidence generated massive depositor runs against private banks. In March, the private banks had lost 40 percent of their deposits. By September, their deposits were depleted by two-thirds, much of this loss being transferred to the state banks, which the public perceived as safer, or less likely to be closed. A severe liquidity problem was thus created in the private banks.

- The authorities' response was to restrain bank withdrawals, which further undermined public confidence, and to order private banks to strengthen their cash position by calling in loans. These banks tended to shorten the term of new lending. The authorities required private banks to adhere to a deposits-to-capital ratio capped at 7, thereby constraining their ability to collect new deposits and limiting their activities and growth.

- All these measures aggravated the liquidity problems, which spread to the real sector through a sharp drop in the volume of financial intermediation. At its peak, six problem banks were prohibited from accepting new deposits or extending any new credits. Later, three banks were allowed to resume normal operations, while two were closed, and one remained under a special supervisory regime.

- Early 2004: Deposits started to recover for the private banks, but from a low level. In June, three private banks merged.

Table 2. Myanmar: Financial Soundness Indicators
(In percent; end-March)

	2006		2007	
	State Banks	Private Banks	State Banks	Private Banks
Capital adequacy ratio (CAR)	…	43	…	40
Nonperforming loans (NPL)	19	3	23	2
Return on assets (ROA)	…	3	…	3
Return on equity (ROE)	33	23	13	25
Noninterest expenses to gross income	55	49	88	50
Liquid assets to total assets	89	33	90	35
Liquid assets to short-term liabilities	93	38	91	39

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

34. **In the course of the financial year 2006/07, public confidence in the banking system has strengthened with growth in deposits**. At the same time, based on reported data, the level of nonperforming loans for the private banks stands at 2 percent, while that in

state banks is 23 percent. A sizable part of the state banks' credit operations is reportedly directed lending based on noncommercial criteria. When, over time, such loans to state-owned enterprises become nonperforming, this is viewed as an intra-state problem. State banks also have less capital to cover lending risks than private banks. Data for the state banks' capital adequacy ratio are not made public. In its supervisory work, the Central Bank of Myanmar (CBM) has not identified any major financially troubled banks.

35. **Formal financial intermediation continues to remain low**. Credit to the private sector as percentage of GDP stood at 4.6 percent as of March 2006. However, the maximum value of the deposits-to-capital ratio has since been raised from 7 to 10, thereby allowing a future expansion of financial intermediation.

36. **The authorities have relaxed some administrative measures put in place during the crisis**. Six private banks have been allowed to open new branches. Prudential regulations and supervision have also been strengthened. All banks are now required to maintain 10 percent of total deposits as minimum reserves, maintain capital adequacy ratios, and raise paid-up capital. The CBM has been monitoring the private banks' financial position on a daily basis and is upgrading on- and off-site examinations.

37. **In the AML/CFT area, the authorities have made progress over the past year in strengthening the regime**. Partially, as a result of technical advice provided by the international community, the authorities have improved their capacity to administer an effective preventive regime on AML/CFT and to conduct related prudential supervision. In October 2007, the FATF decided to end formal monitoring of Myanmar. An evaluation of Myanmar's AML/CFT framework by the Asia Pacific Group is expected to be undertaken in November 2007. The result of that assessment will provide an important lead as to which particular areas should be targeted to further strengthen the AML/CFL regime.

C. Challenges

38. **Although the banks have largely recovered from the crisis of 2003/04, fundamental structural problems in the banking system remain**. The structural weaknesses described below are acute and major challenges. Because of these, banking institutions continue to be excessively constrained in carrying out their intermediation function.

