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Myanmar's Two Decades of Partial Transition to a Market Economy: A Negative Legacy for the New Government

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Abstract

Despite more than two decades of transition from a centrally planned to a market-oriented economy, Myanmar's economic transition is still only partly complete. The government's initial strategy for dealing with the swelling deficits of the state economic enterprises (SEEs) was to put them under direct control in order to scrutinize their expenditures. This policy change postponed restructuring and exacerbated the soft budget constraint problem of the SEEs. While the installation of a new government in March 2011 has increased prospects for economic development, sustainable growth still requires full-scale structural reform of the SEEs and institutional infrastructure building. Myanmar can learn from the gradual approaches to economic transition in China and Vietnam, where partial reforms weakened further impetus for reforms.

Keywords: Myanmar, transition, state economic enterprises

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Myanmar's Two Decades of Partial Transition to a Market Economy: A Negative Legacy for the New Government¹

1. Introduction

The installation of a new government in March 2011 has increased Myanmar's prospects for economic growth and integration into the international economy. However, the economic conditions inherited by the new government are less than ideal. In 2011, the gross domestic product (GDP) per capita was USD 856.8, and the trade per capita was USD 330.3, both of which are the lowest among the members of the Association of Southeast Asian Nations (ASEAN).²

From 1962 to 1988, Myanmar (then Burma) pursued the 'Burmese Way to Socialism', a variant of central planning with self-imposed isolation from the international economy. More than two decades have passed since 1988, when the former junta announced the transition to a market-oriented economy. Due to the peculiar transition strategy, however, it can be considered only partly complete.

This paper explores this economic transition. Although the Myanmar economy has sometimes been analyzed from the viewpoint of transition economies in the 1990s (Cook, 1995; Rana, 1995; World Bank, 1995; Tun Wai, 1996), it has seldom been discussed from this viewpoint in the 2000s due to a lack of information. This paper aims to profile the challenges faced by the new government that are particular to transition economies.

The remainder of the paper is organized as follows. Through a literature survey, Section 2 lists the major elements of the transition process from a centrally planned to a market-oriented economy. Myanmar's performance with regard to these elements is examined in the subsequent sections. Section 3 outlines the transition strategy of the former military junta. Sections 4 and 5 describe the salient features of the public and private sectors, respectively, under Myanmar's transition. Section 6 outlines remaining challenges that the new government must deal with in the transition process. Section 7 summarizes the analysis and offers some concluding remarks.

¹ This paper has benefited from discussions with former senior officials of the Government of Myanmar. All remaining errors and omissions are the responsibility of the author.

² These figures are calculated from the data in Asian Development Bank (2012).

2. Elements of Transition to a Market Economy³

This section lists the major elements of the transition process to a market economy, on which Myanmar's performance is evaluated in subsequent sections. There are three main components of the transition process: macroeconomic stabilization; price and market liberalization; and restructuring and privatization of old state enterprises and allowance of new private firms and activities (IMF, 2000: 91). Due to diverse initial conditions and reform strategies of the governments, transition economies took diverse paths in transitioning to market economies, with varying degrees of success in terms of economic performance.

Macroeconomic stabilization includes the management of inflation. Many transition economies experienced high inflation during the early years of transition. High inflation was caused in some cases by the elimination of controlled prices and in others by a fall in output during the initial transition. Liberalization of price controls often resulted in sharp price increases. Monetization of fiscal deficits that came about as a result of the fall in output and the restructuring of state enterprises also played a role in sparking inflation. Tight monetary and fiscal policies were the usual prescription for containing inflation, and the shortage of fiscal revenues was a major obstacle for fiscal consolidation.

Price and market liberalization, and restructuring state enterprises and permitting private firms are structural reforms designed to replace a centrally planned economy with a system of market-oriented resource allocation. Centrally planned economies employ controlled prices that distort relative prices and cause inefficient resource allocation and black markets. Price liberalization refers to the elimination of controlled prices and includes the alignment of the official foreign exchange rate to the parallel market rate. Market liberalization refers to the elimination of entry barriers for industries that were formerly monopolized by state enterprises as well as the liberalization of foreign exchange and foreign trade. Price and market liberalization is used to create greater economic efficiency and to enhance economic growth.

The restructuring and privatization of state enterprises and the allowance of new private firms are designed to allow the private sector to supplant the state sector as the major actor in the economy. Privatization of state enterprises was more prominent in the transition economies of Central and Eastern Europe and the former Soviet Union, whereas the establishment of new private firms was emphasized in the case of East

³ This section heavily draws on IMF (2000). Other comprehensive reviews include European Bank for Reconstruction and Development (1999) and World Bank (2002).

Asian transition economies (Rana, 1995).

These three pillars of the transition process are not sufficient conditions for a successful transition; the literature stresses the importance of institutional infrastructure building (IMF, 2000; Havrylyshyn, 2001; Svejnar, 2002) as well. Institutional infrastructure underpins the operation of market economies. Necessary reforms include the elimination of direct and indirect subsidies from the state budget and the implementation and enforcement of bankruptcy laws and creditor rights. All of these impose hard budget constraints on economic agents.

In regard to institutional infrastructure building in the transition process, there has been debate between advocates of the big bang approach and the gradual approach (Roland, 2000). Given the complementarity among the above-mentioned three pillars of transition processes, the advocates of the big bang approach propose implementing all the reforms simultaneously and rapidly. In contrast, the advocates of the gradual approach contend that institutional infrastructure building is evolutionary and that existing institutions will adapt to new environments gradually. They argue that the big bang approach fails to recognize the long and difficult process of institutional infrastructure building.

The debate over these two approaches remains unresolved. McMillan and Naughton (1992) argue for the advantages of the gradual approach, pointing to the high performance of the gradual approach economies such as China when compared with the big bang approach economies in Central and Eastern Europe and the former Soviet Union. On the other hand, Sachs and Woo (1994) contend that China's high economic performance is more a consequence of its initial conditions, in particular its large agricultural sector. In the subsequent literature, the slow reform of large state enterprises in countries taking the gradual approach is cited as a concern because the enterprises could evolve into vested interest groups that obstruct further reform to preserve rents from the partial reform (Roland, 2000).

