AMRO Annual Consultation Report

Myanmar– 2019

The ASEAN+3 Macroeconomic Research Office (AMRO)

October 2019

Acknowledgements

1. This Annual Consultation Report on Myanmar has been prepared in accordance with the functions of AMRO to monitor, assess and report its members' macroeconomic status and financial soundness and to identify the relevant risks and vulnerabilities, and assist them in the timely formulation of policy recommendations to mitigate such risks (Article 3(a) and (b) of AMRO Agreement).

2. This Report is drafted on the basis of the Annual Consultation Visit of AMRO to Myanmar from 18-27 June 2019 (Article 5 (b) of AMRO Agreement). The AMRO Mission team was headed by Dr. Jae Young Lee, Group Head and Lead Economist. Other members included Dr. Xianguo Huang (Country Economist for Myanmar), Mr. Paolo Hernando (Senior Economist and Back-up Economist for Myanmar), Ms. Diana del Rosario (Back-up Economist), Dr. Zhiwen Jiao (Sector Specialist), Ms. Pyae Nandar Aung (Associate) and Ms. Nyaung Tai (Associate). AMRO Director Mr. Toshinori Doi and Chief Economist Dr. Hoe Ee Khor also participated in key policy meetings with the authorities. This AMRO Annual Consultation Report on Myanmar for 2019 was prepared by Dr. Lee, Dr. Huang, Mr. Hernando, Ms. Rosario, Dr. Jiao, Ms. Pyae Nandar Aung and Ms. Nyaung Tai. This report was peer-reviewed by Dr. Chaipat Poonpatpibul (Group Head and Lead Economist) and Dr. Jade Vichyanond (Economist); and approved by Dr. Khor.

3. The analysis in this Report is based on information available up to 23 August 2019.

4. By making any designation of or reference to a particular territory or geographical area, or by using the term "member" or "country" in this Report, AMRO does not intend to make any judgments as to the legal or other status of any territory or area.

5. On behalf of AMRO, the Mission team wishes to thank the Myanmar authorities for their comments on this Report, as well as their excellent meeting arrangements and hospitality during our visit.

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Executive Summary

1. **Myanmar's economy slowed during the six-month transition fiscal year, from April to September 2018 (FY18), due to subdued agricultural production, slower manufacturing expansion, and weak government spending.** Growth moderated to 6.5 percent in FY18 from 6.8 percent in FY17/18. With the reform momentum picking up, the economy is projected to grow at 6.8 percent in FY18/19 and 7.1 percent in FY19/20.

2. **Inflation has remained volatile with inflation rising recently on account of supply side shocks.** Inflation rose from 4.0 percent in FY17/18 to 7.1 percent in FY18 interim, owing to the effects of flooding and exchange rate depreciation. In 2019, inflation increased further from 6.1 percent in January to 9.5 percent in June due to rising food prices and tax increases on tobacco and alcoholic drinks. Inflation is forecast to increase to around 8.8 percent in FY18/19 and 9.0 percent in FY19/20, driven by the base effects of exchange rate and electricity price adjustments.

3. **The external position improved in the last few quarters on the back of a narrower trade deficit and the gradual recovery in FDI.** The current account is expected to have improved in H1 2019, with a sharper slowdown in imports than exports. The Myanmar kyat has been relatively stable, moving in the range of 1500-1550 kyat per U.S. dollar in the first eight months of 2019. In tandem, international reserves increased to USD5.8 billion as of April 2019, equivalent to 3.5 months of imports. Gross external public debt remains low, and estimated at around 15 percent of GDP as of end-FY18/19.

4. **Domestic credit growth has moderated under the stricter regulatory regime, while foreign bank lending has accelerated on account of an expansion in its lending scope.** Credit growth slowed to 18.2 percent yoy in November 2018 from 22.1 percent a year ago. Reserve money growth has moderated while broad money growth has been stable, consistent with the reserve money-targeting framework. The financial market is deepening with more activity in the interbank market and more non-bank players.

5. **Fiscal revenue in FY18/19 is expected to increase only modestly with sluggish performance in tax collection and low energy prices, while fiscal expenditure is expected to increase further driven by infrastructure and social spending.** The fiscal deficit is budgeted to rise significantly to around 6.0 percent of GDP in FY18/19, financed by external funding and the issuance of government securities. On this front, the rapid development of the government bond market over the past few years has helped to reduce the need for financing by the Central Bank of Myanmar (CBM).

6. **Risks to growth stem mainly from continued ethnic tensions in the Rakhine State and uncertainties in the global economy related to trade protectionism, geopolitical risks, and energy prices.** The protracted ethnic tensions in Rakhine State are expected to continue to have a dampening effect on investor sentiment, in particular, of Western investors. It may also pose difficulties for the authorities in maintaining preferential trade arrangements and sustaining access to Official Development Aid (ODA) funding.

7. **Myanmar's economy could suffer from weaker demand from China as a result of the US-China trade conflict**. However, the US-China trade conflict could also accelerate the relocation of manufacturing—especially labor-intensive industries—to Myanmar, thereby boosting investment inflows. Myanmar can use this time window to attract more investment. However, it needs to improve the business environment and upgrade its hard infrastructure.

8. **The weak banking system is a key vulnerability in the economy, as it is still transitioning to the more stringent banking regulatory framework under Basel II.**

9. **Sustaining reform momentum with timely implementation remains challenging.** Reform momentum has picked up with a series of new policy actions in FY18/19. Investor optimism has been rising with renewed reform. However, if such momentum is not sustained, it will result in lower growth than in the baseline in FY18/19, and also drag down medium-term growth prospects. The recent increase in electricity tariff—which is expected to alleviate the fiscal burden—could also exert short-term pressure on both inflation and growth.

10. **Strengthening the tax revenue system is essential in providing a stable and adequate source of funding for the development of the country.** The recent strengthening of the debt management framework provides the authorities with greater flexibility in tapping on both domestic and external financing to boost fiscal spending for long-term development while phasing out CBM financing.

11. **The implementation of the reserve money-targeting framework is commendable, as is the increased flexibility in interest rates.** With further development of the financial markets, the gradual liberalization of interest rates should enhance policy effectiveness in the medium term, but further liberalization should proceed cautiously. The CBM should also continue to let the exchange rate move flexibly in line with market forces and continue to build up its holdings of international reserves in order to strengthen its capacity to manage external shocks.

12. **Improving the soundness of the banking system requires further strengthening of the CBM's regulatory and supervisory capacity.** At the same time, leveraging on foreign capital and expertise to modernize the financial system through various partnerships is commendable. Ongoing reforms of state-owned banks should continue, although medium-term rehabilitation is needed to minimize the risk to financial stability and fiscal sustainability.

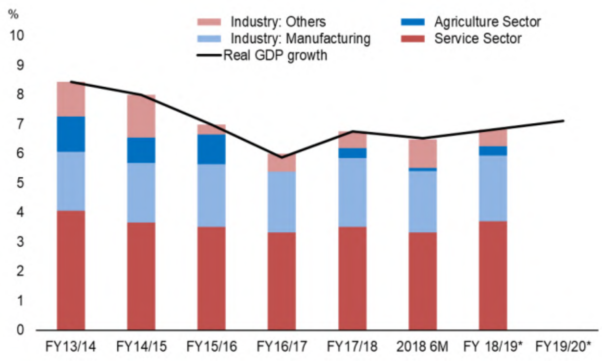
13. **We welcome the launch of the Myanmar Sustainable Development Plan (MSDP) as an expression of the nation's long-term development vision for the period 2018-2030.** There is an urgent need to address infrastructure bottlenecks and human resource constraints to achieve private sector-led economic growth and raise growth potential. While reforms have gained renewed momentum, enhancing public service capacity to implement these new policies is essential.

A. Recent Developments and Outlook

A.1 Real Sector Developments and Outlook

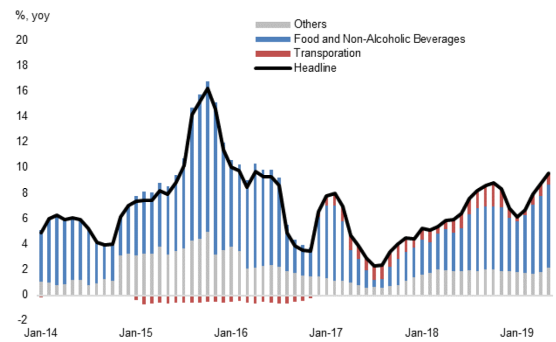
1. **Myanmar's economy slowed in the six-month interim FY18[1] due to subdued agricultural production, slower manufacturing expansion and weak government spending.** Growth moderated to 6.5 percent in FY18 from 6.8 percent in FY17/18. The moderation in growth was mainly due to subdued agricultural production resulting from natural disasters, and slower manufacturing and trade activities owing to higher input costs associated with the weaker exchange rate. During the six-month transition period to the new fiscal year, sluggish government expenditure also weighed on growth. FDI inflows, meanwhile, were dampened by the wait-and-see sentiments among foreign investors over ethnic tensions in the Rakhine State.

Figure 1. Real GDP Growth (Production)



Note: FY18/19 and FY19/20 are rebased with FY15/16.
Source: Ministry of Planning and Finance (MoPF)

Figure 2. CPI Inflation and Contributions



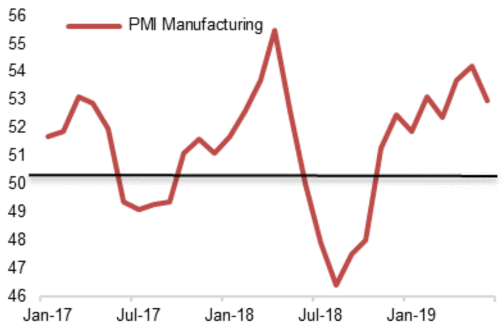
Source: Central Statistical Organization (CSO)

2. **Inflation has been volatile mainly driven by supply-side factors, with inflation rising significantly recently.** Inflation rose from 4.0 percent in FY17/18 to 7.1 percent in FY18, owing to the effects of flooding and exchange rate depreciation. Towards the end of 2018 through early 2019, inflation declined as the exchange rate stabilized and flood effects faded. More recently, price pressures have resumed with inflation increasing from 6.1 percent in January to 9.6 percent in May 2019, largely due to higher food and oil prices. There are considerable price pressures, especially in some segments of the services sector such as health, education, and recreation. While some of the price hikes are related to the tax adjustment specified in the 2018-2019 Union Tax Law, demand factors such as a rising number of formal workers thanks to the booming garment sector, and spending by fast-rising tourists, could also have contributed. More recently, the new electricity tariffs, effective since July 2019, would likely to have a significant impact on headline inflation from August 2019 onwards.[2]

[1] The interim year FY18 refers to the period from April to September 2018, and the new fiscal year starts from October 2018.
[2] The hike in electricity tariffs for both residential and commercial users started on 1 July 2019 and the pricing structure has become more progressive. For instance, for households with an average consumption of 100kw and 200kw, the payment will increase by 73 percent and 134 percent, respectively. Although the direct weightage of electricity in the CPI basket is 2.34 percent, the impact could be channeled significantly through other components indirectly. On the other hand, the rapidly rising electricity bill could also dampen demand through the disposable income channel. In our view, the former could outweigh the latter, leading to higher inflationary pressure in FY19/20. i

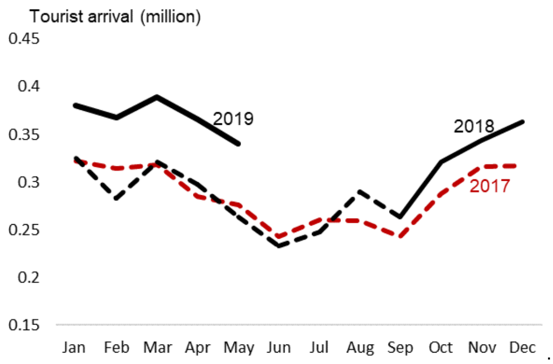
3. **High-frequency monthly indicators point to a recovery in real economic activities.** PMI readings show a solid expansion in manufacturing activities since November 2018 after the setback during the summer, supported by employment and future output index. While the growth in fabric imports continued to be robust, the domestic production of garment fabric has also been rising since Q4 2018, encouraged by continued strong garment exports. Rebounding from the previous year's low base, FDI approvals in the first nine months of FY18/19 increased by 60 percent. On the service front, while detailed retail data are not available, tourism-related services could be on the upside with the continuing recovery in tourist arrivals starting from the second half of 2018. Tourist arrivals grew 24 percent in the first seven months of FY18/19 with support from Asian tourists, especially from China, Korea and Japan. U.S. tourist arrivals have also grown mildly while arrivals from Europe declined.

Figure 3.PMI



Note: Values above 50 indicate expanding activity, and vice-versa.
Source: Nikkei/ IHS Market

Figure 4. Tourist Arrivals



Source: CSO

4. **Going forward, Myanmar's economy is projected to grow at 6.8 percent in FY18/19 and 7.1 percent and FY19/20**. **Inflation is forecast to increase to 8.8 percent in FY18/19 and reach around 9.0 percent[3] in FY19/20.** The economic recovery will be supported by improving business sentiments amid renewed reform momentum, strong growth in garment and other manufacturing products, expansion of tourism-related services, and stronger fiscal spending. Following the sharp slowdown in FDI project approvals in 2018, the downward trend has been contained and approvals rebounded significantly in 2019. Although the progress in phasing out CBM direct financing of the fiscal deficit has helped to reduce the risk of monetary financing, medium-term inflation could remain high due to supply side factors, including the trend of exchange rate depreciation.

A.2 External Sector and the Balance of Payments

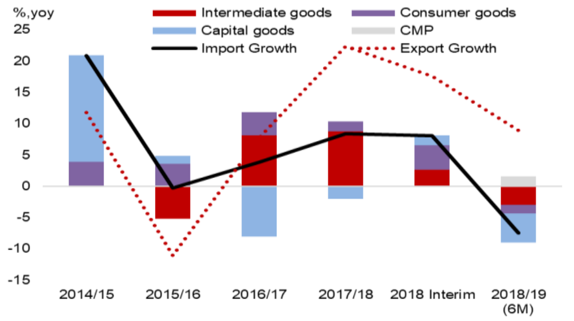
5. **The external position has improved in the last few quarters on the back of a narrower trade deficit and a gradual recovery in FDI**. According to data available up to the end of 2018, the current account deficit improved as a result of the booming garment sector. In the same period, the trade deficit remained sizable with imports and exports growing slower than in the previous year. The current account is likely to have continued

[3] The forecasts take the first round effects of hikes in electricity tariff into account but not second-round effects. Excluding the effects of hikes in electricity tariff, the estimated inflation in FY18/19 is at 8.1 percent and to stabilize at 6.5 percent, respectively.

improving in H1 2019 with a sharper slowdown in imports than in exports, as shown in the higher-frequency customs trade data, which recorded a USD1.2 billion goods deficit, USD0.7 billion less than that in the same period in 2018. Such contraction in imports—reflecting ongoing import substitution and control of used car imports[4]—even as exports continued to expand on the back of strong garment shipments. The service account surplus likely improved with the rapid increase in tourist arrivals over the past half year. Likewise, FDI inflows have recovered somewhat owing to improving investor sentiment resulting from the rebound in FDI approvals.

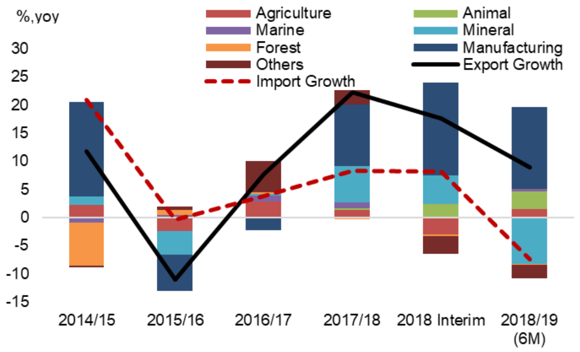
6. **The exchange rate has stabilized since late 2018, and international reserves have increased gradually.** The kyat had depreciated sharply against U.S. dollar in line with other regional currencies and exacerbated by a higher trade deficit between Q2 and Q3 2018. Since October 2018, the kyat has stabilized in the range of 1500-1600 kyat per dollar.[5] Exchange rate stability provided a window of opportunity for international reserves accumulation, which rose from USD5.3 billion in September 2018 to USD5.8 billion in April 2019. Starting from January 2019, domestic banks have been allowed to use the Chinese yuan and Japanese yen for international payments and trade settlements, which will facilitate bilateral trades and also contribute to greater repatriation of export proceeds through the banking system going forward.

Figure 5. Imports



Source: CBM, AMRO staff estimates

Figure 6. Exports



Source: CBM, AMRO staff calculations

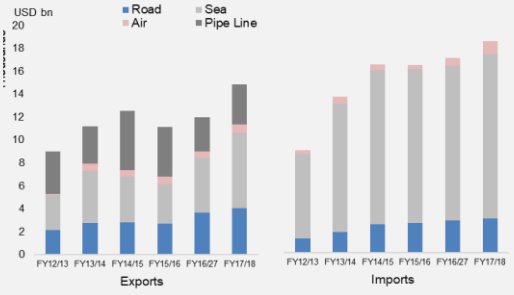
7. **External public debt is low and remains contained.** Gross external public debt remains low, and it has not been growing as a percentage of GDP due to increasing repayments and slow Official Development Aid (ODA) disbursements. It is estimated at around 15.2 percent of GDP as of end-FY18/19 and comprised largely of medium- and long-term debt at concessional interest rates. The debt service ratio is estimated at 2.9 percent of exports of goods and services.

[4] Myanmar started to restrict used car imports starting in 2017, with stronger enforcement in 2018. The restrictions tightened further in January 2019, allowing the import of only left-hand drive vehicles and used cars produced from 2016 onwards.
[5] According to CBM's calculation, the real exchange rate depreciation of Kyat was 1.9 percent yoy as of April 2019, compared to 8.2 percent in nominal exchange rate depreciation.

Box A. Estimating Myanmar Trade Using Sectoral Mirror Data

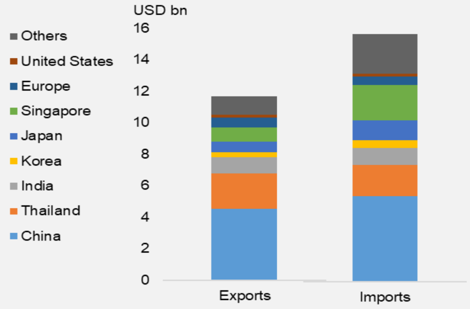
Myanmar's international trade has been growing rapidly since the opening up of its markets, in tandem with its GDP. According to official statistics, Myanmar's nominal GDP grew at an average of 11.8 percent per annum between FY12/13 to FY17/18. During this period, export and import growth were at 9.0 percent and 14.1 percent per annum, respectively. Export and import figures increased from USD9 billion and USD9.1 billion to USD14.8 billion and USD18.7 billion, respectively. Trade with neighboring China and Thailand collectively accounted for 60.6 of all exports and 47.1 percent of imports in 2016. On account of export diversification and a changing import structure, Myanmar has also been trading with other economies such as Japan, South Korea, the E.U. and the U.S.. With regards to major exports, gas exports to China and Thailand by pipeline is one of the major export items. More recently, booming garment exports have surpassed energy exports in value, making the garment sector the largest contributor to exports since FY17/18. Imports have also been growing rapidly across the board.

