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IDE DISCUSSION PAPER No. 320

**Restructuring the State Budget System  
for Disinflation and Exchange Rate  
Unification in Myanmar**

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**Abstract**

The installment of a new government has augmented the prospect for implementing disinflation and exchange rate unification in Myanmar. A close look at the state budget shows that the reform of the budget system for state economic enterprises (SEEs) is essential. Reforms need to hold the replacement of controlled prices including the official exchange rate with market prices in SEE operations, and the separation of the SEEs from the state budget. But separating the SEEs from the state budget will necessitate careful planning to cope with SEE bankruptcies which would impose another fiscal burden on the government. Therefore, economic viability must be a criterion for the continuation of their operations.

**Keywords:** Myanmar, state economic enterprises, disinflation, exchange rate unification

**JEL classification:** H61, O24, O53

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## **Restructuring the State Budget System for Disinflation and Exchange Rate Unification in Myanmar<sup>1</sup>**

### **1. Introduction**

Since Myanmar's new government took office in March 2011, there has been the general perception that long pending economic reforms will finally be implemented. While disinflation and unification of the multiple exchange rates have been seen as priorities (Myat Thein, 2004), there has been little discussion on how to implement them. Pervasive administrative controls and little information on the Myanmar economy make it difficult to evaluate the necessary reform processes. The objective of this paper is to offer prospects for reform to deal with disinflation and exchange rate unification.

While more than two decades have passed since Myanmar (previously Burma) started its transition to a market economy from 'the Burmese way to socialism', reform of the state sector has hardly been implemented. Government policy has done little more than tide over the economic crisis by partially allowing economic activity in the private sector. Deficits in the public sector have been financed by printing money which has caused chronic inflation. In addition, the government imposed strict controls on foreign exchange and on foreign trade by the private sector to secure foreign currency for the public sector. The combination of inflation and administrative controls has repressed the private sector.

Disinflation cannot be achieved without overhauling the state sector. The heart of the problems in the state sector has been the state budget system for state economic enterprises (SEEs), in particular the use of officially controlled prices for SEE operations, and financial integrity of SEEs in the state budget.

First, SEEs have operated under controlled prices, and the most important factor determining these prices has been the official exchange rate. This rate has never been adjusted for more than three decades; it now overvalues the domestic currency against the US dollar by more than a hundred times. The use of the controlled prices has functioned as cross subsidies in the public sector, and has made it difficult to grasp the economic performance of individual SEEs.

Second, to cut down the expenditures of SEEs, the government deprived them of financial autonomy and subordinated their budgets to the state budget in 1989. This

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<sup>1</sup> This paper has benefited from discussions with former senior officials of the Government of Myanmar.

policy change did more harm than good. While the expenditures have been cut, the state budget system now automatically makes up for the deficits of the SEEs. This has aggravated their managerial inefficiency.

The multiple exchange rate system that exists is the result of the state budget system based on the official exchange rate and the circumvention of exchange-rate controls by the private sector. Unifying the exchange rate will entail the abolition of the foreign exchange budget in the state budget system.

This paper attempts to consolidate the available information in order to present the whole spectrum of necessary steps for disinflation and exchange rate unification. The remainder of the paper proceeds as follows. Section 2 describes the macroeconomic trends, especially the trend of inflation and fluctuations in the exchange rate. The main analysis is developed in Sections 3 and 4. Section 3 describes the state budget system for SEEs and the administrative controls on foreign trade and foreign exchange. Section 4 explains why it is necessary to restructure the state budget system for SEEs; it also breaks down reform processes into several steps. Section 5 argues that the time is ripe to restructure the state budget system for SEEs to achieve disinflation and exchange rate unification. Section 6 offers some concluding remarks.

## **2. Macroeconomic Trends: Inflation and Exchange Rate Fluctuation**

In 1988 Myanmar started its transition to a market economy from ‘the Burmese way to socialism’, a variant of a centrally planned economy. However, weak macroeconomic conditions were carried over into the transition process from the planned economic regime. Figure 1 summarizes the rate of inflation and changes in the parallel exchange rate for the last fourteen years. The parallel exchange rate refers to the Myanmar kyat vis-à-vis US dollar. A positive change indicates depreciation of the kyat.

Figure 1

Both the consumer price index (CPI) and the parallel exchange rate have exhibited instability. The average inflation rate per annum for the period from January 1998 through December 2010 went as high as 22.6 percent. For the parallel exchange rate, a notable change has been its continuous appreciation against the US dollar in nominal terms since 2007 while inflation remained high in 2007 and 2008. This implies a sharp appreciation of the real exchange rate, which will be discussed later in this section.

## 2.1 Inflation and Fiscal Deficit

High inflation in Myanmar has been attributable to monetization of fiscal deficit. Three factors are involved. First, Kubo (2007) confirmed a cointegration relationship between the money supply (money plus quasi money; M2) and the price level (CPI), suggesting that inflation is related to the growth in money supply over the long term. Fischer et al (2002) showed that while the short-run dynamics of the price level are influenced by various shocks, there is a stable relationship between the price level and the money supply in high inflation developing countries over the long term. Their argument applies to Myanmar. Second, the growth in the money supply mostly comes from changes in the amount of reserve money. Currency in circulation made up 58 percent of M2 as of the end December 2008. Third, the growth in reserve money is closely related to the growth in the central bank's lending to the central government. In other words, the central government finances its fiscal deficit with treasury bills, and the central bank accepts them and increases its reserve money. This leads to a growth in currency in circulation, and a growth in money supply, which in turn brings about inflation.

Heavy dependence on monetization as a measure to finance fiscal deficit is confirmed in Figure 2. This figure shows the changes in the central bank's claims on the central government, the changes in commercial banks' claims on the central government, and the net sales of treasury bonds in terms of percentage of GDP. Given that the size of the fiscal deficit has been more or less around five percent of GDP, the figure implies that the bulk of the fiscal deficit has been financed by the central bank.

Figure 2

A related question concerns the sources of the fiscal deficit. The operations of the Myanmar's SEEs are diverse. They include large-scale monopolistic operations such as electric power generation and supply, railways, and the post and telecommunications. They also include operations such as textiles and foodstuffs where competition exists 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 SEEs.

