

## **6. A Case for the Rehabilitation of Industrial Zones (IZs) in Myanmar**

### **6.1 Introduction**

In order to operate modern industrial activities, the provision of an appropriate amount of economic infrastructure is essential. The status of infrastructure development in Myanmar can be estimated to be “underdeveloped”<sup>1</sup> compared with the standards of other ASEAN countries. It is obvious that the poor infrastructure of the country serves as a considerable bottleneck to industrial development. Among the areas that remain insufficient in terms of infrastructure provision is the energy sector, and power shortages are a critical issue that needs to be addressed.

However, if the entire electric power system, including power generation, transmission and distribution, were to be improved and total power demand was immediately satisfied, the government of Myanmar would certainly face fiscal bankruptcy. The fiscal deficit has remained considerably large and the government therefore should find ways to minimise the amount of immediate investment necessary for promoting industrialisation, while at the same time ensuring that sufficient results are achieved.

For industrialisation, two possible immediate solutions corresponding with these two contradicting requirements is to phase the implementation of infrastructure development and to concentrate funds and efforts on some selected areas. This will help promote modern industrial activities by supplying sufficient infrastructure, such as electricity, and, at the same time, minimise fiscal expenses.

In order to provide essential infrastructure with manufacturing industries the first step in Myanmar should be the intensive rehabilitation of several estates/zones among the currently existing 29 Industrial Zones (IZs)<sup>2</sup> which were developed during the 1990’s. These IZs were developed by different entities, including the government of Myanmar, joint ventures between governmental agencies and foreign firms, and by pure foreign investment, and therefore their present status, to a certain degree, is varied. However the infrastructure level in these IZs remains insufficient, regardless of their respective backgrounds. In order to promote and encourage domestic and foreign manufacturing firms, such IZs should be upgraded/improved one by one, or in gradual phases based on long-term industrial strategies.

Moreover, for the promotion of FDI in manufacturing sector – which is another immediate action that needs to be taken in Myanmar – although the conditions of ordinary IZs remain

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<sup>1</sup> For details of the status of infrastructure development in Myanmar, see the separate report by the Trade and Industrial Policy Working Group.

<sup>2</sup> In Myanmar, there are “industrial estates” and “industrial zones”, and there is practically no difference between the two. In this report, the term “IZ” represents both of these above-mentioned areas.

insufficient to attract FDI based on international standards, they are still a necessary base essential for the introduction of FDI. Myanmar thus should continue its special efforts to upgrade/improve the management system of IZs so that it at least complies with the international standards for Export Processing Zones (EPZs), along with the physical rehabilitation of existing IZs that have already been completed.

Another aspect, which is the most significant for FDI promotion and stimulation of export activities, is reform of the nation's inefficient investment/trade policies and revitalising economic liberalisation, including the unification of the foreign exchange rate. However experiences in other countries tell us that the governments in developing economies had to face substantial difficulties to shape sufficient policies and institutions for export-oriented/FDI activities. This is because they had to make appropriate adjustments with other related policies and laws and they were also required to build positive consensus among all ministries and agencies involved. In order to avoid critical delays in implementing required promotion policies for export/FDI businesses and economic liberalisation, exclusively introducing such policies and measures in special IZs, i.e. EPZs or special economic zones (SEZs), as pilot cases might be a tentatively effective idea.

## **6.2 Definitions of IZs, EPZs and SEZs**

Among the similar types of zones, IZs are the most general and basic type of ready-made and providable industrial sites. They represent a selected area where necessary infrastructure (utilities inside of the IZ and external connections outside of it) and common administrative services are provided. Firms located in IZs often enjoy certain preferential taxes or special financial/technical supports. However the nature of tenant firms is usually not limited.

Export-Processing Zones (EPZs) are a specially managed type of IZ which promote exporting industries. EPZs are often established as places of “offshore production” and built and managed as enclave zones. They are often called as “fenced-in” EPZs.<sup>3</sup> The status of infrastructure and facilities to be prepared for tenant firms must be the same as that in IZs of international standards, however the nature of companies located in EPZs is limited to export processing industries and the tax systems and financial services, as well as rules/restrictions of origins of raw materials, are separated from ordinary domestic ones. Management of EPZs requires a higher level of skilled personnel and more sophisticated economic policies and strategies in comparison with IZs.<sup>4</sup>

The term “Special Economic Zone” (SEZ) is used differently from country to country. In