Figure A1: Myanmar Exports and Imports



Source: CSO

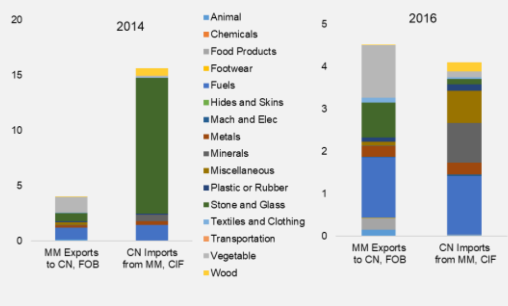
Figure A2: Trade by Country (2016)



Source: WITS

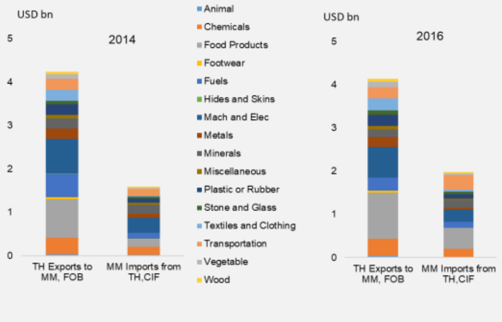
While the official trade statistics have been improving and capturing more trade activities, various factors could have hampered the improvement. As also experienced in other countries, the deviation of official data from actual trade could be due to factors such as smuggling, trade restrictions and bans, under-invoicing or misclassification of goods to avoid taxes, and weak administrative capacity in data compilation. In the case of Myanmar, trade restrictions on certain items, arising from national concerns and international agreements, such as timber, jade, and rare animals, could cause such trade to go through informal channels. Under-invoicing, especially for big value items, is also a common practice to avoid taxes, leading to differences in trade statistics between exporting and importing countries after the adjustment in shipping costs, insurance, and other transactions costs.

Figure A3: Myanmar's Exports to China



Source: WITS

Figure A4: Myanmar's Imports from Thailand



Source: WITS

Various approaches have been used by trade experts to better understand the size of actual trade. Direct methods such as checking against mirrored data of trading partners, surveys and border checkpoints monitoring,[6] and indirect approaches such as Multiple Indicators Multiple Causes Model and currency demand, among others, have been used to study informal trade and the informal economy. Given that all these methods have their pros and cons, the choice of method depends on

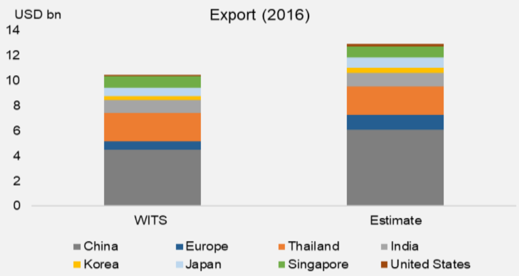
[6] Nkendah et al. (2014) use a monitoring method of cross-border flows of informal trade between Cameroon and its CEMAC neighbours; Ackello-Ogutu (2016) examine methodologies for estimating informal cross-border trade in Eastern and Southern Africa.

the availability of relevant data, the legitimacy of assumptions, and the resources needed to conduct the studies.

Among these approaches, sectoral mirror estimates based on more disaggregated data and on judgment could assist in better understanding of trade statistics. Considering the potential drawbacks that the aggregated import and export data could lose the information available at a disaggregated level, such a method examines the mirror data of key trade partner countries at a sector level. We compared the statistics of both reporting countries and data of trading partner countries available from the World Integrated Trade Solution (WITS)[7]. Both imports and exports can be broken down into 14 detailed types of commodities. Some assumptions are needed in the interpretation of results, including whether there is a motivation for over-reporting and whether the goods are correctly classified. Taking Myanmar's export data to China and China's import data from Myanmar as an example, there was a substantial divergence between these two data sets in 2014, but it was somewhat reduced in 2016. The examination of the details of export items suggests that either unrecorded informal trade or misclassification still prevailed in 2016. Taking another example, Myanmar's imports from Thailand reported in Myanmar were significantly lower than what was recorded as exports by Thailand to Myanmar.

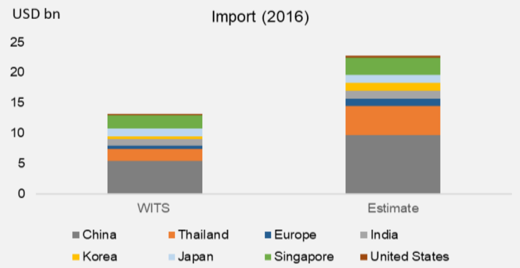
There could be a sizable underestimation of the size of trade, particularly of imports, as suggested by mirror data. Given certain assumptions[8], a significant difference in trading value and volume between two countries reflects informal trade on one side. Examining such bilateral information based on more disaggregated categories of goods provides more insights into the size of trade. By comparing Myanmar's data with those recorded by the top eight trading partners of Myanmar, the comparison suggests that Myanmar's trade data could be significantly underestimated, in terms of both exports and imports. On the export side, significant discrepancies with two neighboring countries—China and Europe—are largely caused by products such as mining products and garments exports. For instance, the adjusted export value could reach USD13 billion as compared to the reported export value of USD10.5 billion in 2016. On imports, the value of imports from most trading partners could be much higher than recorded, reflecting the practice of undervaluation–USD13.2 billion in recorded imports by WITS compared to an estimated value of USD22.7 billion after adjustment.

Figure A5: Adjustment of Myanmar's Exports



Source: WITS and AMRO staff estimates

Figure A6: Adjustment of Myanmar's Imports



Source: WITS and AMRO staff estimates

Myanmar could manage its imports better not only to strengthen tax revenue but also help address macro imbalances in the economy. Officially recorded imports—if significantly less than actual imports—suggest a substantial revenue loss which constrains the fiscal space. The smaller size of recorded imports may also lead to an inaccurate assessment of the current accounts situation and policy conclusion. To address the problem, improving the capacity and administrative procedure in customs is critical. In addition, reducing certain trade restrictions could also help to reduce informal trade.

A.3 Monetary Condition and Financial Sector

8. **The banking sector is in transition to comply with a stricter set of banking regulations under Basel II.** To implement the clauses specified in the Financial Institutions Law 2016, CBM announced a series of regulations in July 2017 related to capital, loan

[7] The WITS data is compiled by the World Bank and United Nations Conference on Trade and Development (UNCTAD).
[8] It assumes (a) there is no motivation for over-reporting in either side of trading counterpart countries;(b) goods classification for both sides of trade is largely correct; 3) CIF term is 15 percent more the value of FOB term.

exposure, reclassification and recovery of overdraft loans (Table 1). In the past two years, banks have been making efforts to comply with the new regulations and they have been strengthening their balance sheets to meet the timelines for compliance. Moving forward, efforts are directed towards addressing nonperforming assets by enhancing the capital buffers and loan provisioning, while upgrading the banking sector's capacity in risk management. In addition, CBM has announced five new directives related to governance issues in March 2019, including those on fit and proper criteria, directors of banks, external auditors of banks, related parties and acquisition of substantial interest.

Table 1. New Regulatory Framework

Regulation	Content	Effective Date
Capital Adequacy Ratio (CAR)	Minimum Tier-1 and regulatory CAR are 4 and 8 percent respectively	6 January 2018
Liquidity Ratio	20 percent of assets in cash (or cash-equivalents)	7 July 2017
Large Exposure	Single borrower is capped at 20 percent of capital	7 July 2017
Non-performing Loans (NPL) and Provisioning	Reclassification with shorter-due date and more provision needed	6 January 2018
Overdraft Exposure	Reducing to 50/30/20 percent of loan portfolio	6 July of 2018, 2019, 2020 respectively

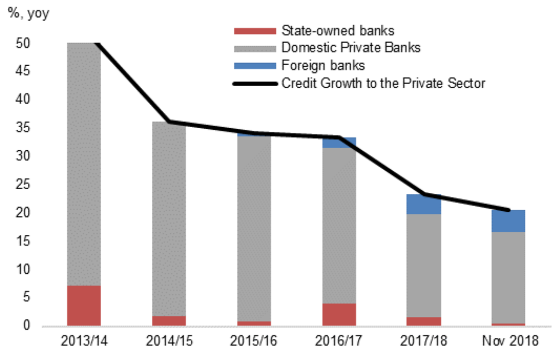
Source: CBM

9. **Under the stricter regulatory regime, overall domestic credit growth has moderated while foreign bank lending has accelerated on account of an expansion in lending activities.** Credit growth continued to slow to 18.2 percent in November 2018 from 22.1 percent a year ago and over 30 percent in previous years. Faster credit growth among foreign banks resulting from an expanded business scope as allowed by CBM, has partly offset the slower credit growth by domestic banks. Loans extended by foreign bank branches accounted for 6.1 percent of outstanding credit to the private sector as of November 2018, up from 3.5 percent a year ago. Reforms aimed at moving the banking system to higher regulatory standards are largely on track, although a few individual banks are still trying to comply with the new regulations.

10. **Reserve money growth has moderated while broad money growth has remained stable, consistent with the reserve money-targeting framework.** The CBM's financing of the fiscal deficit was reduced to zero in interim FY18 from 25 percent in FY17/18, reflecting a smaller fiscal deficit and a more active bond issuance program. As a result, reserve money grew more slowly at 4.6 percent in FY18 compared to 6.0 percent in FY17/18. During the same two periods, the growth rates of broad money were 18.6 and 18.0 percent, respectively. The growth rates of monetary aggregates are well within the targets set by CBM's monetary policy framework, which sets ceilings for reserve and broad money growth—16 percent and 23 percent—in FY17/18 and similar annualized rates in FY18. In

FY18/19, the ceilings for reserve and broad money growth rates were set at 11 percent and 21 percent, respectively.[9]

Figure 7. Credit Growth to Private Sector



Source: CBM

Figure 8. Capital Asset Ratio (Private Banks)

Source: CBM

11. **The property market is still sluggish, with some positive signs of recovery in a few segments.** The supply overhang in the higher-end residential market continues to put downward pressure on price and dampens construction activities. For example, there is an imbalance in the upscale residential developments in Yangon where supply exceeds demand. On the flip side, however, there is a shortage of smaller-size and affordable housing catering to the low- to middle-income segment in Yangon. The supply overhang is also apparent in the high-end hotel segment which has low occupancy rates. On the other hand, retail markets are performing well with a strong demand for retail space, especially in shopping malls with food and beverage spaces, as well as entertainment facilities.

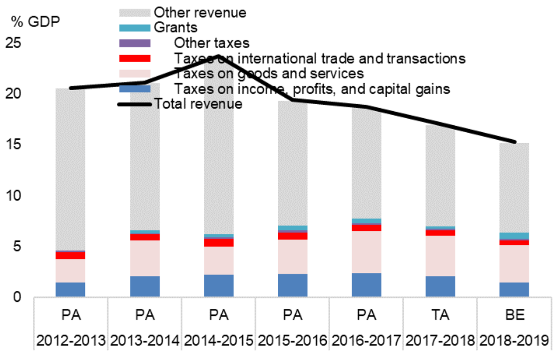
A.4 Fiscal Sector

12. **In the interim FY18, the fiscal deficit was reduced due to better-than-budgeted revenue and lower capital spending in the transitional six months.** There was a six-month interim fiscal year between April to September 2018 in the transition from old FY to the new FY starting in October. The transition of the fiscal year was accompanied by low capital expenditure due to difficulty in disbursing funds within the shorter half-year period. On the other hand, revenue collection was better than what the budget had estimated, largely due to bigger contributions from State Economic Enterprises (SEE), which benefitted from temporally recovering energy prices at the time.[10]

13. **In the new FY18/19, the fiscal deficit is budgeted to rise to 6.0 percent in support of economic growth and structural reform.** On the fiscal revenue front, total revenue and grants are estimated to be 15.3 percent of GDP, lower than the 17.0 percent in FY17/18, as a result of declining tax revenue and SEE proceedings as a percentage of GDP. The major contributor to tax revenue—taxes on goods and services—is expected to decline further in FY18/19. That said, the recent passing of the tax administration and procedure law has been encouraging, in support of medium- to long- term revenue mobilization.

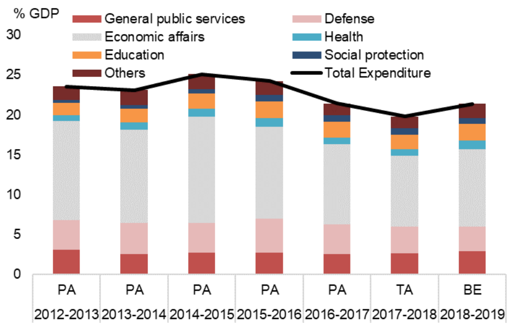
[9] In November 2018, reserves money growth rebounded to 7.6 percent, supported by increased claims on the central government and further accumulation of foreign reserves, while broad money growth softened to 16.0 percent.
[10] Due to seasonal factors, GDP during April-September was less than 35 percent of the whole year. The revenue and expenditure as of GDP during FY18 were not compared to other full-year fiscal year. In comparison to the original budget, the realized revenue and expenditure were 112.5 percent and 94.8 percent respectively.

Figure 9. Fiscal Revenue (Public Sector)



Source: MoPF

Figure 10. Fiscal Expenditure (Public Sector)

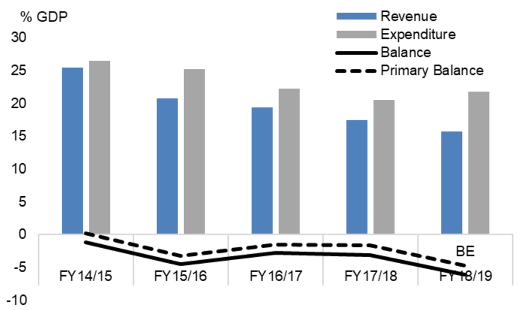


Source: MoPF

14. **The budgeted fiscal expenditure is mainly targeted at enhancing needed infrastructure and social services.** Compared to FY17/18, the government intends to boost both capital and current spending in areas such as electricity generation and transmission, education and health. Based on disbursements in the first six months of FY18/19, the capacity of line ministries to spend remains limited and some infrastructure projects could take longer to start, which will likely affect the overall disbursement rate for the whole fiscal year.

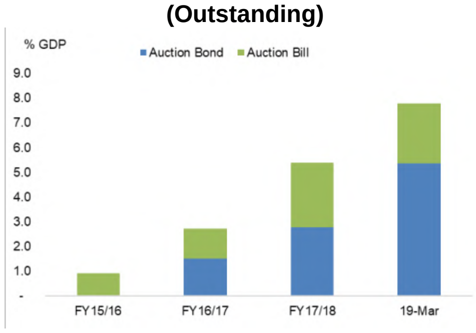
15. **The higher fiscal deficit is to be financed through increased bond issuance and external ODA funding, and public debt as a percentage to GDP is expected to rise to around 38.1 percent in this fiscal year.** While the fiscal deficit is budgeted to rise significantly to around 6.0 percent in FY18/19, the actual deficit could be around 3.7 percent in light of lower-than-expected expenditure disbursement. The fiscal deficit will be financed through external borrowing and the issuance of government securities, likely with longer maturities. The rapid development of the government bond market over the past few years has helped reduce reliance on CBM direct financing.

Figure 11. Public Sector's Fiscal Position



Source: MoPF

Figure 12. Government Securities (Outstanding)



Source: MoPF

B. Risks, Vulnerabilities and Challenges

16. **Our baseline for FY18/19 and FY19/20 economic growth projects a resumption of growth momentum after a temporary slowdown caused by domestic and external factors.** However, the higher growth trajectory is subject to both short-term risks and uncertainties, and the need to address vulnerabilities and long-term challenges. Over the short term, these include

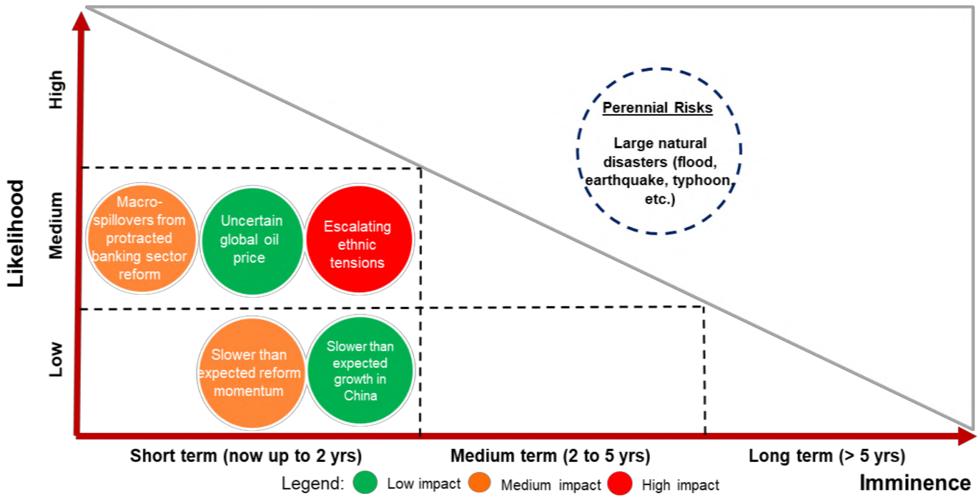
the continuing ethnic tensions in Rakhine State, escalating global trade and geopolitical tensions, the impact of electricity tariff hikes on the macro landscape, and managing a weak domestic banking system. Over the medium-term, the key challenges relate to upgrading infrastructure and maintaining reform momentum.

B.1 Near-term Risks to the Macro Outlook

17. **Risks to growth stem mainly from continued ethnic tensions in Rakhine State and uncertainties in the global economy related to trade protectionism, geopolitical risks, and energy prices.** The protracted impact of Rakhine crisis is expected to continue having a dampening effect on investor sentiments, in particular, of Western investors. Meanwhile, the resumption of insurgent operations in Rakhine State over the past few months has led to renewed instability, although the impact remains relatively localized so far. If not managed well, such recurring incidents could weigh negatively on the economy through weak investor confidence and slower tourist arrivals. It may also increase difficulties for the authorities in maintaining preferential trade arrangements and sustaining access to ODA funding.

18. **The recent hikes in electricity tariffs, while helping to address the fiscal burden and the demand and supply imbalance, could also exert pressure on both growth and inflation.** As the increase in electricity tariffs is quite large, inflation could rise sharply starting from August 2019 when electricity bills for July are received by households and businesses. At the same time, it could also dampen household consumption and lead to lower demand for goods and services.

Figure 13. Risk Map



Source: AMRO

19. **While a sharp slowdown in China—possibly caused by escalating US-China trade conflicts—may weaken Myanmar's growth, the direct impact of the trade conflicts on Myanmar's economy may be limited.** Myanmar's major export items include gas and agricultural products (to China) and garments (to the E.U.), and these items are not directly

linked to the global value chain that is susceptible to the ongoing trade conflicts between the U.S. and China. Nevertheless, Myanmar's economy could suffer from weaker demand from China should the bilateral conflict lead to a slowdown in the Chinese economy. On the flip side, however, the trade conflicts could accelerate the relocation of manufacturing—especially labor-intensive industries—to Myanmar, thereby boosting investment inflows. Myanmar could use this time window to attract more investment, depending on how fast it can improve the business environment and upgrade its hard infrastructure.

