

SPECIAL REPORT**MYANMAR'S FINANCIAL SECTOR SUPPORTING THE
COUNTRY'S ECONOMIC GROWTH**

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EXECUTIVE SUMMARY

Myanmar's remarkable and on-going political reform process has been followed by an economic opening to trade and investment. There has been great interest to enter what has been called "Asia's last frontier market", attracting considerable interest from many companies – not only from Asia but also further afield from Europe and the USA.

Initial growth rates have been well above the global and regional average, albeit from a low base, and the potential for further growth is clear. But the opening has brought greater attention to a multitude of needs in the country, especially in basic infrastructure as well as rules and laws. The amount of foreign investment actually realised so far has been relatively modest. One critical factor weighing on corporate investment decisions – whether by those already in Myanmar or thinking to enter – is for the country's financial sector to develop further.

Studies show that having a stronger and more open financial sector is key to spur and sustain the country's long term economic growth. There are many strengths that the right foreign banks can lend to Myanmar's development.

But moves to reform the financial sector are facing considerable and audible pushback from within, especially from incumbent local banks. Many in the local banking sector prefer that the pace of opening should proceed by stages, in accordance with the country's stage of development.

Indeed, the experience of other countries that have opened up, such as China and Vietnam, suggests that progressive liberalisation of the financial sector may be preferred – to set a steady pace rather than attempting a 'big bang' approach.

A progressive programme can allow time for the domestic players to adapt, as well as for government agencies and regulators to better prepare and manage the development of the country's respective sectors. There will also be time for foreign entrants to better understand

local conditions, the country's needs and how they might best participate.

Nine foreign banks were awarded provisional operating licences in October 2014 to provide only wholesale banking services to foreign companies. This narrow opening served as a shot of adrenaline that jolted into action the country's once sleepy financial sector and banks.

Foreign investor interest was rejuvenated. Domestic banks, awakened after more than two decades in isolation, quickly initiated waves of long-overdue reforms to modernise and restructure themselves to compete in the country's retail banking service space. A number of domestic banks are keen to improve their public image, widen their reach in the country and improve banking services.

But challenges are abound. Three previous crippling demonetisation processes between 1962 and 1985, and multiple bank runs have severely eroded public trust. Regaining depositor's trust and building legitimacy in the country's banking sector will take time.

Yet real banking needs are also being felt in the wider economy. Myanmar's strong macroeconomic performance since its opening has more than doubled international trade and encouraged a surge of foreign investment. In order to sustain long term positive economic growth, President Thein Sein's administration has made attracting foreign investment into the country's agricultural, manufacturing, and service industry a priority – sectors earmarked as potential drivers of Myanmar's economy.

There are implications for the government too. Myanmar's accelerated economic growth have raised the expectations of its own people. But the bulk of ordinary citizens have yet to feel the trickle-down effects of the country's economic opening. Before the country goes to the polls at the end of the year, the onus will be on the current administration of President Thein Sein to prove that his reforms can deliver. In particular, the need to develop and support the country's Small and Medium-sized enterprises (SMEs) has become a priority. There is conviction in the country that SME growth is needed for the potential multiplier effects in boosting local employment figures and encouraging a more equitable distribution of wealth.

Financial sector development is also important in the context of the ASEAN Economic Community (AEC), to be committed in 2015. Myanmar has to position itself to ensure that it benefits from the realisation of the economic bloc. This means ensuring its own economy and financial sector supports a free flow of investment, and that its domestic market becomes better connected to both regional and international markets.

This Special Report aims to provide an analysis on the value and impact of a more open financial sector on Myanmar's economy. The three sections provide an overview of the country's economy and financial sector, as well as analyses and observations made in the domestic and foreign banking sector. The fourth section discusses the value of Myanmar's financial sector opening on its economy, and the final section provides recommendations on the short, medium and long-term goals of supervising the sector.

1. OVERVIEW: MYANMAR'S ECONOMY

As President Thein Sein and his reform-minded administration approach the end of their first term, the country's first phase of economic growth seems to be nearing its peak. Rapid economic reforms have taken place against a flurried backdrop of political reforms since Myanmar's opening in 2011. Economic growth has also risen to hit a robust average 6.7 per cent.¹

The gradual lifting of sanctions has boosted international trade, albeit from a low base. Exports and imports of goods and services grew at estimated annual average rates of 11 per cent and 17 per cent respectively between FY2008/09 and FY2013/14², making Myanmar the second fastest-growing importer in ASEAN.³

However, while Myanmar's short to mid-term growth outlook have been reported to remain favourable, significant downside risks are to be expected.

According to a recent IMF statement, Myanmar's real GDP growth is expected to slow to 7.8 per cent in the FY2014/15, down from 8.3 per cent in FY2013/14.⁴

¹ (2014) Myanmar: Ending poverty and boosting shared prosperity in a time of transition, A systematic country diagnostic, *World Bank Group*, November 2014, Available:

http://www.worldbank.org/content/dam/Worldbank/document/EAP/Myanmar/WBG_SCD_Full_Report_English.pdf, pp. 1-67, Retrieved: 18 April 2015.

² IMF Country Report.

³ (2014) Myanmar: Ending poverty and boosting shared prosperity in a time of transition, A systematic country diagnostic, *World Bank Group*, November 2014, Available:

http://www.worldbank.org/content/dam/Worldbank/document/EAP/Myanmar/WBG_SCD_Full_Report_English.pdf, Retrieved: 18 April 2015.

⁴ (2015) Statement at the end of an IMF Staff Visit to Myanmar, *Press Release 15/48*, 11 February 2015, Available:

Pushing up growth will depend on whether the government has the ability to diversify its economy. There is a current over reliance on extractive industries as a key driver for growth and a need to develop Myanmar's agricultural, manufacturing, and service industries.

That development needs to be supported by a well-functioning and developed financial sector to ensure a more efficient and effective allocation of capital. To this end, fiscal and monetary institutions are needed to effectively regulate excessive fluctuations in prices, interest rates, exchange rates and wages.⁵

At present, Myanmar's institutional capacity lags and more reforms are needed for the long term.