Table 1

The table shows that the deficit of the SEEs accounts for a large portion of the fiscal deficit. However, it is difficult to disaggregate the deficit between the central government and the SEEs. On the one hand, the SEEs contribute financially to the central government through monetary transfers. For 2007 such transfers from SEEs surpassed their overall deficit. On the other hand, the World Bank (1995: 56-58) argues that there have been implicit subsidies from the central government to the SEEs which have been embedded in the provision of electricity and petroleum products at subsidized prices as well as interest subsidies on investment grants. The World Bank considers that when these subsidies are taken into account, the SEEs were still responsible for approximately 20 to 50 percent of the fiscal deficit in the early 1990s. Such estimates are not available for the fiscal deficit of recent years.

## **2.2 Exchange Rate Fluctuations**

The official exchange rate is pegged to the Special Drawing Rights (SDR) of the International Monetary Fund (IMF) at K8.51 to one SDR. It has never been adjusted since 1977. As described in Hori and Wong (2008), the official exchange rate is applied only for transactions within the public sector. Private exporters have been allowed to retain the full amount of export revenue (after deduction of export taxes) since 1989; foreign exchange transactions in the private sector have been conducted at the parallel exchange rate. As of January 2012, the parallel market rate is around K800 per US dollar, while the official exchange rate is approximately K5.5 per US dollar.

The prevalent use of the parallel exchange rate is indicated in the share of private sector imports to total imports. Table 2 summarizes the value of imports by ownership. There are two data sources, the *Selected Monthly Economic Indicators* (SMEI) of the Government of Myanmar, and the *Direction of Trade Statistics* (DOTS) of the IMF. SMEI reports the import values by ownership (the private and public sectors). Apart from this, there is considerable discrepancy between SMEI and DOTS. In recent years, the discrepancy rose to the equivalent of the recorded volume of private imports. On the assumption that the discrepancy represents smuggling and under-invoicing by the private sector,<sup>2</sup> the share of private sector imports to total imports was around 80 percent for most of the years from 1997 through 2010. Such a high share of private sector imports implies that the parallel exchange rate has a greater influence on the economy than the official exchange rate.

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<sup>2</sup> When the import value of DOTS surpasses the total import value of SMEI, it suggests smuggling and under-invoicing by the private sector. On the other hand, when the import value of DOTS falls short of that of SMEI, one interpretation is over-invoicing by the private sector for the purpose of remittances.

Table 2

The parallel exchange rate has exhibited sharp fluctuations in real terms. Figure 3 depicts the trends of the real exchange rates of Southeast Asian currencies vis-à-vis the US dollar. In this figure, a rise in real exchange rate indicates depreciation. From 2006 through 2010, the real exchange rate of the kyat has appreciated by 128 percent. While this appreciation is partially explained by the weakening of the US dollar against most currencies, the appreciation of the kyat is by far the sharpest among the Southeast Asian currencies, meaning that the Myanmar kyat has appreciated against the other Southeast Asian currencies as well during this period.

Figure 3

### **3. State Budget System and Administrative Controls**

Reforms for disinflation and exchange rate unification are related to reforms of the state budget system and relaxation of administrative controls on foreign trade and foreign exchange. This section outlines the state budget system<sup>3</sup> and administrative controls.

#### **3.1 State Budget System for State Economic Enterprises**

##### **3.1.1 Kyat Budget**

The foundation of the state budget system for state economic enterprises goes back to the change of national policy in 1988. Before this change, Myanmar had adhered to ‘the Burmese way to socialism’. The government implemented price controls on major agricultural crops and industrial goods, and SEEs operated according to the state plan with controlled input and output prices.

Until 1989 the government permitted the SEEs to take loans from the Myanmar Economic Bank (MEB), one of the state banks, and maintain revolving funds outside the centrally controlled budget. However, such loans resulted in accumulating debt. The outstanding loans from the MEB to the SEEs swelled from nine percent of GDP in 1978 to 61 percent in 1988. Furthermore, the source of funds for loans to the SEEs was

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<sup>3</sup> The information on the budget system is based on the facts before 2009. Since then, there can be some changes in the system.



mostly the central bank lending to the MEB. In fact, the central bank had been lending to the SEEs indirectly through the MEB by printing money.<sup>4</sup> In 1989, as a measure to cut SEE expenditures, the government prohibited them from taking loans.

Since this policy change, the SEEs as well as ministerial departments have had to receive financing from the state budget not only for capital expenditures but also for current expenditures. The SEEs have to obtain approval from the Ministry of Finance and Revenue for their expenditures. Then the budget of individual SEEs is disbursed to their current accounts at the MEB. In addition, SEEs are not allowed to dispose of their revenue; they have to surrender it to the state budget. Thus, the disbursed budget imposes an effective ceiling on the SEEs expenditures.

A schematic of the state budget system for the SEEs is presented in Figure 4. All SEEs and ministerial departments receive their budget from the central government through the State Fund Account (SFA). The SEEs also transfer their revenue to the SFA. In terms of cash flow, the SEEs surrender the remaining balance of their current account to the SFA by the end of each fiscal year. In terms of profit and loss, if a SEE happens to have a profit, its transfer to the SFA is registered as the SEE's income tax and contribution to the government. A SEE's deficit is registered as a net transfer from the government to the SEE. That deficit is already financed with the disbursed budget from the SFA, and the central government is liable for the remaining debt.

Figure 4

From the standpoint of the SEEs, their deficit does not remain as their debt. Thus, while the budget system does not allow the SEEs autonomy in their expenditures, neither does it hold them accountable their poor performance. Apart from the centrally planned production, some SEEs undertake consignment production for private firms, or form joint ventures with foreign firms. However, the profits (in a joint venture, the SEE's portion of the profits) are also transferred to the SFA.

While the SEEs perform poorly, the controlled prices of their goods are likely to produce private profits for SEE managers and their cronies. Because of the gap between the controlled selling prices of SEE goods and the prices for the same goods selling on the open market, SEE managers and cronies can profit privately by selling SEE goods on the black market.