20. **Risks to inflation are related to global energy prices, a weaker exchange rate, and weather related supply shocks, which could also weigh on economic growth to some extent.** Supply-side factors continue to have a major impact on inflation in Myanmar, especially those affecting food prices which account for more than half of the CPI basket. As a result, weather conditions and recurring natural disasters have been key drivers of inflation volatility.[11] As Myanmar relies on imports of refined oils and other consumer goods, global oil prices and exchange rate movements are directly correlated with inflation. Should the headline inflation spikes due to the changes in electricity tariffs, it could also affect the inflation expectation.

21. **The weak banking system—still in transition to comply with a more stringent banking regulatory framework—remains a key vulnerability.** The transition requires banks to restructure their balance sheets in order to comply with the higher standards—it entails moving away from the current dominance of overdraft facilities to a more term-loan based asset portfolio. Overall, the banks' capital buffer remains low, and they do not have relevant tools and facilities for effectively managing liquidity. The NPL ratio has increased sharply due to the new stricter NPL classification standards[12]. The bulk of NPLs was incurred during a period of high credit growth, under a weaker regulatory regime.

B.2 Longer-term Challenges

22. **The lack of basic hard and soft infrastructure remains the key bottleneck to sustaining high economic growth over the medium to long term.** Infrastructure and logistics gaps constrain export competitiveness in the manufacturing sector. In this regard, upgrading the infrastructure for electricity, transportation and telecommunications, is critical to boosting the potential growth of the economy. In particular, insufficient and unreliable electricity supply has hindered the development of industries across sectors in the economy and reduced overall productivity. The recent adjustments in tariffs could help moderate demand while reducing the fiscal loss. Meanwhile, supply remains a key challenge that must be addressed. Meanwhile, building and upgrading basic infrastructure, enhancing human capital for digital skills, and encouraging entrepreneurship, are also critical, especially in leveraging digital technologies for development.

23. **Sustaining the reform momentum with timely implementation remains challenging.** Reform momentum has resumed with a series of new policy actions in

[11] The impact of natural disasters on GDP loss could also be significant.
[12] Under new regulations in line with international standards, the doubtful loan—classified as overdue loans more than 90 days but less than 180 days—is also classified as NPL together with those overdue for more than 180 days.

FY18/19. As a result, investor optimism has been rising with the renewed reform. However, if the reform momentum is not sustained, it will result in lower growth than the baseline in FY18/19, and also drag down medium-term growth prospects.

Authorities' Views

24. **The authorities broadly agreed with the risk assessments and longer-term structural challenges presented by AMRO.** The authorities recognize the risks related to ethnic tensions in Rakhine State and its potential impact on the economy both directly and indirectly. Inflation continues to be driven by supply shocks, exchange rate movements, and oil prices, and it is not clear whether demand factors have also been contributing to inflation. The challenges in revamping the banking sector remain significant, especially in further enhancing capital buffer and disposing of non-performing loans. However, progress made over the past two years is in the right direction, addressing the sector's vulnerabilities and aiming for healthy, long-term growth. Over the medium term, the young demographics, potential domestic market, and strategic geographic location will continue to give Myanmar comparative advantages, amidst improving hard and soft infrastructure.

C. Policy Discussions and Recommendations

25. We commend the authorities' initiatives in launching the MSDP and subsequent policies based on the plan, which has helped the government strengthen reform momentum.[13] The MSDP will help align the government's policies in achieving stronger and more inclusive growth in the longer term.

C.1 Prioritizing Fiscal Spending and Strengthening the Fiscal Position

26. **Strengthening the tax revenue system is essential in providing a stable and adequate source of funding for the development of the country, and that should continue to be a top priority in fiscal policy.** Myanmar has one of the lowest tax revenue-to-GDP ratios in the region. To increase tax collection against declining resource revenues, more efforts are required to expand the tax base and simplify and ease the process to pay taxes, particularly by leveraging on information technology and tax auditing. The authorities' efforts towards implementing an integrated tax administration system and e-payment services are commendable and should be enhanced further. Moving forward, the government could consider a shift towards greater reliance on indirect taxes such as VAT, which has proven effective in increasing tax revenue in other countries. In tandem with that, the number of staff in revenue departments should be increased, and their capacity strengthened to realize the potential of higher revenue.

27. **SEE reform needs to be prioritized to reduce the fiscal burden on the government**. The fall in natural gas revenue, rising costs from inefficient SEEs and increasing subsidies, particularly to the power sector, have resulted in a reversal of SEE

[13] The MSDP was published in August 2018 to achieve the development of a peaceful, prosperous and democratic Myanmar. The plan is elaborated under three pillars with five goals. The three pillars are peace and stability, prosperity and partnership, and people and planet. The goals include a) peace and national reconciliation, security and good governance; b) economic stability and strengthened macroeconomic management; c) job creation and private sector led growth; d) human resources and social development for a 21st century society; and e) natural resources and the environment for national prosperity.

contribution to the overall fiscal accounts since FY15/16. In this context, the recent announcement of tariff adjustments effective in July 2019 is a welcome development. This will eliminate the need for the government to subsidize the direct cost of producing electricity, enabling more resources to be used for the expansion and improvement of electricity supply. [See Annex 1: ***Reform of Electricity Sector in Myanmar*** for more details]. Moving forward, improving the overall efficiency and governance of SEEs, particularly those in the power sector, is essential to further reduce their drag on the fiscal accounts.

28. **While continuing to prioritize much-needed infrastructure and social services spending, the government should further strengthen capacity to spend efficiently and effectively.** Limited administrative capacity calls for better planning and prioritization, focusing on rolling out key projects with large economic and social impacts such as in education, health, power and logistics. In this regard, the launch of the Project Bank is commendable, as it facilitates the alignment of proposed and ongoing projects with the MSDP. Continuing to emphasize transparency and efficiency for public spending remains essential. For instance, in the education segment, both the number of schools and teachers, as well as the quality of education, should be further increased. The government needs to provide the workforce with skills needed for the future economy and vitalize the education sector, working closely with the private sector. Building the budgeting process to allow for multi-year funding could further boost the implementation and efficiency of public investment as a whole.

29. **In light of the strengthening of the debt management framework, the authorities are better able to tap on both domestic and external financing to boost fiscal spending for long-term development, while phasing out CBM financing.** The rising demand for government securities has allowed the CBM to adhere to its deficit financing ceiling. In tandem with the development of market-based financing, CBM financing of the fiscal deficit should be phased out by 2020, as planned. On the other hand, the external debt—accounting for 15.0 percent of GDP as of March 2019—remains low with an average remaining maturity of around 16 years and an average interest rate about 1.6 percent. With enhanced capacity for effective and efficient spending, it is recommended that Myanmar should take advantage of favorable ODA financing terms to boost public investment to address infrastructure gaps such as in electricity, transportation, education and health.

Authorities' Views

30. **The authorities highlighted that the improved legal framework could help strengthen tax administration, while the Project Bank can be a useful tool to enhance efficiency to implement priority projects.** The new Tax Administration Procedures Law is aimed at streamlining the tax administration procedure and reducing legal barriers in revenue collection, which could enhance tax revenue collection. On the other hand, to enhance the disbursement rate, the line ministries' implementation capacity should be

improved. The operation of Project Bank could help enhance capacity in matching and screening projects, aligning projects with development goals.

C.2 Enhancing Monetary Policy Framework

31. **The implementation of reserve money-targeting framework is commendable and the increase in flexibility of interest rates is a good start to enhancing monetary policy transmission channel.** The reserve money-targeting framework has helped CBM contain the monetization of fiscal deficit, thereby contributing to greater monetary and financial discipline and reduction of macroeconomic imbalances. The recent introduction of multi-tiered lending rate ceilings has provided more room for the market to better price risks and adjust capital. However, this may still be inadequate for banks to compensate for the whole spectrum of risks and develop a rigorous risk management system.

32. **While there is no need at this time for a monetary policy response to the recent hike in headline inflation after the one-off electricity tariff adjustment, the central bank should be ready to take measures to contain second-round effects from the higher input prices.** The rising inflation has been mainly due to the base effects of the energy prices and the exchange rate, and recently driven by the increase in electricity tariffs starting from August 2019. While these are mainly temporary factors, CBM should work closely with other government agencies to ensure that the price increases do not significantly feed into wages and other prices which would make the inflation more persistent.

33. **With further development of the financial markets, the gradual liberalization of interest rates should enhance policy effectiveness in the medium term, but further liberalization should proceed cautiously.** Further development of the interbank market, money markets and the government securities market, would deepen the markets and improve their price discovery function. Over time, interest rates could be liberalized further. However, the liberalization should be gradual as hasty deregulation without appropriate safeguards can be destabilizing. Capacity building is critical for a smooth and successful deregulation process. It is recommended that the authorities prepare a roadmap and take gradual and measured steps in pushing forward necessary reforms.

Authorities' Views

34. **The authorities broadly agreed with AMRO's policy recommendations and highlighted that the development of market infrastructure would facilitate open market operations and the conduct of monetary policy.** While continuing to adhere to the current quantitative framework of monetary policy, the CBM has been actively using auctions for the liquidity management of local banks, and is also considering new liquidity facilities to help foreign banks obtain better access to local currency funding.

C.3 Enhancing Financial Stability

35. **Improving the soundness of the banking system requires the strengthening of the CBM's regulatory and supervisory capacity.** CBM's regulations to enhance capital and liquidity buffers, contain loan exposures to single customers, and to implement stricter

asset classification and provisioning, are essential for increasing transparency, pushing banks' to adopt modern banking practices, and ensuring the soundness of the banking system. These measures have likewise strengthened the CBM's reputation as a regulator and supervisor. We welcome CBM's close coordination with individual banks in implementing the new regulatory regime and taking measures to improve corporate governance.

36. **Leveraging foreign expertise to modernize the financial system through various partnerships is commendable.** On the recapitalization of the banks, while relying on existing shareholders to inject new capital to meet the capital requirements, the regulators could also encourage local banks to seek foreign investors who are interested in acquiring an equity stake in the local banks. Meanwhile, broadening foreign banks' lending scope and opening up the insurance sector would also help to develop financial services. Permitting foreign insurance companies will not only help enhance knowledge-sharing among local players, but will also improve market efficiency through competition. Moreover, the demand for government securities will increase with more insurance companies starting business in Myanmar.

37. **The authorities are encouraged to continue with efforts to develop the financial sector.** The creation of a credit bureau and further relaxation of restrictions on the scope of foreign banks' business have considerable potential in enhancing banks' risk management and broadening access to financing in the country. We also welcome existing efforts to upgrade the financial infrastructure for payments and settlements to address operational inefficiencies in the banking system. Over the medium term, the requirement for banks and other domestic enterprises to adopt internationally-recognized standards in financial reporting—targeted by FY22/23—and auditing, would be essential to the continued opening of the financial sector. This would be in the areas of insurance and the broader scope of foreign banks. Doing so would further increase Myanmar enterprises' access to financing and insurance protection. Likewise, the liberalization of the insurance and banking industry—alongside a broader liberalization of the financial sector, including strengthened corporate governance—will develop the country's capital markets for savings mobilization. Meanwhile, on developing the financial and other economic sectors, leveraging the benefits from digitalization to possibly reap late-mover advantages should be prioritized. [See Box A: ***Leveraging Digitalization in the Development of Myanmar's Economy*** for more details].

38. **The continuation of ongoing reforms of state-owned banks is highly encouraged, although medium-term rehabilitation is needed to minimize risks to financial stability and fiscal sustainability.** It is encouraging that state-owned banks are pursuing internal reforms to keep up with their private sector counterparts such as by broadening and digitalizing their banking services, increasing their paid-up capital and building staff capacity, among others. However, the reforms should ultimately be geared towards aligning the mandates of the state banks with the country's development priorities. In addition, the financial soundness of SOBs must be strengthened so that risks to the financial system and fiscal position are minimized. On this front, reforms would entail a

consolidation of state-owned banks to eliminate areas of overlap and address operational inefficiencies [See Annex 2: ***Transforming State-owned Banks as Effective Agents of Economic Development*** for more details].

Authorities' Views

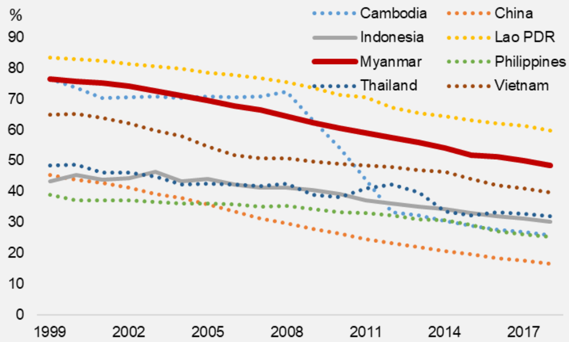
39. **The authorities are cautious over further liberalization, as the banking sector is still in transition.** While the banking sector has been improving with the enhanced regulatory framework, it needs more time to strengthen its balance sheets, particularly its capital and liquidity buffers. In this context, pushing forward further reform measures should depend on how resilient the banking sector is.

Box B. Leveraging Digitalization in the Development of Myanmar's Economy

Myanmar has been undergoing a rapid economic transformation where services and manufacturing sectors have attracted more investments and contributing more to economic growth. As a result, the manufacturing and services have been able to attract more labor from the agriculture sector over the past two decades, which has seen its share of the workforce fall from 76.6 percent in 1999 to 48.3 percent in 2018. Such a shift in employment from the primary sector to the secondary and tertiary sectors has enhanced factor productivity and has helped to spur economic growth.

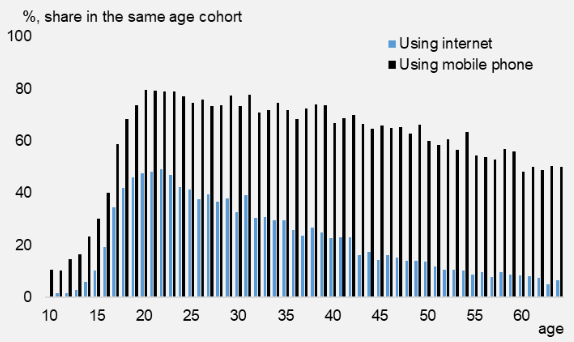
The changing landscape in the global manufacturing sector requires Myanmar to be more forward-looking in its development process. Manufacturing is being transformed by the new digital technologies through robotics, automation, and artificial intelligence. The changes are affecting not only technologically advanced and capital intensive industries but also labor-intensive ones in many countries. Industries such as garments, for example, have been undergoing restructuring, replacing labor with automation. As a result, the time window for less developed countries to follow the traditional growth path by leveraging their comparative advantages in cheap labor through developing labor-intensive sectors is now shorter. In the case of Myanmar, the garment sector has been growing rapidly over the past four years, becoming the biggest exporter and the largest employer of labor. While enjoying the benefits of fast-growing labor-intensive sector, Myanmar needs to make more efforts on upskilling its labor force and preparing its workforce for the more skill-intensive and capital intensive industries.

Figure B1. Agricultural Labor as a Share of Total Employment



ote: agriculture incl. forestry and fishing
Source: World Bank

Figure B2. Mobile and Internet Users by Age (Percentage of Population)



Source: CSO

The non-manufacturing sector could be as heavily impacted by digital transformation as the manufacturing sector. Besides jobs related to manufacturing, other jobs in areas such as food services, transportation, construction, and agriculture could also be vulnerable to automation. The rapid adoption of the latest digital technologies such as mobile banking, lending and e-commerce platforms in Myanmar, have shown that the country can catch up on these fronts, with enormous benefits. There are various areas where this can make a difference—for example, agriculture and tourism. The lack of access to credit and the low level of agro-literacy have led to low productivity in agriculture, and these areas could be enhanced with digital services that can reduce the cost of machinery rentals and microloans. Similarly, the tourism sector, which is now becoming more important as a source of foreign exchange earnings for Myanmar, can also benefit from digital technologies, such as online advertising and customized services through apps. Finally, there is a critical role for digitization in transforming public services and optimizing policies and program designs, enhancing efficiencies such as in tax payment and communications.

In this context, the rapid development of the telecom sector over the past few years has been a key enabler in developing the digital economy. Myanmar has witnessed a fast-growing mobile telecom sector, catalyzed by market-based reform in 2013 which attracted foreign investors and encouraged competition. As a result, the price of a SIM card dropped dramatically between 2013 and 2015 by 99 percent. Mobile phone penetration has been increased sharply since then, especially in the smartphone segment. By end 2018, Myanmar's four mobile network operators have a combined user base of over 27.5 million unique mobile subscribers, and the 4G penetration rate in the country has been rising sharply, reaching above 80 percent of the population on average. According to the Myanmar Living Conditions Survey 2017, 67 percent of the population nationwide lived in households owning at least one smartphone. In urban areas, more than 93 percent of phone users choose to own smartphones, illustrating how the country has leapfrogged in adopting latest technologies.

That said, Myanmar needs to do much more before it can reap the benefits of a new wave of digitalization. While ICT infrastructure and services have jump-started with the fiber-optic network and international bandwidth has growing impressively from a low base, Myanmar is still lagging behind across a broader range of ICT infrastructure and services. For instance, data centers and big data, cloud services, and Internet of things are still at a nascent stage. Higher rates of entrepreneurship and investment are needed to expand e-commerce, mobile payments, financing and smart logistics, all of which are an integral part of the digital economy. Globally, most developed countries are upgrading to 5G, which could potentially have a large impact on manufacturing and service activities. Myanmar should also consider investing in the infrastructure for the 5G technology.

There are broader constraints in soft infrastructure that must be addressed soon in order to grab opportunities and meet challenges arising from digital technologies. While hard ICT infrastructure can be improved significantly by opening up to foreign investment, soft infrastructure such as the availability of talents, especially with digital skills, may take more time. Myanmar lags in the overall human capital index, and the country is ranked 107 globally. The younger generation—which is the primary adopter of digital technology in Myanmar—still lacks opportunities to equip itself with digital skillsets to compete effectively in the new era. At the same time, regulatory and business environments need further development. The formation of the Digital Economy Development Committee and rolling out the digital economy roadmap are helpful in synergizing the efforts in developing the economy. The committee will also help in leading action plans towards this.

While addressing the constraints in hard and soft infrastructure to speed up digital transformation is important, mitigating risks associated with digital disruption is critical too. While digital technologies are changing the business environment and improving economic efficiency, they also bring a set of risks such as implementation, governance, third-party and security risks. Differing across business models, such risks require continuous efforts in training human talent, applying more secure and sophisticated software and hardware, designing better regulatory measures, and strengthening oversight.

C.4 Maintaining External Stability

40. **The central bank should continue to allow the exchange rate to move flexibly, in line with market forces.** We support the central bank's use of the average market rates for setting the reference rate. This will allow the exchange rate to adjust in a timely manner to reflect the market demand and supply.

