

ECONOMIC REFORM (SUMMARY)

I. INTRODUCTION

1. This economic reform assessment (summary) provides the background to the identification of issues, constraints, and threats to, as well as the government's priority reforms in support of achieving inclusive growth. It focuses on key cross-cutting strategic issues such as business climate reforms, trade policy liberalization, measures to improve trade facilitation, and financial sector development. It also touches on the need to implement structural policy reforms on a sector-by-sector basis.

II. CONTEXT AND STRATEGIC ISSUES

A. Context

2. Myanmar has a momentous opportunity for advancing its development and raising the standard of living for its population. Being located beside the two fastest-growing economies in the world (People's Republic of China and India) and middle-income Thailand and combined with expected higher budget revenues from the booming resource sector provides the country with tremendous potential for economic growth and development over the longer term. However, in realizing this potential Myanmar faces a series of critical challenges of which include creating an enabling environment for businesses in the non-resource sector to grow and develop.

3. **Economic growth performance has been mixed.** While the Myanmar economy has been relatively resilient against the adverse effects of the global financial crisis of 2008 and the subsequent slow global economic recovery due to its relative insulation from global markets, various estimates of economic growth and production indicators suggest that long term growth has been relatively low compared with neighboring economies. Based on IMF estimates, GDP growth has averaged 4.6% since 2005 with a pick up in growth above 5.0% in the last two years.

4. **Structural transformation of the economy has been relatively slow.** According to national income accounts both agriculture and services each account for about 38.0% of GDP in 2010. Industry accounts for 24.5% of GDP, of which manufacturing accounts for 18.8% of GDP. Over the last three years, services sector has grown the fastest at about 5.4% per annum, followed by industry at 4.8% per annum and agriculture at 4.2% per annum. The expenditure side of the national accounts is less reliable as the statistical discrepancy between estimates of GDP expenditure and GDP production are in the order of 4.0%. The national accounts show that government and household consumption accounts for 75.0% of GDP, followed by total investment of 24.0% of GDP. Net exports are essentially zero primarily due to low levels of economic integration with global markets.

5. **Long term economic growth has been relatively low.** Based on IMF estimates of growth, ADB staff estimate that Myanmar's long term or potential economic growth is in the range of 4.0% to 5.0% per annum. This potential growth rate is lower than other low income economies in the region and much lower than growth rates achieved by Indonesia, Malaysia, and Thailand in the 1970s and 1980s when at their early stages of industrialization. Weak business climate, limited integration with global markets, dominance of state owned enterprises in key productive sectors of the economy, and frequent episodes of macroeconomic instability are the key reasons for Myanmar's relatively low potential growth rate.

6. **Macroeconomic effects of the resource sector on the non-resource sector.** The booming resource (primarily gas) sector could potentially transform the Myanmar economy over the longer term. The Government anticipates significant future revenues to the budget from gas and mining in the form of income taxes and royalties over the next decade. The revenue flows provide Myanmar for its first time in its modern history a tremendous opportunity for it to finance its development goals, raise per capita incomes, and reduce poverty. At the same time there are important lessons from international experience for Myanmar in supporting private sector growth when there is a large commodity resource sector. A resource boom can affect the growth conditions of the non-resource sector if it leads to an excessive appreciation of the real exchange rate. An excessive appreciation of the exchange rate may slow growth of the non-resource tradable goods sector (manufacturing and agriculture). The manufacturing and agriculture sectors (especially labor intensive sectors) are particularly vulnerable to an excessive real appreciation. Estimates of the real Kyat exchange rate (using the parallel market rate) show that the exchange rate has appreciated faster than its regional neighbors between 2006 and 2012, although there is no definitive evidence that this has hurt competitiveness of the non-resource sector just yet: Kyat rate has appreciated against the dollar by % since 2006, compared with xxx.

7. **Limited trade integration with global markets.** Myanmar's trade with the rest of the world is relatively low with total value of trade less than 60.0% of GDP. Exports are concentrated among resources especially gas, minerals, and timber accounting for 58.0% of total exports in FY2009/10. Labor intensive manufacturing exports and agricultural exports are relatively small, accounting for 37.0% of total exports.

8. **Low investment rate.** Various sources of data indicate a long term decline in private investment. The national income accounts indicate an investment rate of about 14.0% of gross domestic product (GDP), among the lowest for low income economies in the region. Only 36 foreign direct investments have been approved between FY2005/06 and FY 2009/10, of which 30 projects were in mining, gas and power sectors. A weak investment climate, underdeveloped financial sector and international sanctions on Myanmar help explain the low investment rate. ADB staff estimates suggest that Myanmar could be underinvesting by at least 10 percentage points of GDP if it is to raise its potential growth towards levels achieved by its regional peers.