The next question is how the central government finances the SFA. The government

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<sup>4</sup> While MEB loans to SEEs equaled 61 percent of GDP, savings in the banking sector came to 11.3 percent of GDP as of 1988.

employs treasury bills and treasury bonds to finance the SFA, with the former as the main tool. The central bank accepts treasury bills, and prints and injects money into the government. The government uses the receipts from the SFA to discharge the treasury bills. Then, if the revenue of the SFA falls short of budget expenditures, it mostly results in the accumulation of outstanding treasury bills. This is the process of monetizing fiscal deficit where the deficit of the SEEs is automatically financed by the central bank through the SFA.

### **3.1.2 Foreign Exchange Budget**

In addition to the kyat budget, the budget system collects and allocates foreign exchange within the public sector at the official exchange rate. SEEs have to obtain a Foreign Exchange Permit (FE permit) from the Ministry of Finance and Revenue as well as authorization from their respective parent ministries for individual expenditures in foreign currency. Once an FE permit is issued, the central government credits foreign exchange to the SEE's account at another state bank, the Myanmar Foreign Trade Bank (MFTB), and subsequently debits the equivalent kyat amount at the official exchange rate from the SEE's account at the MEB. In this way, foreign exchange is rationed to a SEE at the official exchange rate.

Furthermore, the SEEs cannot dispose of their foreign currency revenue. They must surrender all such revenue to the MFTB. When a SEE surrenders its foreign currency revenue, the equivalent amount of kyat at the official exchange rate is then credited to its current account at the MEB.

### **3.1.3 Transactions at Officially Controlled Prices**

SEEs also do not have the autonomy to set input and output prices. Official prices are controlled by either their parent ministries or the Cabinet, depending on the importance of products. Strategic products whose prices are determined by the Cabinet include petroleum and vehicles. In a sense the official exchange rate, as the price of foreign currency, becomes the most significant officially controlled price.

Apart from the official exchange rate, official prices are set based on costs and a certain mark-up. Because the costs of imported goods are calculated based on the official exchange rate, the more a product contains imported components, the wider the gap between the official and the competitive market prices in kyat. Moreover, official prices are not adjusted in a timely manner, so there can be a substantial gap between the official and market prices other than because of imported components. As a result, the official prices do not provide useful signals for resource allocation.

### **3.1.4 Evaluation**

While the state budget system allows the central government to hold down SEE expenditures, it has an adverse effect on the SEEs' financial discipline. The losses of individual SEEs are passed on to the SFA, and the SEEs are not liable to the SFA. SEEs are not only state-owned but also state-run enterprises and financially subordinate to the state budget. The budget system provides little incentive for SEE managers to improve their operations.

Moreover, the centralized budget system imposes obstacles on the management of the SEEs. For example, when a SEE needs to import repair parts for equipment, it has to go through the process of getting a foreign exchange permit with the parent ministry and the Ministry of Finance and Revenue. Since the introduction of the SFA, the profitability of the SEEs has declined (World Bank, 1995).

Furthermore, transactions at the controlled prices mask the economic performance of individual SEEs. These enterprises often conduct transactions among themselves. Suppose that SEE-X imports petroleum using a ration of foreign exchange at the official exchange rate, and then delivers that petroleum to SEE-Y at the officially controlled price. The official price of petroleum is lower than the parallel market price since its cost is calculated at the grossly overvalued official exchange rate. That means the effective subsidies flow from the government to SEE-X along with the allocation of foreign exchange, and to SEE-Y in the form of the allocation of petroleum at the controlled price. Such cross subsidies between SEE-X and Y make it difficult to figure out the individual economic performance of both SEEs.

## **3.2 Administrative Controls and Parallel Foreign Exchange Market**

### **3.2.1 Administrative Controls on Foreign Trade and Foreign Exchange**

Administrative controls on foreign trade and foreign exchange are applied to the private sector. While these controls are interrelated, it is useful for the purpose of analysis to disaggregate them into three categories: the holding of foreign currency, the convertibility of the kyat, and controls on imports.

First, the foreign exchange regulations prohibit Myanmar people from holding foreign currency. It is the right as well as duty of private exporters to deposit their export earnings as foreign currency deposits (FCDs) at state banks,<sup>5</sup> instead of holding foreign currency informally in hand. But the informal holding of foreign currency has

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<sup>5</sup> At times foreign currency deposits at private banks were also permitted.

been tolerated and widespread. These include proceeds from smuggling and remittances from people working outside the country. Informally held foreign exchange cannot be deposited in FCD accounts of the state banks.

The second point concerns the convertibility of the Myanmar kyat with foreign currency. The official exchange rate is applied to transactions in the public sector only. When external trade in the private sector was legalized in 1988, private exporters could retain 60 percent of the foreign exchange they earned from exports, and 40 percent had to be surrendered to the government at the official exchange rate. In 1989 the retention rate was raised to 100 percent, and exporters were subject to a 10 percent export tax at the time they deposited their export earnings in their FCD accounts at the state banks.<sup>6</sup> The export tax has to be paid in foreign currency. Neither the government nor the central bank offers competitive buying rates to the export-tax-deducted FCDs. At the same time, there has been no allocation of foreign exchange to the private sector at the official exchange rate.

Instead, the government has tolerated letting exporters carry out account transfers of FCDs to importers. This enables exporters to sell their export earnings and convert them into kyat at a competitive rate. Furthermore, from 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.

The third point is concerned with regulations on current account transactions; both imports and exports require government licenses per shipment. Import licenses are issued on condition that applicants have sufficient FCDs at state banks to cover the import bills. This has resulted in two distinctive types of foreign exchange trade within the private sector as described in Figure 5. One is the buying and selling of FCDs. These are export earnings after the deduction of export taxes. These are eligible for obtaining import licenses. The other is the buying and selling of informally held foreign exchange. This is not eligible for obtaining import licenses, but it can be used to settle smuggling transactions. The large discrepancies between Myanmar import data and the corresponding data of trade-partner countries suggest that the unreported trade to Myanmar Customs settled with informally held foreign exchange is prevalent (See Table 2).

