ECONOMIC ANALYSIS (SUMMARY)[1]

I. INTRODUCTION

1. This assessment identifies the issues and constraints in relation to fiscal sustainability, macroeconomic stability, and public finance in Myanmar, and discusses associated priority reforms. It focuses on key cross-cutting strategic issues such as macroeconomic institutions and monetary policy, tax policy and administration, and public financial management (PFM). It draws on the 2012 macroeconomic assessment and ongoing diagnostic work by the Asian Development Bank (ADB).

II. CONTEXT

2. **Economic growth.** The outlook for Myanmar's economy over the near term is positive, bolstered by strong export earnings from resource-based commodities and an increase in foreign direct investment (FDI). ADB forecasts Myanmar's GDP growth to accelerate from about 5.5% in FY2012 to about 6.3% in FY2013 and 6.5% in FY2014.[2] Inflation is expected to remain in single digits through FY2013. Official international reserves, estimated at about 8 months of imports for FY2013, are being reviewed in terms of data accuracy and in light of the ongoing exchange rate and import liberalization reforms. Prospects for faster economic growth over the medium term remain promising as a result of the improved political environment, the suspension of most international economic sanctions, the move toward exchange rate unification, the easing of foreign currency restrictions, increased FDI, and an acceleration of credit growth. Risks to the baseline projections include domestic and external uncertainties, as well as low capacity for macroeconomic policy making and implementation. While Myanmar remains fairly insulated from global shocks, stress in global credit markets may affect FDI inflows. Economic growth over the longer term is expected to be driven by exports of resource-based commodities, infrastructure investments, a strong increase in FDI, and greater international trade. Myanmar's economy could potentially grow at 7%–8% per year over an extended period if the reform process is sustained; at such growth rates, GDP per capita would reach $2,000–$3,000 by 2030—three times its current level—and propel the country to middle-income status.

3. **Slow structural transformation**. National income accounts show that agriculture and services each accounted for about 38.0% of GDP in 2010. Industry accounted for 24.5% of GDP, of which manufacturing accounted for 18.8%. In the past 3 years, the services sector has grown the fastest at about 5.4% per year, followed by industry at 4.8% per year and agriculture at 4.2% per year. National accounts show that government and household consumption accounted for 75.0% of GDP in 2010, followed by total investment at 24.0% of GDP. Net exports are essentially zero, primarily because of low levels of economic integration with global markets. Myanmar's natural resources are among its most important assets and source of wealth. Natural resources will continue to be a source of inclusive growth, especially those that underpin the agriculture sector, if sustainably managed.

4. Myanmar's trade with the rest of the world is low; the total value of trade is less than 60.0% of GDP. Resources, especially gas, minerals, and timber, accounted for 58.0% of total exports in FY2010. Labor-intensive manufacturing and agricultural exports account for only 37.0% of total exports.

[1] Based on Staff assessments and ADB. 2012. *Myanmar in Transition: Opportunities and Challenges*. Manila.
[2] ADB. 2012. *Asian Development Outlook*. Manila.

5. **Macroeconomic stability**. Maintaining macroeconomic stability—relatively low inflation and a stable exchange rate—has been a major challenge for Myanmar. Myanmar has experienced frequent episodes of very rapid inflation in the past 2 decades. This has triggered exchange rate instability, as reflected in the movement in the unofficial or parallel exchange rate. Consumer price inflation has remained in single digits since 2009, mainly because of the government's shift from central bank financing to partial bond financing of the budget deficit and the decline in international commodity prices.

6. **Public debt sustainability**. Myanmar's public debt level is high, estimated at 47.6% of GDP in FY2011, largely because of poor revenue performance. Central bank financing of the fiscal deficit has been the primary cause of Myanmar's high inflation regime in the past 2 decades. The International Monetary Fund's debt sustainability assessment carried out in 2011 concluded that Myanmar should remain classified as in debt distress due to the continued presence of substantial arrears.[3] External debt was estimated to be at 30.6% of GDP in FY2011, down from 35.3% in FY2010. Progress has been made by the government and external creditors in developing strategies to resolve external arrears and once implemented these initiatives will lower Myanmar's risk of debt distress. ADB has been working with the government and in collaboration with the International Monetary Fund, the World Bank, and bilateral creditors (including the Paris Club) on the arrears clearance. The International Monetary Fund and the World Bank are preparing a revised debt sustainability analysis taking into account arrangements for arrears clearance expected to be completed by ADB, the Government of Japan, and the World Bank.