Myanmar is heavily reliant on the use of fiscal policies and the use of direct monetary policy instruments to stabilise its economy.⁶ This is partly due to the country's underdeveloped and restrictive financial sector that has yet to form a formal interbank market. These limitations in the financial sector inhibit Myanmar from progressing further towards using indirect monetary instruments that could improve market efficiency.

<http://www.imf.org/external/np/sec/pr/2015/pr1548.htm>, Retrieved: 18 April 2015

⁵ (2014) Myanmar: Ending poverty and boosting shared prosperity in a time of transition, A systematic country diagnostic, *World Bank Group*, November 2014, Available:

http://www.worldbank.org/content/dam/Worldbank/document/EAP/Myanmar/WBG_SCD_Full_Report_English.pdf, Retrieved: 18 April 2015

⁶ (2014) Myanmar: Ending poverty and boosting shared prosperity in a time of transition, A systematic country diagnostic, *World Bank Group*, November 2014, Available:

http://www.worldbank.org/content/dam/Worldbank/document/EAP/Myanmar/WBG_SCD_Full_Report_English.pdf, Retrieved: 18 April 2015.

Last year, the Central Bank of Myanmar (CBM) announced plans to gradually allow interest rates on Kyat-denominated loans to float.⁷ This could encourage credit growth by lowering the cost of borrowing in Myanmar and encouraging a more efficient and effective allocation of capital. Further reforms that have been mooted by CBM include setting up a Treasury bonds market and an interbank lending market.

Myanmar's financial sector needs to evolve so that it can attract and release capital to support the development of key growth industries and SME initiatives.

It is imperative that Myanmar's financial sector evolves and develops its capacity and openness in policy. Only then can it attract and release capital to support the development of key growth industries as well as SME initiatives. The latter is important to encourage innovation-based growth leading to greater productivity gains in the long term.

As such, many argue that the entry of foreign banks is needed at least as a stop-gap measure to address the current lack of capital in the country and help keep growth rates up. But further ahead, in the middle to longer term, there are concerns that, like other developing countries, Myanmar might become overly reliant on foreign investment.

Moreover, within the financial sector, there are concerns that a more open

financial sector that benefits foreign investors and banks would leave smaller local banks unable to compete.

This comes on top of the potential risks of global macroeconomic shocks. In this regard, there are proponents that suggest developing countries might be better off managing their money supply and strengthening financial stability first⁸, before undertaking ambitious processes of capital and financial market liberalisation.

However, the relationship between how effective and efficiently a country's financial sector is able to spur greater economic growth is influenced by multiple factors and not simply by its degree of openness. Political and economic stability, the capacity of financial institutions, regulators, and effectiveness in enforcing government policy are factors that must be taken into consideration.

2. THE BANKING SECTOR

The granting of provisional operating licences to nine foreign banks on 1 October last year triggered a transformative change throughout Myanmar's banking sector.

The opening of the banking sector spurred the domestic banks to upgrade and modernise their systems. Fierce competition among more than 20 domestic banks has emerged to establish competitive advantages in terms of quality of service, banking products and population reach. New and smaller local

⁷ Aye Thida Kyaw (2014) Loan interest rates could float by 2015, *The Myanmar Times*, 13 October 2014, Available: <http://www.mmtimes.com/index.php/business/11918-loan-interest-rates-could-float-by-2015.html> Retrieved: 7 May 2015.

⁸ Stiglitz, J.E. (1994) The role of the state in financial markets, in Bruno M. and Pleskovic B. (eds), *Proceeding of the World Bank Annual Conference in Development Economics 1993: Supplement to the World Bank Economic Review and the World Bank Research Observer*, Washington DC: World Bank, pp. 19-61.

banks have also been set up to take advantage of the growth and profit-making potential of Myanmar's banking industry.

In this regard, the entry of foreign banks have been seen by some to have a positive impact on the industry by kick-starting much-needed reforms.

But the opening is experiencing considerable and audible pushback. A number of domestic banks have indicated that the pace of liberalisation should proceed in accordance with the country's stage of development.

There is a growing sense of protectionism among several domestic banks questioning the speed of reforms. Foreign banks, anxious to bring in more banking products, are frustrated over the lack of clear "rules of the game".

While domestic banks do recognise the importance and benefits that come with the entry of foreign banks into Myanmar, they are concerned that the banking sector, which is currently loosely regulated and supervised, will not be able to keep up with the foreign banks' internationalised and highly competitive nature. This has led to a growing sense of protectionism among several domestic banks questioning the speed of reforms implemented by the Central Bank.

Differences of views on the pace of reform for Myanmar's financial sector between incumbents and new entrants is to be expected, given their different commercial interests. There has nevertheless been a policy impact. The pace of opening has become cautious and there has been a delay in the

implementation of important laws such as the Banks and Financial Institutions Law of Myanmar.

The promulgation of this law will be highly anticipated as it is set to provide more certainty and clarity on the rules and regulations for domestic and foreign banks, as well as how they will be regulated and managed.⁹ The law is currently being debated in Parliament and expected to be passed before a new administration takes over in 2016.¹⁰

At present, however, the lack of clear "rules of the game" has frustrated foreign banks who are anxious to bring in more banking products, services and initiatives but are hesitant to do so because enforcement rules are either outdated or do not exist.¹¹ There is currently an environment of uncertainty and grey areas that could be exploited. This is especially where the CBM might have limited capacity to monitor, regulate and enforce new rules and laws on errant banks.

Due to growing sentiments of uncertainty surrounding Myanmar's banking sector, domestic banks have developed a protectionist nature in order to safeguard their long-term survival. Foreign banks, on their part, are also choosing to be more conservative and cautious, and this will limit their potential to generate positive effects on the economy.

⁹ Tangmeesang, Onravee (2013) Myanmar honing investment laws to ensure a level playing field for all, minister says, *The Nation*, 7 October 2013, Available: <http://www.nationmultimedia.com/business/Myanmar-honing-investment-laws-to-ensure-a-level-p-30216428.html> Retrieved 7 May 2015.