3. The Myanmar Way to Transition to a Market Economy

Until 1988 the government led by the Burma Socialist Programme Party (BSPP), Myanmar (Burma) pursued the Burmese Way to Socialism, a variant of central planning.⁴ The agricultural sector, which accounted for the bulk of economic activity, was never collectivized, but the marketing of principle agricultural commodities was

⁴ Myat Thein (2004) offers a detailed description on the 'Burmese way to Socialism'.

monopolized by the state enterprise under the state procurement and distribution system. The industrial and services sectors were wholly under the control of the central planning office, although they accounted for a minor share of GDP, around 21.7% as in other transition economies in Southeast Asia (Rana, 1995). Foreign trade was also monopolized by the state. Nonetheless, smuggling was considered pervasive (Tin Soe and Fisher, 1990).

Myanmar started its transition to a market economy during the economic turmoil of the late 1980s. Before the transition, the real GDP growth rate was negative for three years in a row, and it recorded minus 11.4% in 1988 (World Bank, 1995). To counteract the economic downturn, in September 1987 the BSPP government announced the abolition of the state procurement and distribution of rice, which led to an immediate jump in the price of rice. To combat inflation, the government demonetized large denomination banknotes in September 1987. The demonetization invalidated 57% of the currency in circulation. The rise in the price of rice and the demonetization led to a nationwide anti-government movement in August 1988. Under these circumstances, the military staged a coup d'état in September 1988, seizing power from the BSPP. The military established the State Law and Order Restoration Council (SLORC) and announced the abandonment of the Burmese Way to Socialism, aiming to revitalize the economy. The military junta remained in the office until March 2011 and implemented its peculiar transition strategy.⁵

The transition strategy of the military junta emphasized the creation of new private firms and activities as opposed to state enterprise reform. The government liberalized the domestic marketing of agricultural commodities but resumed the procurement and distribution system for rice, though on a smaller scale than before. The government also allowed private firms to enter the industrial, commercial, and foreign trade sectors, while the State Economic Enterprise Law instituted in March 1989 designated 12 sectors for monopolization as state economic enterprises (SEEs). These included teakwood, minerals, petroleum and natural gas, and precious stones and pearls.

The junta recognized the inefficient operations of existing state enterprises. Under the BSPP regime, SEEs took loans from the Myanmar Economic Bank (MEB), one of the state banks, and maintained revolving funds outside of the centrally controlled budget. These loans resulted in large accumulation of debt. The outstanding loans from the MEB to the SEEs swelled from 9% of GDP in 1978 to 61% in 1988. Furthermore, the source of funds for loans to the SEEs was mostly the central bank lending to the

⁵ The junta changed its name to the State Peace and Development Council in November 1997.

MEB. In fact, by printing money, the central bank had been lending to the SEEs indirectly through the MEB.⁶

The most striking feature of the state enterprise reform was the inclusion, starting in fiscal year 1990, of SEE financing within the state budget. This allowed the government to scrutinize SEE expenditures more carefully. The government also banned bank loans to the SEEs and created the State Fund Account (SFA) within the state budget, from which all financing of the SEEs was provided. Under this system, SEEs surrendered all surpluses, if any, to the SFA and the SFA covered all deficits, if any, of the SEEs. Thus, the SEEs were no longer accountable for their losses or profits. In fact, the introduction of the SFA exacerbated the soft budget constraint problem of the SEEs (Cook, 1995; World Bank, 1995).⁷

Another salient feature of the reform was that the central planning of production and distribution and the use of the price controls in the public sector remained intact. Official prices of SEE products were controlled by either their parent ministries or the Cabinet, depending on the importance of the product. Strategic products whose prices were determined by the Cabinet included petroleum and vehicles. In a sense, the official exchange rate for foreign currency remained the most significant officially controlled price. The official exchange rate had been fixed at 8.50847 kyat per special drawing right (SDR) of IMF since 1977, and it had never been devaluated until April 2012. Because the SEEs often traded with each other, the use of the controlled price resulted in cross-subsidies, masking the economic performances of individual SEEs.

As a consequence of this transition strategy, two resource allocation systems stood side by side in Myanmar: central planning of the state sector and the market-oriented economy of the private sector.

4. Public Sector in Transition

As of 1990, the overall public sector share of GDP was 22%, and the total employment in SEEs was 312,000 (World Bank, 1995: 52-53). The operations of the Myanmar's SEEs have been diverse. They included large-scale monopolistic operations such as electric power generation and supply, railways, and the post and telecommunications. They also included operations such as textiles and foodstuffs

⁶ While MEB loans to SEEs equaled 61% of GDP, savings in the banking sector came to only 11.3% of GDP as of 1988.

⁷ The next section will examine the state budget system in more detail.

where there was competition with the private sector and with imported goods. Table 1 summarizes the consolidated non-financial public sector operations for selected fiscal years. The term ‘Consolidated Accounts’ used in the table refers to the consolidated accounts of the central government and the SEEs.

Table 1

Although the SEEs appear to have accounted for a large portion of the fiscal deficit, it is difficult to determine the exact size of their deficits. On the one hand, the SEEs contributed financially to the Union Government through monetary transfers. In 2007, such transfers from SEEs surpassed their overall deficit. On the other hand, the World Bank (1995: 56-58) argued that there were implicit subsidies from the Union Government to the SEEs embedded in the provision of electricity and petroleum products at subsidized prices as well as interest subsidies on investment grants. The World Bank considered that when these subsidies were taken into account, the SEEs were still responsible for approximately 20% to 50% of the fiscal deficit in the early 1990s.⁸ Thus, the deficits of the Union Government and the SEEs are difficult to disaggregate with precision.

The most important feature of Myanmar’s transition was the worsening of the soft budget constraint problem embedded in the state budget system. The budget system was divided into the local currency (Myanmar kyat) budget and foreign exchange budget. The remainder of this section presents the details of the budget system.

