

# MYANMAR'S ECONOMIC POLICY PRIORITIES

Vikram Nehru

ASIA | NOVEMBER 2012

CARNEGIE ENDOWMENT

FOR INTERNATIONAL PEACE

WASHINGTON DC ■ MOSCOW ■ BEIJING ■ BEIRUT ■ BRUSSELS

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## Summary

Myanmar's leaders are pressing ahead with ambitious political change. But support for that process can evaporate quickly unless there is material improvement in ordinary people's living standards. Carefully sequenced economic reforms are now a priority to generate broad-based growth in employment, incomes, and output. Over time, the economy will enter a virtuous circle of reform and growth, and Myanmar's future will become decidedly more promising.

### Lessons From Asia's Successful Globalizers

- Increased trade integration with world markets is essential to spur productivity growth in agriculture and manufacturing.
- Adopting policies that “best fit” country circumstances is more effective than borrowing “best practice” approaches from abroad.
- Structural change from agriculture to labor-intensive manufacturing holds the promise of contributing significantly to sustained GDP growth and employment generation.
- Macroeconomic stability, with prudent public finances and a stable financial sector, is essential for sustainable, rapid growth.
- Geography strongly influences development—and here Myanmar has little to worry about. Its location is ideal, as it borders China, India, Southeast Asia, and the Bay of Bengal.

### Myanmar's Economic Policy Priorities

**Open the economy to international trade and foreign investment.** The government should lower barriers to trade by eliminating import licensing and converting import bans and quantitative restrictions into low or zero tariffs.

**Promote competition in domestic markets.** To encourage the Burmese to start private businesses, investment licenses should be eliminated except in industries producing armaments, toxic products, and similar potentially harmful materials. The government should engage in open, regular, and candid communication with the private sector to help identify policy and public investment priorities.

**Maintain macroeconomic stability with sound public finances and well-capitalized and prudently managed banks.** Generating additional government revenue is necessary, while public expenditures must focus on high-priority investments in energy, roads, health, and education. Banks should be given the freedom to make lending decisions on a commercial basis, but at the same time the state must ensure bank balance sheets are sound and portfolio risks are kept within strict limits.

**Manage natural resource development cautiously.** Natural resources should be developed in a way that supports long-term sustainable growth.

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## The Challenge

Events have moved rapidly in Myanmar. In the space of less than a year, the political landscape of the country has been transformed from a system wholly dominated by the military to one moving toward democracy. Concerns about the durability of some of the changes have given way to growing optimism about the future. Political prisoners have been released. By-elections were conducted fairly and peacefully and were swept by the opposition National League for Democracy. The country's press has been granted new freedoms, and unions are being allowed to engage in collective bargaining. Rights to peaceful assembly and expression are exercised within limits. And the country's parliament, no longer the rubber stamp it once was, is flexing its muscles.

On the economic front, too, important reforms are being introduced. Most prominent among these are the gradual reunification of the market and official exchange rates, the introduction of a daily foreign exchange auction, and the approval of a new foreign investment law. Two new agricultural laws have also been passed with important implications for land rights and land use, the government is thinking about privatizing some state enterprises, and a new draft law is being considered to give the central bank greater autonomy to design and implement monetary policy. In addition, the recently approved budget incorporates significant increases for health and education. As important, the president has appointed key economists and reform-minded ministers to help design and implement further reforms.

Myanmar's new economic and political reforms have drawn considerable support from the international community. The International Monetary Fund is once again actively engaged in providing macroeconomic advice. The World Bank and the Asian Development Bank are conducting economic assessments of the country's most pressing needs and preparing to clear Myanmar's arrears so it can borrow again for development projects. The World Bank recently approved an \$80 million pre-arrears clearance grant for community development projects and announced that a further \$165 million will be made available in loans following arrears clearance. Meanwhile, the United Nations Development Program is gearing up to expand its program significantly, focusing on governance, rule of law, institutional strengthening, and capacity building at national and local government levels. Bilateral support is also pouring in. The Paris Club, made up of financial officials from the United States, Germany, Japan, and other advanced economies, has agreed on a coordinated approach to bilateral arrears clearance. Independently, Japan is expanding its assistance rapidly, Europe has suspended its trade and investment sanctions



and announced \$100 million in development aid, and the United States has selectively eased restrictions on U.S. businesses investing and conducting financial transactions in Myanmar. It has also suspended its import ban on Myanmar's products following Daw Aung San Suu Kyi's recent plea to the U.S. Congress. Thailand is actively promoting the construction of a port at Dawei together with supporting infrastructure, and India is already constructing a port in Sittwe.