7. **Fiscal policy**. Poor fiscal policy management coupled with poor monetary policy management have been the main contributors to macroeconomic instability in Myanmar. The government estimates the overall fiscal deficit to be 3.8% of GDP in FY2013.[4] While deficits of this magnitude are not unusual for low-income economies, the government may finance the deficit by selling treasury bills to the Central Bank of Myanmar (CBM), which would then monetize the deficit or print money to pay the deficit; this would result in persistently high expansion in money supply and lead to macroeconomic instability. In FY2010, the government for the first time financed one-third of the deficit from the issuance of treasury bonds to domestic banks, which has helped contain the expansion in the money supply and lowered the inflation rate.

8. The weak fiscal situation is primarily due to poor tax revenue performance. In FY2011, total national budget revenues were recorded as about 7.0% of GDP, of which tax revenue collection accounted for only half. Transfers from state enterprises and other nontax revenues accounted for the other half of total revenue. Caution should be taken with the budget revenue data before FY2013 as revenues and expenditures denominated in foreign currency were converted to kyat at the official rate of MK6.4 = $1 rather than the much higher parallel market exchange rate (MK800–MK900 = $1). Nevertheless, more tax revenues are required to support the government's priority development spending initiatives over the medium term.

III. STRATEGIC ISSUES

9. This section discusses key medium-term policy issues for macroeconomic performance and government reforms to address institutional, policy, and structural weaknesses in the macroeconomic framework. The assessment also recommends ways to improve the framework.

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[3] International Monetary Fund. *Staff Report for the 2011 Article IV Consultation—Debt Sustainability Analysis*. 2012. Washington.

[4] International Monetary Fund estimates the overall fiscal deficit at 5.2% of GDP in FY2013.

These cover fiscal policy, revenue administration, PFM, public debt management, and monetary policy. While Myanmar has achieved relative macroeconomic stability in recent years, it faces substantial risks to stability. These arise from fiscal risks related to (i) the increased reliance on resource revenues in the state budget, which are vulnerable to volatile commodity prices; (ii) the limited sources of non-resource revenues; and (iii) the continued partial monetization of the budget deficit. The limited monetary policy levers available to contain money supply growth also pose risks to maintaining macroeconomic stability.

10. **Fiscal policy**. The major medium-term fiscal issues are (i) achieving fiscal consolidation and meeting deficit targets: the government is targeting a budget deficit of 3.5% of GDP over the medium term, (ii) eliminating the monetization of the budget deficit over the medium term, (iii) managing resource revenues, and (iv) managing debt more effectively. The draft amendments to the CBM Law will require parliamentary approval for any future CBM funding of the deficit. While this reform will help contain monetization of the deficit, it will not eliminate it. Resource revenues are substantive and expected to increase based on investor interest in the sector. Thus, the government will have to ensure optimal inter-temporal (inter-generational) allocation of consumption and savings of the gas and mining revenues, and mitigation of the impact of price volatility of natural resources. The government might consider a sovereign wealth fund, which would also help implement countercyclical fiscal policy, address the sustainability of resource revenues, and improve revenue transparency.

11. **Revenue mobilization.** Increasing priority spending through improved revenue collection will require strengthening revenue mobilization and administration. Limited revenue collection has resulted in suppressed public spending, especially in social sectors such as education and health. The government recognizes the urgency of raising tax revenue to meet its development goals. Revenue management is challenged by the following issues:

(i) **Limited sources of revenue**. The two main sources of tax revenue for the MOFR are direct income tax and commercial taxes on goods and services. Combined, these account for about 90% of MOFR tax revenue collection. The MOFR also collects stamp duty and funds allocated from the state lottery. Commercial taxes account for 80% of total indirect tax income. The share of customs duties applied to imported goods (8% of total indirect tax collections) is low by developing country standards. Myanmar does not have valued-added tax or excise taxes.

