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Myanmar Kyat Exchange Rate Issue¹

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I. Introduction



Burmese government economic adviser Dr. Myint and Aung San Suu Kyi listen to a discussion at a three-day economic forum in Naypyitaw. Photo: Mizzima

1. There has been a consistent and sharp appreciation of the kyat dollar exchange rate for the past few months.³ This has caused problems. The extent of the kyat exchange rate appreciation and its impact on costs and returns in some key sectors of the Myanmar economy are presented in a paper prepared by U Set Aung⁴, a member of the President's Economic Advisory Team. These matters are therefore not discussed here. Instead, three issues have been taken up in this paper. They are:

2. *First*, to explain why a currency's exchange rate can rapidly appreciate and how this causes problems;

3. *Second*, to suggest measures that are to be undertaken immediately to deal with the kyat exchange rate appreciation problem presently facing Myanmar, in order to restore business and investor confidence in the exchange rate, and to prevent the situation from getting out of hand; and

4. *Third*, the current kyat exchange rate problem presents a good opportunity to initiate the process of reform of the exchange rate regime in Myanmar. The objective of the reform is to establish a foreign exchange market in Myanmar that meets international standards and where the exchange rate is relatively stable, is market-determined, and becomes a useful tool of macroeconomic management for the Central Bank of Myanmar. A suggestion on how to start this reform process is briefly presented in this paper.

II. Reasons for exchange rate appreciation and its consequences

5. It will be useful to start by giving a brief account of the *Dutch disease* which is a well-known concept in economics⁵. It provides an interesting case of a sudden rapid and sustained appreciation of the exchange rate of a currency and its consequences. The case refers to what happened in the Netherlands in the 1960s. At that time, the Netherlands exported large amounts of natural gas discovered in its offshore areas. These exports brought a huge inflow of dollars and foreign exchange into the country. The huge inflow of foreign exchange caused a rapid rise in the exchange rate of the *guilder*, the Dutch domestic currency. There were four consequences from the rapid exchange rate appreciation.

6. *First*, the country's exports of natural gas – a natural resource – were not affected by the exchange rate increase. Hence, despite the exchange rate rise, the Dutch natural gas exports continued to boom and continued to bring large inflows of foreign exchange into the country. In the economic literature, this is referred to as the “Booming sector.”

7. *Second*, there are economic sectors and economic activities that produce goods and services that are not traded in the world market. The construction industry is a good example. It produces buildings, roads and bridges in the country. Unlike, rice, beans and marine products, roads and bridges cannot be transported and sold as exports to foreign countries. They can only be used locally and they are called “non-traded goods.” Likewise, retail services provided by supermarkets cannot be exported and they are useful only for domestic consumers. They are called “non-traded services.” The point to take note of is that non-traded goods and services cannot be exported, do not enter international trade, and as such are not adversely affected by the exchange rate appreciation. On the contrary, they can benefit from such an exchange rate rise. This is because an exchange rate appreciation makes imported foreign goods cheaper in terms of domestic currency. A supermarket that sells imported foreign goods will make more profits when it can buy these foreign goods more cheaply. Similarly, a construction firm will also benefit if it can import the machinery and building materials it needs more cheaply from abroad.

8. *Third*, and this is the most important issue. It has to do with the fact that in a country where there is a persistent and sharp appreciation of the exchange rate due to huge natural gas exports, the exchange rate appreciation has a serious adverse impact on other exports, such as those from the manufacturing and agricultural sectors. A sharp rise in the exchange rate that persists reduces competitiveness of manufactured and agricultural exports in the world market. It also reduces export earnings of foreign exchange when converted into domestic currency. As costs of production of local producers for wages and raw materials have to be met in local currency, a large appreciation of the exchange rate will mean a large fall in the earnings of these enterprises. If the exchange rate continues to appreciate unchecked, a stage will be reached when earnings from exports in local currency are no longer able to cover costs of production, huge losses are incurred, and enterprises have to close down. When enterprises close down, workers lose jobs, farmers and fishermen cannot sell their products, and when they cannot sell

their products this year, they will not produce them next year. The economic, social and political consequences of this chain of events can be serious. So in contrast to the “booming” natural gas sector, at the same time manufacturing and agricultural sectors are in decline and are designated as “lagging sectors.” Aside from manufactured exports, cheaper imports coming into the country due to exchange rate rise, also means import substituting industries will suffer because they have to compete with cheaper imports coming into the domestic market. The term “Dutch disease” was in fact coined by the *London Economist Magazine* in 1977 to describe the decline of the manufacturing sector in the Netherlands after it discovered and exploited a large natural gas field that began in 1959. This led to large natural gas exports and huge inflows of foreign exchange, which in turn caused a rapid rise of the exchange rate of the Dutch local currency.