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**Myanmar's untapped potential represents one of the few unexplored frontiers in Asia's rapidly expanding economy.**

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Individuals and businesses have also been beating a path to Myanmar's door. Prominent politicians, noted development economists, nongovernmental organizations, and global multinationals are visiting the cities of Yangon and Naypyidaw in droves. Myanmar's untapped potential represents one of the few unexplored frontiers in Asia's rapidly expanding economy—and it is hardly surprising that this has fired the imagination and goodwill of the entire international development community.

All these sources—international financial institutions, bilateral aid donors, nongovernmental organizations, academics, think tanks—have also been plying Myanmar with advice on what needs to be done. Indeed, advice is arguably the only input in Myanmar's development that is not in short supply.

The challenge facing Myanmar's policymakers is not to decide what needs to be done, but what needs to be done first—and how.

Lessons for Myanmar can be garnered from the experience of countries that have recently liberalized their trade and investment policies and integrated with the world economy. Those experiences can inform immediate policy priorities for Myanmar's policymakers and point to the instruments at the government's disposal while demonstrating what the government should not do. It becomes immediately obvious that even when every effort is made to whittle down the number of priorities to a select few, the agenda remains very large. Policymakers must find a way to leverage government policies through markets and prices as well as through the participation of local governments, communities, businesses, households, and individuals.

## Lessons for a Latecomer

In one respect, Myanmar's late emergence from autarkic policies and its delayed integration with the rest of the world is fortunate. Many other countries in Asia and elsewhere have recently traversed the same path, so Myanmar does not have to reinvent the wheel. China, for example, began its journey toward integrating with the world economy in 1978. Similar policy inflection points occurred in Indonesia (1968), Vietnam (1986), India (1992), Laos (1989), Cambodia (1999), and Timor-Leste (2002). Examples outside Asia include Eastern Europe (1989) and Mauritius (2005), among others. While

there are many lessons one could potentially draw from these examples, a few have emerged as the building blocks for sustained economic growth and are of particular importance to Myanmar.

Perhaps the most important of these is that a few key (“higher order”) policies help trigger growth. Among Asia’s recent globalizers, these have usually been policies that encourage competition through international trade and investment and lower entry barriers for domestic and foreign investors. Once growth accelerates, savings tend to rise and international and domestic competition help ensure those savings are used efficiently. Higher growth therefore leads to higher savings, which, in turn, lead to higher growth—a virtuous circle that needs reinforcement by government policy.<sup>1</sup>

In addition, countries with limited government and administrative capacity have benefited from keeping policies and incentives simple and straightforward. Policies should work through markets and prices rather than through administrative regulations and government bureaucracies. Even if some policies are “optimal” from a theoretical perspective, the emphasis should be on what is practical given the country’s circumstances and whether there is sufficient implementation capacity. At this stage of its development, Myanmar must adopt policies that “best fit” its circumstances, rather than apply “best practice” policies from advanced countries with a much higher per capita income level and stronger administrative capabilities.

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Prior experience has also shown that at each stage of the economic reform process the focus must be eliminating—or at least relaxing—binding constraints that hamper growth and employment. Binding constraints usually appear in the form of high relative prices or of shadow prices prevailing in the informal or black market in cases where governments restrict or control markets. In Myanmar’s case, the high black market price for foreign currencies made it clear that foreign exchange was a binding constraint. Fortunately, the country’s new foreign exchange auction system has largely corrected this, although some remaining restrictions still need reform.

Similarly, transportation in Myanmar could be another binding constraint because of the high cost of moving goods and people. Yet another could be energy because the government’s price controls on electricity have inhibited growth in power generation and transmission, leading to power shortages and rolling brownouts, and users are willing to pay a relatively high price for reliable energy supplies. Government permits for trade or investment could also be binding constraints because they tend to be acquired using either influence or bribes (or both), as could be access to finance, especially for small borrowers who live and work outside of Yangon.

Of course, as one binding constraint is relaxed, the economy grows until another constraint becomes binding. This means that policy reforms and adjustments should be a never-ending pursuit of governments. It also underlines that no two economic reform programs can ever be alike for the simple reason that no two economies are ever alike.