(ii) **Complicated tax structure**. The corporate tax rate (25%) is competitive with other countries in the region. The personal income tax rates are also competitive with the highest marginal tax rate at 20% for incomes over MK20 million a year (about $28,000 at the current market exchange rate). However, the structure of personal income tax rates reduces the tax base and collections. The average effective tax rate is below 8%. The complicated corporate income taxation regime encourages tax avoidance; the largest share of income tax collections is from the state economic enterprises. The commercial tax structure is also complicated. It has both negative and positive schedules stating which goods and services are subject to or exempted from commercial taxes, rather than having a simple exemption schedule. Different commercial tax rates are applied to different categories of goods and services, making the tax difficult to administer. The commercial tax is also inefficient as it taxes the value of goods and services at different points in the distribution channel rather than taxing value added.

(iii) **Weak tax administration**. The taxpayer base is very small. There are approximately 16,000 registered corporate tax payers, 250,000 registered commercial tax payers and 457,000 registered individual tax payers. This low taxpayer and revenue base partly arises from weaknesses in tax administration. Some of the weaknesses include the following: (a) tax authorities have limited administrative autonomy in setting staff requirements and competitive remuneration for staff; (b) tax authorities are underfunded and staff lack training in carrying out tax functions; (c) the taxpayer database is a manual system that is not frequently updated (it is common for taxpayers to hold multiple tax numbers); (d) the systems for monitoring tax exemptions and incentives, managing tax arrears, and conducting tax audits are weak; and (e) tax authorities' policy of mandatory audits of taxpayers stretches its administrative capacities and can lead to governance problems.

(iv) **Revenues from resources**. Resource revenues are substantive and expected to rise based on investor interest in the sector. Thus, the government needs to ensure optimal inter-temporal allocation of consumption and savings of the gas revenues, and mitigation of the impact of price volatility of natural gas. Likewise, transparency with respect to the management of resource revenues needs to be increased; the government's consideration of joining the Extractive Industries Transparency Initiative is an encouraging signal.

(v) **Revenues from licensing**. More than 11 ministries collect revenues from licensing functions. Line ministries are allowed to keep a share of the revenues they collect. Transparency in the collection and recording of revenues is limited.

12. The government has initiated some important steps towards simplifying tax structures to ensure broader tax bases and more stable tax revenues. Reform efforts include: (i) abolishing and replacing gross profit tax with net profit tax, which is standard taxation practice; (ii) increasing taxable income thresholds for salary earners; and (iii) abolishing differential corporate tax rates on foreign exchange earnings. The government is also simplifying commercial tax on goods and services by reducing the number of different tax rates applied as well as expanding the number of services subject to the commercial tax. The government has also initiated steps for better transparency by publishing on its website the English and Myanmar language versions of the corporate income tax law and the commercial tax law. This has been supplemented by education outreach activities to taxpayers explaining the tax laws.

13. **Public financial management issues.** For priority spending to be sustainable in the medium term, the efficiency of public expenditure management needs to be improved by ensuring a balance between capital spending and recurrent expenditures, as well as between discretionary and nondiscretionary spending items (interest payments and wages). This will require the continued reorientation of spending towards the priority sectors of education, health, and productive public infrastructure. However, the increase in public spending will need to be supported by improvements in PFM. Significant weaknesses in budget transparency, budget planning, execution, and reporting and accounting undermine government effectiveness in responding to emerging policy priorities. Budgeting is currently input-based, incremental, and largely top down with little regard for performance or service delivery. The capital and recurrent budgets are prepared separately and are not integrated. Internal control and audit systems are inadequate.

14. **Improving public financial management**. Recognizing the weaknesses in its PFM, the government has initiated reform measures. In 2012, the government implemented several measures to promote budget transparency. These measures included: (i) applying the market exchange rate to foreign currency revenues and expenditures in the Union Budget; (ii) submission for the first time of the FY2013 national budget to the Parliament for approval; and (iii) publishing the Union budget law in the media. Another major transparency reform was an

improvement made to the structure of the Union budget by preparing separate Union and State/Regional Budgets for the first time in FY2013. Finally, the government introduced initial steps for improving accountability in the budget process by granting the Office of the Audit General with budgetary autonomy and the government issued instructions to establish internal audit units in all line ministries and agencies. Improving transparency and PFM systems will be a long term effort. Going forward, the government intends to complete a comprehensive review of the PFM system and develop and start implementing a reform action plan covering budget process, budget execution and internal control, accounting, and reporting. Moreover, government intends to produce a full non-inflationary budget financing plan for the proposed Union budget that will support macroeconomic stability and medium term fiscal consolidation.