9. *Fourth*, as manufacturing and agriculture are lagging sectors there is a tendency for capital and labour to move away from these sectors and into the booming natural gas sector and the non-trade sector that is not affected by the exchange rate increase. This is not desirable. The oil and gas sector does not need domestic capital inflows. The sector’s capital requirements are already well provided by foreigners that are keen to develop this industry to meet their energy needs. Since the oil and gas sector is capital intensive, its employment creation capacity for local labour is limited. Besides, foreign companies may bring their own labour that they consider are more reliable to lay pipelines, setup installations and to operate the machines.

10. As for the non-traded goods and services sector such as construction, supermarkets and restaurants they may create some employment opportunities but are not likely to impart skills and technology to their workers that are required to develop human resources which is essential to move poor people out of poverty and to develop the economy. In short, the important point here is that manufacturing is where labour skills, technology, and managerial and marketing know-how can be acquired and nurtured that are essential to become a modern developed nation.

11. With regard to agriculture, it is a key sector for a developing country where the majority of the population earn their livelihood and where we find most of the country’s poor.

12. It has been pointed out that the rise in the exchange rate associated with the Dutch disease can result not only from a large inflow of foreign exchange due to selling a country’s natural wealth to foreigners, but also from a large inflow of foreign investment into the country for all sorts of reasons. This disease by turning agriculture and manufacturing into lagging sectors, with their exports in decline and with resources moving away from them, can cause serious harm to a developing country. There are indications that Myanmar maybe suffering from this disease. It is essential that timely and firm action is taken to deal with the problem, so that the situation does not get out of hand. This is taken up in section (III) below.

III. Proposals to deal with the rapid kyat exchange rate appreciation and its adverse consequences

13. A start should be made by reiterating that a *timely and decisive action* must be taken to deal with the kyat exchange rate appreciation problem. Experience has shown that, as in the case of Indonesia in 1997-1998 Asian financial crisis, a currency problem (if not properly handled) can become a financial problem, then an economic problem, which then develops into a social problem, followed by a political problem and finally ending up with a security problem with adverse consequences with respect to the peace and stability of the country.

14. Some time ago, Saddam Hussein said the Gulf War was the *mother of all wars*. The Gulf War did not have a happy ending for Saddam, but his idea can be borrowed and we can say the exchange rate which is the price of a country's currency is the *mother of all prices*. As a mother, the exchange rate can have a major impact on the health of an economy. Nevertheless, it is still a price, and like any other price, it is determined by demand and supply.

15. On the demand side, let us say for dollars, there are three types of demand. First, there is *transaction demand* – where dollars are required for transactions, that is to buy and sell in the market. Second, there is *precautionary demand* – to have dollars in store for security and to meet unexpected events and emergencies. Third, there is *speculative demand* – to use dollars to speculate in foreign exchange, commodity, real estate, stock and financial markets.

16. On supply side, in the case of Myanmar large foreign exchange inflows have come from sale of natural gas, jade and gem auctions, and upsurge of direct foreign investment especially in the energy sector and the associated special economic zone projects. Aside from these, there is also a growing feeling that a lot of private capital is flowing into Myanmar from neighbouring countries and from financial centers of the Middle East. These are to take advantage of high interest rates and to buy up real estate and other economic assets in anticipation of an opening up of business and reintegration of the Myanmar into the regional economy. Rapid privatization of recent years is believed to be another contributing factor. Wealthy Myanmar nationals are alleged to have brought dollars into the country and converted them into kyats to buy lucrative state assets put up for sale under the privatization programme. Information is difficult to obtain on these types of private investment and financial dealings for any country and lack of information has contributed to an atmosphere of uncertainty, which in turn encourages speculative activity. Given these circumstances, listed below are some recommendations that may be considered to address the immediate concerns of the kyat exchange rate appreciation.