As the experience of Asia's recent globalizers has demonstrated, macroeconomic stability is also key to growth, and governments should prepare for economic shocks. Integration with the world economy inevitably increases exposure to sudden changes in the external economic environment—a downturn in export prices, an increase in the price of capital, supply contraction of key inputs, an economic crisis in key markets, and so on. Protective policies include building “shock absorbers” by accumulating external reserves, diversifying export markets and products, and strengthening balance sheets of banks and state enterprises. At the same time, it is important to shrink the size of “shock amplifiers” by, for instance, reducing budget and balance of payments deficits and lowering external and public debt burdens.

A common feature among successful globalizing countries has been the pivotal role of manufacturing, an unusual sector because it displays unconditional convergence globally.<sup>2</sup> As long as economies remain open to international trade and investment, the productivity gap in manufacturing between advanced and developing countries shrinks with time irrespective of initial conditions. Moreover, the least-developed countries seem to catch up at the fastest rate—the lower the productivity level of firms in relation to those at the technology frontier, the faster their productivity growth is likely to be.<sup>3</sup> Similarly, export unit values of manufactures also show unconditional convergence.<sup>4</sup>

Of course, Asia's new globalizers initially nurtured a healthy agricultural sector that provided the foundation for successfully developing manufacturing, which then became a powerful driver of growth. While a healthy agricultural sector is necessary, the shift from low-productivity agriculture to higher-productivity manufacturing is critical to the growth process over the longer term. Manufacturing also needs to reach a critical size before it can become an engine of growth that drives the entire economy. The challenge of policy is then one of supporting and stimulating structural change from agriculture that leads to a critical mass in manufacturing so that convergence in

manufacturing productivity drives growth in output and ultimately per capita incomes. Employment generation is another reason to emphasize manufacturing. The pace of manufacturing growth and its pattern are both important for creating jobs.

At Myanmar's stage of development, it is labor-intensive manufacturing that holds the best chance of contributing significantly to GDP growth and employment generation. But Myanmar's dependence on commodities

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and resource-based industries will make it difficult to promote labor-intensive manufacturing. The exchange rate, for example, strengthened by earnings from natural resource exports, tends to make manufacturing internationally uncompetitive. Similarly, policies—or other restrictive measures—that prevent firms from entering manufacturing can smother the growth process.

Finally, many of these countries' experiences have demonstrated that geography and location play an important role in shaping development outcomes. The economies of mainland Southeast Asia, including the low-income countries (Laos, Cambodia, and Vietnam), for example, have taken advantage of their proximity to China by intensifying their trade and investment links with the Chinese economy. Moreover, new networks of rail and highway infrastructure on the Southeast Asian mainland and southern China will cut transport costs, support more intensive trade, knit these economies closer together, and enhance integration, efficiency, and the international competitiveness of the region.

Myanmar, fortunately, is blessed on this score. Located strategically between India and Southeast Asia on the one hand and between China and the Bay of Bengal on the other, Myanmar not only borders three important growth poles, but its economic structure is also complementary to its neighbors, which will help amplify the gains from trade. China considers Myanmar of strategic importance in part because of its access to the Bay of Bengal. Similarly, Myanmar is the land bridge between India and East Asia, making it a geographically strategic element in India's "Look East" policy. Myanmar has to make its role pivotal to the continued growth and prosperity of these giant neighbors.

## Myanmar's Policy Priorities

Myanmar policymakers can take a leaf from the book of its neighbors and focus on a few critical policies needed to kickstart growth and trigger the same virtuous circle of growth-savings-growth that Asia's successful globalizers have enjoyed. Myanmar's location is already ideal. Now it must leverage that location by opening up to trade, maintaining economic stability, adopting "best fit" not "best practice" policies, and supporting manufacturing. These are the lessons from successfully developing Asian countries that can serve Myanmar well.

The government's first and foremost priority will be to encourage trade and domestic competition. This will stimulate savings and increase the level and efficiency of investment. The best way to do this is not only to remove as many impediments to trade and private investment as possible (without jeopardizing other objectives such as environmental protection) but also to facilitate trade and investment by constantly devising new ways to reduce the cost of business regulations, such as the time it takes to clear goods through customs, start a business, get a construction permit, or register property.