Kyat Budget⁹

Both SEEs and ministerial departments received financing from and surrendered all revenues to the SFA. A diagram of the state budget system for the SEEs is shown in Figure 1. Since the SFA, as well as the current accounts of the SEEs and the Union Government, was at the MEB, this institution played the role of cashier for the public sector.

Figure 1

The SFA created a more centralized budget system for the state sector than that used

⁸ Such estimates are not available for the fiscal deficit of recent years.

⁹ The information on the budget system is based on the facts before 2009. Since then, there may have been some changes in the system.

prior to 1988. The SEEs had to obtain approval from the Ministry of Finance and Revenue for both capital and current expenditures. After approval, the budget of individual SEEs was disbursed to their current accounts at the MEB. In addition, SEEs were not allowed to dispose of their revenue freely; they had to surrender it to the SFA. Thus, the disbursed budget imposed an effective ceiling on SEE expenditures.

The SFA exacerbated the soft budget constraint problem of the SEEs. In terms of cash flow, the SEEs surrendered revenues at their current account to the SFA. In terms of profit and loss, if a SEE happened to have a profit, its transfer to the SFA was registered as an income tax and contribution to the central government. In contrast, a SEE's deficit was recorded as a net transfer from the central government to the SEE. That deficit was already financed with the disbursed budget from the SFA, and the central government was liable for the remaining debt. From the standpoint of the SEEs, their deficit did not remain as their debt. Thus, although the budget system did not allow the SEEs autonomy in their expenditures, neither did it hold them accountable for poor performance.¹⁰

The next question is how the Union Government financed deficits in the SFA. The Union Government employed both treasury bills and treasury bonds to finance the SFA, with the former as the main tool. The central bank accepted treasury bills and, in exchange for them, printed and injected money into the Union Government. The Union Government used the receipts from the SFA to discharge the treasury bills. If the revenue from the SFA fell short of budget expenditures, it mostly resulted in the accumulation of outstanding treasury bills. This is the process of monetizing fiscal deficit, where the deficit of the SEEs was financed primarily by the central bank through the SFA.

The strong dependence on monetization to finance the fiscal deficit is evident in Figure 2, which shows changes in the central bank's claims on the Union Government, the changes in commercial banks' claims on the Union Government, and the net sales of treasury bonds in terms of percentage of GDP. Given that the size of the fiscal deficit had been around 5% of GDP, the figure indicates that the central bank financed the bulk of the fiscal deficit. As will be shown later, such monetization of fiscal deficit undermined macroeconomic stability.

Figure 2

¹⁰ Apart from centrally planned production, some SEEs undertook consignment production for private firms, or entered into joint ventures with foreign firms. However, the profits (in a joint venture, the SEE's portion of the profits) were also transferred to the SFA.

Foreign Exchange Budget

The budget system collected and allocated foreign exchange within the public sector separately from the kyat budget. The foreign exchange budget and kyat budget were not convertible; an SEE who had a surplus in its kyat budget could not convert it into the foreign exchange budget. For individual expenditures in foreign currency, the SEEs had to obtain a foreign exchange permit (FE permit) from the Ministry of Finance and Revenue in addition to authorization from their respective parent ministries. Once an FE permit was issued, the government credited foreign exchange to the SEE's account at another state bank, the Myanmar Foreign Trade Bank (MFTB) and subsequently debited the equivalent kyat amount at the official exchange rate from the SEE's account at the MEB. In this way, foreign exchange was rationed to the SEEs at the official exchange rate.

Furthermore, the SEEs were not permitted to dispose of their own foreign currency revenue, but had to surrender all such revenue to the MFTB. When the SEEs surrendered their foreign currency revenue, the equivalent amount of kyat at the official exchange rate was then credited to its current account at the MEB.

Thus, the foreign exchange budget was more strictly controlled than the kyat budget so there was little scope for rent seeking among the SEEs despite the large gap between the official and parallel exchange rates. Moreover, the SEEs were not profit-oriented entities in the first place.

These strict controls were a reaction to a shortage of foreign exchange during the 1990s. As shown in Table 2, the trade balance of the state sector had been in deficit until the Myanmar Oil and Gas Enterprise, an SEE, began exporting of natural gas in 2000. Major export items of the SEEs included natural gas and timber, and the foreign exchange revenues from these exports were allocated for mainly imports of fuel oil.

Table 2

The use of the overvalued official exchange rate complicated the management of the state budget. The foreign exchange revenues of the SEEs were converted into kyat at the official exchange rate, thus overvaluing the kyat by a factor of more than 100 compared with the parallel exchange rate in the 2000s. Thus, the trade surplus, if any, would be undervalued and would not contribute much to the state budget in nominal terms. According to an estimate by Kubo (2011), devaluation of the official exchange rate to the level of the parallel rate would have turned the government's fiscal deficit

into a surplus for 2008.

5. Private Sector in Transition

This section evaluates three aspects of Myanmar's transition to a market economy in relation to the private sector: macroeconomic stability, market liberalization, and institutional infrastructure.

Macroeconomic Stability

Monetization of fiscal deficits led to excess money supply, which is considered to have then brought about high inflation (Turnell, 2011). Figure 3 summarizes the rate of inflation per annum, as well as year-on-year changes in the money supply and retail rice price. The inflation rate refers to the consumer price index (CPI) inflation, and money supply indicates the sum of money and quasi-money. The negative growth in money supply in the early 1988 was due to the demonetization in September 1987. Rice is the staple food in Myanmar, and expenditures on rice accounted for 30.1% of the total expenditures of an average household in 1989, and 18.3% in 2006, implying that rice had higher weight in the CPI.¹¹ It can therefore be concluded that the changes in the retail rice price partially translated into inflation. Two observations can be made on the figure below.