Figure 5

### 3.2.2 Evaluation

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<sup>6</sup> The export tax has been temporarily reduced for six months since September 2011.

Given the segmentation of the foreign exchange market, the question is why the government has maintained its restrictive administrative controls on the foreign exchange market of the private sector. Although segmented, there are two linkages between the public and private sectors, as shown in Figure 5.<sup>7</sup> Such linkages might be the rationale for the government maintaining administrative controls, and for two reasons. First, export taxes are collected from the private sector in foreign currency. This becomes a part of the government's fiscal revenue, and is allocated within the public sector through the state budget system. Second, state banks can channel the FCDs of the private sector to the state budget as loans. By tightening import licenses going to the private sector, the government can avail itself to more foreign exchange through this channel.

If the government can bring the export earnings of the private sector into the banking system as FCDs, it is easy to impose taxes on them as well as temporarily borrow from them. By restricting import licenses on condition of possessing sufficient export-tax-deducted FCDs, the government can provide incentives to private exporters to properly declare export earnings and pay export taxes.<sup>8</sup> Consequently, the administrative controls as a whole have the effect to bringing together the foreign exchange available to the public sector.

What are the prospects for relaxation of administrative controls? Since the mid 2000s, exploration and export of natural gas has brought in large export revenue which is believed to have improved the foreign exchange position of the government. Accordingly, administrative controls for keeping foreign exchange available to the government might be less crucial than before.

On the other hand, tight import controls on certain goods such as vehicles have distorted the relative price of goods, and import licenses have come to yield a large amount of rent to those who obtain them. Groups with vested interests in tight import restrictions will most likely oppose to reforms to loosen them.

Apart from the distortion caused by import restrictions, the gap between the official

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<sup>7</sup> In addition to these two, there is another linkage. Some SEEs and ministerial departments procure imported goods from private importers 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 is not always allocated for one-off purchases of imported machines, in which case they are procured through the kyat budget from private importers. Such official procurement through private importers, when a large sum, may exert a depreciation effect on the parallel exchange rate.

<sup>8</sup> In fact, FCDs are traded in the private sector with some mark-up over the parallel market price of the US dollar, so that consumers of import goods partially shoulder the export tax by indirectly paying the mark-up on export earnings.

exchange rate and that of the parallel market does not itself directly distort the economic activity of the private sector. Since private exporters are permitted to retain export earnings as FCDs, the gap between the two exchange rates does not impose an effective tax on exporters, unlike the dual exchange rate regimes in other countries. At the same time the gap does not function as a subsidy to private importers because they are not allocated any foreign exchange. Instead, transactions in the private sector are conducted at the parallel exchange rate, and this rate is determined by market forces. Thus under Myanmar's segmented foreign exchange market, the official exchange rate has scarcely any impact on the private sector.

Nonetheless, there are a number of merits in unifying the segmented foreign exchange market. First, it would improve allocation efficiency. There can be a surplus of foreign exchange in one segment and a deficit in another. In such case, the reallocation of foreign exchange from one segment to the other would improve efficiency.

Second, once the foreign exchange market is integrated, the government and the central bank can intervene to stabilize the exchange rate. Currently the private sector has been exposed to sharp fluctuations of the parallel exchange rate as pointed out in Section 2. Existing studies show that sharp fluctuations in exchange rate impede the growth of exports (Arize et al, 2000; Chowdhury, 1993; De Grauwe, 1988). One likely reason for such exchange rate fluctuations is that the parallel exchange market has been left uncontrolled by the government. By unifying the segmented foreign exchange market, the government and the central bank can influence the exchange rate of the private sector and bring more stability.

#### **4. Reform Process**

To address the question of what kinds of reforms are involved in disinflation and exchange rate unification, it is useful to consider the side effects of disinflation and exchange rate unification. Complementary reforms to alleviate such side effects can be regarded as a part of reforms.

Disinflation requires preventing the monetization of the fiscal deficit. The deficits of state economic enterprises have accounted for a considerable part of the state's fiscal deficit in the past and most likely still do, and the state budget system in effective automatically finances their deficits. Thus, reforms should include separating the SEEs from the state budget.

Exchange rate unification signifies replacing the foreign exchange budget of the state budget system with a foreign exchange market where the kyat is convertible with foreign currency. Once convertibility is established, there will be no need to institute the allocation of foreign exchange to the SEEs. At the same time, the SEEs will have to cope with the rise in the cost of foreign exchange from the official exchange rate to the competitive market rate.

Successful disinflation and exchange rate unification hinges on whether the SEEs can stand on their own feet after separation from the state budget. Once separated from the state budget, the SEEs will have to accept market prices, and their financing will have to be replaced by bank loans. However, if SEEs are not economically viability, reforms could easily end up in a disaster of SEE bankruptcies and non-performing loans to banks. Rescuing SEEs and bailing out their debt would impose a fiscal burden on the central government, which is another obstacle for disinflation. Therefore, disinflation and exchange rate unification necessitate the careful designing of SEE reform.

#### **4.1 Devaluation of Official Exchange Rate**

The economic performance of the SEEs is masked by the controlled prices and official exchange rate. SEEs are required to sell goods at official prices that are lower than the market prices for the same goods. At the same time, SEEs are required to procure inputs from other SEEs at the official prices. Allocation of foreign exchange at the official rate from the state budget to SEEs works the same way. These transactions result in cross-subsidies among the SEEs, which makes it difficult to evaluate the economic viability of individual SEEs.

Therefore, the first step for the reforms is to replace the controlled prices with market prices of the equivalent goods. This includes devaluating the official exchange rate to a level close to the parallel exchange rate. This would at least allow policy makers to understand better the economic performance of individual SEEs.

When the central government has a surplus in its foreign exchange current account for a fiscal year, devaluation of the official exchange rate also lessens the fiscal deficit in terms of nominal kyat. According to the estimation of Kubo (2011), devaluation of the official exchange rate to the level of the parallel rate would have shifted the government's fiscal balance to a surplus for 2008.