Myanmar should also take steps to shore up its macroeconomic stability to protect itself from shocks that could derail the development process. In line with the experience of Asia's recent successful globalizers, doing so requires acting on many fronts—maintaining sound public finances and avoiding the monetization of fiscal deficits, focusing public expenditures on the highest priority programs and projects that deliver essential services, ensuring a prudently managed financial system, and building “shock absorbers.” A further key to that stability is the careful management of Myanmar's vast natural resources.

### Opening Up International Trade

Barriers to trade must be reduced or done away with in order to encourage investment and economic growth. Import bans and quantitative restrictions should be converted into tariffs, and tariffs should then be lowered to the extent possible.

At this stage of Myanmar's development, imports of equipment and intermediate goods are critical to encouraging private investment, upgrading technology, expanding capacity, and stimulating growth. Indeed, the social returns for investment in equipment are usually very high.<sup>5</sup> It follows that such imports should attract low or even zero tariffs. Indeed, there is little reason to have a high tariff on any imported product, even luxuries (expensive cars, jewelry, cosmetics, alcohol, and so on), because tariffs or other trade barriers distort incentives for domestic manufacture and encourage wasteful investment.<sup>6</sup>

Authorities in Myanmar may rightly wish to discourage the conspicuous consumption of luxuries. This is an entirely appropriate policy objective. An excise tax applied equally to imports and domestically produced goods would be the appropriate policy response because such taxes discourage consumption without encouraging inefficient domestic production.

Reducing or even eliminating quotas and taxes on agricultural exports will help boost agricultural production and rural incomes. It is instructive that when Myanmar liberalized the production of pulses and beans in 1988, production

increased twelvefold in the following two decades, even as cereals production remained largely stagnant. Ironically, because pulses and beans remain less strategic than rice, they are today the second-largest (recorded) export earner in the country (after oil and gas)—notwithstanding the dearth of credit for agricultural production and the lack of infrastructure in rural areas.

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Just as trade liberalization worked for pulses and beans, it could also have a significant impact on rice exports. Myanmar used to be Asia's rice bowl and could still potentially become a larger exporter of rice than Thailand. However, rice exports are languishing because the government continues to place restrictions on exports, driven mainly by food security concerns. The government is rightly fearful that removing restrictions on rice exports, while

helping rice farmers, risks depleting domestic rice stocks and exposes the country to potential shortages in the event of a supply shock. To prevent such an occurrence, the Myanmar Rice Federation (previously the Myanmar Rice Industry Association—a conglomeration of producer, trader, and miller associations that is led by one of Myanmar’s leading businessmen, Chit Khine) has been entrusted with the task of managing export volumes and ensuring adequate domestic rice stocks. But placing monopsony power in the hands of one organization (and that too a confederation of business associations) potentially leads to conflicts of interest, high economic rents, reduced prices to farmers, lower production levels, and eventually lower farm incomes.

There are a number of alternatives the government could consider. It could convert the Myanmar Rice Federation into a full-fledged, government-owned food administration authority (like BULOG in Indonesia) to buy rice at market prices and build a rice stockpile for use in a possible emergency. Being owned by the government, the organization could focus on domestic price stability without any conflict of interest. At the same time, however, it would replicate the current potentially costly approach of having to cover the costs of storage, spoilage, and possible price fluctuations even though the stockpile would be used in the relatively rare occurrence of a supply shock.

Myanmar could consider freeing exports of rice completely with little government interference and entering into long-term contracts with other rice exporters (Thailand or Vietnam) for emergency rice imports contingent on a sudden shortfall in Myanmar’s rice production. Such an approach would work only if the counterparty does not suffer from the same supply shock (for example, an abnormal weather pattern that affects the whole region).

The government could also buy insurance in the form of a contingency loan from the Asian Development Bank or the World Bank that would be disbursed if rice production falls and rice prices exceed an agreed benchmark level. This approach would be relatively costless (the annual commitment fee for such loans is minimal to zero) and would operate like any other insurance arrangement that is drawn down only if and when a shock hits.<sup>7</sup>

Of course, the government could pursue all three alternatives at the same time. The two insurance arrangements, however, would reduce the pressure to hold large domestic stockpiles.

## **Improving the Investment Environment**

Currently, private domestic investment in Myanmar is regulated by a “positive” list system—that is, domestic firms are allowed to invest without a license in only a few sectors listed by the government. Firms wishing to invest in all other sectors require a license.