Figure 3

First, the dynamics of inflation were largely the result of changes in rice prices. There were several sources of rice price fluctuations. One is the liberalization of the domestic rice market in 1989. Although monthly data are not available, the annual data show that the rice price index increased from 100 in 1986 to 112 (1987), 191 (1988), and 339 (1989) before falling to 266 in 1990, implying that the rice price overshot its equilibrium after the liberalization of domestic marketing (Fujita and Okamoto, 2006). Export controls on rice also exacerbated the fluctuation; due to tight controls on rice exports, a good harvest would result in a collapse of the price, as occurred in 2000. In fact, the retail rice price in real terms fluctuated more than the export price did, indicating that domestic factors were the dominant sources of price fluctuations as

¹¹ These figures are from *Statistical Yearbook*, Central Statistical Office (CSO), Myanmar.

opposed to international market factors.

Second, the inflation rate did not exceed double digits during the initial transition process as it did in other transition economies such as Vietnam. As shown in the above figure, the retail rice price increased by 70% in 1988 and 77% in 1989. The CPI-based inflation remained below 50% in these years, whereas the average inflation rate for the entire period from 1988 through 2012 was 22.4%.

However, despite no clear correlation between inflation and changes in the money supply in Figure 3, inflation might be partially attributable to the excess money supply. Kubo (2007) confirmed a co-integration relationship between the money supply (money plus quasi-money; M2) and the price level (CPI), suggesting that inflation was related to the growth in the money supply over the long run. Fischer et al (2002) argued that the short-run dynamics of the price level are dominated by various shocks, but in the long run, there is a stable relationship between the price level and the money supply in developing countries with high inflation. Their argument applies to Myanmar. The averages of annual inflation rate, changes in the retail rice price, and changes in money supply for the period from April 1990 through March 2011 were close to each other at 23.4%, 27.0%, and 31.4%, respectively.

High inflation imposed an inflation tax on the private sector's holdings of domestic currency. For an inflation tax, the currency in circulation is equivalent to the tax base, and the inflation rate is equivalent to the tax rate. For example, in fiscal year 2001, the currency in circulation was 18.7% of GDP and the average inflation rate was 34.6%, so that the inflation tax was equivalent to 6.5% ($=18.7\% \times 34.6\%$) of GDP. High inflation was a factor that depressed private sector growth.

Market Liberalization

The government allowed the operations of private firms, but they were subject to various interventions. The most extensive interventions were observed in the foreign exchange market and foreign trade.

Since 1989, the official exchange rate for foreign currency was applied within only the public sector and not within the private sector. When external trade in the private sector was legalized in 1988, private exporters were permitted to retain only 60% of the foreign exchange they earned from exports; 40% had to be surrendered to the government at the official exchange rate. In 1989 the retention rate was raised to 100%, but exporters were subject to a 10% export tax paid in foreign currency.¹² Since then, there was no surrender requirement on export earnings for the private sector or on

¹² The export tax was reduced in September 2011.

foreign exchange allocation to private importers, so the foreign exchange market became divided between the public and private sectors (World Bank, 1995; Hori and Wong, 2008; IMF, 2012).

If the foreign exchange transactions in the private sector were all in the parallel market, how was the parallel market exchange rate determined? Because the foreign exchange regulations prohibited the people of Myanmar from holding foreign currency, private exporters were required to deposit their export earnings as foreign currency deposits (FCDs) at state banks.¹³ While the government did not permit FCD holders to withdraw their deposits in foreign currency,¹⁴ the government tolerated domestic account transfers of FCDs. Thus, exporters were able to transfer FCDs to the buyers' accounts, and received payments in kyat. In this way, FCDs were traded in negotiated transactions between exporters and importers at competitive prices. Apart from FCDs, informal holding of foreign currency was also tolerated and widespread.¹⁵ Both FCDs and informally held foreign currency were traded in the parallel market. In March 2012, just before the move to the managed float system, the parallel market rate was around K850 per US dollar, while the official exchange rate was approximately K5.5 per US dollar.

The gap between the official exchange rate and that of the parallel market did not itself directly distort the economic activity of the private sector. Since private exporters were permitted to retain export earnings as FCDs, the gap between the two exchange rates did not impose an effective tax on exporters, unlike the dual exchange rate regimes in other countries. At the same time, the gap did not function as a subsidy to private importers because they were not allocated any foreign exchange. Therefore, in Myanmar's segmented foreign exchange market, the official exchange rate had scarcely any impact on the private sector.

On top of these foreign exchange regulations, there were strict regulations on foreign trade. Both imports and exports required government licenses for every shipment. Issuance of import licenses for vehicles was restrictive, which distorted the price of vehicles. Furthermore, in the face of a surge in private imports, in July 1997 the government conditioned issuance of import licenses on license applicants having sufficient FCDs at state banks to cover the import bills. This regulation is often

¹³ At times, foreign currency deposits at private banks were also permitted.

¹⁴ Starting in February 1993, the government introduced foreign exchange certificates (FECs). Since then, it has been possible for FCD holders to withdraw in FECs, and to sell these for kyat in the parallel market.

¹⁵ These include proceeds from smuggling and remittances from people working outside the country.

referred to as the ‘export first and import later’ policy, or simply the ‘export first’ policy. As a result, two distinctive types of foreign exchange transactions emerged within the private sector as described in Figure 4. One was the buying and selling of FCDs. FCDs were export earnings after the deduction of export taxes, and could be used to obtain import licenses. The other was the buying and selling of informally held foreign exchange, which could not be used for import licenses.

Figure 4

Growth in private imports was constrained by the amount of private exports after the enforcement of the ‘export first’ policy was strengthened in 2002. Table 2 shows that the trade balance of the private sector was more or less even from 2002 through 2009. This implies that the demand for imports in excess of the available FCDs was channeled to the black market. In fact, the large discrepancies between official Myanmar import data and the corresponding data of trade-partner countries suggest that smuggling was a large portion of foreign trade. In 2009, the government expanded the categories of export earnings eligible for import licenses to include foreign currency incomes from services such as local hotels and tourism. This helped private imports to surpass private exports in 2010 and 2011. In any case, it is evident that the tight controls on private imports, especially the ‘export first’ policy, had distorted the foreign trade in the private sector.