9. **Underdeveloped financial sector.** Myanmar's financial depth measured by financial assets to GDP is low compared to regional neighbors. Like Vietnam, Cambodia and Lao PDR, Myanmar's financial sector is at an early stage of development and measures of financial depth appear to widely fluctuate from year to year indicating much more financial sector volatility (and potential financial system instability) than in neighboring economies. It is also far less diverse compared to regional economies and more volatile. Financial assets are about 26.0% measured by broad money supply to GDP lower than in Cambodia and about the same as Lao PDR, and well below that of neighboring countries—Hong Kong, China at 947% of GDP, Singapore at 451%, Malaysia at 401%, the Republic of Korea at 329%, Thailand at 227%, Philippines at 160%, and Viet Nam at 140%. While credit to the economy has accelerated in recent years, it is starting from a very low base with outstanding loans to the private sector approximately 3.8% of GDP in 2010. The banking sector dominates the finance sector and accounts for most of the financial sector assets held outside the central bank. State owned banks are dominant in the banking sector and limited competition prevails in the sector.

10. The relatively shallow depth and lack of diversity of Myanmar's finance sector is a drag on efficient investment and broad-based economic growth. Explanations for Myanmar's

relatively shallow finance sector include the predominantly rural nature of the economy (80% of the population lives in rural areas), its stage of economic development (annual per capita income is about \$800), high transaction costs for financial intermediation because of the underdeveloped payments system and non-bank finance sector, lack of competition in the banking sector, weaknesses in the legal framework and also sanctions on financial transactions.

B. Strategic issues

11. While the Government has initiated steps towards a more market economy for private sector to grow and develop, much more needs to be done to improve the environment for private sector development. At the macroeconomic level the challenge will be to manage the potentially adverse effects of the resource boom on the competitiveness of the non-resource sector. At the microeconomic level the challenge will be to advance reforms to reduce transaction costs of doing business and creating a level playing field between firms, or a competitive neutral policy environment. This will need to be done through addressing the complex business licensing system, trade liberalization, measures to improve trade facilitation, promoting competition in domestic markets, and SME access to business development services and technology, credit, and skilled labor, and strengthening the institutional framework for SME policy making.

12. **Managing the impact of the resource boom on the growth and development of the non-resource sector.** The experience of Indonesia and Botswana show that modest appreciation in the real exchange rate can be successfully managed and can be consistent with growth of the non-resource sector. The critical lessons from these two countries include i) fiscal discipline (guarding against inflationary pressures from excessive spending of resource revenues in the domestic economy), ii) promoting a balanced public expenditure program, iii) maintaining a conservative debt strategy; iv) developing effective monetary policy instruments to support a low inflation environment, and v) promoting business climate reforms and investments to raise productivity in the tradable sector. The Myanmar government's reform agenda is still crystallizing and this provides a unique opportunity to set in place reforms measured to promote productivity growth. At the macroeconomic level, the Government has initiated a set of major reforms to strengthen its macroeconomic institutions including i) unifying the official and unofficial foreign exchange rates, ii) implementing a managed floating exchange rate, iii) drafted amendments to the central bank law providing for central bank operational autonomy, and iv) Government set out a fiscal consolidation program with a medium term target of Union budget deficit of 3.5% of GDP.

13. **Business climate reforms.** Insufficient investor protection, a cumbersome and complex licensing and regulatory environment, and dominance of state economic enterprises (SEEs) in key sectors of the economy have been a drag on private sector development. The regulatory environment is complex, costly and unpredictable. It can take up to 6 months for an investment license to be approved, as it requires cabinet approval. It can take up to 2 months for firm to be registered under the companies act. Until recently, there was only one company registration office, which is located in Nay Pyi Taw. Similar cumbersome licensing systems permeate throughout the government. Small and medium-sized enterprises are particularly hurt by the complex licensing system. State economic enterprises dominate key productive sectors of the economy and this also helps to explain low investment in the economy and limited private sector involvement in key sectors of the economy.

14. **Institutionalizing regulatory review processes.** Myanmar does not have a regulatory review system that promotes good practice regulation through the application of a systematic

review process and regulatory impact assessments (RIA). International evidence shows substantial gains to policy development, governance, and the economy through adopting an evidenced-based approach to regulation development such as RIA. An effective institutional architecture for RIA requires an oversight agency to provide advocacy information to regulators and monitor compliance with RIA. Good international practice suggests the following sequencing of reforms: (i) establish an oversight agency such as the Australian office of best practice regulation and the United Kingdom office of better regulatory practice. The oversight agency provides advocacy information to line ministries on good practice in regulation. (ii) Line ministries and agencies implement good practice regulation guidelines and carry out RIA on proposed regulations. (iii) Once good practice regulation and RIA architecture are established and institutionalized, then implement a red tape reduction program. In the Myanmar context, a strategy could start with building awareness on regulatory review processes and establishing a pilot project in one or two sector line ministries.

15. Small and medium-sized enterprises (SMEs) development. Like most other economies SMEs dominant the size distribution of firms in the Myanmar economy. Stakeholder consultations carried out by the SME Center, an agency attached to the Ministry of Industry indicates that the complex licensing regime, limited access to business development services, technology and access to credit are the main drags on formalizing SMEs and their growth and development. The Government has prioritized SME development in its economic agenda. Recently, it established the SME Center mandated to develop an SME Policy and action plan for SME development. It intended to draft SME legislation to provide SME Center with stronger mandates for establishing institutional coordination among the different line ministries.