Myanmar should instead transition to a “negative” list system that lists only those sectors that require an investment license. Burmese entrepreneurs would then be free to start a business in every other sector without a license. All

they would need to do is register the business—preferably online. This would significantly reduce the number of investment license applications requiring government scrutiny and approval, lower opportunities for corruption, and bring down the start-up costs for private businesses.

Investors in sectors on the negative list would still need licenses to operate, although even here every effort should be made to keep the licensing process streamlined and efficient. Ideally, the negative list of sectors subject to trade or investment licensing restrictions should be kept to a bare minimum. Military-controlled monopolies should not be granted exclusive monopoly status; on the contrary, these should be subsectors (such as gasoline, power generation and distribution, steel, and so on) that are definitely kept off the negative list.

Similarly, there is little to be gained by insisting that all trade transactions require licenses. Only products considered potentially harmful (such as toxic chemicals, armaments, ammunition, and so on) should be subject to quantitative restrictions and import licenses—so that the authorities can properly monitor and control their use. All others should be importable without a license. This is exactly the approach that has been adopted by virtually all Asian countries.

To promote a healthy environment for investment in all sectors, an investment law that clearly delineates the rights and responsibilities of investors together with the requirements for setting up businesses, registering with the authorities, and so on could also be implemented. Myanmar's draft foreign investment law, which incorporates revisions to the Foreign Investment Law of 1988 and the Myanmar Citizens Investment Law of 1994, has been in preparation for several months and it is important that the president and parliament reach agreement on a final draft that can be approved and implemented. In the meantime, however, the government should press ahead with ensuring that the two existing investment laws are implemented properly. These laws are progressive and include appropriate investor safeguards. That they were not effective in the past was not because of their content but because they were not implemented by the previous military government.

### **Promoting Domestic Competition**

Domestic competition, combined with open trade, will be a powerful driver of lower costs, greater efficiency, and better quality goods and services—with economy-wide consequences. The new foreign investment law is an important step in the right direction. In addition, the government should consider taking steps to promote competition domestically by encouraging the entry of new private small and medium enterprises (SMEs), especially in subsectors and industries that are controlled by large private or military monopolies. For example, bus transport in Yangon and other cities should not remain the preserve of an influential few—but should be opened to private sector SME entrants. No doubt, this will require political courage, but the government

has shown such courage before—and in this case, the results would be far-reaching.

The government could even leverage the power of Myanmar's handful of elite private sector and military-controlled conglomerates by using them as agents of change. It could encourage them to enter into new sectors and take advantage of the new economic environment, provided they also welcome increased competition from new entrants.

In addition, careful thought needs to be given to reforming rural land markets to give farmers security of tenure so they invest in their farms and expand agricultural production. The recently enacted 2012 Farmland Law gives the government sole ownership rights of farmland but gives farmers land use rights (though not “to the extraction above and below the ground of natural resources such as gems, minerals, petroleum and gas”<sup>8</sup>). While the bill protects farmers from “land grabbing” by businesses and other private agents, the government reserves for itself the right to exercise the principle of eminent domain in exchange for “suitable compensation.” This is reasonable, provided the compensation arrangements are fair and the rights to appeal contained in the law can be exercised.

Farmers, however, have also been given the right to “permanently transfer” their user rights in land, which effectively means that farmers have the right to sell their land to others. But land is often the only social security that farmers possess. In low-income countries where farmers have the rights to sell land, land ownership concentration has increased dramatically, creating large numbers of landless and exacerbating rural poverty.

An alternative approach could be to restrict farmers from selling their land while allowing them to lease their land to ensure that the distribution of land assets does not become highly unequal. It is also important that farmers receive legal land titles in due course—a medium-term priority—to help increase access to credit and establish the foundations of a rental market in land (but not land ownership) rights.

Further, the government should ensure that communication between the private sector and the government is open, regular, and candid to convey that it is prepared to listen to—and partner with—the private sector without playing favorites with a few conglomerates. To achieve this, the president could chair a monthly meeting between his economic ministers and advisers and private sector representatives (appropriately balanced and rotated between big and small, foreign and domestic enterprises) to explain the government's program and intentions, seek feedback on ongoing policy implementation and reforms, solicit ideas on what further actions can be taken, and hold the private sector to account to deliver results. Setting the right tone at such meetings will send a clear message that the government is ready and prepared to support a healthy and competitive private sector.