Regardless of the segmentation of the foreign exchange market, why did the government maintain the restrictive controls on foreign exchange and foreign trade of the private sector? Figure 4 hints at the answer. The two linkages between the public and private sectors¹⁶ may be the rationale for the government’s strict administrative controls. First, export taxes were collected from the private sector in foreign currency. This became a part of the government’s fiscal revenue, and was allocated within the public sector through the state budget system. Second, state banks were able to channel the FCDs of the private sector to the state budget as loans. The tight controls compelled exporters to deposit export earnings in state banks, which allowed the

¹⁶ In addition to these two, there is another linkage. Some SEEs and ministerial departments procured imported goods from private importers by using their kyat budget. Government allocation of foreign exchange is concentrated in a small number of SEEs that have regular expenditures in foreign currency. Foreign exchange was not always allocated for one-off purchases of imported machines, in which case they were procured through the kyat budget from private importers. Such official procurement through private importers, when a large sum, may have a depreciating effect on the parallel exchange rate.

government to collect export taxes as well as temporarily borrow from them.

Institutional Infrastructure

Weak development of institutional infrastructure was manifested in the underdevelopment of the banking system. The banking system is a key piece of institutional infrastructure for shifting resource allocation from a centrally planned to market-oriented system. Some macroeconomic indicators in Figure 5 confirm the underdevelopment of the banking system.

Figure 5

The high ratio of currency to money supply indicates the dependence of the Myanmar economy on cash as opposed to bank deposits. This ratio was 63% in 1995, improved to 43% in 2002, and worsened to 70% after the banking crisis in 2003. As of 2010, it was 51%. For reference, the ratio was 13% in Indonesia (2010), 16% in the Philippines (2007), 9% in Thailand (2010), and 14% in Vietnam (2010). Myanmar's ratio of currency to money supply is the highest among Southeast Asian economies.

The trend of the currency to money supply ratio was dominated by the development of private banks in the case of Myanmar. The Financial Institutions of Myanmar Law, enacted in July 1990, permitted private commercial banks. The first license to a private bank was granted in May 1992, and overall 20 private banks had obtained the banking licenses as of May 1997. Because they offered more convenient banking services than the state banks did, the total deposits of private banks surpassed the overall deposits of the four state banks as early as 1998. Private banks developed resiliently until 2001, and the ratio of total deposits at private banks to money supply reached 42%. However, six major private banks faced a contagious bank run in February 2003, and the total deposits of the private banks fell from K 645 billion to K 216 billion during 2003.

This banking crisis was symptomatic of the underdeveloped institutional infrastructure. The root problem was the depositors' weak confidence in banks, which was mainly a result of insufficient disclosure of banks' financial condition and weak supervisory capacity of the financial authorities (Turnell, 2003). In this environment, the collapse of pyramid-scheme informal companies triggered panicked withdrawals of deposits at the largest private bank. Liquidity assistance from the central bank was both too little and too late, and only exacerbated the bank run, setting off a chain reaction that led to bank runs at other major private banks.

6. Challenges for the New Government

The new government inherited the incomplete transition to a market economy from the former military junta. The economic structure of the public and private sectors described in Sections 4 and 5 remains mostly unchanged as of 2012. There are at least four remaining challenges for the new government.

The first challenge is the reform of the SEE system. This has been slow even when compared with the gradual approach of other transition economies in East Asia. The integration of the SEEs into the state budget through the SFA worsened the soft budget constraint problem. To contain the deficits of the SEEs, it is essential to abolish central planning of the prices, production, and distribution of the goods and services that SEEs provide. The necessary reforms include the separation of the SEEs from the state budget as well as the abolition of the price controls and the implicit cross-subsidies in the state sector. These reforms will harden the soft budget constraints and allow the SEEs to integrate into the market-oriented economy of the private sector.

In February 2011, just before the change of the government from the military junta, there was a fire sale of state assets, including factories owned by SEEs. This could be viewed as a bold step toward privatization, but there are also concerns that the main purpose of the fire sale was to transfer blue-chip state assets to cronies of the military junta, leaving the new government with a larger financial burden.

Separating the SEEs from the state budget is not the end of restructuring. Henceforth they will need to raise working capital and investment from the market or their own proceeds. The soft budget constraint problem could thus reemerge in the form of weak financial discipline on the part of the SEEs or their lenders. Should the SEEs become financially distressed, they could seek assistance from the government *ex post*; this gives less incentive for the SEEs to improve operations *ex ante*. Banks may also expect the government to bail out their non-performing loans to the SEEs, and may therefore lend to the SEEs without scrutinizing the economic viability of the projects. The experiences of other transition economies, particularly Vietnam, show that non-performing loans can cause problems for state enterprises undergoing restructuring (Unteroberdoerster, 2004). This form of the soft budget constraint problem is a major concern in the transition process, and Myanmar can learn from the experience of Vietnam.

Second, price and market liberalization is only partly complete. For example, both exports and imports of the private sector are still subject to licensing. The new

government has undertaken several bold reforms in foreign exchange and foreign trade. One is the move from the fixed exchange rate system to the managed float system in April 2012. Others include the abolition of the 'export first' policy in April 2012 and the deregulation of car imports in May 2012. The new government aims to obtain IMF Article VIII status of the current account liberalization in 2013.

It should be noted, however, that the introduction of the managed float system and the devaluation of the official exchange rate have had only a relatively minor impact on the private sector. First, since the private sector did not use the official exchange rate, its devaluation had less effect there. Second, the Central Bank reference exchange rate was introduced in April 2012 to guide the price of foreign exchange transactions in the banking sector. Since formal transactions in the banking sector are subject to restrictions such as documentation of sources or usage of foreign exchange, black market transactions of foreign exchange are still pervasive. The restrictions separate the Central Bank from the black market, so that the Central Bank does not lead the black market rate, but rather follows it. Third, the SEEs are not yet integrated into the foreign exchange market with the private sector. Thus, the unification of the foreign exchange market remains as a challenge for the new government.

Compared with the introduction of the managed float system, the abolition of the 'export first' policy and the deregulation of car imports are more substantial. Issuance of import licenses was formerly at the discretion of the military junta. The tight import control distorted the price, with car import licenses yielding large rents which were shared between the junta and its business wing, the Union of Myanmar Economic Holdings Limited (UMEHL). The deregulation of car imports, along with the abolition of the 'export first' policy, stimulated private imports. Since Myanmar is facing severe appreciation of the local currency against major foreign currencies (IMF, 2012), a rise in imports would serve as a favorable countermeasure for alleviating currency appreciation.