16. Restrictive trade policy and inefficient trade facilitation. While tariff rates on imports of goods are low, imports and exports are highly restricted through a complex licensing system. All importers require import licenses for each shipment, which is valid for three months. Several export commodities are restricted. The Government is looking at ways to liberalize trade. It has removed or relaxed restrictions on some import and export commodities. It is also experimenting with automatic licensing for imports of about 152 items at the 4 digit level. It has also requested the WTO for its first trade policy review. Microinfrastructure for trade facilitation such as customs procedures, trade logistics and sanitary and phyto-sanitary standards (SPS) are underdeveloped. Improving SPS, especially food management systems, are critical to improve SME access to export markets and for building confidence in its tourism industry. The policy and regulatory framework for SPS is underdeveloped. There is no standards body and conformity assessment body (issue standard certificates) and underdeveloped testing laboratories. Given that the trade reform agenda is large, the Government (through the Ministry of Commerce) intends to develop a trade sector development strategy with assistance from ADB.

17. Competition policy. Several major sectors of the economy are dominated by the state sector and are characterized by restrictions on entry of new competitors and anti-competitive practices. The telecommunications sector is one example. The Government is thinking about competition policy partly driven by the Government's commitments to implementing measures under the ASEAN Economic Community initiatives. This also includes drafting a competition law.

18. State economic enterprises (SEE) reform. In Myanmar, there are over 300 SEEs supervised by the Ministry of Industry, Ministry of Agriculture and Irrigation, Ministry of Energy, among others. Many of the SEEs have public sector obligations. The SEEs are a major drag on private sector development and economic growth. The government is looking at ways to start

privatizing some of these SEEs. As a first step in the process the Government established a Privatization Commission under the office of the Vice President. It will be important that the privatization process is transparent and competitive. Privatizing state monopolies should be accompanied by a competition policy for the sector. Public sector obligations will also need to be unbundled from the SEE.

19. **Financial sector development.** Myanmar's financial sector is excessively restrictive with controls on intermediation. Private banks' deposit taking behavior is restricted through the application of an unconventional prudential rule of maintaining a fixed deposit to capital ratio, instead of a risk-weighted capital adequacy ratio (CAR), onerous collateral requirements, and other administrative rules impede financial intermediation and limit growth of private banks. Expansion of bank branches is restricted. State owned banks are dominant in the sector and have non-commercial public service obligations including quasi-fiscal activities to the budget and central bank functions. Both deposit and lending rates are fixed at the same rate for all tenures. Reportedly, these restrictions on intermediation have created a large informal banking sector. The government recognizes these impediments and potential risks to financial system instability and its impact on the poor. In response, the Government has implemented a series of steps to improve access to credit and intermediation in the sector. The Government has allowed expansion of private bank branch network and further expanding the list of collateral to lessen impediments to access to credit.

III. GOVERNMENT'S SECTOR POLICY AND PLANNING FRAMEWORK

20. Improving the competitiveness of industry and services is a core component of the Government economic agenda. It has prioritized achieving higher, sustainable and inclusive growth as its overriding objective. The government seeks to enable the industry and service sectors to contribute significantly to economic growth and employment. While its reform agenda is still crystallizing, it has made some important steps towards a better business climate. These include: (a) drafted amendments to the foreign investment law strengthening investor protection; (b) implemented small steps towards improved licensing such as extended the registration renewal period from every two years to every three years and established a companies registration office in Yangon; (c) drafted amendments to the special economic zones law to provide a consistent framework for their establishment; (d) established SME Center mandated to produce an SME Policy and action plan; and (e) some initial measures to improve intermediation in the banking sector.

IV. ADB'S SECTOR EXPERIENCE AND ASSISTANCE PROGRAM

21. ADB has just begun its policy dialogue with the Government during this reengagement process. ADB's reengagement with Cambodia and Viet Nam in the early 1990s provides important lessons for assisting Myanmar in its early reform period. These lessons include: (i) policy reforms are more likely to show impact if they are performance-based; (ii) programs and projects should focus on assisting Myanmar crystallize its reform agenda, including prioritizing reforms and defining the sequence and pace of reforms; and (iii) introduction of best practices for policy reforms through significant levels of technical assistance should be embedded in the reengagement period.

22. ADB is considering assistance in the economic policy arena including: (i) a policy based loan (PBL) focusing on (a) fiscal sustainability, macroeconomic stability and strengthening public finance, (ii) improving investment, trade and financial integration through policy reforms; (b) stimulating rural development for inclusive growth and (c) promoting human capital

development for inclusive growth through improving funding of the education sector and implementing steps towards better delivery of education to the poor; (ii) small-scale technical assistance (SSTAs) in the initial reengagement period to work with Government to carry out diagnostic studies and policy advice on the reforms agenda, particularly in the areas of enhancing trade integration with the Ministry of Commerce, enhancing revenue mobilization with the Ministry of Finance and Revenue, and upgrading the companies registration system to improve business start up licensing system; and (iii) longer term TA assistance building on results of the SSTAs including support for developing a trade sector strategy, support for public financial management, and support for financial sector development.

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