41. **The further accumulation of international reserves will help strengthen the CBM's capacity to manage external shocks.** Although increased somewhat, Myanmar's holding of international reserves remains relatively low, compared to regional peers. Continued growth in export-oriented industries, tourism and an improved investment environment will help in raising foreign exchange inflows and help the central bank in building up reserves. We encourage the central bank to continue building up its foreign reserves by opportunistically intervening in the FX market.

C.5 Advancing Structural and Institutional Reforms

42. **We welcome the launch of the MSDP as an expression of the nation's long-term development vision for the period 2018-2030.** The MSDP provides a framework for coordination and cooperation among government agencies towards achieving a stronger and more inclusive growth; however, implementation is key to its success. Peace and reconciliation will need to progress further under the framework of federal decentralization and national unity. This will help sustain political stability and enhance governance. Continuing to advance peace and strengthening the rule of law will be fundamental to economic development.

43. **There is an urgent need to address infrastructure bottlenecks and human resource constraints to achieve private sector-led economic growth and to raise growth potential.** The government's campaign to achieve a 100 percent electrification rate nationwide is commendable. However, more concrete efforts are needed to increase supply in a timely manner. In addition, reducing logistics costs is crucial to attracting foreign direct investment and improving Myanmar's external position over the medium term. Meanwhile, more skilled labor is needed to facilitate the development of higher value-added industries.

44. **While reforms have gained renewed momentum, enhancing public service capacity to implement these new policies is essential.** Such reform dynamism should continue in tandem with improving public service capacity, contributing to growth prospects and enhancing investor confidence in the medium term.

C.6 Enhancing Data Adequacy

45. **The progress in official data compilation and dissemination has been remarkable and should continue.** The authorities have taken remarkable strides in making data publicly available. Further improvement in the quality, timeliness and comprehensiveness of data, especially in the compilation and dissemination of quarterly

macro-financial data, is needed in monitoring economic developments as well as assessing risks and vulnerabilities using the ERPD Matrix framework.

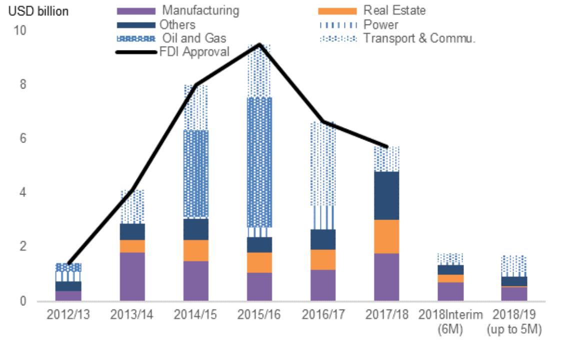
46. **Further improvement in data adequacy is required to enhance economic assessment.** Detailed quarterly GDP statistics are not available, and the production index and production price index are still unreported. In the fiscal sector, government financial statistics could improve further, especially those relating to external debt.

Appendices

Selected Figures for Major Economic Indicators

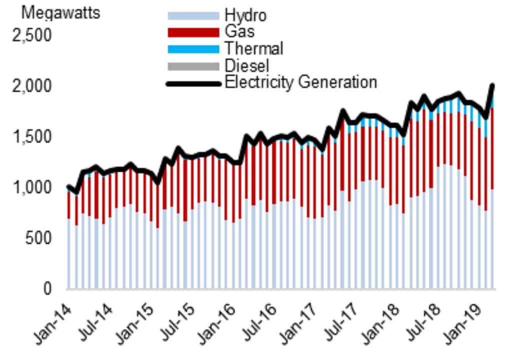
Figure 1.1. Real Sector

FDI approvals in the first five months of the new fiscal year 2018/19 increased.



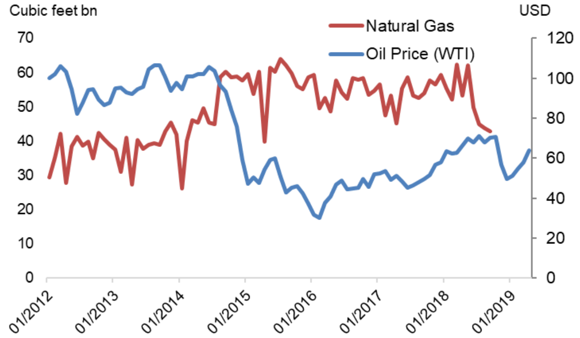
Note: 2018 refers to a special half-year interim fiscal budget from April to September 2018.
Source: Directorate of Investment and Company Administration (DICA)

Although increasing, electricity demand is far greater than supply.



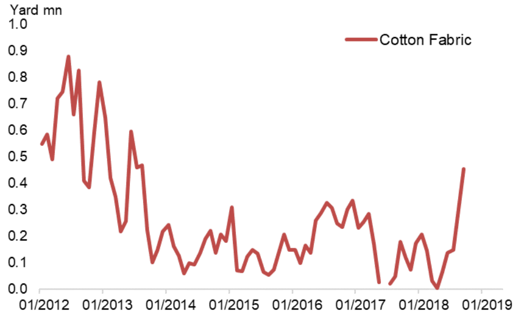
Source: CSO

Gas production has peaked and it will take time to start new production sites.



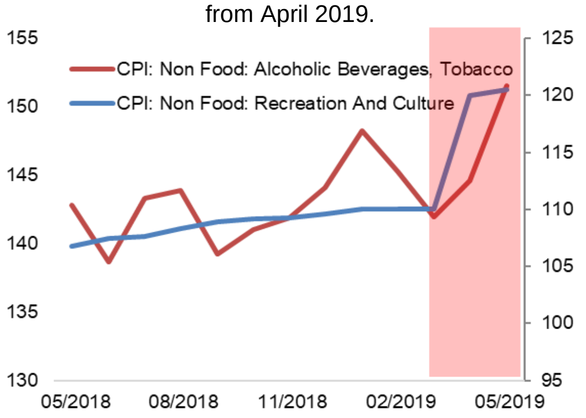
Source: MoPF and CEIC

With a fast-growing garment sector, domestic cotton fabric production has been recovering to compliment fabric imports.



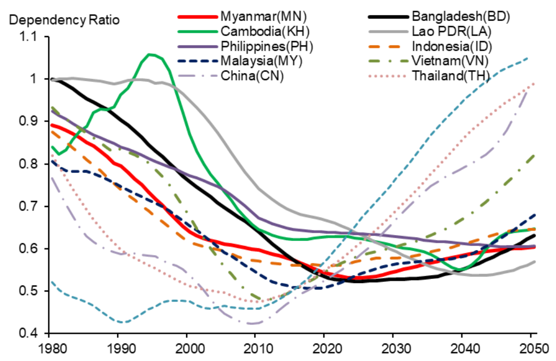
Source:MoPF

The adjustment of tax rates according to 2018-2019 Union Tax Law has led to price hikes in certain items from April 2019.



Source: CSO

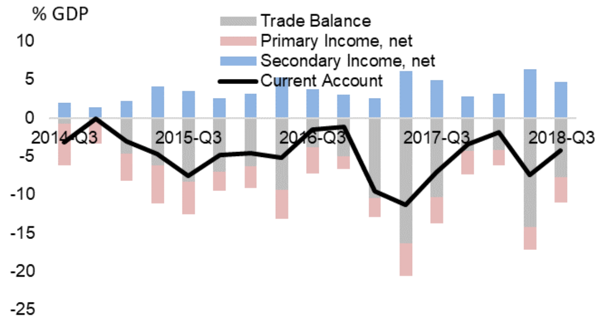
Myanmar is still enjoying the premium from its demographic structure. The dependency ratio will start to rise but remain at a low level.



Source: CSO

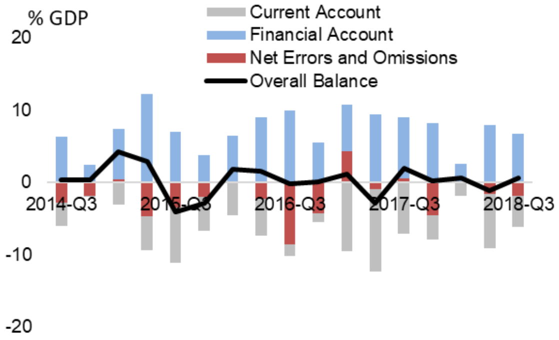
Figure 1.2 External Sector

BOP data, which was available up to Q3 2018, suggests the current deficit was mainly driven by changes in the trade deficit.



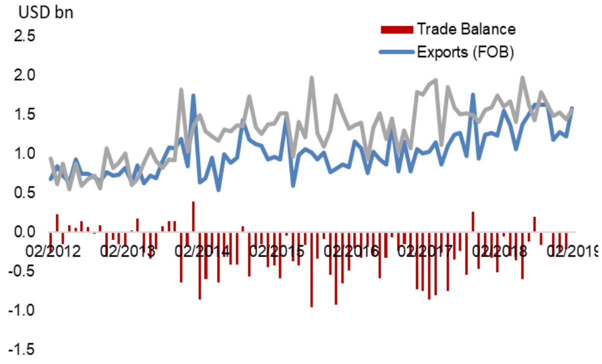
Source: CBM

The overall balance has been slightly in surplus on account of inflows to the financial account.



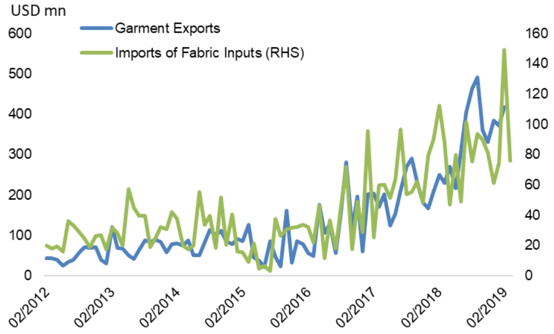
Source: CSO, AMRO staff estimates

Monthly custom data show that the trade deficit improved with slowing imports.



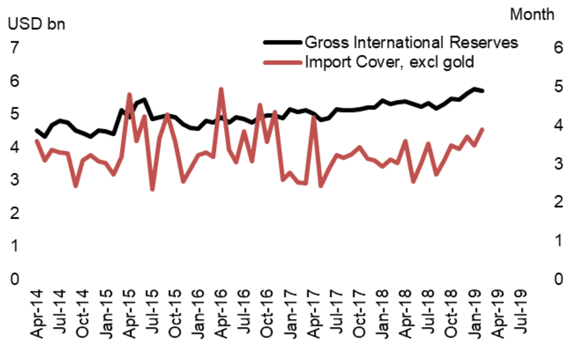
Source: CSO

The garment sector has become the biggest export sector, for which the import of fabric input has been substantial.



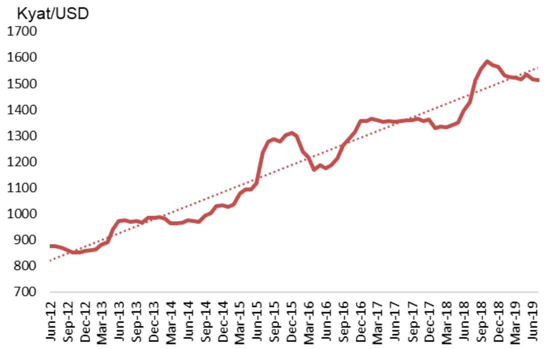
Source: MoPF

International reserves have been increasing somewhat since Q4 2018.



Note: Import cover is in months of imports of goods & services
Source: CBM

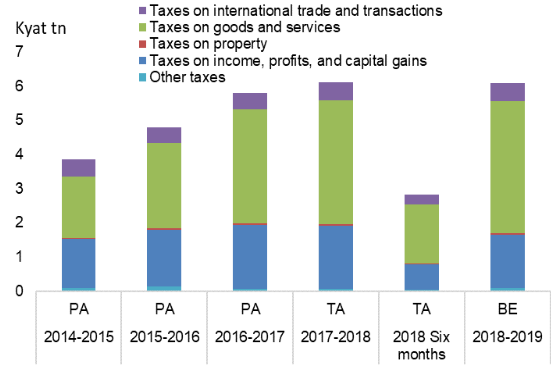
Although still on a depreciating trend, the Kyat has started stabilizing since Q3 2018.



Source: CBM, AMRO staff calculations

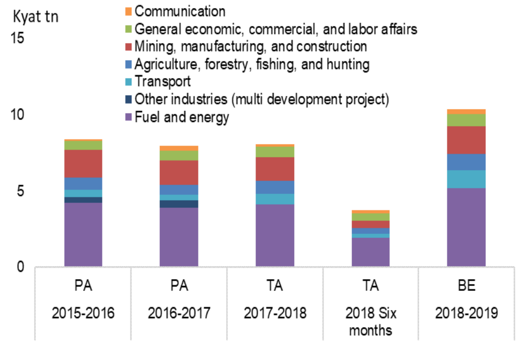
Figure 1. 3 Fiscal Sector

Taxes on goods and services, the main drivers of revenue growth during FY14/15-FY17/18, is expected to grow slow in FY18/19.



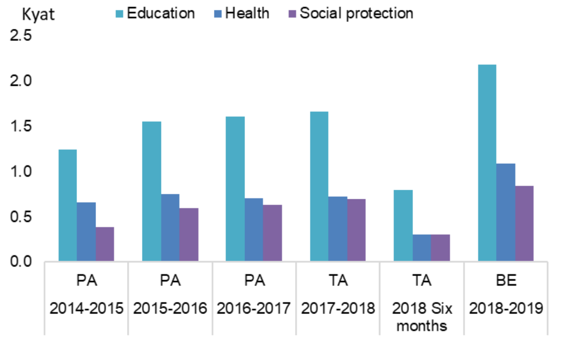
Note: PE,TA and BE stand for provisional actual, tentative actual and original budget estimates.
Source: MoPF

With regards to spending in economic affairs, the energy sector is expected to get the largest share of spending.



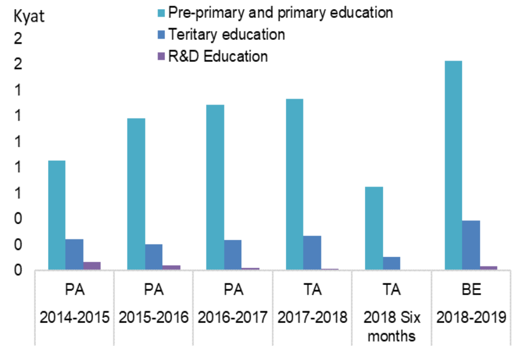
Source: MoPF

Expenditure in social spending areas such as education and health is also budgeted to increase sharply.



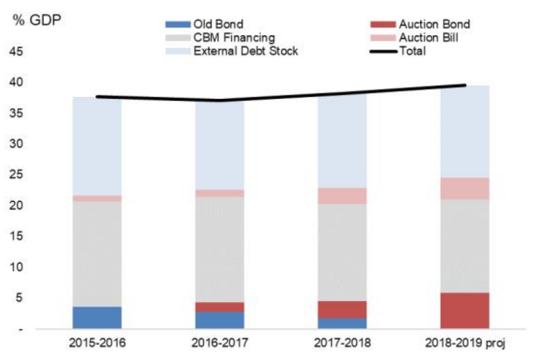
Source: MoPF

Education spending is expected to be enhanced in FY18/19.



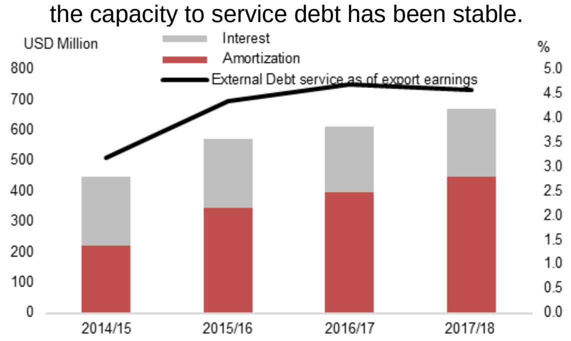
Source: MoPF

Public debt will rise with more budgeted spending, supported by an increase in government securities.



Source: MoPF

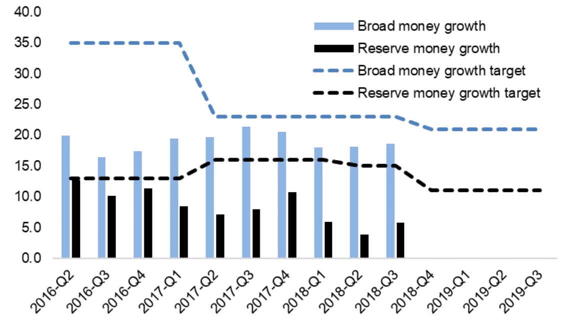
External debt service is on a rising trend in value, but the capacity to service debt has been stable.



Source: MoPF

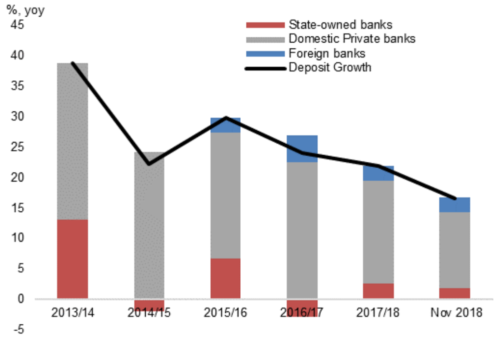
Figure 1. 4. Monetary and Financial Sectors

Broad money growth was stable while reserve money growth slowed during FY18 (Q2-Q3, 2018).



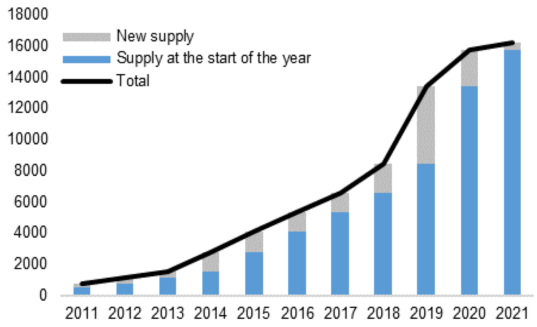
Source: CBM

The slowdown in deposit growth has been mainly owing to domestic private banks.



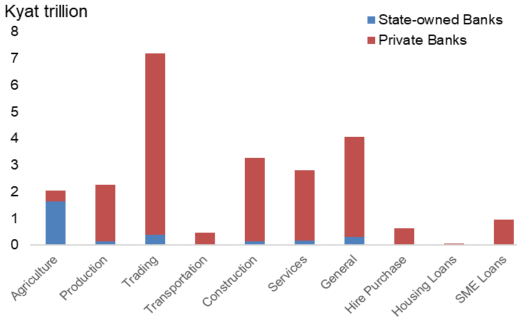
Source: CBM

Condominium supply will increase sharply in Yangon during 2019 and 2020, subject to the expectation of market demand and construction delays.



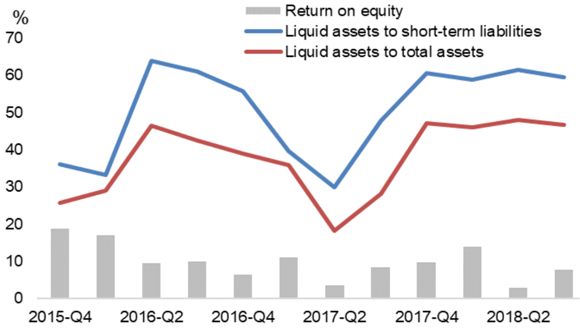
Source: Colliers International

Bank loans from state and private banks to the domestic private sector remained low at 26.0 percent of GDP as of Q3 2018.