The improved foreign exchange position of the government has also given impetus to liberalizing foreign exchange and foreign trade. Exploration for and export of natural gas has brought the government large amounts of export revenue, which has led to the accumulation of foreign reserves. This should allow the government to unify the foreign exchange market more comfortably without resorting to quantitative controls.

Third, macroeconomic stabilization is still incomplete. Monetization of fiscal deficits has been routine. The shortage of fiscal revenues remains a major obstacle to fiscal consolidation. Inefficient performance of SEEs is considered as one of the major sources of fiscal deficits. The controlled prices, including the grossly overvalued

official exchange rate, used to mask the true financial position of the state sector. In this regard, the move to the managed float system is expected to help clarify the financial position of the consolidated state sector as well as the individual SEEs.

Fourth, institutional infrastructure building has scarcely begun. The resumption in January 2011 of parliament, which had been suspended under the military junta, was an important development in the political economy dimension. Although the military-backed party accounts for the majority of seats, parliament has begun to examine the fiscal budget as well as to consider legislation such as the Foreign Investment Law. The resumption of parliament could speed up the reform of the governance of the public sector.

7. Concluding Remarks

More than two decades have passed since Myanmar's military junta announced the transition from the Burmese Way to Socialism to a market-oriented economy. This paper shed some light on the economic transition in Myanmar, which has seldom been examined in the recent literature due to scarce information on Myanmar economy. An investigation into the past transition processes clarified the remaining challenges for the new government.

This paper showed that Myanmar is lagging far behind in its reforms compared to the transition economies of China and Vietnam, two countries well known for their gradual approaches to state enterprise restructuring. The delay spans all of the following principle elements of transition processes; macroeconomic stabilization, price and market liberalization, restructuring of state enterprises, and institutional infrastructure building.

The root problem lies in the transition strategy's slow approach to structural reform of the state economic enterprises (SEEs). The government attempted to counteract the swelling deficits of the SEEs by integrating them into the State Fund Account (SFA) under the state budget and scrutinizing their expenditures while at the same time maintaining controls on the prices, production and distribution of the goods and services of the SEEs. This policy change exacerbated the soft budget constraint problem of the SEEs. The inefficient operations of the SEEs became a part of the fiscal deficits, and the monetization of the fiscal deficits resulted in macroeconomic instability.

Although the government permitted new private firms and activities, the private

sector has been subject to a high inflation tax, pervasive economic restrictions, and meager institutional infrastructure. Economic restrictions included tight import controls, which distorted the relative price and brought in economic rents to the former junta and its cronies. The meager institutional infrastructure was manifested in the underdevelopment of the banking sector; the major private banks once collapsed in a contagious bank run in February 2003 partially due to the weak financial regulatory framework.

Thus, the remaining challenge for the new government is to complete the reforms in restructuring the SEEs and to consolidate the fiscal balance, as well as to build institutional infrastructure. Myanmar can learn from the experiences of reforms in other transition economies, especially China and Vietnam, which followed the gradual approach in the reform of state enterprises. There is a concern that partial reform could produce opportunities for rent seeking, and those who have vested interests in the partial reform could obstruct further reforms.

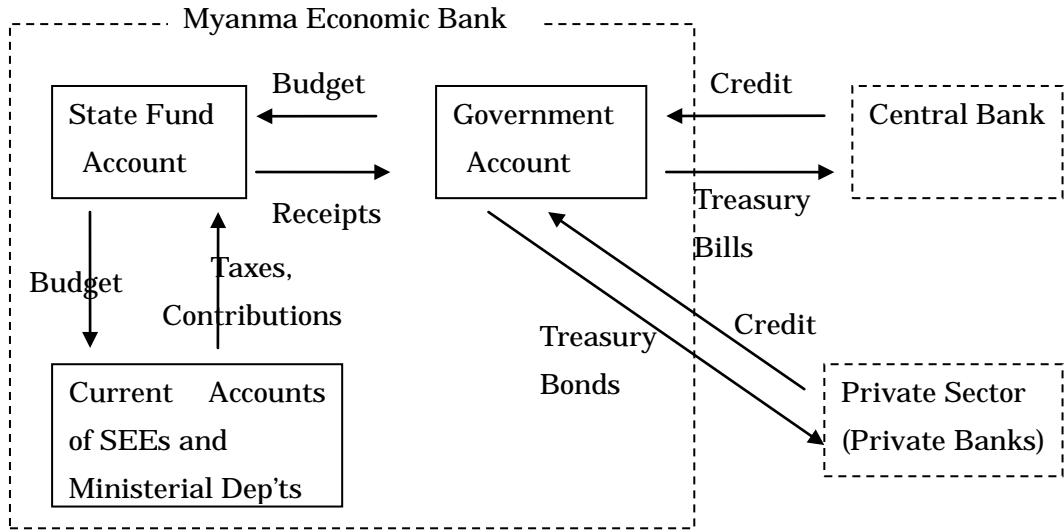
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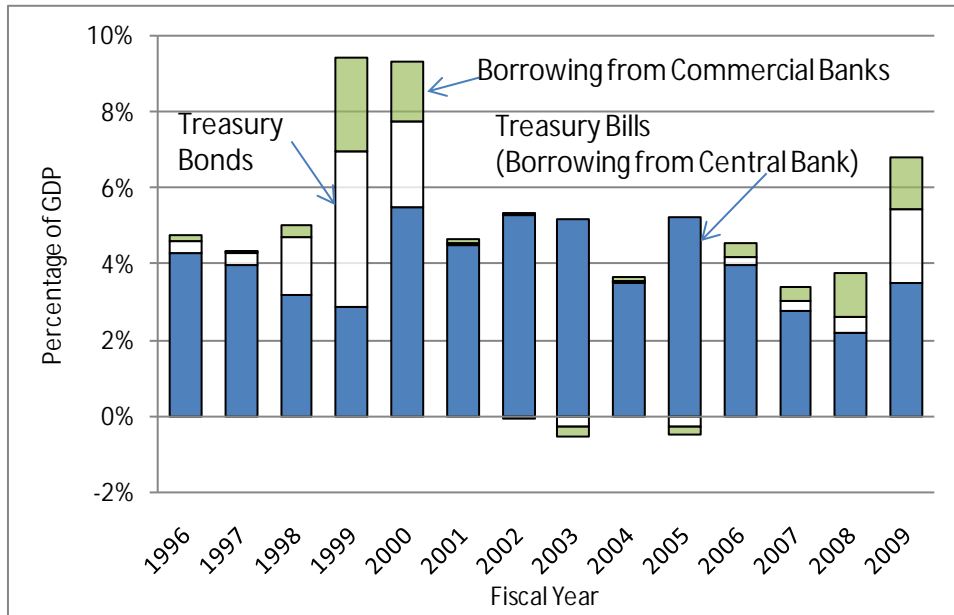
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Figure 1
 State Budget System and Monetization of the Fiscal Deficit