Devaluation of the official exchange rate itself does not necessarily involve changes in allocation of foreign exchange in terms of US dollars. There is a concern that devaluation of the official exchange rate would raise the costs of the SEEs, which would in turn be shifted to the prices of the goods that SEEs provide to the economy and

aggravate inflation. Nonetheless, such a concern does not legitimate the budgeting of foreign exchange at the overvalued official exchange rate. If the policy objective is to maintain the affordable prices of certain SEE products, allocation of foreign exchange at the official exchange rate could be replaced by explicit subsidies to such SEEs. In fact, the allocation of foreign exchange at the official exchange rate is an implicit subsidy to the SEE at the cost of implicit taxation on those SEEs who are earning foreign exchange. After devaluation of the official exchange rate, explicit subsidies can substitute for it.

#### **4.2 Demarcation of State Economic Enterprises**

The next step of the reform is to select the SEEs to be separated from the state budget. A useful guideline for this selection is the economic viability of each SEE at market prices and a competitive exchange rate. If it is economically viable, a SEE can be separated from the state budget.

For SEEs not economically viable, the government should maintain its involvement only if their operations are not easy to be commercialized but have external benefits to the whole economy. SEEs not economically viable and having little external benefits should be separated from the state budget. There are two options for such SEEs: one is liquidation, the other privatization. State involvement itself may be the original cause of managerial inefficiency. In such cases, privatization may improve managerial efficiency and economic viability.

Separation from the state budget and termination of state ownership are two different dimensions. It is possible that the government maintains state ownership of a SEE after separating it from the state budget. There are many state-owned (not state-run) enterprises (SOEs) in China and Vietnam. Unlike in Myanmar, SOEs are in principle managed on a commercial basis. A particular concern with SOEs is financial discipline. Should an SOE become financially distressed, it can seek assistance from the government *ex post*; this gives less incentive for SOEs to improve operations *ex ante*. This is the so-called 'soft budget constraint' problem. In this regard, privatization is one step ahead of the simple conversion of SEEs to SOEs.

#### **4.3 Promotion of Financial Sector**

Once SEEs are separated from the state budget either as privatized enterprises or as SOEs, they have to rely on the financial market for financing. This necessitates development of the financial sector, especially that of banking. The banking sector includes both state banks and private commercial banks. Separation of SEEs from the state budget would improve their managerial efficiency and contribute to cutting down



the fiscal deficit, which would in turn stabilize inflation. Then disinflation would allow financial institutions to mobilize more deposits and provide financing to former SEEs. Thus, there can be a virtuous cycle of state budget reform and financial development.

However, the experiences of other transition economies, particularly Vietnam, point out the non-performing loans problem in the process of reforming state enterprises (Unterberdoerster, 2004). The soft budget constraint problem of SOEs is a major concern, and Myanmar can learn from the experience of Vietnam.

#### **4.4 Relaxation of Administrative Controls on Foreign Trade and Foreign Exchange**

Relaxation of administrative controls needs to take place on two fronts: one is to institute convertibility between the kyat and foreign currencies; the other is to relax regulations on current account transactions, namely import restrictions. These can be treated separately.

Convertibility of the kyat provides the private sector with an authorized channel to buy and sell foreign exchange at a competitive rate. This means that the central bank buys and sells foreign exchange with the private sector through private and state commercial banks.

In the context of Myanmar where the confidence in the kyat is weak, convertibility should be restricted to current account transactions. If permitted for purchasing foreign currency for asset portfolio selection, speculative demand on foreign assets could stimulate the flight to quality. The resulting reduced demand for kyat would lead to higher inflation (Giovannini and de Melo, 1993; Adam, 1995). Therefore, the purchase of foreign exchange should be restricted to current account transactions (i.e., for the settlement of imports).

Two related issues concerning the convertibility of kyat are the foreign currency deposits (FCDs) of exporters and foreign assets of commercial banks. The former have already become prevalent, so it would be difficult to abandon them. Compelling exporters to surrender all their export earnings even at a competitive rate could stimulate mis-invoicing of exports. Conversely, if the market exchange rate were stabilized, exporters would voluntarily release their FCDs for kyat.

As for the foreign assets of commercial banks, asset portfolio selection should be regulated as well. From the viewpoint of risk management, commercial banks should be allowed to maintain foreign assets to cover their holdings of foreign liabilities, namely FCDs of exporters. It would enable banks to mitigate potential losses from exchange rate fluctuations. Nevertheless, they should not be allowed to carry an excessively long position of foreign exchange, which could lead to speculation.

Regarding import restrictions, they are compatible with convertibility of the kyat and could continue even after exchange rate unification. Under the current system, import licenses are issued on condition that applicants have export tax-deducted FCDs at state banks. If the government institutes convertibility of the kyat, it should permit imports paid for with the foreign exchange raised from the authorized foreign exchange market. After that the government can still maintain import licensing if necessary.

Finally, import restrictions should be reconsidered given the appreciation of the kyat in the parallel market since 2006. The kyat has appreciated sharply in the last five years. In the parallel market in late 2006, it was traded at around K1,300 per US dollar; now in January 2012 it has appreciated to around K800 per dollar. Given Myanmar's high inflation rate relative to the United States, the kyat has appreciated more sharply in real terms (see Figure 3). This sharp appreciation damaged private exports which led the government to cut the export tax rate for six months from September 2011 as a temporary countermeasure .

While the circumstances of such a sharp appreciation of the kyat are still not clear, a remedy to alleviate it is simple; relaxing import restrictions would stimulate demand for foreign exchange, which in turn would lead to depreciation of the kyat. In this regard, the government should at least consider increasing the issuance of import licenses on restricted items such as vehicles.

## **5. Time is Ripe for Reforms**

The problems of the state budget system for state economic enterprises raised in this paper are not new; most of them have already been pointed out by Cook (1995) and the World Bank (1995). Since then there has hardly been any movement toward reforming the state budget system. This suggests that the reforms are not easy to implement.