15. **Public debt management.** Debt management lacks strategic perspective. With the CBM gaining more autonomy, the MOFR will need to take over more of the debt management functions. An important medium-term policy reform to support fiscal sustainability will be public debt management. The government has initiated some basic reforms, such as the shift away from CBM financing of the deficit to partial bond financing. The MOFR will need to strengthen public debt management. In the long term, it will require improving the institutional framework, including establishing a public debt office with clearly delineated functions for the back office (accounting and recording debt), the middle office (debt policy and strategies), and the front office (issuance of treasury bonds). The government will have to establish a government bond market comprising an auction (primary) market and a secondary market. Interest rates will need to be liberalized for a bond market to function. However, in the short term the most pressing need will be to assist the MOFR establish its ‘back office’ functions for accounting, recording and reporting of domestic and external debt.

16. **Monetary and exchange rate policy.** The government recognizes the urgency of reorienting monetary policy away from the primary function of financing the fiscal deficit to creating a low and stable inflation environment. The government has articulated a far-reaching reform strategy, which will provide an anchor to macroeconomic stability in the medium to long term. The reform agenda comprises the following measures:

- (i) Abolishment of the pegged exchange rate and establishment of the managed floating exchange rate.
- (ii) The drafting of a new central bank law, which will provide the CBM operational autonomy over monetary policy, internal structures, staff remuneration, and human resource development. This major reform, which has already been initiated, would allow the CBM to focus on creating a low and stable inflation environment. It would also allow the CBM to implement a sound and independent bank supervision framework. The draft law is being finalized and expected to be submitted to Parliament in late 2012.
- (iii) Implementation of an effective monetary policy framework. This may start with implementing tools to manage reserve money, which has been the key influence on money supply, inflation, and exchange rate depreciation. The CBM has issued a regulatory framework for targeting reserve money through auctioning interest earning deposit accounts to domestic banks. It carried out its first auction of deposit accounts at the end of September 2012. A key to an effective monetary policy will be improving transparency in publication of monetary data.

17. **Underdeveloped financial sector**. Myanmar’s financial depth, as measured by financial assets to GDP, is lower than its regional neighbors, and at an early stage of development. Financial assets, as measured by broad money supply, are about 26.0% of GDP, which is about

the same as the Lao People's Democratic Republic, but well below that of neighboring countries—Malaysia at 401%, Thailand at 227%, and Viet Nam at 140%. While credit growth has accelerated in recent years, it started from a low base; outstanding loans to the private sector were about 3.8% of GDP in 2010. Myanmar's financial sector is also far less diversified than other regional economies. The banking subsector dominates the finance sector and accounts for most of the sector assets held outside the central bank. State-owned banks are the major players and face limited competition. The shallow depth and lack of diversity of Myanmar's finance sector is a drag on efficient investment and broad-based economic growth. Reasons for Myanmar's shallow finance sector include (i) the predominantly rural nature of the economy, (ii) the country's stage of economic development, (iii) high transaction costs for financial intermediation because of the underdeveloped payments system and nonbank finance sector, (iv) lack of competition in the banking sector, (v) weaknesses in the legal framework, and (vi) sanctions on financial transactions.

18. **Overall Strengths, Constraints and early Reform Steps**. Myanmar can exploit several strengths and opportunities to catalyze its transition to an open, market economy. Commitment to broad-ranging reforms, coupled with a rich endowment of natural assets, abundant land, water, and energy resources; a youthful, low-cost labor force and a strategic location, providing a strong foundation for growth. With the country's rich agricultural resources and favorable climate, the agricultural sector provides enormous potential for growth and poverty reduction. However, Myanmar also faces multiple constraints and risks that may limit its progress. Key constraints include a weak macroeconomic management framework devoid of market mechanisms, insufficient fiscal resources and inefficient domestic fund mobilization, limited access to finance, deficient infrastructure, inadequate social services that hamper human capital development, and limited economic diversification. While the government has initiated steps towards a market economy, much more needs to be done to improve the environment for private sector development and inclusive growth. 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 in order to reduce transaction costs and create equal opportunities for all firms—or a competitive neutral policy environment.