Source: Author

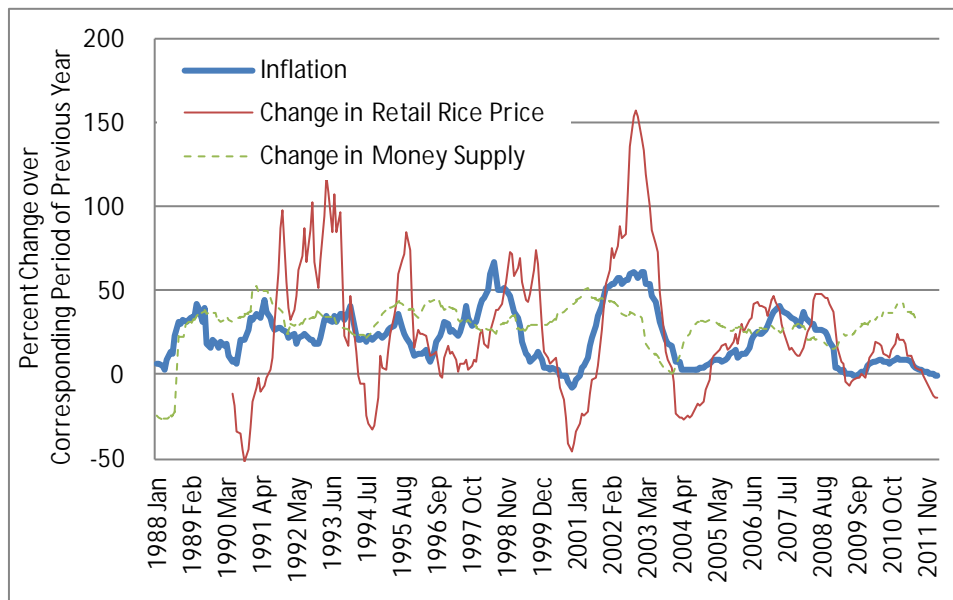
Figure 2
Financing of Fiscal Deficit, 1996-2009



Sources: *International Financial Statistics* CD-ROM, IMF; IMF (various issues); *Selected Monthly Economic Indicators*, CSO, Myanmar; *Statistical Yearbook*, CSO, Myanmar; *Key Indicators for Asia and the Pacific 2010*, Asian Development Bank.

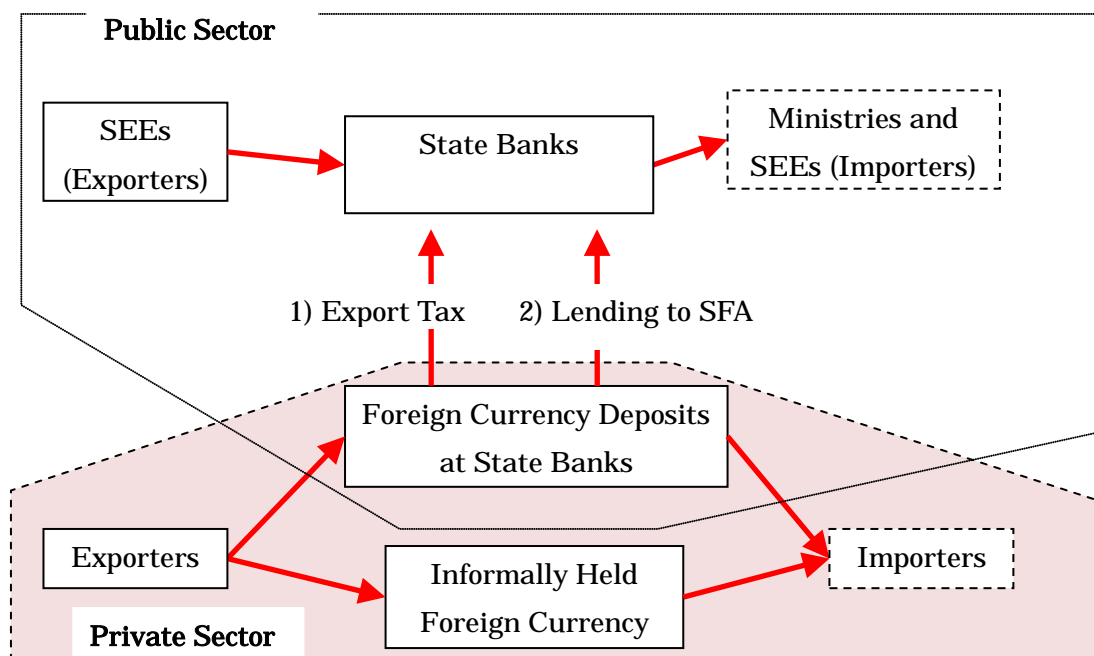
Notes: “Treasury Bonds” refers to the net sales of treasury bonds (total sales minus discharged). “Borrowing from Central Bank” is calculated as the balance between the central bank’s claims to the government as of the end of the current fiscal year compared with the end of the previous fiscal year. “Borrowing from Commercial Banks” is calculated from the balance-sheet data of the consolidated deposit money banks.