Financial stability

39. **For maintaining a safe and sound banking system, it is critical to have: (i) good internal governance in the banks themselves; (ii) market discipline; and (iii) prudential oversight**. First, regarding governance, challenges exist in the entire banking sector, for example:

- **Delineation of tasks**. As previously mentioned, the four state banks perform, to various degrees, a number of nontraditional banking activities. These institutions are involved in actively implementing ministerial policies; the Agricultural and Rural Development Bank is owned by the Ministry of Agriculture and Irrigation and the remaining three banks are owned by the Ministry of Finance and Revenue. Commercial banking services are sometimes "bundled" with operations undertaken by the state bank in its capacity as a government agency.
- **Conflict of interests**. The close personal and business connections that reportedly exist between many private bank owners or bank managers and their customers may have implications on the decision-making process. After the 2003/04 crisis, the rules on large exposure and connected lending were strengthened, but it remains essential to ensure that the "arm's-length distance" that should characterize banking relationships is always met.

40. **Second, market discipline is currently not an effective means of strengthening banks in Myanmar**. Banks suffer from what internationally would be regarded as excessively detailed regulation. The CBM determines, for example, quantitative lending limits, minimum interest rates on deposits, maximum interest rates on different types of bank lending, and maximum levels on fees and commissions charged by banks. The total impact of such regulations prevents "banks-from-being-banks," limiting competition by undermining the ability of the managers from operating banks on a fully commercial basis. Furthermore, only one banking institution, Myanmar Commercial Bank, is formally listed on the Myanmar Securities Exchange Centre (MSEC). During the financial year 2006/07, no shares of that bank were traded at MSEC at all. Other private banks appear to prefer to select the buyers to whom they sell shares.

41. **Third, prudential oversight is undertaken by two relatively new departments of the CBM**, the Banking Regulation Department and the Internal Audit and Bank Supervision Department. The staff of both departments are geographically split between the new headquarters in Nay Pyi Taw and the old headquarters in Yangon, creating information and coordination difficulties. This and other current challenges in banking supervision and prudential regulation are summarized in Box 2.

Box 2. Financial Stability Challenges

- **Organizational fragmentation**. The prudential oversight function is divided between two departments; both are geographically divided; and the on-site and off-site functions operate separately.
- **Absence of a clear definition of what supervision should accomplish**. No active discussion has taken place with respect to the purpose of supervision, what it is and what it is not.
- **Lack of documentation of supervisory practices**. The CBM has not prepared a manual for on-site or off-site supervisory practices. This makes it difficult for both old and new staff to be kept up to date with existing rules and past experiences.
- **International best practices for banking supervision**. No assessment has been made regarding the extent of compliance with the Basel Core Principles for Effective Banking Supervision in Myanmar.
- **Selective supervisory forbearance**. The legislative frameworks for banking supervision and prudential regulation make no distinction between whether a banking institution is state owned or privately owned. Still, state banks are not subject to a number of prudential or supervisory instructions or guidelines.
- **Problem bank resolution**. The CBM's approach to dealing with banks that are financially weak or are facing other major problems unduly disrupts public confidence and intermediation. The strategy needs to be further developed based on domestic and international experiences.

Growth

42. **The banks in Myanmar have considerable potential to do more to support economic growth in the country**. To achieve this, a vision is needed for the future banking system. The authorities, in collaboration with the banking community and representatives of bank customers, should prepare a plan to modernize the sector, with both near-term and medium-term actions. A set of structural weaknesses that need to be addressed in that context is suggested in Box 3.

43. **A vibrant financial sector is key to a dynamic economy and increased growth**. Experience from other countries indicates that competition is key, and a good way to increase competition is by maximizing the use of market forces.

Box 3. Challenges to Growth

- **Low level of formal financial intermediation**. The banking system as a whole is in various ways constrained in being able to sufficiently reach out to the general public. Moreover, diversification of financial services in not encouraged by the regulatory regime. Instead, an informal credit market exists outside the oversight and regulation of the CBM.
- **Financial lending is not encouraged**. The restrictive regime imposed at the time of the 2003/04 crisis does not encourage lending to the private sector, which, in most countries, provides a major impetus for economic growth.
- **Competition is limited**. The state banks and private banks are subject to limited market-based competition internally and none from abroad. Consequently, the sector does not seem particularly vibrant or innovative.
- **Lack of supportive financial infrastructure**. The infrastructure framework for financial services is typically not very developed, for example, in the areas of insurance, payments, and capital market.
- **Challenges in the state bank sector**. Certain central banking and government functions are bundled with commercial banking operations; governance problems exist; state banks are not run as banks and have major problems with nonperforming loans.