¹⁰ Meeting with the Central Bank of Myanmar.

¹¹ Private interviews.

The CBM will play an increasingly crucial role in the financial sector reforms and opening. It will have to provide domestic banks with the confidence and assurance that they will not be left out in the cold, as well as to ensure a clearer playing field for both domestic and foreign banks.

2.1. Competition among Domestic Banks

The entry of foreign banks into Myanmar’s wholesale banking sector sparked off a competitive race among Myanmar’s domestic banks. Frontrunners have emerged in the domestic banking sector (see Table 1). The rise of these large and strong domestic private banks have the potential to revamp Myanmar’s retail banking sector and to broaden financial inclusion in the country.

Domestic banks that were more nimble, prepared for change, and had better resources and capacity, were able to accept and respond quickly to changes in the banking industry. Top domestic banks are making good strides to modernise and adopt modern core banking systems,

Others are struggling to keep up. This is largely due to a lack of capital, skills and banking experience. Domestic banks continue to be bogged down by bank inefficiencies perpetuated by decades of isolation and for having to operate within a highly restrictive market with basic banking services.

Some anticipate that the industry will undergo a consolidation phase, which will see smaller banks shutting down, merging or being acquired by other local banks.

The entrance of foreign banks have also increased the competition for a limited pool of local banking professionals. Foreign banks are not allowed to poach

employees from local banks, but their ability to offer significantly higher wages are causing domestic banks to lose their best and most experienced employees. An overall increase of wages has also pushed up operation costs among domestic banks.

Table 1: Top 10 largest private banks in Myanmar (as of August 2014)

	Name of Bank	Assets (MMK billion)	No. of Branches
1	Kanbawza Bank	4144.97	180
2	Ayeyarwaddy Bank	1200	76
3	Co-operative Bank	1180.7	100
4	Myawaddy Bank	1028.1	37
5	Myanma Apex Bank	721.2	45
6	Global Treasure Bank	588.9	81
7	Yoma Bank	506	51
8	United Amara Bank	505	32
9	Asia Green Development Bank	463.1	50
10	Myanmar Oriental Bank	238.9	26
Total		8923.4	678

Source: GIZ (2015)¹²

Many welcome this as a necessary development in a still small market that is saturated with more than 20 private banks.¹³ Bankers and local experts say that a consolidated banking sector will strengthen the capital base of banks, and combine the industry’s talents in the top local banks. In the long term, a consolidated sector will enable domestic banks to stay competitive in the face of current and future competition with foreign banks, as well as contribute towards financial and economic stability.

¹² GIZ (2015) Myanmar’s financial sector – A challenging environment for banks (updated version, February 2015), *Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH*.

¹³ Private interview.

There is growing sense of uncertainty among the domestic banks because of the presence of foreign banks in the country. Speculation and ambiguity continue about how the CBM will regulate foreign banks.

Now that the first round of foreign banking licences have been issued, domestic banks hope that the government and the CBM will take a step back to take stock of the costs and benefits from the initial opening. This will allow the CBM to properly assess which sectors have benefited most from reforms, to what extent, and to determine whether and how soon more foreign banks should be allowed to operate in the country.

2.2. State-Owned Banks and the Informal Lending System

In addition to the private domestic banks, there is a handful of state-owned banks, such as the Myanmar Economic Bank and Myanmar Investment and Commercial Bank that continue to operate.

Ensuring long term stability in Myanmar's financial system must factor into account how these state-owned banks will be managed and regulated in future. There are questions whether they will be partially or fully commercialised in order to remain competitive.

Currently, state-owned banks in Myanmar are not subjected to the same regulatory framework as the private banks. Not all banks fall under the jurisdiction of the CBM, and are instead controlled and managed by the ministries that own them.

There have been calls for the future roles of Myanmar's state-owned banks to be more clearly outlined under the forthcoming Banks and Financial Institutions Law. This will be important as

“driving up the role of the state bank in the law” will ensure depositors of their continued legitimacy, and prevent bank runs that could destabilise the banking industry.¹⁴

Given decades of weakness and prohibitive costs in the formal financial sector, Myanmar's informal lending market has continued and continues to thrive. Also known as the *hundi* system, the system is seen by locals as being convenient, simple to use and even has strong overseas networks. It has become a preferred avenue for Myanmar's small businessmen such as its farmers to take out loans, as well as for Myanmar people working overseas to remit their monies home.

The presence of an efficient *hundi* system undermines the ability and potential of the formal financial sector to reallocate capital into Myanmar's formal economy and limits the CBM's capacity to effectively regulate the monetary system.

The *hundi* system has grown so much in sophistication that it is able to link Myanmar-based money changers and businesses up with their counterparts throughout the region including Thailand and Singapore. Cheap and efficient transfers of money based on personal relationships and trust can be done quickly. Door-to-door services, which bypass the need for users to set up a formal bank account, are also available and commonly used.

On average, inbound remittances from Myanmar citizens' abroad amount up to about US\$8 billion annually, with only half

¹⁴ Private interview.

flowing through formal bank channels, and the rest through the informal system.¹⁵

The presence of an efficient *hundi* system has resulted in capital that remains in informal and unaccountable channels. This undermines the ability and potential of the formal financial sector to reallocate capital back into Myanmar's formal economy and limits the CBM's capacity to effectively regulate the monetary system.

As the financial system modernises, the government and CBM must start to address the current *hundi* system. How to do this will be another challenge that will impact the future of domestic banks and the overall financial system.

But including state owned banks and informal lending into the framework of reforms will be important to ensure that domestic banks have a level playing field.

3. ENTRY OF FOREIGN BANKS

Foreign banks are expected to stem the current credit and liquidity gap that Myanmar's domestic banks currently do not have the capacity to fill. The services that they bring to Myanmar include providing loans, trade finance, cash management services, structured finance, and foreign exchange services to foreign invested enterprises.¹⁶

The presence of foreign banks is also expected to facilitate greater cross border trade between Myanmar and the region,

and to serve as conduits that will connect Myanmar to the global economy.