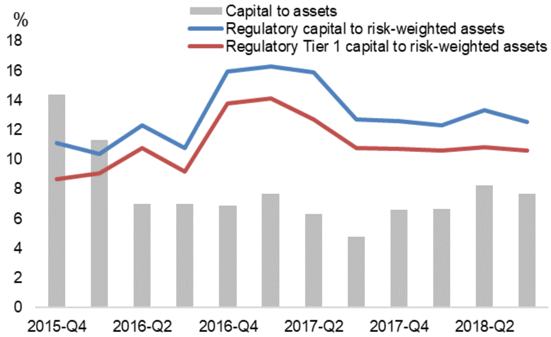
Source: CBM

The overall liquidity ratio improved upon the implementation of the new regulatory framework.



Source: CBM

The capital buffer of the banking system has remained thin, although it has stabilized somewhat.



Source: CBM

Selected Economic Indicators for Myanmar

	2015/16	2016/17	2017/18	2018 Int*	2018/19* Proj.	2019/20* Proj.
Real sector and prices	(in annual percentage change)					
Real GDP	7.0	5.9	6.8	6.5	6.8	7.1
CPI (2012=100, period average)	10.0	6.8	4.0	7.1	8.8	9.0
CPI (2012=100, end-period)	8.4	7.0	5.4	8.6	13.2	4.8
Balance of payments	(in millions of USD, unless specified)					
Trade balance	-4048	-4409	-4696	-2448	-4580	-6030
Current account balance	-3090	-2736	-3120	-1309	-2106	-3141
in percent of GDP	-5.2	-4.3	-4.7	-5.6	-3.1	-4.2
Financial account	-3897	-4532	-4405	-1687	-3483	-3892
Direct investment (net)	3443	3260	3589	820	3089	3398
ODA (net)	444	-35	225	126	370	393
Gross international reserves	4764	5134	5366	5303	6080	6231
In months of imports	3.5	3.8	3.5	3.3	3.6	3.2
Fiscal sector	(in percent of GDP)					
Revenue and grants	19.4	18.7	17.0	24.1	15.6	16.0
Tax revenue	6.6	7.3	6.7	8.5	6.0	6.1
Expenditure	23.7	21.3	19.7	25.6	19.3	19.5
Net acquisition of nonfinancial assets	8.0	6.5	6.0	6.7	6.9	6.9
Fiscal balance	-4.3	-2.5	-2.7	-1.5	-3.7	-3.5
Primary balance	-3.2	-1.2	-1.3	0.7	-2.3	-2.1
Public debt	38.1	35.6	38.4	37.7	37.1	38.6
External	16.7	13.4	15.4	14.1	14.9	14.2
Monetary and financial sector	(in annual percentage change, end-period, unless specified)					
Domestic credit	31.3	25.4	20.2	21.4	19.7	21.7
Private sector	34.2	33.4	23.4	21.2	18.0	17.8
Reserve Money	22.8	8.8	6.0	4.6	7.0	8.0
Broad money	26.4	19.4	18.0	18.6	17.3	17.5
Loan-to-deposit ratio	70.6	69.2	70.0	-	-	-
Memorandum items:						
Exchange rate (kyat per US$, average)	1222	1261	1356	1414	-	-
Exchange rate (kyat per US$, end of period)	1216	1362	1335	1560	-	-
Nominal GDP (in billions of USD)	59.5	63.2	66.7	23.2	69.0	74.5
Nominal GDP (in billions of Kyat)	72714	79723	90451	32873	105742	119138

Notes:*2018 half-year Interim refers to April to September 2018; new full-year fiscal year starts from October to September next year
1/ Real GDP series base year during 2015/16 to 2018 Interim was 2010/11 prices and changed to 2015/16
2/ Fiscal sector refers to general government operations and non-financial state enterprises

Sources: National authorities, AMRO staff estimates

Balance of Payments

Unit: USD million	FY15/16	FY16/17	FY17/18	FY18 6M	FY18/19	FY19/20
Current Account	**-3090**	**-2736**	**-3120**	**-1309**	**-2106**	**-3141**
Goods	**-4048**	**-4409**	**-4696**	**-2448**	**-4580**	**-6030**
Exports (f.o.b)	9498	9456	10452	5490	11787	13201
Imports (f.o.b)	13546	13865	15148	7938	16367	19231
Services	**1078**	**1193**	**1072**	**618**	**1709**	**2111**
Receipts	3678	3638	4170	2356	5573	6409
Travel	2137	2146	1964	825	2271	2611
Others	1541	1493	2206	1530	3303	3798
Payments	2601	2446	3098	1738	3865	4298
Transport	1444	1389	1461	791	1462	1535
Other	1156	1057	1637	947	2402	2763
Primary Income, net	**-1986**	**-1604**	**-1987**	**-734**	**-2099**	**-2239**
Receipts	984	945	1246	673	1390	1529
Payments	2971	2548	3233	1406	3489	3768
Secondary income, net	**1867**	**2084**	**2491**	**1254**	**2864**	**3016**
Receipts	2388	2457	2739	1438	3175	3334
Payments	521	373	248	184	311	318
Capital Account	0	1	0	0	0	0
Financial Account (+ = net increase / - = net decrease)	**-3897**	**-4532**	**-4405**	**-1687**	**-3483**	**-3892**
1. Assets (+ = net increase / - = net decrease)	**-177**	**-1478**	**-154**	**-606**	**-606**	**-606**
of which: Currency and Deposits (assets)	-183	-1480	-220	-606		
2. Liabilities (+ = net increase / - = net decrease)	**3720**	**3054**	**4383**	**1081**	**4089**	**4498**
Direct investment (Liabilities)	**3443**	**3260**	**3589**	**820**	**3089**	**3398**
Other investment (Liabilities)	277	-243	792	261	1000	1100
Currency and Deposits (Liabilities)	-329	-420	122	-281	200	200
Loan (Liabilities)	706	316	673	552	800	900
of which: Government Loans (liabilities)	444	-35	225	126	370	393
Disbursements	786	366	682	349	881	925
Repayments	342	401	457	**224**	511	531
Allocation of SDRs	0	0	0	0	0	0
Net errors and omissions	-1227	-1418	-1082	-405	-600	-600
Overall Balance	-419	379	203	-27	777	151
Gross Reserves (- increase)	419	-379	-203	27	-777	-151
Memorandum Items:						
Gross reserves (in millions of U.S. dollars)	4,764	5,134	5,366	5,303	6,080	6,231
In months of imports	3.5	3.8	3.5	3.3	3.6	3.2
GDP (in millions of U.S. dollars)	72714	79723	90451	32873	105742	119138
Exchange rate (kyat per US$, average)	1222	1261	1356	1414		

Notes: FY18 6M refers to April to September 2018; new full-year fiscal year starts from October to September next year
Sources: National authorities, AMRO staff estimates

Statement of Public Sector Operations

Unit: Kyat Billion	FY15/16	FY16/17	FY17/18	FY18 6M	FY18/19 Proj	FY19/20 Proj
Revenue	**14111**	**14930**	**15394**	**7913**	**16160**	**19026**
Taxes	4788	5800	6100	2809	6378	7305
Social contributions	53	73	89	56	95	107
Grants	330	362	220	106	663	866
Other revenue	8939	8695	8986	4942	9327	10747
Expense	**11447**	**11749**	**12375**	**6209**	**14320**	**14955**
Compensation of employees	2144	2966	3130	1821	3806	4288
Use of goods and services	6125	5991	7083	3121	6803	7665
Interest	828	1043	1250	746	1509	1700
Social benefits	663	704	732	325	827	1051
Other expense	1686	1046	180	197	117	251
Net Acquisition of Nonfinancial Assets	**5809**	**5193**	**5463**	**2206**	**7343**	**8273**
Net lending / borrowing	**-3145**	**-2012**	**-2443**	**-502**	**-5503**	**-4203**
Net acquisition of financial assets	**325**	**160**	**14**	**50**	**203**	**-**
Domestic	311	152	7	50	174	-
Foreign	14	8	8	0	29	-
Net incurrence of liabilities	**3668**	**2511**	**2954**	**1715**	**1743**	**-**
Domestic	3261	2321	2728	1753	64	-
Foreign	406	191	226	-38	1679	-
Memorandum Items						
Exchange rate (Kyat per US$, period aver	1222	1261	1356	1414	1532	-
GDP in billions of Kyat dollars	72714	79723	90451	32873	105742	119138

Notes: : FY18 6M refers to April to September 2018; new full-year fiscal year starts from October to September next year
Sources: National authorities, AMRO staff estimates

Monetary Survey

Unit: Kyat Billion	FY15/16	FY16/17	FY17/18	FY18 6M	FY18/19 Proj	FY19/20 Proj
(In billions of kyat at end of period)						
Net Foreign Assets (NFA)	**9263**	**9281**	**9306**	**10841**	**11824**	**10723**
Central bank	5374	6550	6693	8010	8757	7290
Assets	5847	7016	7178	8544	9257	7800
Liabilities	473	466	485	534	500	510
Other depository corporations	3888	2731	2613	2831	3067	3433
Assets	7165	5856	5997	6158	6672	6833
Liabilities	3276	3125	3385	3327	3605	3400
Net Domestic Assets (NDA)	**26777**	**33753**	**41466**	**43640**	**52743**	**64211**
Domestic Credit	27401	34372	41322	44081	52743	64211
Net claims on central government	13198	15538	18252	18562	22739	28960
Other	14204	18834	23070	25519	30005	35251
Private Sector	13682	18254	22523	24919	29405	34651
Other items (net)	-624	-609	143	-441	0	0
Broad Money (M2)	**36040**	**43034**	**50772**	**54480**	**63880**	**75056**
Currency Outside Depository Corporations	10157	10920	11604	11504	12309	13171
Deposits	25883	32114	39168	42976	51571	61885
(in annual percentage change, end-period, unless specified)						
Net domestic assets	**30.5**	**26.0**	**22.9**	**17.8**	**20.9**	**21.7**
Domestic credit	31.3	25.4	20.2	21.4	19.7	21.7
Net claims on central government	29.5	17.7	17.5	29.4	22.5	27.4
Private Sector	34.2	33.4	23.4	16.1	18.0	17.8
Broad money	**26.4**	**19.4**	**18.0**	**18.6**	**17.3**	**17.5**
Memorandum items:						
Velocity (GDP-to-average broad money)	2.25	2.02	1.93	0.62	1.79	1.71
Broad money/GDP	0.50	0.54	0.56	0.83	0.60	0.63
Exchange rate (kyat per US$, end of period)	1222	1261	1356	1414	-	-
GDP at current price	72714	79723	90451	32873	105742	119138

Notes: FY18 6M refers to April to September 2018; new full-year FY starts from October to September next year.
Sources: National authorities, AMRO staff estimates

Data Adequacy for Surveillance Purposes: A Preliminary Assessment

Surveillance Areas	Data availability[i]	Reporting frequency/Timeliness[ii]	Data quality[iii]	Consistency[iv]	Others, if any[v]
National Account	GDP on the production side is the main approach, while the expenditure approach is not publicly available.The data has been re-based on base year FY15/16.	Disseminated on an annual basis, with a 3-6 month lag.	Coverage of the growing private sector is incomplete due to a lack of annual enterprise/ economic surveys.	Myanmar's National Account broadly follows the concepts and definitions of the *System of National Accounts 1968*.	In the medium term, they plan to adopt the *2008 SNA* with the help of the SNA team established in the Planning Department.
Balance of Payments (BOP) and External Position	Data is available.	Quarterly, with a three-quarter lag.	Gaps in some services, direct investment assets and other investment assets impact the reliability of data.	The statement of the BOP is compiled broadly according to the classification of the *BPM6.*	-
Nation (Union+ Region/ State) Budget and Government/ External Debt	The Budget Department of MoPF has disseminated Government Fiscal Data on the MoPF website since 2018 March. Monthly budget executions are not available in English.	The periodicity of data is annual, on a fiscal year basis. The budget figure is presented two months before the new fiscal year.	The data has been improved and the figures are based on Myanmar's available accounting and analytical methods.	The Budget Department of MoPF compiles Government Finance Statistics according to GFS 2014 Methodology cash basis.	The plan for future improvement is to compile the quarterly Gov-ernment Finance Statistics.
Money Supply and Credit Growth	Selected Monthly Economic Indicators are available online.	Data on monetary aggregates is available on a monthly basis with a five-month lag.	Source data comprises five sets of accounts, each one in a different format: a separate set of accounts for each of the four state-owned banks and one set for the private banks.	Money supply and credit statistics are compiled broadly in accordance with the Monetary and Financial Statistics Manual (MFSM) methodol ogy.	Revisions on past time-series are made without adequate explanation of the underlying reasons for the revisions.
Financial Sector Soundness Indicators	Some data is publicly disseminated and other data is available upon request. NPL data is not reported.	Some data with a one-year lag is available upon request.	Banking sector indicators have yet to be brought in line with international standards.	Revisions on past time-series are made without adequate explanation about the underlying reasons for the revisions.	-
State-Owned-Enterprises' Statistics	Some data is publicly disseminated and other data is available upon request.	State-owned enterprises' production (volume, value and unit price) is reported monthly and yearly by line ministries.	-	Accounts of SEEs are compiled according to internal methods.	-

Source: AMRO staff compilations. This preliminary assessment will form the "Supplementary Data Adequacy Assessment" in the ERPD Matrix.

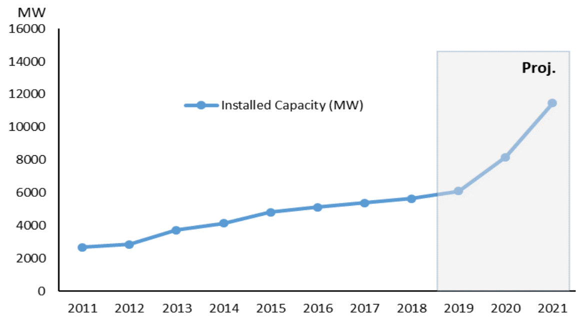
Notes:
(i) Data availability refers to whether the official data is available for public access by any means.
(ii) Reporting frequency refers to the periodicity that the available data is published. Timeliness refers to how up-to-date the published data is relative to the publication date.
(iii) Data quality refers to the accuracy and reliability of the available data given the data methodologies.
(iv) Consistency refers to both internal consistency within the data series itself and its horizontal consistency with other data series of either same or different categories.
(v) Other criteria might also apply, if relevant. Examples include, but are not limited to, potential areas of improvement for data adequacy.

Annexes: Selected Issues

Annex 1. Reform of Electricity Sector in Myanmar [14]

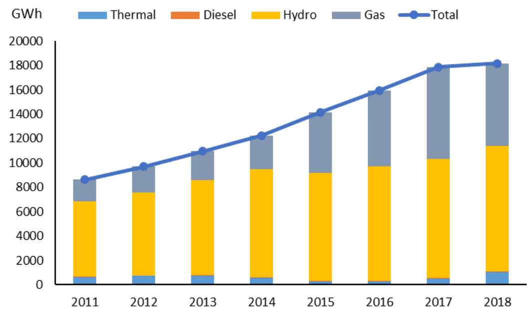
1. **Rapid economic growth in recent years amid low electricity tariff have resulted in a significant increase in electricity demand.** Since the economy opened up, electricity consumption has grown at an average of 15 percent per year for the period 2012-2018. Higher energy consumption was due in large part to the overall increase in economic activity, fueled by services, real estate and manufacturing sectors, particularly in the Yangon area, which accounted for almost half of all electricity consumption in the country. In addition, the rapid increase in electricity consumption can be attributed to expanded access to the main grid, the release of pent-up demand as incomes rose, as well as having one of the lowest electricity tariff rates in the region.[15]

Figure A1.1. Installed Capacity



Source: Ministry of Electricity and Energy (MoEE), AMRO staff estimates

Figure A1.2. Electricity Generation by Type of Fuel



Source: MoEE

2. **Electricity supply has not been able to catch up with demand, resulting in extensive power outages in Myanmar.** Although installed capacity has increased from 2,682 MW in 2010 to 5,642 MW in 2018 (Figure A1.1), electricity supply has remained insufficient and unstable. The old power plants are unable to generate electricity according to the installed capacity, with output by various government owned plants ranging from 30-70 percent of installed capacity depending on its age and maintenance. The situation is particularly severe during the dry season, in part due to the dependence of Myanmar on hydropower, which accounts for 57 percent of electricity generation (Figure A1.2).[16] During the dry season, electricity output from hydropower is reduced as the water level goes down, and this situation is aggravated by increased electricity consumption, resulting in severe electricity outages throughout the country, particularly in Yangon, which is the country's center of economic activity.[17]

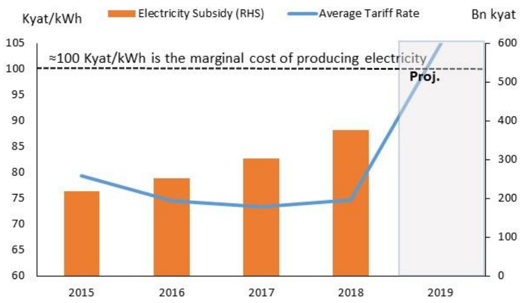
[14] Prepared by Paolo Hernando and Nyaung Tai.

[15] Prior to 2014, the household electricity tariffs was around 35 kyat per kWh (below US$0.4 per kWh) and from 2014-2018 the tariff for household electricity ranged between 35-50 kyat per kWh (around US0.2-$0.3 per kWh in 2018).

[16] The problem of over-reliance on hydropower has actually improved, with the share of hydropower falling to 57 percent in FY2017/18 from 70 percent of the energy mix in 2011/12. The energy mix shifted mainly to natural gas, which now accounts for 37 percent of the energy mix, from 22 percent in FY2011/12.

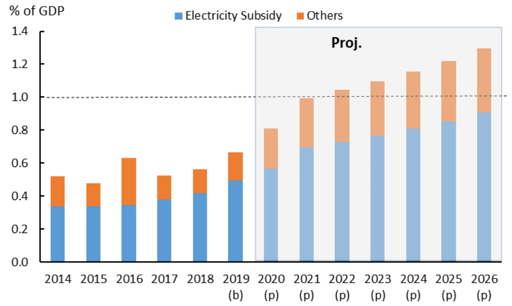
[17] Due to the high energy requirements of Yangon brought about by the dense population and presence of more high-rise buildings, rolling blackouts are instituted during the hot summer months, and were particularly severe from April to June 2019 with up to 4-6 hour outages per area.