D. Modernization Agenda

44. **To strengthen the sector's ability to support economic growth, an agenda for the modernization of the banking system should have a two-pronged approach that safeguards banking sector soundness, and focuses on addressing structural weaknesses**.

Safeguard banking sector soundness

45. **Prudential oversight should clearly** focus on (i) ensuring bank safety and soundness to advance a strong national economy; and (ii) foster competition by allowing banks to offer new products and services to their customers as long as banks have the expertise to manage their risks efficiently and to provide the necessary consumer protection.

46. **Moving toward a prudential and regulatory bank supervisory framework that is consistent with international best practices is a good way to deal with existing gaps in prudential regulation and supervision**. An important aspect would be to upgrade prudential instructions and enforce them fairly and in a fully transparent manner. Early action should be considered with respect to selected regulations that are in urgent need of redress to improve governance. This could include enhancing the fit-and-proper regulation and strengthening the general compliance with the prudential rules on large exposure limits, single exposure, etc. Another priority should be reforming the collateral requirement, which presently, in practice, recognizes only real estate as collateral.

47. **Focus should also be directed on evaluating the different risks of the banks' operations using a prudential supervisory approach together with the necessary compliance methods**. The compliance nature of detailed regulation should be reduced as should supervision with respect to the parameters for the banks' lending and deposit operations, as well as restrictions on opening branches or introducing new financial services.

48. **The organization of prudential oversight should be reconsidered and strengthened**. The increasing fragmentation that characterizes the current organization of prudential supervision goes against a strong international trend. During the last two decades, most countries have tended to concentrate, rather than divide, supervisory resources into larger units rather than to divide them organizationally and geographically.

49. The CBM should review and revise the legal and regulatory framework in the medium term and to prepare a comprehensive supervisory manual in the near term. For this work, external technical support should be requested.

Address structural weaknesses

50. **High priority should be given to addressing the structural problems that the banking sector faces and which impede its development and financial intermediation**. More steps need to be taken to support the transition from the remaining elements of a centrally planned economy in Myanmar to a fully market-based economy. This venture must be undertaken with considerable care to avoid the problems experienced by some other countries that have deregulated the financial sector without paying sufficient attention to the need to correspondingly strengthen financial sector oversight. Deregulation in such cases have often included privatizations and removal of micromanaging regulation.

51. **A medium-term plan need to be developed to modernize the banking sector**. Important components of such a plan would include: allowing more entry, granting licenses for competent private banks to engage in the foreign exchange business, deregulating interest rates, clarifying the role of state banks, and creating an even playing field for all institutions.

52. **To enhance competition among banks, the following actions should be considered**:

- **Undo "bundling" of services by clearly redefining the objectives for each state bank**. Strictly commercially oriented financial services should remain with the banks, and the administrative government agency activities should be reallocated to appropriate government authorities.
- **Improve internal governance in the whole banking system** by strengthening the fit-and-proper requirements for appointing members of the board of a bank, the bank's chief executive, other senior managers, and selected key positions in the bank.
- **Level the playing field between state banks and private banks**, ensuring equal treatment among institutions.

Framework

53. **The modernization program should not exclusively cover the banking system, but also other key areas of the financial infrastructure**. This section will address three such areas: payment systems, insurance sector, and money and capital markets.

Payment systems

54. **The existing payment systems infrastructure in Myanmar is predominantly cash based**; banknotes are still the most important payment medium for the general public. The use of noncash payment instruments is relatively modest and dominated by checks and paper-based direct transfer orders. The clearing and settlement of payment transfers are based mainly on manual procedures and lack adequate risk management safeguards. The regulatory frameworks for both the clearing and settlement activities are not clearly defined.