Foreign banks are for a step-by-step liberalisation process that gives them time to familiarise themselves with the country's newly liberalised economy and its policies.

But while these benefits are anticipated, the current opening is narrow and foreign bankers have expected limitations to be imposed. Many accept that a controlled pace is to be expected given the country's stage of economic development.¹⁷ As such, foreign banks also support the stated policy to have a step-by-step liberalisation process. This gives them time to familiarise themselves with the country's newly liberalised economy and its policies.

Another benefit of taking time relates to the considerable number of larger and influential Myanmar companies still on the US Specially Designated Nationals (SDN) blacklist. A slower opening allows banks the chance to get to know Myanmar companies and business figures better and to conduct proper due diligence processes where needed.

Yet while a slower pace of opening is accepted, there are concerns that overly conservative measures and requirements set up by the CBM on foreign banks could stifle their ability to contribute positively to the economy – now and into the longer term.¹⁸

One clear example of this is that the CBM requires foreign banks to put up a

¹⁵ Aye Thidar Kyaw (2014) Hundi remittance lives on, *The Myanmar Times*, 15 July 2014, Available: <http://www.mmmtimes.com/index.php/special-features/194-your-money-2014/11067-hundi-remittance-lives-on.html> Retrieved: 20 April 2015.

¹⁶ Foreign invested enterprises include wholly owned foreign enterprises and joint ventures in Myanmar.

¹⁷ Private interview.

¹⁸ Private interviews.

minimum paid-in capital of US\$75 million, of which some US\$40 million must serve as a statutory deposit at the CBM. This is an expensive initial cost, compared to other developing countries such as Cambodia, Vietnam and China.¹⁹

In response, foreign banks are likely to add this cost to the price of loans and thus raise the overall cost of borrowing and doing business. This reduces the competitiveness and attractiveness of Myanmar as a business and investment destination compared to its regional neighbours.

4. BENEFITS OF FINANCIAL OPENING

While opening Myanmar's financial sector is expected to generally benefit companies and the overall economy, different corporate sectors will benefit to different degrees. The extent of the effects are also dependent on the company's current levels of access to capital markets.

For foreign companies operating in Myanmar, they should expect lower costs of borrowing. But foreign banks in Myanmar are presently bound by conservative regulations that raise the costs of loans to these companies.

For Myanmar-owned conglomerates, it is likely that the entry of foreign banks and financial sector reforms could have a limited but positive impact. The larger Myanmar business conglomerates, known also as the Myanmar Billion Group or Biz-15²⁰, are large, family-owned and well-

connected business groups. While these businesses are not truly global conglomerates, these companies are key drivers of Myanmar's economic growth and are invested across the country's most profitable sectors, such as resource trading, construction and real estate development, airline, banking and tourism.

Myanmar's financial sector reforms may not affect Myanmar-owned conglomerates directly but they could stand to indirectly benefit the most from increased FDI as a result of a more open financial sector.

Due to their wide-spread access and connections, many of these tycoons have been able to amass large volumes of tangible assets and therefore enjoy credit at relatively favourable rates despite the presence of heavily repressed and credit markets. This has enabled their businesses to thrive and grow despite tough and restrictive business conditions caused by military rule and international sanctions.

Although Myanmar's financial sector opening and reforms may not affect these business conglomerates directly, they could stand to indirectly benefit the most from increased foreign direct investment as a result of a more open financial sector.

Since Myanmar's opening and with most economic sanctions lifted, some of these local conglomerates have become sought-after business partners for foreign investors, valued for their local networks, knowledge of the local conditions, and

¹⁹ Private interviews.

²⁰ Larkin, Stuart (2012) Myanmar at the crossroads: rapid industrial development or de-industrialisation, 1 January 2012, Available: http://www.burmalibrary.org/docs12/Stuart_Larkin-

[Myanmar at the Crossroads.pdf](#) Retrieved: 27 April 2015.

established names among the domestic consumer.

In this regard, Myanmar's conglomerates have become increasingly important for Myanmar's economy as they also attract foreign investment through joint ventures and partnerships on large-scale projects.

Potentially, financial sector reforms can be of the most help to those firms that currently face financial constraints and have had to rely on bank funding for capital.²¹ These include SMEs, whose growth has been difficult to date.

Local firms, such as SMEs, that currently face financial and capital constraints, are likely to enjoy improved access to credit under a more open and reformed financial sector.

SMEs are now recognised as new engines of economic growth and development, and are expected to play an important role in Myanmar's industrialisation process.²²

Identifying and helping SMEs is a priority but faces many challenges. The country's SMEs are widely defined, to mean enterprises with capital from one to five million Myanmar Kyat, and with operations that employ between 10 and 100 workers. According to the OECD, there are more than 126,000 registered SMEs in Myanmar, or 2.6 SMEs per 1,000 people. This is relatively low compared to other developing or least developed

countries that record between 9 and 27 SMEs per 1,000 people²³.

Their relatively smaller size means SMEs are more flexible and adaptable to today's rapidly changing environments compared to their larger business counterparts²⁴. Their labour-intensive nature also has the potential to provide large number of jobs, which can help to lower unemployment rates and spur development of domestic technologies and skills.

A more developed SME sector will reduce Myanmar's reliance on its large conglomerates and foreign companies. SMEs have the potential to provide ancillary services to those offered by larger businesses, both foreign and domestic, contributing toward long-term sustainable growth.

However, SMEs, which are wholly owned and controlled by Myanmar citizens, are likely to continue facing difficulties in accessing credit to grow their businesses. This is compounded by other weaknesses that include a lack of skills and knowledge of how to tap on regional market opportunities.

Improving access of credit in Myanmar will create a more positive and nurturing business environment for local entrepreneurial spirits to grow and thrive.

Myanmar will need to address SME-financing issues before embarking on a nationwide programme to narrow the

²¹ Agca, Senay et. al. (2013) Banking sector reforms and corporate leverage in emerging markets, *Emerging Markets Review* 17, pp. 125-149.