Figure A1.3. Electricity Subsidy and Average Tariff



Source: MoEE, AMRO staff estimates

Figure A1.4. Losses of State Power Sector Enterprises



Source: MoEE, AMRO staff estimates

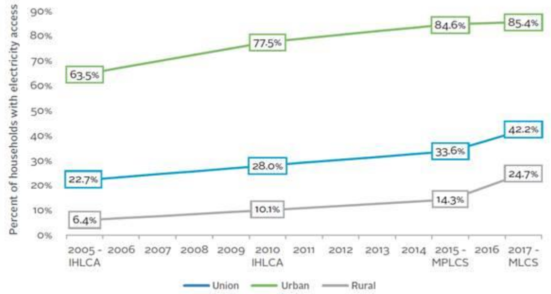
3. **Low electricity tariff has been a key contributing factor to rising fiscal burden due to electricity subsidies.** In this regard, the government is losing money in the electricity sector as a whole since residential rates are substantially below the cost of production, and this cannot be offset even with higher industrial rates, thus requiring subsidies from the government to maintain operations. In addition, low electricity rates have resulted in over-consumption and under-investment in electricity infrastructure, worsening the electricity shortage. The government has indicated that subsidies to the electricity sector has risen steadily, from MMK185 billion (US$170 million) in FY2013/14 to MMK363 billion kyat (US$240 million) in FY2017/18 (Figure A1.3). With the average tariff of around 75 kyat per kWh being below the cost of production of around 100 kyat per kWh, subsidies have grown with the rising consumption of electricity. Below cost tariffs have contributed to increasing fiscal burden, with electricity subsidies possibly increasing to above 1 percent of GDP in the medium-term if the trend is not reversed (Figure A1.4).

4. **Structural and fiscal constraints, combined with capacity limitations and very low electricity tariffs have held back the development of the electricity sector.** The lead government agency for the electricity sector is the Ministry of Electricity and Energy (MOEE). The Electricity Power Generation Enterprise (EGPE) is in-charge of managing the power plants of government, and is the sole buyer of electricity in the wholesale market, with the authority to purchase electricity from different operators including independent power producers (IPPs). The EPGE then sells the electricity to state-owned distributors. The state enterprises in charge of electricity distribution include the Yangon Electricity Supply Corporation (YESC), Mandalay Electricity Supply Corporation (MESC) and Electricity Supply Enterprise (ESE). The distribution companies, particularly YESC and MESC have been corporatized since 2015, and therefore are outside the Union Budget. According to budget documents, both YESC and MESC are able to generate annual profits. However, the corporatization process is still incomplete, as the ability of power distribution companies to generate a profit mainly rests on the EPGE selling electricity to them at below market rates.

5. **Myanmar has embarked on a massive program to expand nationwide electricity supply.** Myanmar had one of the lowest electricity penetration in the region prior to the

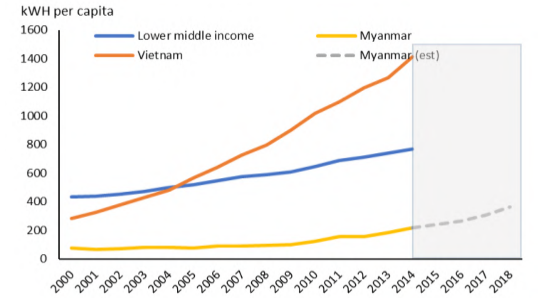
opening up of the economy in 2012 due to years of under-investment and neglect.[18] The infrastructure was old, resulting in low efficiency and unreliable electricity supply. To improve the situation, the country embarked on the National Electrification Plan (NEP) in 2015, which sought to progressively increase access to electricity by the general population. The plan called for a rapid increase in electricity coverage, with milestones of 50 percent electrification in 2020, 75 percent in 2025 and universal access to electricity by 2030. The NEP applies a combined strategy of expanding access to the main grid and developing off-grid access to outer states and other areas that are not within reach of the main grid. In the latest survey completed in 2018, a significant improvement in access to electricity has occurred, with 42 percent of households having access to electricity, an increase from the previous 34 percent (Figure A1.5).

Figure A1.5. Households Connected to the Grid



Source: Myanmar Living Conditions Survey 2017 (June 2018)

Figure A1.6. Electricity Consumption per Capita



Note: World Development Indicators (WDI) data for electricity consumption up to 2014 only
Source: WDI, AMRO staff estimates

6. **Reforms have been initiated to liberalize and strengthen the legal and regulatory framework for the electricity sector.** Electricity demand in Myanmar has the potential to grow rapidly especially from a low base, as the country strives to develop its economy towards middle-income status (Figure A1.6). To achieve greater development, massive investments are needed to upgrade and expand the electricity sector, with the cost estimated by various international agencies to be between US$15 - 28 billion over 15 years.[19] Private sector investment remains a crucial component to ensure the success of the NEP amid fiscal constraints of the government. Prior to the opening up of the economy, the electricity sector was dominated by the government, accounting for around 80 percent of total investments. Since then, joint ventures, IPPs and other private sector arrangements have steadily grown (Figure A1.7). Supporting this positive development was the significant enhancement in the environment for investing in the electricity sector with the passage of the new Electricity Law in 2014, which replaced the previous law of 1984. The new law enabled more private sector participation, established an Electricity Regulatory Commission (ERC) to regulate the sector, and provided clear delineations between the Union and Local governments in issuing licenses for power plants depending on the size of the project.

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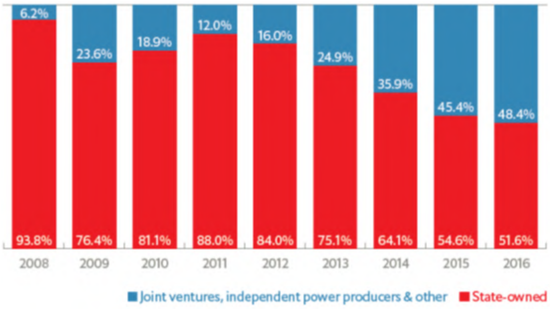
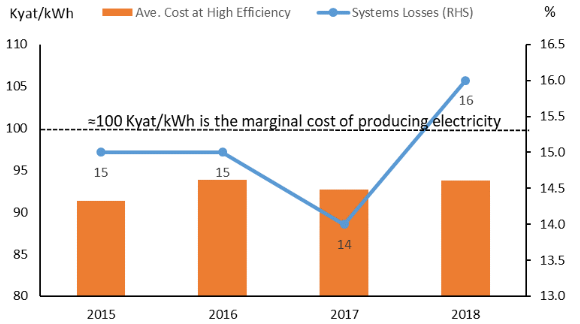
[18] From 2010 up to 2014, 70-72 percent of the population and 84-90 percent of rural households lacked access to grid electricity in Myanmar.
[19] ADB Energy Sector Assessment, Strategy, and Road Map for Myanmar (2016); World Bank National Electrification Project Paper (2015).

Figure A1.7. Investment in Electricity Sector



Source: MoEE

Figure A1.8. System Losses and Improving Efficiency



Source: MoEE, AMRO staff estimates

7. **Electricity tariff reform made by the government in June this year is a significant step forward towards ensuring the viability of the electricity sector and containing fiscal strain.** The recent announcement of tariff adjustments effective in July 2019 is a welcome development. From a low base, tariffs have on average doubled for households (households consuming more than 150kWh would see their bill almost triple).[20] Meanwhile the increase in tariffs for businesses and industries would see their bill rise by an average of 40 percent. This will eliminate the need for the government to subsidize the cost of electricity, freeing up an estimated Kyat500 billion (0.5 percent of GDP) which can now be re-allocated towards the proper maintenance of plants and other long term investments to improve necessary infrastructure in line with the goal to achieve universal electricity access by 2030. Despite the considerable increase in electricity cost to households, the policy would be justified in the medium-term not only on the grounds of efficiency, but also on equity considerations. Previously, a large proportion of the population that was not connected to the electricity grid did not receive any benefit from the government's subsidy to the electricity sector. With the increase in tariffs, they will have an opportunity to be connected to electricity through funds reallocated away from subsidies and towards the expansion of the main grid and off-grid access.[21] The tariff reform is also seen as timely due to the expected rise in power purchase prices from IPPs coming online this year. With the tariff now set at a more reasonable level, the financial viability of commercial power plants has also improved, which is expected to attract more private participation into the sector. The revised overall tariff is now estimated to be slightly above the cost of producing electricity, estimated at around 105 kyat per kWh, with the lower household rate cross-subsidized by the higher rate of industrial and commercial users. However, losses are still expected to persist in state-owned power enterprises due to inefficiencies, system losses and other operational constraints (Figure A1.8). By reducing system losses and improving operational efficiency, the cost of producing electricity can fall in the medium term.

[20] Despite the significant increase, a lower lifeline tariff of 35 kyat per kWh was maintained for consumption lower than 30 kWh per month.

[21] For households currently connected to the grid, those that benefitted most from the electricity subsidies where the high income households that used significant amounts of electricity (through the use of household appliances, air conditioners, refrigerators and the like).

8. **Continued reforms of the electricity sector are needed to address risks and, at the same time, take advantage of opportunities.** With the tariff reform, the risk that very low regulated prices would cause unsustainable fiscal losses has been significantly mitigated. To a large degree, the tariff reform has enhanced the financial viability of the electricity sector to attract private sector investment. There are various risks that the private sector have to contend with (particularly financial, market, and political risks), and being adequately compensated to bear these risks is fundamental in attracting the required investment to the power sector. In allowing the price to determine the actions of the various players in the power sector, efficiency gains are expected to significantly improve the business and investment environment. Improvements in planning and project selection will likewise encourage investment. In this regard, the use of price signals instead of government guarantees to attract private investment is highly commendable, and will help limit the creation of government contingent liabilities in the future.

9. **Strong policy support to enhance the efficiency and governance of power sector enterprises is needed to maintain the momentum for reform.** The high cost of production, particularly among state-owned companies needs to be tackled. Excessive losses arising from inefficiency costs need to be minimized, particularly losses due to poor maintenance, lack of replacement, inadequate metering and billing practices as well as electricity theft. Beyond the technical losses, improving the operations of state economic enterprises (SEEs) involved in the electricity sector is also essential. Institutional development and reform in power sector enterprises (such as EPGE, YESC, MESC, ESE, etc) need to be strongly pushed. Appropriate incentives need to be provided to maintain efficient personnel and labor cost, enhance the management of expenses, and ensure appropriate returns on capital. In this regard, the steady implementation of SEE corporatization to minimize the fiscal burden on the budget needs to progress further. Efforts to improve operational efficiency will allow SEEs to play a crucial role in planned future improvements in energy capacity and upgrading of service quality. In addition, reforms in MoEE need to advance to enable the ministry to better deliver on its mandate, particularly in expanding the access to reliable and cost-effective energy to contribute to national development. In this regard, capacity for regulation, planning, procurement and financial management needs to be steadily developed.

10. **Social and environmental issues, together with the appropriate energy mix need to be integrated into the overall strategy for the electricity sector.** Better identification and effective management of social and environmental risks are critical, and should form an important component of the development of the electricity sector. Enabling an integrated approach between economic, social and environmental issues will improve stakeholder engagement and help push forward the development of needed electricity infrastructure such as power plants and transmission lines, especially in areas experiencing ethnic tension and armed conflict. Gaining a holistic view will better enable Myanmar to decide on the appropriate and feasible energy mix for the future, by carefully balancing off least-cost energy alternatives against environmental and social concerns.

Annex 2. Transforming State-owned Banks as Effective Agents of Economic Development[22]

A historical perspective

1. **Most of Myanmar's existing state-owned banks (SOBs) date back to the military takeover in 1962 and the socialist regime that ensued until 1988.** All foreign and local banks in the country were nationalized in 1963 and then merged to become the People's Bank of the Union of Burma in 1970.[23] This single monolithic bank was later split into four banks in 1976 to establish the Myanma Economic Bank (MEB), Myanma Foreign Trade Bank (MFTB), Myanmar Agriculture Bank (MAB) and the Union Bank of Burma (UBB) (GIZ, 2018; Turnell, 2006).

2. **The four banks that emerged from the monolithic bank were given respective areas of responsibility.** The UBB—the precursor to the Central Bank of Myanmar (CBM)—was conferred with the functions of a central bank. Its foremost function was the issuing of domestic currency. MEB became the country's primary deposit-taking and general banking institution; while MFTB dealt with foreign exchange-related transactions; and the function of MAB, which was a remodeling of the State Agricultural Bank that operated from 1953 to 1962, was to provide financing for the agriculture sector. The MAB was later renamed Myanmar Agricultural Development Bank (MADB). A fourth SOB was created in 1990, named the Myanmar Investment and Commercial Bank (MICB).

3. **The creation of MICB brings the number of active SOBs to four, in addition to MEB, MFTB, and MADB.** MICB was created in 1990 at the beginning of the transition to a market-oriented economy.[24] It started out as a unit of MEB in 1989 and was formally established as a separate entity the following year to provide corporate and investment banking services to the private sector during the transition before the eventual re-entry of private banks in the country. In 1990, three important laws impacting the country's financial sector were passed. These laws provided the legal framework for the CBM and the four SOBs, and permitted the return of private sector banks to the country (GIZ, 2016).[25] Private bank licenses were first issued in 1992.

Challenges and opportunities for growth among SOBs

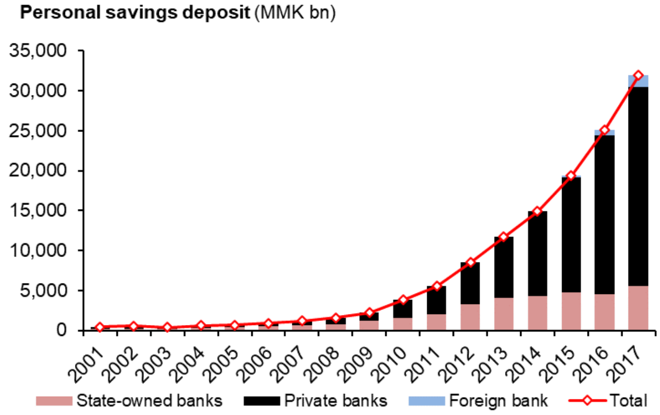
4. **Since the financial liberalization during the early 1990s, Myanmar's banking system has evolved to comprise three different types of banks.** Apart from the four SOBs, there are 27 private banks in Myanmar today. In addition, there are 13 foreign bank branches, although the scope of their lending until recently had been restricted to foreign entities in foreign currencies. Since November 2018, foreign bank branches have been

[22] Prepared by Diana del Rosario, with assistance from Pyae Nandar Aung.
[23] Later shortened to the Union of Burma Bank in 1972.
[24] The widespread protests in 1988—triggered by two rounds of demonetization in 1985 and 1987, with the latter rendering 60-80 percent of the currency in circulation worthless—put an end to the socialist ideology and paved the way for a market-oriented economy under the subsequent military regime.
[25] The three laws are: 1) the Central Bank of Myanmar Law, which provided the CBM a certain degree of autonomy over monetary policy and financial supervision; 2) the Financial Institutions of Myanmar Law which enabled the re-emergence of private banks in Myanmar, and provided the legal framework for the three state-owned banks (MEB, MFTB, and MICB); and 3) the Myanmar Agriculture and Rural Development Bank Law which created the MADB, a newer form of the MAB.

allowed to lend to local businesses in both local and foreign currencies. Currently, foreign banks are not allowed to pay interest on local currency deposits, hence there is no incentive for them to offer retail banking services as they are unable to compete with the local banks in attracting deposits. However, the CBM plans to allow for the establishment of foreign banking subsidiaries in the future, which will allow them to engage in retail banking.

5. **The rapid growth of private banks in Myanmar has come at the expense of the SOBs which have not been exposed to competition.** For instance, referring to a particular type of deposits, the rapid build-up in personal savings deposits—an average growth rate of 37 percent per annum between 2005 and 2017—was largely absorbed by private banks. Personal savings with private banks comprised 78 percent of the total savings deposits in 2017, up from just 39 percent in 2005 (Figure A2.1).[26] Meanwhile, the share of SOBs shrank from 61 percent to 18 percent in the same period, with the remainder of 4 percent being absorbed by the foreign bank branches. More broadly, private banks—according to September 2018 data—account for 68 percent of total deposits, and 83 percent of the banking system's total loans (Table A2.1). Private banks now also comprise more than 50 percent of the banking system's assets, with the SOBs' share falling from from 72 percent (end-2012) to 31 percent (September 2018).

Figure A2.1. Personal Savings Deposit, by Bank Type



Source: MoPF

Table A2.1. Structure of the Banking System

	Number		Branches		Total Assets (MMK bn)	% of System	Total Loans (MMK bn)	% of System	Total Deposits (MMK bn)	% of System	Loan-to-Deposit Ratio (%)
	Jun-14	Sep-18	Jun-14	Sep-18	As of Sep-18						
State-owned Banks	4	4	511	518	19,062.9	*33.1*	3,016.7	*12.8*	10,513.9	*24.2*	28.7
Private Banks	22	27	837	1,710	35,288.1	*61.3*	20,869.1	*88.2*	31,129.8	*71.8*	67.0
Foreign Bank Branches	-	13	-		6,850.6	*11.9*	1,400.0	*5.9*	4,190.8	*9.7*	33.4
Total banking system	26	44	1,348	2,228	**61,201.6**		**25,285.8**		**45,834.5**		55.2
in percent of GDP					*67.7*		*28.0*		*50.7*		

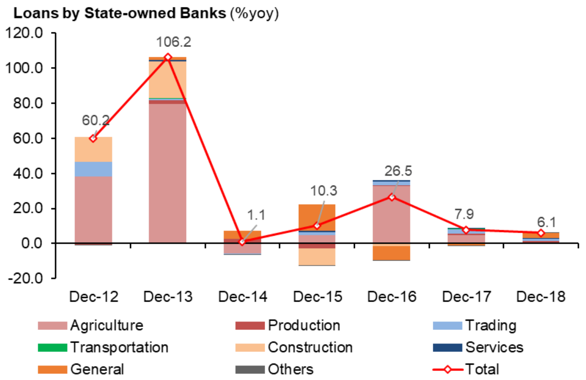
Note: Nominal GDP used was for the period April 2017 to March 2018.
Source: CBM, AMRO calculations

6. **SOBs have been playing a key role as financial service providers to the government, while performing some socio-economic functions.** For example, MEB which is the largest SOB, as part of its treasury function, maintains the State Fund Account system and provides banking services to all government agencies, including ministries, departments, and state economic enterprises. This includes the distribution of pensions to

[26] In order to attract customers, private banks offer interest rates on deposits that are slightly above the minimum rate of 8 percent, seasonal promotions, and better and faster customer service experience, the latter enabled by a large number of employees—some of whom go to employees' offices on a fortnightly basis—and the use of technology, including automated teller machines installed in several areas for easier access to customers' bank accounts.