Given that the controlled prices of SEE goods can produce private profits for vested SEE interests by selling such goods on the black market, the budget system ~~could be~~ is likely a hotbed of corruption. Since it is likely the SEEs and ministries make fortunes from the system, a strong political will be required to reform it. In addition, import restrictions have distorted relative prices and produced the vested interests among cronies. Such vested interests are another obstacle to reforms.

However, there are changes in the political economy landscape that may give impetus to the pending reforms. One is the installation of a new government in March 2011 that may have the political will to undertake the needed reforms. There have been a number

of positive policy changes since March 2011, including the opening of authorized foreign exchange counters from October 2011, and the reduction of the export tax rate, albeit temporarily, from September 2011.

The improved foreign exchange position of the government has also given impetus to reform. The exploration 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 exchange rates more comfortably without resorting to quantitative controls.

The recent sharp appreciation of the kyat is another significant development. It has damaged the export industries in the private sector, notably the garment industry and that of pulses and beans as well as marine products. The government clearly needs to intervene to stabilize the exchange rate. For this purpose, it is essential to unify the segmented foreign exchange market.

## **6. Concluding Remarks**

Since the inauguration of Myanmar's new government in March 2011, expectations have increased that reforms for disinflation and unification of the multiple exchange rates will be undertaken. While pervasive administrative controls and the scarcity of information make it difficult to foresee the reform process, this paper attempted to present an overall view of the necessary reforms for disinflation and exchange rate unification. A close look at the state budget system shows that the reform of that system for state economic enterprises needs to be an essential part of disinflation and exchange rate unification.

Preventing monetization of the fiscal deficit and unifying the exchange rates are expected to affect SEEs severely. As the state budget system has functioned to finance the deficit of the SEEs automatically, fiscal consolidation will require separating the SEEs from the state budget. Exchange rate unification will entail the abolition of the foreign exchange budget system for SEEs. This means the SEEs will have to cope with the rise in the cost of foreign exchange from the official exchange rate to the competitive rate. Thus, disinflation and exchange rate unification will require the SEEs to stand on their own feet. But the reforms will need to be implemented carefully, otherwise the SEEs could end up in bankruptcy, and their rescue would impose another fiscal burden on the central government which would fuel inflation.

The reforms of the SEEs can be carried out in two steps. The first is to replace the

controlled prices, including the official exchange rate, with market prices in the operations of the SEEs. This will clarify the economic performance of individual SEEs.

The second step is to select SEEs to be separated from the state budget. Economically viable SEEs can be separated from the state budget. For those that are not economically viable, the government should maintain involvement only if their operations are not easy to commercialize but have external benefits to the economy. The SEEs that do not fulfill these criteria need to be liquidated. Complementing this separation from the state budget is the need for measures to promote the financial sector. Once the SEEs are separated from the state budget, they will have to rely on the financial market for financing.

Concerning the ownership of the SEEs to be separated from the state budget, there are two options: to maintain state ownership or to privatize. If the former is chosen, there has to be concern about the 'soft budget constraint' problem. The experiences of other transition economies has shown that the weak financial discipline of state-owned enterprises leads to the accumulation of non-performing loans and impose a large fiscal burden on the government to bail them out. Privatization is seen as the way to alleviate this problem.

Regarding the convertibility of the kyat, it should be restricted to current account transactions in order to prevent capital flight and the resulting inflation. On the other hand, regulations on current account transactions, namely import restrictions, can be handled independently from convertibility of the kyat. It is possible for the government to maintain import restrictions even after instituting convertibility. Nonetheless, the recent appreciation of the kyat calls for relaxation of import restrictions to induce depreciation for export industries.

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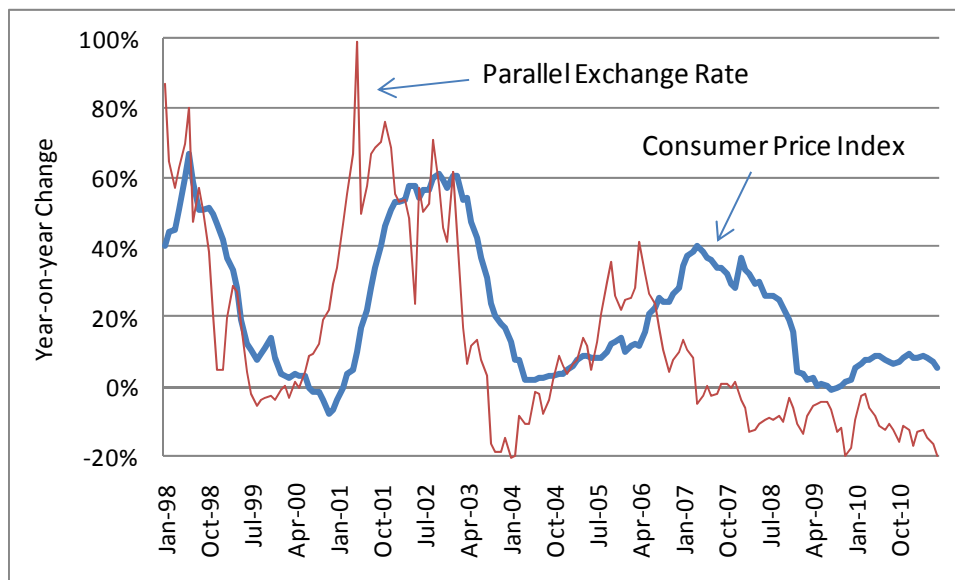
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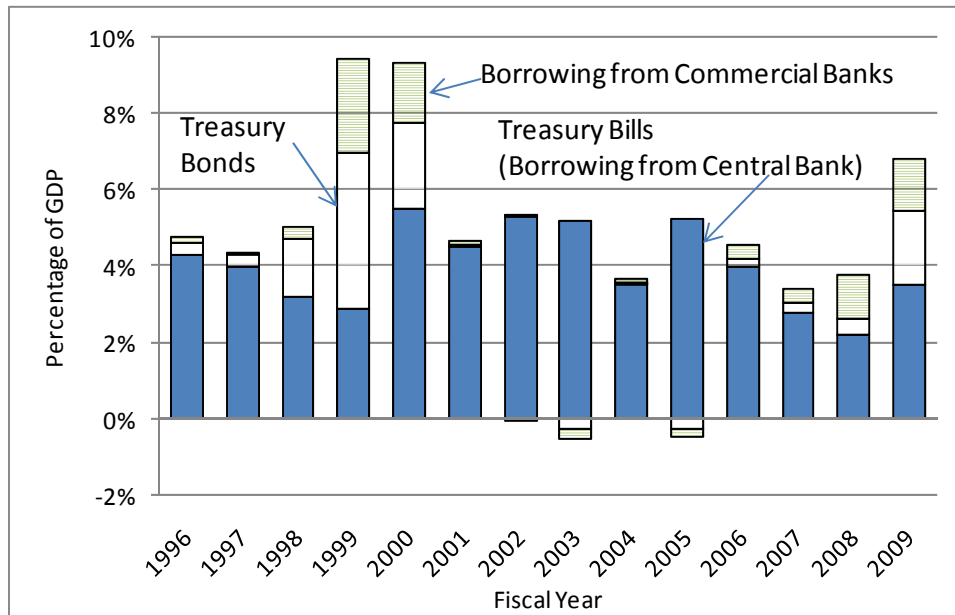
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Figure 1  
 Inflation and Changes in the Parallel Exchange Rate, January 1998 to June 2011