Figure 3
Inflation and Changes in the Retail Rice Price and Money Supply,
January 1988 to March 2012



Sources: *International Financial Statistics* CD-ROM, International Monetary Fund (IMF); *Selected Monthly Economic Indicators*, Central Statistical Organization (CSO), Myanmar.

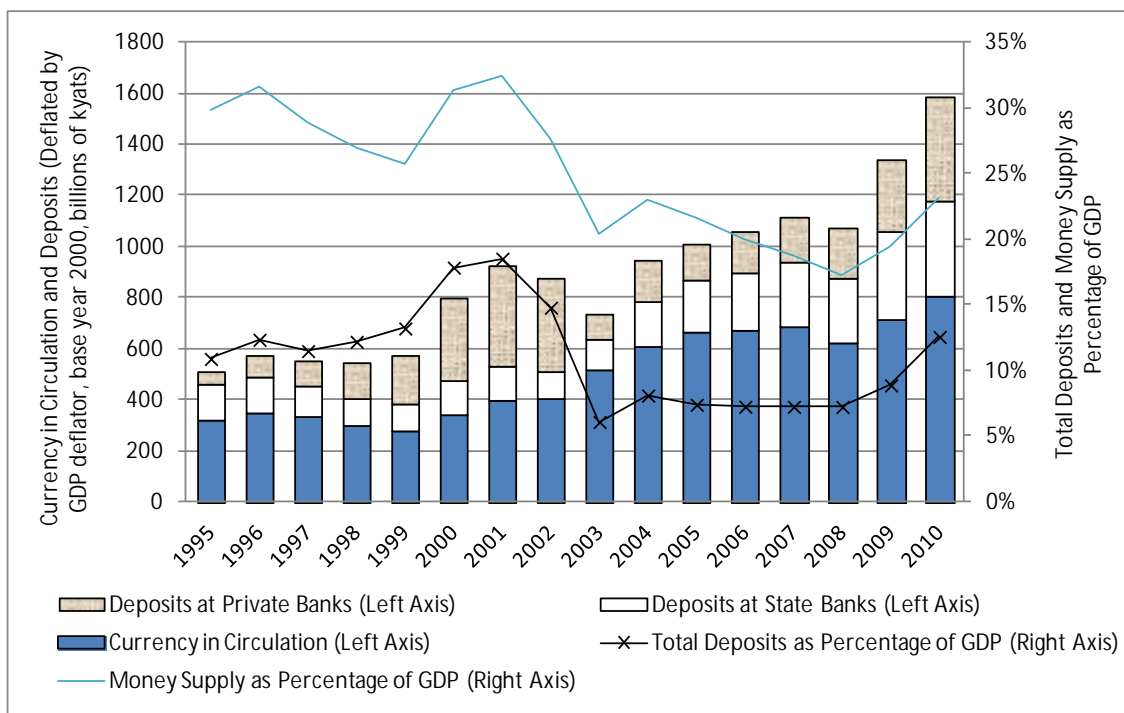
Figure 4
Foreign Exchange Linkage between Public and Private Sectors



Source: Author

Note: SEEs and SFA refer to state economic enterprises and the State Fund Account, respectively.

Figure 5
Indices of Financial Sector Development, 1995-2010



Sources: *International Financial Statistics*, IMF; *Statistical Yearbook*, CSO, Myanmar.

Table 1

Summary of Consolidated Non-financial Public Sector Operations

Fiscal Year	1992	1997	2002	2007
	<i>Unit: Kyats, Billion</i>			
Union Government				
Revenue	n.a.	88	281	1,722
<i>Tax Revenues</i>	<i>12.6</i>	<i>46</i>	<i>107</i>	<i>902</i>
<i>Transfers from SEEs</i>	<i>5.0</i>	<i>27</i>	<i>75</i>	<i>686</i>
Expenditures	n.a.	98	352	2,059
Overall Balance	-7.1	-10	-71	-337
State Economic Enterprises				
Receipts	n.a.	185	445	2,265
Expenditures	n.a.	232	576	2,704
Overall Balance	-5.8	-47	-131	-439
Consolidated Accounts				
Overall Balance	-12.9	-57	-202	-776
Overall Balance (% of GDP)	-5.2	-5.1	-3.6	-3.3

Sources: World Bank (1995); IMF (2001); IMF (2009).

Note: n.a. = data not available.

Table 2
Trade by Sector, 1995-2011

Fiscal Year	Private Sector		Public Sector			Total	
	Imports	Exports	Imports	Exports		Imports	Exports
			All Goods	All Goods	Natural Gas		
<i>Unit: US dollar, Million</i>							
1995	1,236	477	596	418	0	1,832	895
1996	1,559	605	434	323	0	1,993	928
1997	1,645	770	663	266	0	2,309	1,036
1998	1,820	745	882	337	1	2,702	1,082
1999	1,833	1,109	773	325	5	2,605	1,433
2000	1,857	1,380	463	581	171	2,321	1,961
2001	1,777	1,333	958	1,216	632	2,734	2,549
2002	1,786	1,653	511	1,422	912	2,297	3,075
2003	1,532	1,308	703	1,048	580	2,235	2,356
2004	1,354	1,262	626	1,653	1,015	1,979	2,915
2005	1,368	1,603	614	1,951	1,073	1,982	3,554
2006	1,804	2,068	1,125	3,155	2,031	2,928	5,223
2007	2,443	2,369	903	4,044	2,532	3,347	6,413
2008	2,592	2,480	1,971	4,313	2,384	4,563	6,793
2009	2,806	3,087	1,381	4,443	2,906	4,186	7,530
2010	4,623	3,502	1,781	5,354	2,515	6,404	8,856
2011	6,611	4,073	2,421	5,056	3,493	9,032	9,129

Source: *Selected Monthly Economic Indicators*, CSO, Myanmar.

Note: Myanmar's Central Statistical Organization reports the value of imports in kyat, which is converted into US dollar at the official exchange rate.