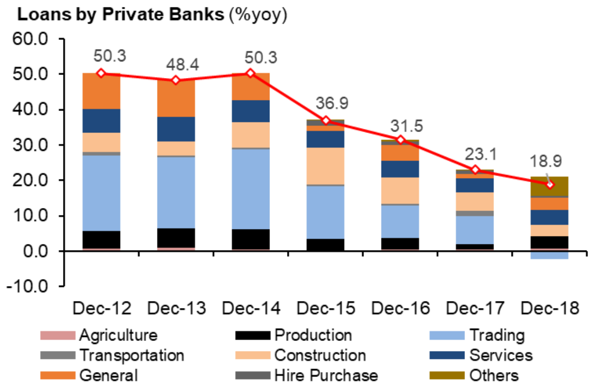
retired military and civil servants. At the same time, MEB also assumes certain development functions by extending concessional loans to certain state enterprises, such as the MADB and the Naypyidaw Development Committee (NDC). The MADB and NDC collectively account for about two-thirds of MEB's loan portfolio in FY18 interim (April-September 2018). In fact, the SOBs—led by MADB—primarily lend to the agriculture sector,[27] albeit with a more volatile loan growth profile in contrast to that of private banks, which also have a more even distribution across sectors (Figures A2.2, A2.3). In addition, MEB's social responsibility function extends to its 326 branches that reach into remote areas not typically serviced by private banks.[28] Moreover, MEB has a sound reputation, especially among the older generation, thereby addressing the gap in the lack of public trust in the private banking system following the banking crisis in 2003.[29]

Figure A2.2. Loan Profile and Growth, State-owned Banks



Source: CBM

Figure A2.3. Loan Profile and Growth, Private Banks



Note: The shift in composition between Dec-17 and Dec-2018 can be attributed to an increase in borrowers and/or data inconsistency. The series is reportedly prone to revision as private banks are unable to provide accurate data, including on borrowing classification, within the designated timeframe. *General* refers to the collection of small loan amounts not falling under the identified categories.
Source: CBM

7. **The SOBs have taken steps to keep up with the rapid expansion of Myanmar's private banking system.** Cognizant of the competition that private banks have brought to the system, all four SOBs have begun to diversify their loan portfolios, to the extent that they have also started competing with one another. MEB has placed a relatively greater emphasis on extending loans to private enterprises and individuals over the years. For instance, since FY18, MEB has been managing a Japan International Cooperation Agency (JICA)-funded loan program for small and medium-sized enterprises (MSMEs) that can be

[27] Agriculture remains an important component of the economy, accounting for 30-40 percent of GDP and representing up to 70 percent of the labor force (Luna-Martinez and Anantavrasilpa, 2014).
[28] MEB's number of branches would place it just behind that of the largest (private) bank by asset size—Kanbawza (KBZ) Bank—with 499 branches and ahead of Ayeyarwaddy (AYA) Bank with 249 branches and Co-operative (CB) Bank with 225. KBZ Bank has around USD8 billion in assets, making it three times larger than the next biggest bank, AYA Bank; and it has nearly twice the number of branches and employees as any private competitor (Schellhase and Sun, 2017).
[29] The collapse of small informal companies in 2002 sparked a crisis of confidence in Myanmar's nascent private banking system, resulting in large-scale deposit withdrawals at major private banks in early 2003. This subsequently prompted banks to restrict the amount of withdrawals and recall loans from borrowers. A flight to cash ensued, which led to a shortage of the kyat and a liquidity crisis (Turnell, 2003).

secured from selected domestic banks including MEB.[30] Likewise, from extending seasonal loans primarily to paddy farmers engaged in subsistence agriculture, MADB has taken steps to diversify its loan portfolio to those engaged in commercial agriculture through another JICA-funded program.[31] In addition, MADB plans to set up more branches to handle increasing loan volumes and cover more townships over the medium term. MICB and MFTB have also widened their services to include foreign currency trade financing through the issuance of letters of credit. In addition, the SOBs intend to modernize and increase their operational efficiency by increasing bank capital buffers, improving loan recovery given substantial non-performing loans (NPLs), streamlining loan approvals and documentation processes, investing in staff development and training, and leveraging on information technology. The SOBs have indicated the need for technical assistance in undertaking the reforms.

8. **Notwithstanding the ongoing and planned reforms, considerable challenges hold the SOBs back from becoming effective agents of economic development.** SOBs need to deal with operational challenges driven by limited staff capabilities, outdated banking infrastructure and weak corporate governance. Together, these weaknesses have weighed in on their financial performance. The SOBs face considerable skill gaps in risk management and credit analysis, as well as in accounting, auditing, asset valuation and marketing. The lack of banking knowhow has been largely induced by strict collateral requirements and regulated interest rates which have, in turn, stifled competition and impaired the capability of domestic banks, including SOBs, to assess credit risks, among others.[32] The shortage of skills is also a consequence of the SOBs' lack of autonomy on human resource policies established by the central government in terms of staff recruitment, compensation and promotion (Luna-Martinez and Anantavrasilpa, 2014). At the same time, human resource issues are compounded by inadequate IT infrastructure, which has resulted in limited management information systems and rudimentary cash management policies and practices. Corporate governance among SOBs can be strengthened with the recruitment of independent board members with the relevant expertise, the government granting operational autonomy to the banks' senior management (alongside strengthened staff capacity through recruitment and continued development), and implementation of international best practices in internal control and external audit systems.

9. **Addressing internal challenges is crucial in transforming the SOBs into viable financial institutions.** Operational inefficiencies among SOBs are evident in the SOBs' considerably lower loan-to-deposit (LDR) ratios relative to the private banks, reflecting the

[30] The program allows an SME to borrow a maximum of 500 million kyat at 8.5 percent interest per annum with a repayment period of 1-5 years, of which 80 percent of the loaned amount is set aside for fixed capital and the remaining 20 percent for working capital. Businesses without sufficient collateral can access loans of up to 20 million kyat under the Credit Guarantee Insurance scheme at an interest rate of within 9-13 percent depending on the credit rating of the business.

[31] The Agriculture/Rural Development Two-Step Loan Project allows an eligible farmer or farmer group to take a 1-5-year loan with an 8 percent interest per annum for the purchase of agricultural machinery (e.g., water pump, threshing machine, power tiller and four-wheel tractor) or capital investment in agribusiness (for example, rice mill, oil mill, food processing machine, warehouse, and factory construction). The project involves a 200 billion kyat loan from JICA at 0.01 percent interest rate with a 40-year repayment period and a 10-year grace period.

[32] In the case of MADB, staff do not participate in the review of loan applications, which is instead done by the village loan screening committee comprising of representatives of local authorities, staff from the Ministry of Agriculture, Livestock and Irrigation and farmers' representatives promotion (Luna-Martinez and Anantavrasilpa, 2014).

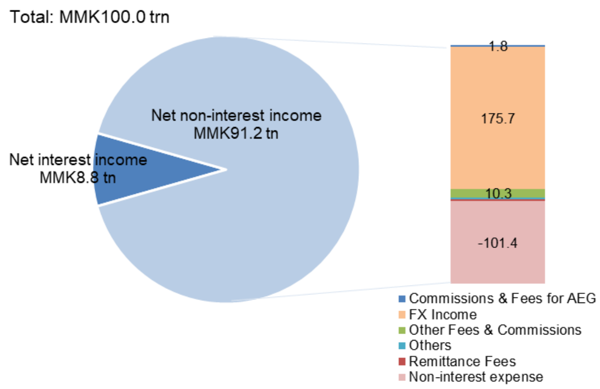
former's weak ability to convert deposits into credit (Table A2.1). For example, MEB takes the most deposits among the SOBs and yet, has an LDR of only 16 percent, which could go further down to 5 percent if the mandatory loans to MADB and NDC are excluded (Table A2.2). As a result, MEB has counted on non-interest income (primarily from the conversion of FCY deposit returns to kyat) for over 90 percent of its profit (Figure A2.4), although this trend is in contrast to its development function as a credit provider.[33] Similarly, MADB only serves two million farmers, compared to over 70 percent of the 22 million workforce who are engaged in agriculture (Schellhase and Sun, 2017; Luna-Martinez and Anantavrasilpa, 2014). This is partly because the MADB has been unable to compete with non-bank and informal lenders, which lend without collateral, albeit at interest rates of well over 20 percent per annum. Likewise, the inability to assess credit risks, a lack of operational autonomy from the state, and weak corporate governance, mean that SOBs are vulnerable to political interference. This has contributed to the build-up in non-performing loans. Regulations can also be a disincentive to innovate – such as the requirement to transfer a large portion of SOBs' net profits to the government, leaving little resources to fund much needed modernization efforts. If these challenges are not addressed, they would continue to affect profitability – as evidenced by SOBs' low net interest margins (Table A2.2, Figure A2.5).[34]

Table A2.2. Financial Profile of the State-owned Banks, March 2018

State-owned Banks (as of Mar-18)	No. of Branches	Total Assets (MMK mn)	Total Loans in MMK mn	Total Loans % of total Assets	Total Deposits (MMK mn)	Loan-to-Deposit Ratio (%)	Return on Assets (%)	Net Interest Margin (%)
Myanma Economic Bank (MEB)	326	9,852,227.5	3,976,032.6	*40.4*	8,106,402.3	49.0[a]	*1.0*	*0.1*
Myanma Foreign Trade Bank (MFTB)	0	5,081,584.4	270,900.5	*5.3*	2,817,198.7	9.6	*0.4*	*0.3*
Myanma Agri Development Bank (MADB)	224	1.4	1.2	*88.9*	0.019	6,276.1	*3.9*	*4.5*
Myanma Inv & Commercial Bank (MICB)	1	3,433,745.5	59,116.4	*1.7*	493,439.4	12.0	*1.4*	*1.3*

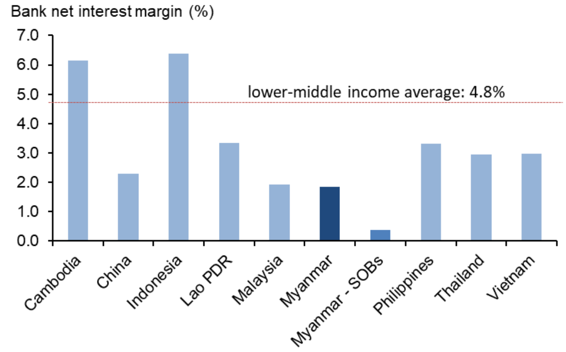
Note: Loans include claims to financial institutions, as there is no breakdown in the balance sheets of MFTB, MADB, and MICB.
[a] Excluding financial institutions, MEB's loan-to-deposit ratio would be 16 percent in the same period.
Source: Ministry of Planning and Finance (MOPF), AMRO calculations

Figure A2.4. MEB's Income Breakdown



Note: Based on MEB's income statement as of 31 March 2018.
Source: MoPF

Figure A2.5. Banks' Net Interest Margin



Note: Data as of 2016, except for Myanmar SOBs which is as of March 2018.
Source: World Bank (Global Financial Development Database July 2018), AMRO calculations

[33] MEB lends to MADB and NDC at 5 percent interest while it pays a deposit rate of 8 percent, severely curtailing its net interest income. Notwithstanding reported profits according to MEB's income statement for FY16 and FY17, there are claims that MEB has been making losses since 1988 at the expense of taxpayers (GIZ, 2018). Similarly, MADB shared that it reported a net loss in FY15, FY17, FY18 interim for a total of 75 billion kyat. Meanwhile, MICB and MFTB have been net contributors to the government, suggesting that they have been generating profits.
[34] MADB only has a higher net interest margin as it obtains financing from MEB at a highly subsidized rate of 5 percent and lends at 8 percent.

10. **In turn, the SOBs' weak financial positions pose a potential risk to financial stability and fiscal sustainability.** Various accounts (World Bank, 2016; GIZ, 2018) have reported on the lack of public understanding of the actual state of the SOBs' financial conditions, even to their owner, the Ministry of Planning and Finance (MOPF). This is largely because the SOBs have mostly operated under weak supervision and their financial statements, if available, are often inconsistent with international standards. To illustrate, SOBs—unlike the private banks—are currently not obliged to comply with the provisions under the Financial Institutions of Myanmar Law (FIML)—passed in 2016—and the by-laws set by the CBM, although they are taking efforts to meet the requirements.[35] Encouragingly, the government—under the World Bank's assistance—initiated a comprehensive audit of SOBs for the first time in 2017, an initial step towards meeting the CBM's requirement for banks to be reviewed by an internationally-recognized external auditor. Such a move is crucial to identify the weak areas of SOBs, such as their reportedly high NPLs, in order to mitigate potential threats to the stability of the financial system—given that SOBs still account for a third of banking system assets—and enable the CBM to take timely corrective actions if needed. Likewise, the SOBs' adoption of internationally-accepted financial reporting standards over the medium term would encourage good corporate governance and provide clarity of the costs and benefits from government involvement, such as in the provision of subsidies to MADB and ongoing recapitalization efforts.

Exploring options to reform

11. **The government—with the World Bank's assistance—has embarked on a program to restructure SOBs.** The program is part of a broad agenda for Myanmar to develop a competitive, sound and inclusive financial sector under the World Bank's Financial Sector Development Project. The program's first phase involved a diagnostic study of the four SOBs, while the second phase involved the formulation of business plans for SOBs. The World Bank is exploring the consolidation of the SOBs into one retail commercial bank and one development bank.[36] According to this proposal, MADB would merge with MEB, leveraging on the two SOBs' wide banking networks and brand recognition to become a retail commercial bank. And separately, MICB and MFTB would be merged to form a development bank, counting on their relatively sound financial positions for easier funding access from multilateral agencies, bond issuances, and/or government transfers. The World Bank proposal envisions a commercially-viable retail bank and development bank where governance is not dictated by the state. While the development bank will extend medium- to long-term loans, the retail commercial bank could still perform certain development functions

[35] The Financial Institutions of Myanmar Law introduced in January 2016 updates banking laws in line with the Basel Committee's requirement on banks following the 2008 financial crisis. Eighteen months after the passage of the FIML in 2016, the CBM issued a set of regulations in which banks had been given six months to comply, such as minimum liquidity ratio of 20 percent and a cap on single counterparty lending at 20 percent of shareholder equity. The single counterparty lending limit, however, is not required for SOBs, according to the directive. Banks have also been required to reduce their overdraft facilities to 20 percent of their loan book by July 2020. Moreover, in line with the goal to strengthen banks' corporate governance under the FIML (2016), the CBM issued five detailed directives to banks in March 2019 covering the duties, powers, and responsibilities of a bank's Board of Directors, appropriate standards for bank directors and senior officials, the requirement for an internationally-recognized external auditor, related-party transactions, and acquisitions of substantial interests.

[36] A retail commercial bank collects deposits and uses them to give credit to firms and individuals, whereas a development bank does not take deposits from the public and is instead funded by multilateral agencies, bond issuances, and/or government transfers in order to lend to other banks or directly to firms that operate in specific sectors (Gonzalez-Garcia and Grigoli, 2014).

by extending short-term loans at concessional rates, so long as the subsidy expense is explicitly stated in the budget. The initial capital for these banks would come from the government, but would eventually be supplemented with funding from development partners and bond issuances. Given the wide range of challenges involved, it is widely understood that the reform could take some time to implement.

12. **Myanmar's economy will benefit from sound financial institutions that have a clear mandate to advance a broad economic development agenda.** Consolidating Myanmar's SOBs, along with the adoption of international standards in corporate governance and transparency is one possible way to address the inefficiencies in their operations and turn them into financially-sustainable institutions. However, all these reforms should aim at transforming the SOBs into highly effective agents in advancing a long-term strategy for sustainable economic development.

13. **The consolidated SOBs could help boost economic growth by supporting MSMEs and priority sectors that may otherwise not be served by private banks.** SOBs could fill the gaps left by private banks by providing adequate financing to a range of customers and sectors—from farmers and small and innovative companies to large infrastructure projects—which are deemed too risky, not creditworthy or not viable by the private banks. Furthermore, SOBs could help to counteract the pro-cyclical nature of private banks' lending, thereby providing some relief to businesses during economic downturns.

14. **With regard to financing of MSMEs and the agriculture sector, Myanmar can draw inspiration from the success of Thailand, Indonesia and Mexico.** The Thai Bank for Agriculture and Agricultural Cooperatives (BAAC) has managed to cover its target market—serving 95 percent of total farm households in Thailand—while becoming self-reliant in its rural financing functions.[37] Deposits account for 84 percent of BAAC funds. Similarly, Bank Rakyat Indonesia (BRI)—following the deregulation of interest rates in 1983—was able to transform itself from a heavily subsidized institution into one of the most globally profitable banks by the mid-2000s with a continued focus on micro loans. Elsewhere, the Mexican government decided on a fresh start (away from high NPLs, growing losses, clientele capture and failed attempts to turn around the institution) for the old agriculture bank and created Financiera Rural (FR) in 2002. According to the World Bank, FR has been profitable in financing farmers in practically all agriculture value chains and drawing in other private financial sector intermediaries through its wholesale lending to microfinance institutions.[38] It must be highlighted, however, that all of these banks took between 10 and 40 years to achieve a broad reach and attain sound financial health.

15. **Myanmar can also draw lessons from existing international experience on the role of national development banks (NDBs) as efficient instruments of national**

[37] That said, BAAC had seen marked NPL increases in the past, such as in late 1998 when the ratio rose to 13 percent although the figure was still low compared to the rest of the banking system where bad loans were estimated at 40-50 percent of the total loan portfolio. However, the government had to inject capital in the wake of the 1998 Asian Financial Crisis as the devaluation of Thai baht substantially increased BAAC's foreign debt service burden and subsequently, slashed more than half of BAAC's capital (Fitchett, 1999).

[38] For details on the reform processes of these institutions, kindly refer to Luna-Martinez and Anantavrasilpa (2014) and Seibel (2000). For specific case studies, refer to Fitchett (1999) for BAAC, Toha and Saraswati (2007) for BRI.

development strategies. One example is the Korea Development Bank (KDB), which has proven instrumental in supporting government policy and has gone through successive transformations in fulfilling its mandate as a medium- to long-term provider of loans for the development of the industrial sector. KDB has been able to reposition itself in response to Korea's different stages of development, from financing the reconstruction of basic infrastructure in the 1950s to redirecting financing towards the future economy more recently[39] (UNCTAD, 2016). Interestingly, Korea's national development strategy has been supported not only by NDBs, but also by commercial banks providing policy loans in a well-coordinated development finance system facilitated by the Bank of Korea. Beyond Korea, NDBs have also been instrumental in supporting national development strategies such as in Brazil, China and India. A common feature among NDBs is their ability to continuously revise the focus of their activities once development crosses a certain threshold or in response to the prevailing environment at the time. Germany's Kreditanstalt für Wiederaufbau (KfW), for instance, has evolved from supporting the reconstruction of the country after World War II to its current role as a promotional bank for the German economy and a development bank for developing economies (UNCTAD, 2016). Overall, analyses of financially-sustainable development banks globally suggests NDBs have been crucial in advancing economic development by providing counter-cyclical finance, creating employment, strengthening capital markets, building capacity in project appraisal and evaluation, encouraging innovation and structural transformation, enhancing financial inclusion, supporting infrastructure financing, promoting environment sustainability and influencing government policies (Griffith-Jones and Ocampo, 2018; Thorne and du Toit, 2009).

16. **These successful examples illustrate that in attaining financial viability, Myanmar's SOBs do not have to compromise on the delivery of socio-economic objectives.** However, in order for SOBs to be financially viable and self-reliant, a strong commitment to the highest standards of corporate governance and transparency as well as considerable investments in human resource training and IT infrastructure are crucial. Equally important, there is a need to create an enabling environment that will offer incentives for reform, such as the imposition of prudential regulations and strengthened supervisory capacity of the CBM as well as the deregulation of interest rates. Indeed, while the approaches to SOBs restructuring has differed across institutions and countries, these recommendations have also been broadly recognized as key elements in the success of SOBs (World Bank, 2014). As such, the government is advised to adhere to these guiding principles as it moves ahead with reforming the SOBs.