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

Figure 2  
Financing of Fiscal Deficit, 1996-2009

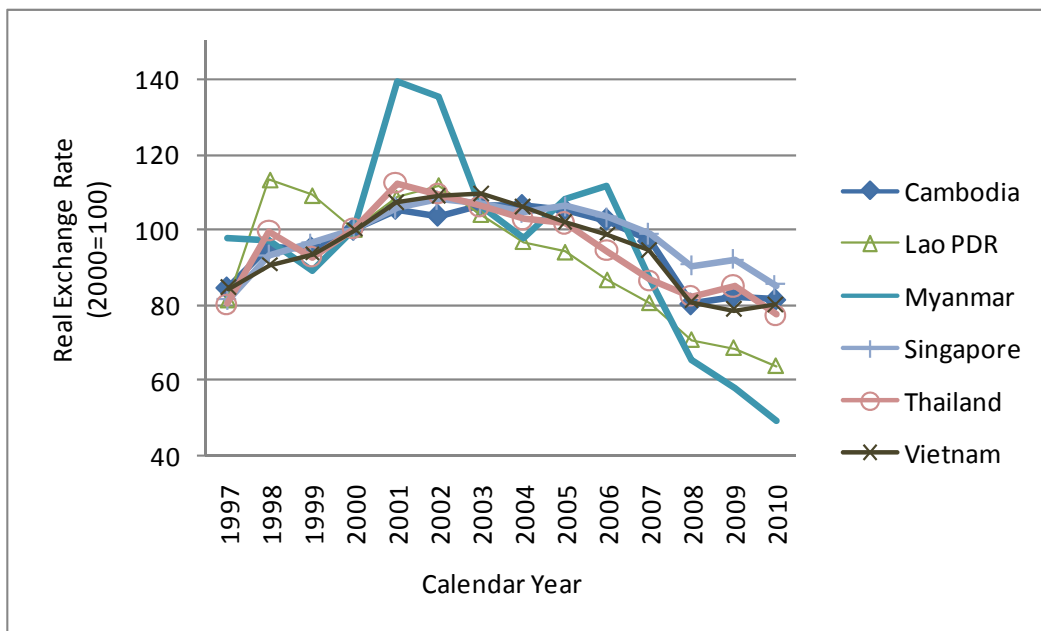


Sources: *International Financial Statistics* CD-ROM, IMF; IMF (various issues); *Selected Monthly Economic Indicators*, CSO, Myanmar; *Statistical Yearbook*, CSO, Myanmar; *Key Indicators for Asia and the Pacific 2010*, Asian Development Bank.

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.

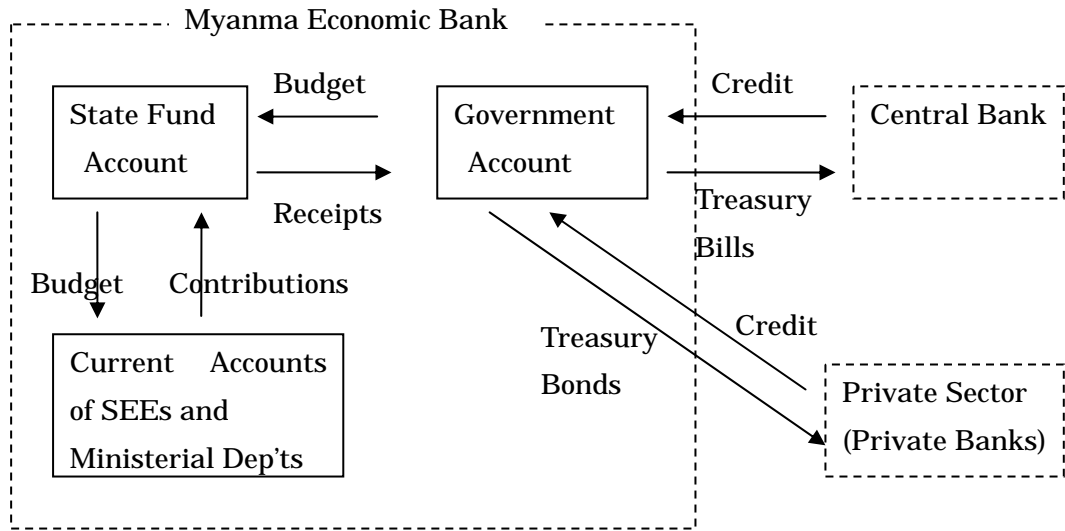


Figure 3  
 Real Exchange Rate of Selected Southeast Asian Currencies to the US Dollar,  
 1997-2010