## Maintaining Macroeconomic Stability

Increased economic integration will expose Myanmar to external economic shocks that can potentially slow growth. This will place a premium on policies that help maintain macroeconomic stability. Most important among these are sound public finances, a stable financial system, and other measures that protect the economy against shocks.

Maintaining sound public finances requires revenue mobilization as well as prudent expenditure management. Myanmar's overall revenue-to-GDP ratio of 13.9 percent, while low, is still respectable (it exceeds India, Bangladesh, Cambodia, and the Philippines). Nevertheless, the tax-to-GDP ratio is the lowest among countries belonging to the Association of Southeast Asian Nations (ASEAN), and much can be done to raise tax revenues. The government could close tax loopholes for corporations, charge excise taxes on luxury consumption, and introduce motor vehicle taxation. It could also ensure that all state enterprise profits are channeled through the budget and, most importantly, that the tax authorities collect resource taxes, including auction proceeds from natural resource concessions and appropriate royalties on raw material extraction (consistent with an appropriate strategy for natural resources management).

Unless revenues are raised, it is likely that the budget will remain in deficit in the short term. But it is essential that these deficits are financed properly from domestic and external sources—and not monetized by the central bank. The central bank's mandate should be ensuring growth with stability and not acting as a lender of last resort for the government. As a central bank bill is considered in parliament, this principle must not be compromised.

On public expenditures, the public expenditure and financial accountability assessment currently being conducted with the help of the World Bank will no doubt provide a road map of medium-term reforms to improve public expenditure management. For the immediate future, however, three actions are critical. The first is to ensure that all public expenditures are accounted for in the budget, including all expenditures financed by foreign grants and loans.<sup>9</sup> The second is to keep fiscal subsidies to a minimum and avoid populist measures. And the third is to ensure the president and his economic cabinet are fully in control of public expenditure priorities. These priorities should be communicated clearly to ministries, including the Ministry of Finance, and must be adhered to strictly by external aid agencies.<sup>10</sup>

While sectoral programs can be crafted with technical assistance from aid agencies, the allocation of public resources across different programs and sectors is essentially a political decision and should be taken at Myanmar's highest political level. Aid agencies must not foist their priorities on the government but rather follow the government's priorities. The location of programs in particular is a sensitive political matter and must be considered carefully by the cabinet and not left to the working level. This is especially true for programs located in

the ethnic states, given the broader political economy objective of building the credibility of the central government with the ethnic minorities. In the medium term, Myanmar will need to develop intergovernmental fiscal arrangements that underpin and reinforce the ongoing ethnic reconciliation process.

The clear sectoral priorities in the short term are infrastructure (roads, ports, and energy), health, and education. But the allocation of resources between them will depend on the availability of financeable projects and programs, implementation capacity, and political considerations. Public investments should not be included in the budget unless financing has been identified for them, and no aid should be accepted unless it finances a project that is included in the budget. Off-budget public expenditures, even if financed by aid, should be strictly forbidden.

Given its limited capabilities, the government must involve the private sector in delivering public services. For example, it will take a few years before new public power projects—based on hydropower or fossil fuels—can add power-generation capacity. In the meantime, the government should seek private sector solutions, including giving private businesses the freedom to import their own power-generating equipment. Similarly, the government should urgently seek out foreign investment to help refurbish existing power plants and develop natural gas sources for power generation.

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Just as sound public finances are important for macroeconomic stability, so is a stable financial sector. If banks are badly run, accumulate portfolios of nonrecoverable loans, and ultimately fail, the economic costs can be so high that they halt or even reverse growth (as the advanced countries are discovering). Myanmar must avoid such an outcome at all costs.

One way would be to reorient the government's role in the financial sector. For example, the government will be tempted to continue dictating loan allocation by Myanmar's four state banks that control over a third of the financial sector's assets. This would be a mistake. While interest rates should continue to be set administratively, allowing for a reasonably healthy intermediation margin, the government should allow banks to make lending decisions without government intervention or influence. At the same time, banks should be allowed to open branches wherever appropriate, and the government should encourage twinning arrangements with foreign banks to facilitate the transfer of knowledge regarding modern banking practices.