²² Aung Kyaw (2008) Financing small and medium enterprises in Myanmar, *Institute of Developing Economies*, Paper No. 148, pp. 1- 75.

²³ Abe, Masato and Dutta, Madhurjya Kumar (2014) A new policy framework for Myanmar's SME, *Asia-Pacific Research and Training Network on Trade, Working Paper*, No. 142, February 2014, pp. 1-57, Available: <http://artnet.unescap.org/pub/AWP-142-Masato-Abe.pdf>

²⁴ Aung Kyaw (2008) Financing small and medium enterprises in Myanmar, *Institute of Developing Economies*, Paper No. 148, pp. 1- 75.

SME development gap between Myanmar and countries in the region. The long term benefit of this endeavour will enable SMEs to form the backbone of the country's economy to support a more sustainable long term growth.

There is also potential, in time, for foreign banks to play a role in assisting the SME sector.

4.1. Benefits from the ASEAN Economic Community (AEC)

Another factor in the opening of Myanmar's financial sector is how it can assist and support the country's fuller participation in the ASEAN Economic Community, which is targeted for end 2015. Economic gaps between the ten ASEAN members remains a concern if the lower income countries feel unable and ill-equipped to compete and gain from ASEAN integration.

In this context, Myanmar's financial opening holds promise. A more open and developed financial sector in Myanmar puts the country in a position to benefit from the realisation of an AEC. By opening up its economy and developing it in line with the AEC's blueprint, Myanmar is also helping to fulfil the region's ambitions of an integrated economic bloc better able to maintain its global competitive edge.

This is especially as a number of ASEAN neighbors are middle income countries and, like Thailand and Malaysia, face costs at home that are much higher than those in Myanmar and other emerging markets.

A more open and dynamic financial sector would allow and encourage a freer flow of investment into Myanmar, and the set up of industrial and other plants that could plug the country into regional production

networks. This would assist Myanmar in participating fully in the ASEAN Economic Community and push the region closer towards its aim to create an effective and efficient single market and production base. This could attract investment into both Myanmar and the ASEAN region in the long term.

A more open and developed financial sector in Myanmar puts the country in a position to benefit from the realisation of an AEC.

According to the World Economic Forum's Global Competitiveness Index (GCI), countries with more open and liberal economies tend to cultivate better investment climates with lower country risks which attract more FDI. However, Myanmar's financial sector remains restrictive and underdeveloped, and is therefore seen as risky among foreign investors. This translates into higher overall costs of doing business. In the long term, this could affect the Myanmar's ability to attract investment as a driver for growth in the country.

5. SUPERVISING THE FINANCIAL SECTOR

While financial opening has begun and foreign banks have allowed to begin operations in the country, there are a number of challenges for the near to medium term. Against this background, this section provides a number of recommendations on how Myanmar's financial sector might evolve.

Even if the speed of Myanmar's reforms and the opening of its financial sector should be managed at a pace that its domestic banks, businesses and institutions are comfortable with, it is

better for there to be consensus of the directions to be set. In this respect, our recommendations aim for Myanmar's financial sector opening to be more inclusive with reforms that benefit both domestic incumbents and the new foreign entrants.

5.1. Communication Channels

Moving forward, one of Myanmar's major challenges will be to create a regulatory system and environment that supports the development of new and innovative financial products in the financial sector.

At the same time, the system cannot allow such new initiatives to overtake the country's regulatory capacity and contaminate the market with systemic risks. Sound regulation and supervision to support an efficient and stable financial system is important to prevent or reduce the impacts of both internal and external shocks to the financial sector.

Cultivating a positive and open working relationship between the CBM and domestic and foreign banks should be encouraged now that the financial sector is still relatively manageable.

This, however, will require the strengthening of Myanmar's institutional framework, which includes updating the country's legal system, and putting in place effective enforcement processes. Instead of a single monolithic regulator body, Myanmar can consider adopting a regulatory network system, similar to that of China, where an overseeing body coordinates and supervises the work of

multiple and smaller regulatory agencies instead.²⁵

This is aimed at minimising the oversight of gaps and abuse of loopholes in the country's regulatory system; help to improve communication between the CBM and the banking industry; as well as to encourage institutions to react quickly to global or regional shocks or bumps.

Cultivating a positive and open working relationship between the CBM and domestic and foreign banks should be encouraged now that the financial sector is still relatively manageable.

These short term efforts will benefit the industry in the long term as open and transparent lines of communication between the industry and its regulator builds mutual trust and a shared vision to help develop an inclusive financial system for the benefit of all its stakeholders. For example, a channel of communication between the CBM and the banking industry could be established to provide updates on laws, rules and regulations to be passed in Parliament.

Two-way communication can be encouraged through another feedback channel that allows both domestic and foreign banks to provide suggestions to the CBM. Regular meetings with domestic and foreign banks should also be held – whether separately or as a combined group. Many financial regulators worldwide have benefited from efforts to encourage open communication,

²⁵ Prasad, Eswar S. (2011) Financial sector regulation and reforms in emerging markets: An overview, Prasad, Eswar S. and Masahiro Kawai (eds) *Financial market regulation and reforms in emerging markets*, ADBI and Brookings Institution.

transparency and to build synergies with the banking industry.

Given that Myanmar's opening is new, we also suggest that these channels be developed quickly and put to use frequently. This would help with the implementation of new rules and regulations by the CBM. Once these have been properly implemented, and the financial sector has grown, the frequency of meetings could ease to a routine. But the channel, once well established could be maintained and ramped up if and when new and important developments come up, and in times of crisis.

It will become increasingly crucial for the banking industry and the CBM as regulator to develop an amicable and positive working relationship. Frustration over the pace of reforms, whether too fast or painfully slow, should be addressed quickly in order to avoid problems from degenerating into a blame game.