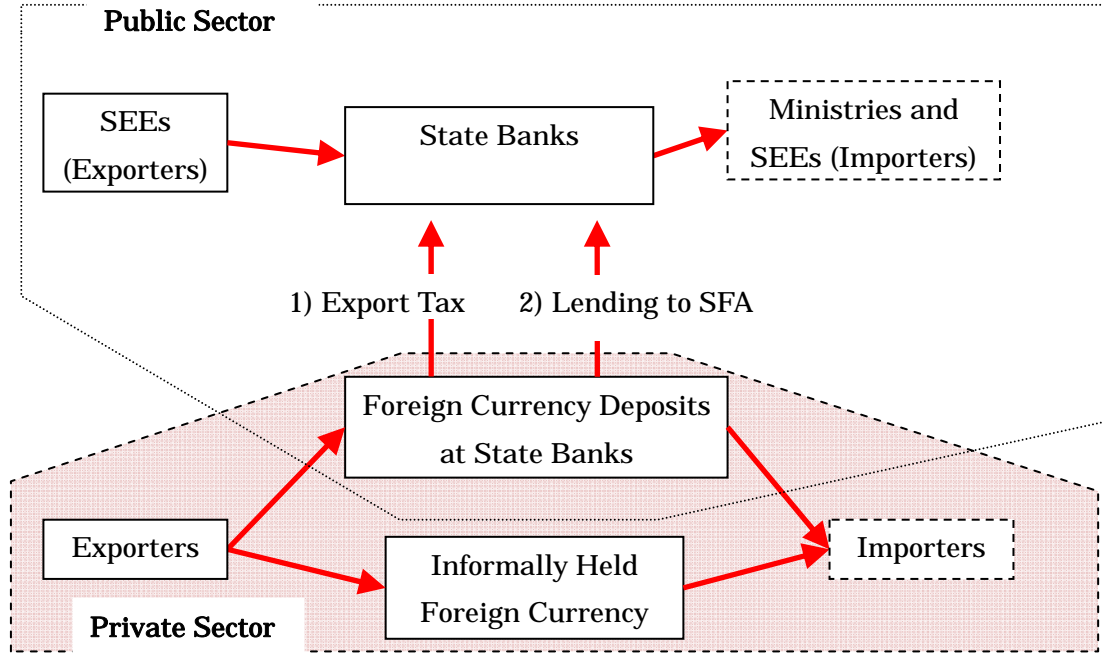
Sources: Same as Figure 1

Figure 4  
 State Budget System and Monetization of the Fiscal Deficit



Source: Author

Figure 5  
 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.

Table 1  
Summary of Consolidated Non-financial Public Sector Operations

| Fiscal Year                         | 1992                     | 1997        | 2002        | 2007        |
|-------------------------------------|--------------------------|-------------|-------------|-------------|
|                                     | <i>Billions of kyats</i> |             |             |             |
| Union Government                    |                          |             |             |             |
| Revenue                             | n.a.                     | 88          | 281         | 1,722       |
| <i>of which Tax Revenues</i>        | <i>12.6</i>              | <i>46</i>   | <i>107</i>  | <i>902</i>  |
| <i>of which 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                     | <b>-7.1</b>              | <b>-10</b>  | <b>-71</b>  | <b>-337</b> |
| State Economic Enterprises          |                          |             |             |             |
| Receipts                            | n.a.                     | 185         | 445         | 2,265       |
| Expenditures                        | n.a.                     | 232         | 576         | 2,704       |
| Overall Balance                     | <b>-5.8</b>              | <b>-47</b>  | <b>-131</b> | <b>-439</b> |
| Consolidated Accounts               |                          |             |             |             |
| Overall Balance                     | <b>-12.9</b>             | <b>-57</b>  | <b>-202</b> | <b>-776</b> |
| Overall Balance (% of GDP)          | <b>-5.2</b>              | <b>-5.1</b> | <b>-3.6</b> | <b>-3.3</b> |

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

Note: n.a. = data is not available.

Table 2  
Imports by Sector, 1997-2010

| Fiscal Year               | (A)                    | (B)                   | (C)           | (D)                | (E)                 | (F)                                    |
|---------------------------|------------------------|-----------------------|---------------|--------------------|---------------------|--|
|                           | Private Sector Imports | Public Sector Imports | Total Imports | DOTS Total Imports | (D)-(C) Discrepancy | [(A)+(E)]/(D) Private Sector Share (%) |
| <i>US dollar, million</i> |                        |                       |               |                    |                     |  |
| 1997                      | 1,645                  | 663                   | 2,309         | 2,706              | 397                 | 75.5                                   |
| 1998                      | 1,820                  | 882                   | 2,702         | 2,443              | -258                | 63.9                                   |
| 1999                      | 1,833                  | 773                   | 2,605         | 2,584              | -22                 | 70.1                                   |
| 2000                      | 1,857                  | 463                   | 2,321         | 2,994              | 673                 | 84.5                                   |
| 2001                      | 1,777                  | 958                   | 2,734         | 2,696              | -39                 | 64.5                                   |
| 2002                      | 1,786                  | 511                   | 2,297         | 2,998              | 700                 | 82.9                                   |
| 2003                      | 1,532                  | 703                   | 2,235         | 3,325              | 1,089               | 78.8                                   |
| 2004                      | 1,354                  | 626                   | 1,979         | 3,491              | 1,511               | 82.1                                   |
| 2005                      | 1,368                  | 614                   | 1,982         | 3,671              | 1,689               | 83.3                                   |
| 2006                      | 1,804                  | 1,125                 | 2,928         | 4,247              | 1,319               | 73.5                                   |
| 2007                      | 2,443                  | 903                   | 3,347         | 6,007              | 2,661               | 85.0                                   |
| 2008                      | 2,592                  | 1,971                 | 4,563         | 6,768              | 2,205               | 70.9                                   |
| 2009                      | 2,806                  | 1,381                 | 4,186         | 7,943              | 3,757               | 82.6                                   |
| 2010                      | 4,623                  | 1,781                 | 6,404         | 10,326             | 3,922               | 82.8                                   |

Sources: *Selected Monthly Economic Indicators*, CSO; *Direction of Trade Statistics* CD-ROM, IMF.

Note: DOTS refers to Direction of Trade Statistics. Myanmar Data reports the value of imports in kyat. This is converted into US dollar at the official exchange rate.