While banks should be given greater freedom to make lending decisions, it is also true that without state direction, banks will inevitably neglect loans for projects that promise high social but low financial rates of return. For this reason, the government should convert one of the state banks into a "development bank" to lend according to the government's stated social priorities—for example, SMEs, small farmers, microfinance, and so on. Other banks should

be permitted to make loans in these areas as well because any competitive pressure would be welcome. The development bank will likely be less profitable than private and state banks, so it may need support from time to time through the budget, but such support should be kept to a minimum.

Myanmar's nineteen private banks and seventeen representative offices of foreign banks account for about two-thirds of the assets in the banking system. The central bank will need to supervise their bank operations carefully (together with those of the state banks) and hold bank managements accountable for their financial performance. But it will take time for the central bank to acquire the requisite level of supervisory and oversight skills. In the meantime, the central bank should insist that banks adopt very prudent capital adequacy ratios that can be easily monitored (more so than required by international norms), and close banks that refuse to observe this rule. Such prudence, backed by tough policies, is necessary in large part because the financial environment will be risky for the foreseeable future and Myanmar cannot afford a financial sector crisis. With some of the banks run by Myanmar's elite families to finance the operations of their conglomerates, it is all the more imperative that these banks are required to uphold high capital adequacy standards.

Myanmar also needs to build financial "shock absorbers," especially larger external reserves. The country's external reserves already seem adequate from a balance of payments perspective. But appearances may be deceiving. The reality is that most of Myanmar's foreign exchange and fiscal earnings derive from the natural resources sector which—apart from hydropower—contains limited and (mostly) exhaustible supplies.

### **Carefully Managing Natural Resources**

Myanmar is rich in natural resources—mainly hydropower, gems, minerals, and natural gas—and the challenge for policymakers is to transform these national assets into long-term productive assets that yield sustained (and sustainable) returns for the economy. Too often, when countries deplete natural resources with little forethought or planning, growth can actually be retarded—in which case, natural resources can become a curse, not a blessing. These are national assets that need to be managed carefully to ensure sustainable development for future generations.

One way to achieve this objective is to build fiscal surpluses that are accumulated and to prudently invest the resulting sovereign wealth fund. In its simplest form, the process requires three steps. First, the cost of natural resource extraction must include not just private but also social costs, such as environmental costs and the costs associated with relocating displaced communities and restoring their livelihoods. Second, when natural resources are extracted, the government should receive a fair share of the economic rent in the form of auction proceeds, royalties, or tax revenues (after deducting for all costs). And third, these revenues then need to be invested wisely so that they

accumulate in the form of physical, financial, or human capital that yields high social returns and contributes to sustainable growth.

The unfortunate reality is that translating natural resource wealth into sustainable development is difficult and requires strong institutions and sound governance.

Few resource-rich countries are able to sustainably develop natural resources because it places a heavy demand on institutional capabilities and disciplines. In fact, the more valuable the natural resources, the more likely it is that governance structures break down. High economic rents tend to breed corruption and predatory behavior. And even if these risks are overcome, there is always the temptation to use resource revenues for consumption, not investment. But that does not ensure long-term growth.

Building the right institutions—to choose projects, assess them, sell the rights of extraction, collect the revenues, and then invest these revenues appropriately—should clearly be a high priority for Myanmar, but that process is likely to take several years under the best circumstances. In the meantime, the government should be very cautious in developing natural resources even though foreign investors are likely to exert considerable pressure to accelerate development. Above all, the government should not rush natural resource development projects for investor consideration. Not only must the government choose the right projects—it should also do projects right, including properly considering and estimating the social and environmental costs. The bidding process for projects should be transparent, and the tax regime must not be so strict as to drive away investors or so lenient as to deprive the country of its fair share of the revenues. Resource tax revenues should be treated as capital revenues in the budget and used to finance investments, not recurrent costs. One particularly useful role for such capital revenues could be to lower outstanding public debt, which will yield a stream of interest and amortization savings in future budgets.

Relevant government departments should initially restrict the number of projects each year. By doing so, and with proper technical assistance, those departments will gradually acquire capabilities and skills, build appropriate processes, and develop confidence. In due course, as the natural resource management strategy is improved and as institutions and procedures mature, the number of projects could be expanded and the scope and complexity increased.

At the same time, to avoid the “Dutch disease” of relying too heavily on natural resources at the expense of other sectors, the government should lean toward undervaluing the currency. This would compensate both for the dependence on foreign exchange earnings from exports of natural resources and for expected massive aid inflows and also restore incentives to produce tradables in the manufacturing and agricultural sectors. The monetary consequences of such accumulation will need to be managed with appropriate sterilization

policies (such as raising the minimum required reserves that banks must hold with the central bank) that mitigate the impact on private investment.