The CBM, as the main regulatory body, will need to play its part to set the tone of relations in the industry and address the growing concerns of the domestic banking sector. The domestic private banking sector too, needs to set aside its discontentment with the country's pace of reforms and to focus on working with the Central Bank to develop pragmatic solutions that plug gaps and strengthen the industry. Settling problems, soothing fears and addressing discontentment issues within the banking industry in the short term will enable the banks to maximise the country's financial opening for the benefit of greater economic growth in the long term.

5.2. Capacity

The lack of capacity is an issue that is not special to the banking industry and the financial sector, but many other sectors in Myanmar in this early phase of opening. But it has particular concerns for the financial sector and the CBM.

The challenge for the CBM and domestic banks will be to improve their capacity fast enough to keep up with evolving modern banking developments such as online banking.

The industry's weak regulatory capacity can be addressed by setting up training and apprenticeship programmes to help officers and institutions keep up with the financial sector's fast-evolving market and products.

The CBM needs to lay a foundation that effectively manages and regulates the country's financial sector and whips it into shape. It also has to stay abreast of new banking services and developments. One of the areas that bears special mention is digital technology involving mobile money transactions and digital currencies. This could be a game changer for Myanmar in which many citizens at present remain unbanked without a basic bank account. Digital banking represents a chance to move ahead quickly. Yet this is an area in which regulators around the world are still grappling with.

Looking ahead, the industry's weak regulatory capacity can be addressed by setting up training and apprenticeship programmes to help regulation officers and institutions understand and keep up with the financial sector's fast-evolving market and products. Such training

programmes can be supported and organised through partnerships or tie-ups with countries and multilateral institutions. Attending regional or international banking and finance conferences will also be important to raise awareness of future trends, as well as to learn from other countries' best practices.

Given the ASEAN Economic Community, it would be especially helpful to develop partnerships, capacity building and exchange programs with member countries or others who are closely engaged with the group.

Improving capacity in the financial sector will be a long term and ongoing endeavour. It is also linked to a larger societal need to implement educational reforms aimed at raising national standards of literacy, and to churn out professionals and technocrats with skill sets aligned with Myanmar's economic needs.

5.3. A Core of Domestic Banks

Myanmar's domestic banking sector is fast changing, and with new banks expected to establish their operations within the year, competition is increasingly stiff.

The CBM has not announced any plans to encourage consolidation among the local banks²⁶. But given increased competition and market forces, it is likely that small and weaker banks will be phased out and/or merged in the middle to longer term.

Such a process may upset the affected owners and operators. But this should not be resisted and indeed can be positive for Myanmar. In the process, the aim should be for a strong core of domestic banks to

emerge. The CBM should support this process and the development of leading domestic banks to play a larger role. This is with the aim that they should be able to compete with incoming foreign banks in terms of capital and range of services provided, and by differentiating their reach and appeal to customer segments as Myanmar's market expands.

Allowing a strong core of domestic banks to grow in size and expertise will help prevent Myanmar from over-relying on foreign banks.

By growing domestic banks in size and expertise, Myanmar can avoid over-relying on foreign banks. A more balanced future between the domestic banks that emerge and grow stronger, and foreign banks as they expand in Myanmar, will better serve both the domestic-driven and investor-driven economic growth engines. However, as discussed above, the CBM and the domestic banking sector must start to develop an amicable and positive working relationship.

Improved consultation and communication is likely to better support the implementation of newer and innovative services, as well as initiatives that will strengthen the capabilities of domestic banks and help deepen expertise in Myanmar's financial sector.

In the short term, Myanmar could adopt a more stringent and selective admission policy with regards to the entry of new domestic private banks. The CBM could consider raising the barriers to entry by imposing higher capital requirements needed to set up a bank. Allowing the industry time to consolidate itself in the short to medium term could reduce the

²⁶ Meeting with the Central Bank of Myanmar.

probability of a bloated domestic banking sector, where weaker banks pose as risks to the overall financial system.

5.4. Engaging Foreign Banks

Now that the first wave of foreign banking licences have been awarded, Myanmar can afford to adopt a more conservative timeline with regards to the approval of its second batch of foreign banking licences. This will also allow the CBM time to assess the costs and benefits of its financial sector's initial opening. This would be necessary and best to make an informed decision on the pace and extent of how it should conduct its next phase of opening.

Encouraging foreign banks to take part in the development of Myanmar's interbank markets can be an important step towards deepening the financial sector and increasing interaction between foreign and domestic banks.

Foreign banks who have been awarded licenses need to be patient in developing their business strategy in Myanmar for the medium to longer term. Expectations for most have been tempered and will need to be managed further.

Most foreign banks have indicated that they are comfortable with the extent of the country's financial sector opening. However, what is of more immediate concern have been the uncertainties that have arisen due to the absence of a clear and effective regulatory environment, which leaves industry laws and rules open to interpretation.

Officials will need some time to tackle these gaps and, in the meantime, foreign banks will have to resist opportunities to

take advantage and abuse loopholes in the system. An informal system of self-monitoring combined with clearer and more effective channels of communication among the banks and with the CBM will assist in this regard.

While restrictions and limitations on foreign banks should remain in the short to medium term, the CBM should consider involving foreign banks to become more closely involved as stakeholders to help develop Myanmar's financial sector.

One step is for foreign banks to employ, train and develop local Myanmar talents which will be an important contribution to the future of the sector.

Another example would be to encourage foreign banks to take part in the development of Myanmar's interbank markets. This can be an important step towards deepening the financial sector and increase interaction between foreign and domestic banks²⁷. Establishing an interbank market will also encourage skills and technology transfer between foreign and domestic banks, as both have a shared and mutually beneficial interest to develop a well-functioning interbank system.

5.5. Reforming state-owned banks

The reform of state-owned banks should start as soon as possible. The process is likely to be lengthy and could otherwise become a drag on the country's financial sector reforms as whole.