Recommendations

17. In the recent past, there was a global financial crisis in 2007-2008. Despite some success in dealing with the problem many difficulties still remain. Currency and financial crises are still with us today in many parts of the world. In the pre-crisis days banks, big players in the financial markets, insurance companies, stock-market operators, and large private businesses in the USA made huge profits. In this process, revelations of misconduct by some prominent US Chief Executive Officers of large banks and financial firms have been devastating. These CEOs have given to themselves luxury yachts, mansions, large chunks of shares in their companies and hundred of millions of dollars to take home as their salaries, legitimate earnings, and rewards for the good work they have done. To make matters worse there was growing evidence that some of these big firms provided misleading information about their performance and falsified accounts.⁶ Joseph Stiglitz has also pointed out that the top one percent of the population in the USA now owns 25 percent of the country's income.⁷ Reason why all this happened was also partly due to the government's pursuit of economic liberalization policy that abolished many controls imposed on the financial sector.⁸

18. When the financial crisis hit, these large firms were in deep trouble and were going under. The government faced a dilemma. Should the firms be saved or should they be allowed to sink. The problem was if they sink, a lot of people are going to lose jobs and are going to face serious economic hardships and social turmoil these could create could spell political disaster for the government. So with considerable misgivings, a decision was taken to bail out these firms and banks with billions of

dollars of US taxpayers money. This sort of rescue operation for private sector firms that got into serious trouble during the global financial crisis, took place not only in the USA, but in China, India and many ASEAN countries.

19. Myanmar at present is faced with a similar dilemma. When the kyat dollar exchange rate was over K1,000 firms exporting agricultural, forestry, marine and manufactured products could meet their obligation to pay the 10 percent “export tax” levied on them. No country imposes such a tax on exports. The “export tax” actually consists of 8 percent commercial tax and 2 percent income tax. The tax is imposed on exports for administrative simplicity and effectiveness. With no proper accounting system for business firms and rampant corruption both on the part of the business tax payer and the government tax collector, the normal way to collect commercial and income tax was impractical.

20. When the kyat exchange rate against the dollar appreciated by 20% to 25% (from k1,000 to K800-K750) the members of the business community are unanimous in pointing out that 10% export tax is imposing a serious burden on them. In assessing the situation with many executives from large firms as well as owners of small family run enterprises, it seems to me that the business people may have a valid case. It is therefore suggested that the 10% export tax be suspended as a measure aimed at providing relief to the members of the business community suffering from the kyat exchange rate appreciation. Such a move will be in line with policies adopted by most governments to extend assistance to the business community faced with a currency or a financial crisis. It will also send a clear message that the government is serious about resolving the currency problem. Once normalcy is restored in the exchange market, tax reforms can be carried out so that the business firms are appropriately taxed through the normal tax system. This is the *first* recommendation.

21. *Second*, the transaction demand for dollars can be increased by liberalizing the licensing requirements in the export and import trade. Removal of both import and export licenses is likely to increase the demand for dollars substantially and will bring down the kyat dollar exchange rate.

22. *Third*, the government may consider buying dollars in the domestic market. In this way it can build up its exchange reserves. It can also request some key players in the country to do the same. Suppose the dollars are bought at K800. Then suppose with government and other key players intervention in the domestic market the kyat exchange rate falls to K900. The government stands to benefit K100 per dollar. Suppose it feels a rate between K900 and K1,000 is a good rate to stabilize the exchange rate, it can then use its exchange reserve to intervene (buy and sell dollars) in the market to hold the exchange rate steady at this rate within a narrow band of a few percentage points.

23. *Fourth*, if high interest rates are attracting an inflow of foreign exchange, the rates can be reduced. However, there is a need to maintain a sufficient margin between the deposit interest rate and the commercial lending interest rate so that banks can earn normal profits. The need to move slowly and cautiously in this area is also advised. An abrupt big change may cause panic among depositors, leading to large cash withdrawals from banks, and resulting in a banking crisis.