## Conclusion

Support for Myanmar's ambitious political reforms can evaporate quickly unless there is material improvement in the living standards of ordinary people. Economic reforms, therefore, must be a high priority, and Myanmar has made a promising start on that front. But it is just that—a start. Much else remains to be done, even in the short term. The design and sequence of reforms must better account for the country's relatively weak institutions and administrative capability, but at the same time build on its strengths. Reforms will need to be implemented one step at a time and leverage the power of markets and market prices.

Based on the experience of Asia's recent globalizers, Myanmar can kickstart growth by opening up to international trade and foreign investment and encouraging competition in domestic markets. It should also take steps to ensure macroeconomic stability, including by maintaining sound public finances and a stable financial sector, and to manage its natural resources carefully.

Even when highly focused, the reform agenda is still daunting. Vested interests could oppose changes to the policy framework. There will undoubtedly be setbacks. But a first wave of reforms would have the potential to generate broad-based growth in employment, incomes, and output. Public opinion could quickly swing in favor of further change, empowering and encouraging the government to undertake more difficult measures over the medium term. The economy could enter a virtuous circle of reforms and growth, and Myanmar's future would become decidedly more promising.

## Notes

- 1 In the literature on savings, the most important explanatory variable affecting the savings rate has been growth. See N. Loayza, K. Schmidt-Hebbel, and L. Servén, “What Drives Private Saving Across the World?” Central Bank of Chile Working Papers, no. 47, November 1999; also see K. Schmidt-Hebbel, L. Servén, and A. Solimano, “Savings and Investment: Paradigms, Puzzles and Policies,” World Bank Research Observer, vol. 11, no. 1 (February 1996): 87–117.
- 2 See D. Rodrik, “Unconditional Convergence in Manufacturing,” unpublished mimeo., Harvard University, July 2012; A. S. Beatrix, K. O’Rourke, and J. Williamson, “The Spread of Manufacturing to the Periphery, 1870–2007: Eight Stylized Facts,” NBER Research Working Paper 18221, July 2012, [www.nber.org/papers/w18221](http://www.nber.org/papers/w18221); M. McMillan and D. Rodrik, “Globalization, Structural Change, and Productivity,” NBER Working Paper. 171743, June 2011.
- 3 Using a cross-country regression, one estimate shows that industries with labor productivity at 10 percent relative to the technology frontier can expect to achieve an incremental 6.7 percentage points a year in their growth rate, all else remaining equal. A corollary test indicates that productivity levels in manufacturing have been converging in recent years.
- 4 In support of this contention Rodrik, “Unconditional Convergence in Manufacturing,” cites J. J. Hwang, “Patterns of Specialization and Economic Growth,” unpublished PhD dissertation, Economics Department, Harvard University, May 2007.
- 5 Lawrence H. Summers and J. Bradford De Long, “Equipment Investment and Economic Growth,” *Quarterly Journal of Economics*, vol. 106, issue 2, 445–502.
- 6 Arguably, an industrial policy that encourages growth of particular industries may include trade protection as one among many instruments. In Myanmar’s case, however, there is little need for an industrial policy because its manufacturing sector is so small. Indeed, the entire manufacturing sector in Myanmar needs protection, but it would be more appropriate to provide such protection through a general policy instrument, such as the exchange rate.
- 7 A key risk of such insurance arrangements is the possibility that crop failures occur in other major rice producing countries, which then curtail exports to keep prices low in their own markets.
- 8 2012 Farmland Law, Chapter 1, Article 3d.
- 9 The government will undoubtedly come under pressure from donors to keep some grant-financed government programs off-budget to help streamline implementation. The government should resist such pressures because they undermine

accountability, reduce transparency, complicate oversight, and distort expenditure allocation.

- 10 The government is turning to the United Nations Development Program to assist with donor coordination efforts.

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## About the Author

**Vikram Nehru** is a senior associate in the Asia Program and Bakrie Chair in Southeast Asian Studies at the Carnegie Endowment. An expert on development economics, growth, poverty reduction, debt sustainability, governance, and the performance and prospects of East Asia, his research focuses on the economic, political, and strategic issues confronting Asia, particularly Southeast Asia.

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