55. **The other side of the low level of formal financial deepening is that informal payment systems are flourishing**. These systems may in a narrow sense be efficient but do not include any of the normal safety and soundness requirements. As a result, the payment and settlement systems infrastructure in Myanmar is far from meeting international standards and best practices in terms of safety, soundness, and efficiency.

56. **The CBM and some of the banks recognize that the current domestic payment systems are extremely limited in meeting the needs of the users in an evolving market economy**. The current features of the payment systems would not allow the creation of cost-efficient payment instruments supported by a sound framework. It is also recognized that the current clearing and settlement procedures would not allow the CBM to fully implement its core functions as a central bank in a safe and efficient manner. Moreover, there are AML/CFT concerns that the current payment system does not allow efficient monitoring of suspicious transactions.

57. **Considering that payment systems operations and oversight are some of the most critical core functions performed by central banks, the current institutional setting in the CBM is not suitable to ensure orderly, safe, and efficient payment and settlement systems**. Recommendations for payment systems modernization are included in Annex II.1

Insurance sector

58. **The insurance business in Myanmar is a state monopoly owned by the Ministry of Finance and Revenue**. Myanmar Insurance (MI), established in 1952, covers the country through 38 offices with a total staff of some 1,400. Foreign companies are obliged to use MI for their insurance needs relating to their operations in the country.

59. **The company offers coverage for various types of insurance** with the most important areas in terms of policy income being: (i) marine insurance; (ii) life insurance; and (iii) motor vehicle insurance. Life insurance is compulsory only for government staff; in 2007, about 600,000 such policies remained outstanding. In addition, some 10,000 life insurance policies covered nongovernment persons.

60. **The insurance monopoly operates without using actuaries to estimate risks**; the pricing of insurance services is instead administratively determined without any specialized focus on investment risk and underwriting risk. Income from policies must exclusively be invested in domestic treasury bonds, which in August 2007 yielded 10.5–11 percent.

61. **The operations of MI are subject to oversight by a special Insurance Supervisory Board under the Ministry of Finance and Revenue**. The members of this Board comprise the MI's managing director and representatives of the CBM and other government agencies. The supervision of this enterprise is not compliant with international industry standards.

62. Steps needed to modernize the sector focus on improving human capital, increasing supervision, and tightening regulations (Annex II.2).

Money and capital market

63. **The Myanmar Securities Exchange Centre (MSEC) is the only existing formal market place in the country for trading government securities and shares of listed companies**. MSEC was established in 1996 as a joint venture with equal shares between Economic Bank and Daiwa Institute of Research Limited. The explicit objective for this initiative to create and develop the securities market in Myanmar was to support marketization, privatization, and internationalization of the economy. MSEC's current activities and services include acting as an intermediary in securities trading and providing consultancy services.

64. **Progress has been slow since MSEC's operations commenced in 1997**. One reason for this has been the lack of diversified securities to be traded. For MSEC's two main agent functions—selling treasury bonds as agent for the CBM and shares of Myanmar companies as agent for those companies—only two securities each have been available for the market place. For bond trading, the supply has been limited to the three-year and five-year treasury bonds and for share trading, to two listed companies in trivial volumes.

65. **Myanmar will have much to gain from a better functioning capital market with competitive instruments**. A starting point would be to transform existing government securities in a market-friendly direction as outlined in Annex II.3.

66. **The authorities are aware that, currently, there is no active market interest in treasury bonds**. An ad hoc committee for capital markets has been set up to review, among other things, how these bonds can be made more attractive. Proposals are also expected on enhancements to bond market operations.

Technical assistance needs

67. **To achieve progress in the areas discussed in the modernization agenda above, the CBM would require technical assistance**. The authorities are keenly aware of the fact that without considerable external support, progress will be slow given the lack of technical capacity. Such assistance could be sought among central banks and international technical assistance providers.