24. *Fifth*, when dealing with currency and exchange rate problems complex technical issues can arise. IMF has a lot of experience on this subject. It should therefore be requested to provide technical assistance. However, accepting technical assistance does not mean the country is under any obligation to abide by what the IMF recommends. In addition another advantage should be mentioned, namely, news that Myanmar is cooperating with the IMF in resolving the kyat exchange rate issue will add credibility to the efforts currently underway to deal with this problem, not only to the people of Myanmar but also to its ASEAN partners and to the international community.

25. *Sixth*, with large foreign exchange inflows causing exchange rate appreciation, it may be prudent to reduce the frequency of holding gem and jade emporiums.

26. *Seventh*, Myanmar now has an elected government. A policy of transparency and accountability has also been announced by the President. The kyat exchange rate appreciation is a matter of great concern to many people of Myanmar. The government should therefore make an announcement on the subject. How, when, where, and in what manner the announcement is to be made should be left to the appropriate authorities of Myanmar.

27. *Eighth*, in currency and financial crises, rumours, lack of information and deliberate dissemination of misinformation create an atmosphere of confusion and uncertainty on which speculators thrive. Hence, it will be helpful if some key macroeconomic data are officially released and regularly published, as it was done several decades ago. These include data relating to the inflation rate, foreign exchange reserves, balance of payments, national budget, money supply, GDP – its sectoral composition and growth rate, results of household income and expenditures surveys, foreign direct investment inflows, and foreign trade statistics.

IV. Reform of Myanmar's exchange rate regime

28. Experience shows that a crisis often creates a good opportunity to initiate a reform process. Advantage should therefore be taken of the present kyat exchange rate appreciation problem to start the process of reforming Myanmar's exchange rate regime. However, this is a complex issue, requiring in depth analysis, and is beyond the scope of this short note. Nevertheless, two things are essential to reform Myanmar's exchange rate system and to bring it in line with regional and international practice. These are:

- First, to unify the multiple exchange rates that now exist in Myanmar; and
- Second, to remove and liberalize the restrictions that now exist in the current account transactions of the country's balance of payments.

29. Undertaking both the above measures will go much beyond matters related to the exchange rate. It will involve making a serious effort at long overdue macroeconomic reforms. This will be a slow and arduous process. A soft landing is not in sight. However, it is hoped the kyat exchange rate problem which the country is experiencing at present, will serve as a wake-up call, and which also provides the political will to start the macroeconomic reform process without further delay.

¹This paper was presented to the high authorities of Myanmar two months ago on 25 June 2011.

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³When the kyat dollar exchange rate is K1,000 = \$1, one thousand kyats will buy one dollar worth of goods from a foreign country. Suppose the exchange rate becomes K500 = \$1, one thousand kyats will now buy \$2 worth of goods from abroad. This means the value of the kyat in terms of US dollar has risen or the kyat dollar exchange rate has increased (appreciated). Such a kyat appreciation will make Myanmar exports more expensive for foreigners. Before, foreigners only have to pay one dollar to buy K1,000 worth of Burmese goods. Now they have to pay two dollars to buy these goods. On Myanmar side, imports become cheaper with kyat appreciation. Before, people in Myanmar have to pay K1,000 to buy one dollar worth of foreign goods. After appreciation, they only have to pay K500 to buy a dollar's worth of foreign goods.

⁴U Set Aung, "Dangers of rapid appreciation of the kyat exchange rate" (Yangon: 25 June, 2011 [in Burmese]).

⁵Corden, W.M, and P.J Neary (1982), "Booming Sector and Deindustrialization in a Small Open Economy", *Economic Journal* 92 :825–848, December.

⁶Please see Katrina Vanden Heuvel, *Meltdown: how greed and corruption shattered our financial system and how we can recover* (New York: Nation Books, 2009); Andrew Ross Sorkin, *Too Big to Fail: inside the battle to save Wall Street* (New York: Penguin Group, 2009).

⁷Joseph Stiglitz, "Inequality: of the one percent, by the one percent, for the one percent", *Vanity Fair*, May 2011.

⁸Joseph Stiglitz, *Freefall: America, Free Markets, and the Sinking of the World Economy* (New York: W.W. Norton and Company, 2010).