[39] Since inception, KDB has supported different industry sectors and activities, in keeping with the needs of the economy. After financing the reconstruction of basic infrastructure in the 1950s, it turned to support the promotion of exports in energy and heavy and chemical industries in the 1960s and 1970s, and then shifted its focus to supporting the automobile and electronics industries as well as lending to SMEs in the 1980s. It subsequently turned into a globally-competitive investment bank that supported Korean companies operating abroad and participated in corporate restructuring in the 1990s and 2000s, before redirecting financing towards the future economy more recently.

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Annex 3. Foundation to be Strengthened for Interest Rate Liberalisation in Myanmar[40]

1. **The Myanmar authorities are considering interest rate liberalization as a part of financial reforms.** The Central Bank of Myanmar (CBM) has made an initial attempt to increase interest rate flexibility by allowing banks to charge higher lending rates for unsecured loans since February 2019.[41] The critical question facing the authorities is whether or (and) how to pursue interest-rate liberalization at the present moment. As demonstrated in many counties, the success or failure of interest rate liberalisation is contingent on certain conditions deemed essential for a smooth transition. Lessons from other countries' experiences can provide insights into the issues of interest rate liberalization in Myanmar.

Global experiences point to several (un)desirable conditions

2. **The success or failure of interest rate liberalization from other countries seems to rest on three factors, namely, the environment, financial institutions and strategy.** Countries with successful experiences tend to have strong institutions, a stable economy, relatively healthy financial institutions, and an appropriate strategy, whereas unsuccessful ones tend to be lacking in at least one of them. The environment—both institutional and economic—dictates the rules and conditions to which financial institutions must adapt. The soundness of financial institutions determines their resilience to the changing financial landscape. And the strategy defines how, when and how fast the regime changes. How smoothly an interest rate liberalization process proceeds depends on how these elements interact with each other. While all three dimensions are crucial for successful interest rate liberalization, the importance of an enabling environment tends to be underappreciated in individual countries' experiences. Particular attention needs to be paid to this aspect.

3. **Proper regulation and supervision are indispensable to contain risks arising from interest rate deregulation.** In almost all cases, removing interest rate constraints has led to more competition. The increased competition can lead to disruptive consequences by prompting banks to take excessive risks when there are inadequate regulation and supervision. In fact, all banking crises after interest rate liberalization could be traced back to inadequate supervision or regulations, which were not keeping up with the changing financial landscape (Tarhan, et al, 2009). The U.S. Savings and Loans Associations (S&Ls) Crisis in 1980s/90s and the Turkey banking crisis in 1982, are two good examples.

A. In the 1980s, competition resulting from interest rate liberalization forced the S&Ls to offer increasingly higher interest rates to attract deposits. To compensate for higher funding costs, S&Ls aggressively expanded new lending to riskier commercial real estate developments and even invested in junk bonds, where they had little expertise. However, the S&L regulator did not strictly enforce capital

[40] Prepared by Dr. Jiao Zhiwen.

[41] The CBM announced the news in a directive issued on 15 January 2019. From 1 February 2019, banks are allowed to charge a maximum rate of 16 percent for loans without collateral. The new maximum interest rate of 16 percent is inclusive of all other charges such as management fees and applies to both instalments and one-off repayments.

requirements on the grounds that S&Ls would prosper and be able to rebuild their capital over time with these new business opportunities. However, many of the high-risk businesses turned out to be unviable and led to a slow-moving financial disaster that lasted from the late 1980s to early 1990s.

B. The Turkish banking crisis in the 1980s was similar but it unfolded rapidly. Soon after the government announced the abolishment of the restrictions on deposit and loan interest rates in July 1980, smaller banks, in particular, started to compete for deposits by offering higher interest rates without paying much attention to how they could utilize these high-cost deposits. Soon, brokerage houses also joined the competition. At that time, bank supervision was so weak that capital adequacy requirements for banks did not even exist. Moreover, the classification of loans and provisioning rules were inadequate and certainly not up to international standards (Tarhan, et al, 2009). As a result, the financial system fell into a crisis in 1982, when several banks and most brokerage houses collapsed. Interest rates were then brought, once again, under the control of the central bank (Saracoglu, 1995).

4. **Prudent monetary policy is necessary to counter the buildup of imbalance in the aftermath of interest rate deregulation.** Interest rates were generally maintained below market levels before liberalization. The loosening of restrictions has often led to an expansion of credit due to excess demand in the economy and more competition in the banking sector. As a result, credit expansion may be inconsistent with the government's macroeconomic stability goals. Central banks' failure in Finland, Norway and Sweden in containing excessive credit expansion after interest rate liberalization was seen as one of the key factors that led to the banking crisis of the three Nordic countries in the early 1990s (Chen, et al, 2009; Tarhan, et al, 2009).

A. Soon after the deregulation in the mid-1980s, lending surged in all three Nordic countries. The ratio of loans to GDP increased from 40 percent of GDP to close to 60 percent of GDP within four years in Sweden, and similar increases were observed in Finland and Norway. The surge in loans was increasingly financed through funds raised in the domestic and international interbank markets, with the latter facilitated by capital account liberalization. It did not take long for a full-blown banking crisis to emerge. By the late 1980s, signs of economy-wide stress became evident and by early 1990s, Sweden and Finland entered one of their deepest and most prolonged recessions. During that time, the authorities in charge of monetary and fiscal policies viewed steps towards financial deregulation in the mid-1980s as technical adjustments that were of no major consequence for aggregate economic performance. Thus, no major counteracting stabilization policy measures were taken until it was too late.

5. **Basic financial infrastructure is needed to support the function of regulatory and monetary policy.** One key element is a domestic interbank market and its supporting components. The latter includes a robust payment and settlement system and a central securities depository and clearinghouse. The interbank market provides the central bank the means to manage liquidity, and it becomes increasingly important when the central bank has to rely more on indirect tools to conduct monetary policy as interest rates become more

liberalized. The importance of the interbank market is widely recognized. Most countries have established the interbank market prior to the start of interest rate liberalization and continued to develop the market and strengthen indirect monetary policy instruments in the process. The beginning of the organized interbank market in Korea, for example, dates back to the 1960s. Thailand, Malaysia, Indonesia and the Philippines all established interbank markets either before or in the 1980s. China unified its 35 local financing centers into a national interbank market in 1996. Turkey was one country that did not have an interbank market before attempting its first interest rate liberalization. The failure raised the authorities' awareness of the importance of an interbank market and prompted the Turkish authorities to establish the market in 1986 before embarking on interest rate liberalization again. In 1987, the establishment of the interbank market allowed the introduction of open market operations with government securities.

6. **Economic stability is required to provide an environment conducive for a smooth transition**. Serious macroeconomic imbalances will not only make the deregulation impact more intense but the imbalance could also be exacerbated when interest rate constraints are removed. If interest rate deregulation is initiated under conditions of high inflation and credit demand, the upward pressure on interest rates will be much more intense. Should high inflation coexist with large fiscal deficit and current account deficit, it would worsen the fiscal and external balances, creating additional inflationary pressures. This is what happened in Turkey. The unresolved problem of fiscal deficits let Turkey continue to suffer from high inflation and high interest rates following interest rate liberalization. The economy went into a severe financial crisis in 1994. On the contrary, most smooth interest rate deregulations have generally been carried out during the period without serious macro instability, both in advanced economies such as Japan and Germany, and in emerging economies such as Malaysia, Thailand, Korea and China.

7. **Financial institutions should have the capacity to absorb shocks from interest rate deregulation.** A certain degree of soundness is necessary for financial institutions to cope with the challenges from more competition, such as higher and more volatile interest rates following interest rate deregulation. The capacity for loss absorption and capability to adapt are of critical importance. Often, the solvency at banks, particularly in terms of high levels of nonperforming loans (NPLs) and low capital adequacy, is the key barrier to interest rate liberalization. For example, if not for the insolvency of several financial institutions in the first half of the 1980s, Thailand would have pursued the financial liberalization program more aggressively (Kirakul, 1996). In addition to the balance sheet vulnerabilities, the causes of vulnerabilities also need to be addressed. Also the governance of the banks needs to be strengthened to enable them to operate smoothly in the new environment. China's experience provides a prominent example across both aspects. In the early 2000s, the Chinese government reformed the banking system by listing state-owned banks on the stock market, not only to raise capital, but to revamp their governance and modes of business operations. At the same time, four asset management companies were established to take over the legacy NPLs from banks to facilitate this process.

8. **A strategy should be developed which seeks to minimize the adverse impacts of deregulation.** Although there is no formula determining what makes a good strategy, the impact minimization principle can generally be found in countries with successful interest rate liberalization experiences. In practice, more countries chose to liberalize lending rates before deposit rates, large amount deposits before small amount deposits and long-term deposits before short-term deposits.[42] A constraint in general was removed when the constraint was less binding. For example, when China scrapped the restriction on lending rate floor in 2013, most loans were already priced above the floor. In addition, most countries pursued interest rate liberalization on a gradual rather than a big bang approach. This type of strategy has the advantage of allowing the authority to control both magnitude and the speed of the shocks to the system, thus increasing the chance of a smooth transition**.** The step by step approach gives both the financial institutions and policy-makers sufficient room and time to adjust to the new regime. Failure to follow the principle usually leads to instability and the reversal of reforms, as was the first attempt in Turkey and Korea in 1980s.

Myanmar still lacks the desirable features

9. **A new legal and regulatory framework has been introduced, but supervisory capacity has yet to be improved.** Over the past few years, Myanmar authorities have been working with the World Bank in modernizing the country's outdated legal and policy framework to make it more compatible with a market-based economy. In 2016, the Myanmar government enacted the Financial Institutions Law 2016 as the new legal foundation for financial regulations. Based on this law, the CBM issued a set of four regulations in July 2017 (Notifications 16-19/2017, pertaining to capital adequacy, asset classification and provisioning, large exposures, and liquidity ratio requirements respectively) concerning banks' balance sheets, and released another five new directives pertaining to governance issues in March 2019. Although the new legal and regulatory framework is generally in line with the Basel Committee's requirements and the CBM is committed to its implementation, it still lacks adequate supervisory capacity with regards to qualified staff, analytical tools for on- and off-site supervision, effective enforcement powers and access to technology to supervise the banking system effectively.

10. **The infrastructure for monetary policy operations is still underdeveloped and lacking in instruments and markets.** The CBM has adopted a reserve money targeting monetary policy framework since 2012. Under this framework, it should be able to affect the liquidity in the banking system through either open market operations, discount window or reserve requirements and interest rates. However, a series of factors hinder effective policy operations. First, the CBM toolbox is incomplete. Currently, the CBM conducts deposit auctions to absorb liquidity, but lacks the instruments to effectively inject liquidity. The CBM's credit facilities are only provided to fill the intra-day liquidity needs of banks that are unable

[42]The rationale behind this sequence is to control the shocks to banks. Liberalizing the lending rate will allow banks to develop asset management capabilities without worrying much about the liability side. The liquidity impact on banks will also be smaller when liberalizing large amount deposit accounts before small amount deposit accounts, as large deposit accounts tend to be held by small number of people, while small amount deposit accounts are held by a large number of people.

to cover payments by the time the settlement window closes. Thus, the tool cannot be used for other funding needs by banks. In particular, foreign bank branches that tend to face a funding shortage do not have access to this facility. Second, the money markets to support monetary operations are underdeveloped. The interbank market is thin, trading is limited to uncollateralized transactions and inefficient, due to the non-existence of a secondary bond market, low trust among banks, and inadequate payment and settlement systems. And third, strict collateral requirements and the lower-than-market lending rate ceiling, may hinder banks' ability and willingness to extend loans.

11. **Modern financial infrastructure has yet to be established and enhanced.** The CBM has developed and implemented the CBM-NET system in January 2016 covering large-value fund transfers and a centralized securities depository, with the support of the Japan International Cooperation Agency (JICA). However, several gaps were identified when compared to the standard features of a Real-time Gross Settlement with global standards (World Bank, 2016). Meanwhile, the current CBM-NET system does not include an automated clearinghouse for retail payments and a securities settlement system. The authorities are planning to build these features into the enhancement project CBM-NET2, aiming for one of the most advanced payment and settlement infrastructures providing full-fledged services.[43] The CBM-NET2 system is expected to start operation in October 2020.

12. **Economic stability has improved but serious challenges remain.** Myanmar has achieved great progress in restoring its economy since 2012, when the government initiated key reforms and began re-opening the economy. Myanmar's GDP has continued growing at an average of above 7 percent per annum since then. However, macroeconomic stability has not been achieved yet. Inflation remains high and volatile due to supply bottlenecks, and exchange rate depreciation. Inflation has largely stayed between 6 percent and 8 percent since the reforms began, and has risen above 10 percent. The current account is usually in deficit, reflecting investment-driven imports. During the investment boom of 2015-2017, the current account deficit widened to around 5 percent of GDP, putting much pressure on the exchange rate. The fiscal deficit, meanwhile, has generally remained below 3 percent of GDP over the past few years. However, revenue capacity is quite weak with the tax-to-GDP ratio expected to hover at around 7 percent over the next few years. As a result, the fiscal deficit could widen to above 4 percent of GDP as the spending gaps for education, health and infrastructure goals set in the Sustainable Development Plan 2018-2030 are estimated to be large in Myanmar (IMF, 2019).[44]

13. **Financial institutions remain weak.** Myanmar's financial system is dominated by unsophisticated banks that can only offer a limited range of services due to long periods of isolation. The banking system's health has improved as the CBM continues to push forward the new supervisory requirement, but the overall situation has not changed materially.

[43] CBM-NET2 includes major functions such as Straight-Through Processing, Liquidity Saving Facility, Message Queuing, Automated Clearing House, Cheque Truncation, and DVP with collateral.

[44] IMF (2019) estimates total additional spending to achieve the Sustainable Development Goals in social and infrastructure sectors to be about 13 percent of GDP in 2030, mostly corresponding to public spending. Government spending needs are about 8 percent of GDP in the social sectors.

Banks' NPLs, particularly those comprised of legacy loans, are still high and concentrated. Although most private banks have met the capital adequacy requirement of 10 percent, there is still no clear plan for state-owned banks, which comprise half the banking system in terms of assets. Compared to these balance sheet issues, governance and operational issues pose more serious challenges to banks' long-term health. Due to the long period of isolation, banks have largely not been operated and managed as commercial entities. In general, they do not have risk management capabilities and are operated more like pawnshops, in part due to policy distortions. This is also reflected in the banking sector's income structure. In 2018, for example, the interest income to gross income ratio was less than 40 percent, indicating banks' disproportionate reliance on fees and charges.

Preparing for smooth interest rate liberalization

14. **The weak initial conditions warrant a cautious approach towards interest rate liberalization in Myanmar.** Current policy efforts should focus on establishing strong foundations that will facilitate smooth interest rate liberalization in the medium-to-long term. Global experiences show that the authorities can play a critical role in fostering the necessary environment by implementing reforms and strengthening weak linkages. Certain regulations may need to be relaxed selectively in the process, but at any time, the deregulation should be in line with the authorities' regulatory capacity.

15. **Building up supervisory capacity.** As the new legal and regulatory framework has already been adopted, more emphasis should be placed on how to make it fully functional. First, recruiting and training staff on banking supervision, so that they not only understand the issues, but also know how to supervise. The CBM may consider hiring more staff with relevant expertise. Some outside consultants with good experience can also be an option. Meanwhile, the CBM should design a comprehensive training program with technical assistance to update the existing staff's supervision knowledge and application of analysis tools. Second, improving access to data and information so that staff has the necessary inputs to conduct supervision analysis. This requires the establishment of a set of rules and norms to standardize data and information, and a reliable and efficient information system for information collection, reporting and dissemination. Accounting and auditing rules need to be in line with global best practices too. Third, granting staff enough enforcement power so that they can effectively supervise. To substantiate the power, enforceable measures and instruments need to be established. For example, some punishment measures (such as penalties, suspension of business, or even the revoking of licenses) may apply if banks violate regulations.

16. **Developing monetary policy infrastructure**. The authorities should focus on developing the supporting components of a well-functioning monetary policy framework. On the one hand, the toolkit needs to be enriched. One priority is to develop tools for liquidity injection. In view of the absence of a secondary bond or treasury bills market and the difficulty in removing legal barriers to foreign bank branches' holding local currency deposits in the short term, the CBM may consider introducing its own version of Domestic Non-

Deliverable Forward. This tool can not only be used to manage liquidity but also can be offered as a tool for hedging against exchange rate risks. More importantly, perhaps, it has the advantage of not losing FX reserves, which is important considering that Myanmar has a low level of reserves. Another adjustment the CBM may consider is to separate the policy rate from the deposit and lending rate to increase policy flexibility. This will free the hand of CBM, allowing it to better manage short-term liquidity in the interbank market. On the other hand, the interbank market should be further developed. In addition to the hard infrastructure of CBM-NET2, soft infrastructure also needs to be established or strengthened. The CBM may consider introducing a primary dealer (market-making) mechanism to facilitate price discovery and stability in the interbank market. An interest rate corridor system is needed. A floor can be introduced such as by offering an interest rate on excess reserves (IOER), while the credit facility rate can act as the ceiling. To fully control the corridor, the CBM needs an instrument, usually a repo, to anchor the level of the band. The collaterals for repo transactions will require the development of a bond market.

17. **Guarding economic stability with better policy management.** One key feature of instabilities in Myanmar's economy is high inflation. In view of its largely supply-driven nature, policy should focus on addressing supply bottlenecks. Efforts can be made to improve transportation infrastructure to reduce logistic costs and to establish a food reserve system to dampen large food price swings, in particular after a natural disaster. At the same time, fiscal policy should follow good discipline and deficit financing should be phased out as planned. Meanwhile, another source of instability that should not be neglected is that most large investment projects are not financed by the government or domestic financial institutions. However, they tend to exert a huge impact on current account, exchange rate and ultimately, on growth and inflation. Therefore, particular attention needs to be paid to arrangements of these projects. Policies should be consistent, coordinated and compatible with the economy's absorptive capacity.

18. **Enhancing the resilience of the banking system.** Policy should focus on removing both the weaknesses as well as the root causes of the weaknesses. The effort to strengthen banks' balance sheet should continue, such as by increasing capital and provisions. More importantly, the authorities should facilitate the development of domestic banks' capabilities in modern commercial banking. The authorities can provide a conducive environment by reducing policy distortions and providing supportive conditions. The CBM may also consider removing the constraint on loan tenors and raising the lending rate ceiling to allow more room for banks' operations. At the same time, establishing a credit bureau will greatly reduce information asymmetry and allow banks to effectively engage in risk management. Although self-reliance is important, there is a lot in modern commercial banking that is difficult to develop in-house, and therefore, learning from outside is important. Strategically allowing foreign equity holdings of domestic banks can help attract capital and usher in much needed management skills and knowledge. Moreover, healthy competition will help in expediting the transformation process. As for chronic issues that state-owned banks are faced with, reforms are necessary. The authorities could consider separating quasi-fiscal and social-economic

burdens from these banks so that they can be commercially viable in the longer term. The social-economic objective can be achieved with specialized development banks. As for addressing the issue of NPLs, setting up a bad bank could be a possible solution.

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