ANNEX II.1

Myanmar: Recommendations for Payment Systems Modernization

- **Establish a separate Payment Systems Department in the CBM** dedicated to managing policy issues, oversight, and operations of the payment systems, with the added responsibility of modernizing the payment systems infrastructure.

- **Undertake a study of a nationwide payment system through a cost/benefit analysis as the first step toward the sequenced introduction of such a system**. It should ascertain whether the current value and volumes of the payment system justify the eventual introduction of an automated clearing house.

- **Cooperate closely with the banking system in modernizing the payment systems**. In the near term, an action plan should be prepared for upgrading existing payment routines.

- **Make an assessment of the information technology needs of the CBM** taking into consideration the account structure and the integration of core functions of a central bank, including payment systems, monetary policy implementation, currency management, and foreign reserves management.

- **The CBM should take the initiative to introduce a modernized payment system infrastructure**. It is recommended that this work follow a step-by-step approach by:

  (i) reviewing the legal framework for the CBM to license, regulate, and oversee payment systems;
  (ii) setting up a National Payments Council, with representation from major stakeholders in the payment systems;
  (iii) establishing a physical place at the CBM's Yangon office for, initially, paper-based clearing; and
  (iv) encouraging a reliable electronic communications network with the banks and moving toward electronic clearing and settlement at the CBM.

ANNEX II.2

Myanmar: Recommendations for Insurance Sector Modernization

- **Follow recent international insurance developments**. By maintaining a domestic monopoly, Myanmar has been in relative isolation with respect to the dynamic developments taking place internationally in insurance. The policyholders and the economy at large would benefit from this new know-how. An immediate objective should be to hire or train actuaries for current operations.

- **Strengthen insurance supervision**. A professional supervisory authority for insurance, independent of the central bank and government, should replace the current formal oversight. The new supervision should focus more on investment risk and underwriting risk. Moreover, during the last decade, as a result of wide international cooperation work has focused on formulating a global code with Core Principles for the supervision of the insurance industry. This code, adopted by the International Association of Insurance Supervisors (IAIS), reflects international best practices. The supervision of the insurance business in Myanmar would benefit from adopting the IAIS Core Principles.

- **Allow wider insurance market entry**. If new firms knowing the trade were permitted to engage in insurance business, the increased competition would provide a wider range of specialized services to the market, thus, underpinning economic growth. Although this should include foreign participation, it is critical that insurance supervision be dramatically enhanced before wider access to the Myanmar market is allowed for new competent actors.

ANNEX II.3

Myanmar: Recommendations for Money and Capital Market Modernization

Transforming treasury bills into a liquid security. These are currently used merely for short-term funding of budget deficits at a fixed interest rate of 4 percent with the CBM as the only buyer. Instead:

- **Replace the current use of treasury bills with an overdraft facility from the CBM**.

- **Use treasury bills, in the future, as market-based instruments for monetary policy**. With a market-oriented return possibly determined through an auction, a powerful instrument would exist providing short-term liquidity, which would benefit the development of a money market in Myanmar.

Transforming treasury bonds into a marketable security.

- **Provide more competitive rates of return**. In the short term, the interest rate on treasury-bonds should be raised above the level of the deposit rate determined by CBM instruction. This will give the banking system a more interesting asset for wider use.

- **Increase the number of treasury bond maturities**. Based on market demand, consideration could be given to issuing, at the appropriate time, on the short end, a 1-year bond and, on the long end, a 10-year bond. Over time, this could facilitate providing a market-based yield curve.

- **Broaden the investor categories**. If it is a priority to encourage demand from private individuals, consideration could be given to arrangements that would provide tax exemption or sell treasury bonds at a discount in the primary market through an auction system.

- **Enhance the market influence**. By determining either the volume of treasury bonds offered or the interest rate, a degree of market flexibility would be added to the issuing process. Over time, this could move in the direction of a fully market-based return on bonds.