The overarching need is to help state-owned banks assimilate into the country's financial system and operate as commercially viable and socially

²⁷ Meeting with the Central Bank of Myanmar.

responsible banks. Plans to commercialise and corporatise these banks by holding an initial public offering and selling shares on the upcoming Yangon stock exchange is one option that the Ministry of Finance is looking to implement as part of its plans to reform the state-owned banks.²⁸ Banks that have been earmarked for restructure include the Myanmar Economic Bank, which is the country's biggest bank but one that has not been profitable. Another is the Myanmar Investment and Commercial Bank, set to become the country's export-import bank.

The Myanmar government should do its best to clean up the state-owned banking sector and to address and reduce the volume of non-performing loans (NPLs) accumulated from past administrations. The experience of Vietnam's state-owned banks should be avoided. Those banks, although commercialised, continue to be weighed down by NPLs held by government-owned or -controlled companies.

To move ahead, state-owned banks must first be required to adopt a sound corporate governance structure, effective internal supervisory systems and remain accountable to the public through transparent and open channels of communication.

5.6. Strengthening the Myanmar Kyat

The increasing risk of dollarisation in Myanmar's economy needs to be addressed quickly. The Myanmar Kyat depreciated about 6 per cent against the US dollar in the first half of 2015, and this has pushed up inflation rates.

²⁸ Meeting with the Ministry of Finance.

Strengthening confidence in the Myanmar Kyat is important to ensure that Myanmar is able to maintain control over its own monetary policy, and to safeguard the country's economic stability.

First, policies that promote the use of local currency in the country need to be promulgated and enforced. According to the Central Bank of Myanmar Law (1990), transactions made in the country must be conducted in Kyat, but this so far, has been little enforced.

Strengthening confidence in the Myanmar Kyat is important to ensure that Myanmar maintains control over its monetary policy, and to safeguard the country's economic stability.

Second, the government should lead nation-wide campaigns to encourage businesses to accept payment or transactions only in Kyat. On 28 May 2015, the CBM issued an official statement instructing all union ministries, government of states and divisions to conduct their domestic transactions only in Myanmar Kyat.²⁹ This initiative is an important step to help strengthen the Myanmar Kyat, as well as to send a strong signal to the population and businesses of the country's intention to phase out the use of US dollars in the local economy. Third, Myanmar needs to address the presence of a black market that allows

²⁹ Central Bank of Myanmar's letter No. MaVaBa-1/111(FEMD)/(904/2015), "Instructions to all Union Ministries and governments of states and divisions to pay in Myanmar Kyat for all domestic transactions", *Central Bank of Myanmar*, Republic of the Union of Myanmar, issued on May 28, 2015, retrieved on June 3, 2015, http://www.cbm.gov.mm/sites/default/files/foreign_exchange/to_be_performed_with_myanmar_kyat.pdf

large amounts of US dollars to be sold at rates five per cent higher than market rates. The presence of an informal foreign exchange channel has contributed to the downward pressure on the Kyat.

To reduce the reliance on such informal channels, the CBM has limited the use of cash transactions to US\$10,000, requiring larger US dollar transactions to be made via official bank channels. Redirecting US dollar denominated transactions back into the formal channels allows the use of the dollar to be properly monitored and efficiently distributed through Myanmar's economy.

However, the successful impact of this requirement depends on how strictly this rule is enforced by the country's authorities. Otherwise, it runs the risk of encouraging the demand for Myanmar's black market on the US dollar to grow.

Addressing the problem of a limited US dollar supply in the country will also depend on the overall economic performance of the country, and also includes Myanmar addressing its growing current account deficit. Overall, Myanmar needs to find a balance between the demand and supply of USD to prevent the proliferation of a black market.

Strengthening the Myanmar Kyat is also imperative for the development of the local banking sector. Restrictions on foreign banks in dealing with Kyat denominated deposits have provided domestic banks with an underutilised comparative advantage for business denominated in the local currency. In order for domestic banks to take advantage of this position, households and corporates need to be confident in the value of the Kyat as an incentive to

encourage more Kyat denominated transactions and loans.

6. CAPITAL AVAILABILITY AND ALLOCATION

In addition to the above recommendations for the financial sector, there are broader needs for steps to increase the availability and efficient allocation of capital. While some steps can and should be started now, these will be primarily for the medium to longer term.

6.1. Sound Interbank and Stock Markets

The presence of a sound interbank market will help Myanmar develop its money market and liberalise interest rates in the country – goals which the CBM plans to fulfil in the next two to three years.³⁰

The liberalisation of interest rates will be highly anticipated in Myanmar. The cost of credit is likely to be lowered considerably, rejuvenating capital-starved industries and businesses. Having a more free flowing supply of capital in the country has the potential to unlock new sectors of growth.

The CBM had previously established an interbank market in August 2013 but with limited success.³¹ However, there are plans to ramp up participation and improvement to the existing interbank market. An inter-ministry coordinating committee involving the Ministry of Finance and the CBM is currently being set up to discuss forward-looking plans on how to develop this market further.³²

To support plans to liberalise interest rates, the CBM launched government

³⁰ Meeting with the Central Bank of Myanmar.

³¹ Meeting with the Central Bank of Myanmar.

³² Meeting with the Central Bank of Myanmar.

treasury bills auction earlier this year, allowing bill prices to float according to market forces.³³ Interest rates on treasury bills were previously fixed.

Both the launch of auctioned government treasury bonds and an interbank market are expected to help the Central Bank monitor market-based interest rates and facilitate interest rates reform.³⁴

6.2. Greater Financial Inclusion

Currently, less than 30 per cent of Myanmar's population has access to formal financial services. Improving access to basic banking services and credit to Myanmar's population and its local private sector businesses will be an important step for both the banks and the wider society. Greater financial inclusion could spur positive long term economic growth for the country.

As mentioned earlier, Myanmar's leading private domestic banks have set up branches across the country, and supported workshops to improve financial literacy. Plans to implement basic digital banking platforms through the use of mobile technology and the internet also serve to help improve formal financial inclusion.

Public-private partnerships can be forged to implement a national savings campaign across schools in Myanmar. This is aimed at inculcating the value of thriftiness and to encourage financial inclusion and literacy at a young age.

However, more needs to be done to build up public confidence in the formal banking system. Initiatives from domestic banks to improve financial literacy and regain trust in the local banking system are a good step forward, but need public sector support.

Public-private partnerships can be forged to implement a national savings campaign across schools in Myanmar. There are multiple benefits for such a campaign. First, the campaign will help to inculcate the value of thriftiness and to encourage financial inclusion and literacy at a young age. Second, these children can be encouraged to transfer basic knowledge on the concept of savings and money management using banking services to the rest of the household. The third benefit has broader implications where deposits generated by the savings campaign can provide Myanmar with a valuable source of funds used to spur economic growth.

6.3. Improving Access of Capital to SMEs

For SMEs, improving the ease of access to credit needs to take priority in order to kick-start the multiplier effect. This can contribute to Myanmar's positive and sustainable economic growth and the development of local companies.

³³ Aung Hla Tun (2015) Myanmar to start government bond auctions this month – c.bank, *Reuters*, 2 January 2015, Available: <http://www.reuters.com/article/2015/01/02/myanmar-bonds-idUSL3NOUH0RG20150102>, Retrieved: 2 June 2015.

³⁴ Meeting with the Central Bank of Myanmar.

To improve the supply of credit to these businesses, the Myanmar Banks Association could team up with foreign banks in the country to engage in capacity building workshops aimed at establishing an industry-wide standard for assessing SME loans. Such partnerships improve the capacity of the domestic banking industry and benefits all stakeholders involved.

Government policies and initiatives need to be implemented so that SMEs benefit and the businesses generate sufficient profit for domestic banks.

Government and the CBM's support for improved credit access to SMEs will also be crucial. However, they must implement policies and initiatives so that the SMEs benefit and the businesses generate sufficient profit for domestic banks.

In order to encourage domestic banks to provide loans for SMEs, the government or the CBM needs to help to mitigate the risks of such loans. One way to do so is by making credit history and information on such businesses and individuals readily available. The CBM also needs to set up an agency, similar to that of an accounting and corporate regulatory authority, which requires business entities in Myanmar to register and disclose their financial statements. The availability of such information will help financial institutions in their credit assessment processes and improve the quality of corporate governance practices.

The authorities are aware of the gap of credit information between SMEs and banks, and plans have been made to

establish a credit bureau "very soon".³⁵ With the assistance of the International Finance Corporation (IFC), regulations for a credit reporting system has already been drafted and submitted to the Central Bank's board of directors for approval.

To complement efforts to ease SME financing and provide banks with more confidence to lend to these businesses, a credit insurance system is also on the cards, which will be coordinated by the Ministry of Finance.

In the short term, international agencies such as the Japan International Cooperation Agency (JICA) will step in to provide a two-step loan. These will be first distributed through the state-owned banks such as the Myanmar Economic Bank and other private domestic banks in Myanmar at an interest rate of 4 per cent. Loans to SMEs will be offered at an interest rate of 8.5 per cent.^{36 37}

6.4. Safeguarding the Financial System

While it is necessary that Myanmar open its financial system, it must safeguard itself against systemic and global risks and shocks. For this, the CBM must consider implementing macro and microprudential measures.

Once Myanmar completes its current phase of reforms in the financial sector, the CBM should consider conducting stress tests on the financial system that involve the country's largest domestic banks. Conducting such tests have the

³⁵ Meeting with the Central Bank of Myanmar.

³⁶ Meeting with the Central Bank of Myanmar.

³⁷ May Soe San (2014) JICA to get more loans for Myanmar SMEs, *Myanmar Business Today*, 19 May 2014, Available:

<http://www.mmbiztoday.com/articles/jica-get-more-loans-myanmar-smes>

potential to (1) test the efficiency and effectiveness of coordination among institutions in the sector; (2) draw attention to weaknesses or potential risks and bubbles in the financial system; and (3) test the soundness of financial institutions and how they might react to crises.

In order to raise the CBM's capacity to implement such measures, exchanges with central banks from other countries can be set up. This not only helps to improve the overall management and supervisory capacity of the CBM but helps to build a more robust and efficient financial system equipped and ready to support Myanmar's next phase of economic growth.

7. CONCLUSION

As Myanmar approaches its election season, questions of how and how much the country's reform process has benefited the country's general population will increasingly come to the fore. Some impatience has surfaced that economic growth has yet to trickle-down to ordinary citizens.

Despite strong headline growth numbers, Myanmar is still one of the poorest countries in Southeast Asia, with an annual per capita income of only US\$876. Moreover, social reforms such as education and healthcare continue to challenge the government to ensure that all benefit in the economic opening.

Moves to develop and reform the financial sector are steps in the right direction to help growth continue and to help more ordinary citizens and SMEs gain access to banking services and capital. But

there are dangers that an opening which remains too narrow will only benefit foreign investors and large Myanmar-owned conglomerates. If so, large segments of the local population may become increasingly frustrated and disgruntled with the imbalance.

Owners of local banks and private businesses already express frustration as old rules and limits remain in place and these have stunted the development of local banks' and private sector credit access.

As surveyed in this special report, despite the efforts made, there is still a long to-do list of reforms that remain. With elections scheduled for end 2015, the incumbent administration may be unlikely to complete these in the remainder of its term. Yet Myanmar should continue to reform this sector, and for that it needs to develop a consensus that can endure despite possible changes at the helm of the government, or in the different ministries and agencies.

A broad consensus is emerging today, as our interactions with government, businesses and banks – both local and foreign – suggest. That consensus affirms: (1) a step-by-step pace that is most beneficial to the Myanmar economy and its people; (2) growth that is sustained into the medium and longer term and can benefit the broadest section of people and companies in the society and not only foreign investors and larger conglomerates; (3) support for a core of stronger local banks allowed to emerge alongside foreign banks that are committed as stakeholders for the long term; and (4) better management by the CBM and other government agencies with

the right mix of tools, regulations and laws administered soundly and in accordance to the rule of law.

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All views expressed in this briefing are those of the authors, unless otherwise cited.

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