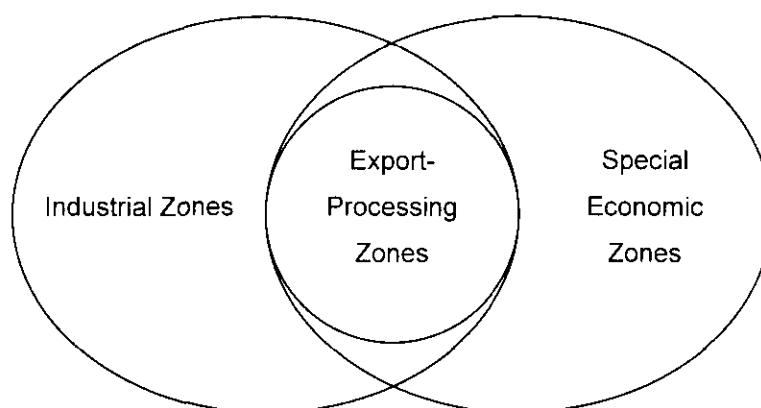
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<sup>3</sup> There are also many quite different arrangements that are sometimes considered EPZs.

<sup>4</sup> World Bank, *op. cit.*

China, an SEZ originally meant a new model “autonomous city” which adopts a comprehensive market-oriented industrialised system located outside of an existing metropolis, thus the firms located in the SEZs are not limited to manufacturing companies but also include commercial as well as financial institutions or even agricultural organisations. Other types of SEZs were also developed for the purpose of technology transfers from foreign companies to their partner domestic firms, and locations for the latter type of SEZ in China were set within existing cities<sup>5</sup>. In the Philippines, the term “SEP” was utilised to represent the two former US-military bases in the country that were rehabilitated for the promotion of FDI and the development of other domestic industries, and such types of SEZs were established as progressive versions of EPZs<sup>6</sup>. In short, SEZs can also be defined as special types of IZs and the nature of the firms located in them vary according to the purpose of the respective SEZ, and thus the level of management must be highly sophisticated.

Figure 6.1 Concept of IZ, EPZ, and SEZ



### 6.3 Infrastructure in existing IZs

The first IZ in Myanmar was developed under the supervision of the National Industrial Promotion Committee (NIPC) in 1992 to cope with activation of the private sector after the economic liberalisation in 1988. In 1995, the Myanmar Industrial Development Committee (MIDC) was established which is responsible for the achievement of industrialisation goals

<sup>5</sup> Japan External Trade Organization, *Kanton/Fukken toshi kankyo –tai-chuh toshikankyo chosa* (III) (Investment environment in Guangdong and Fujian - Study series on investment environment in China III—), 1981.

<sup>6</sup> For details of the rehabilitated former US-military bases, please refer to “Progress Report 3” by the Trade and Industrial Policy WG, pp. 51-53. The Philippines had already introduced an EPZ system in 1970 through the enactment of EPZ Law. But the management of EPZs has long been a serious burden of the government and little success was gained from such EPZs until the 1990s.

defined in the short-term five-year-plan. Nineteen IZs were developed and they were subject to the controls of the MIDC. As of 1999, a total of 34,410 employees were working at 4,850 tenant firms in these IZs. Aside from the IZs developed under the MIDC, ten IZs in the Yangon District have been created by the Department of Human Settlement and Housing Development (DHSHD) of the Ministry of Construction, and some other DHSHD industrial estates are under construction.

The original objectives of these IZs were not clearly defined. The Myanmar government seemed to have simply aimed at locating industries inside certain limited areas. Thus the government did not pay much attention to managing the level of utilities/services provided or to guaranteeing sufficient infrastructure for the tenant firms. However, such IZs can offer many private companies better conditions than anywhere else in the country, even though they only guarantee a piece of land at a relatively good location close to markets or near international airports. Moreover, foreign manufacturing companies that have invested in Myanmar have found these IZs to be almost the only choice for site location, considering the overall insufficient infrastructure conditions and the inconvenience of information gathering for business activities in Myanmar.

As mentioned above, circumstances at IZs are far from sufficient when compared with the international standards. According to the tenant companies, water supply and sewage systems are only partially prepared, and some firms have had to dig wells in order to access necessary water. Internal roads, drainage systems, and telecommunication facilities are not provided either, even though all of these constitute essential lifelines for tenant companies. Most seriously, electricity distribution is not guaranteed in most IZs and companies located in such zones have to additionally use captive diesel generators that are paid for with their own capital. Considering the recent hike in fuel prices in Myanmar, power costs bear a significant weight on the financial situations of tenant companies. The burden of additional fuel costs sometimes destroys a company's entire business, and there have been some firms which have withdrawn from business operations.

In a few IZs, the condition of power supply seems to be better than that of others, without any clearly defined reason for such. Such irrational discrepancies in equality level discourage the business mindset at firms and should be eliminated as soon as possible.

#### **6.4 A case for promotion of IZs**

Not only in Asia, but almost on a global scale, industrial estates and industrial zones have been developed as significant facilities for industrialisation in many countries. There are no uniform definitions regarding the general state of IZs, however there are some minimum conditions required for the successful development and management of IZs: appropriate location, the provision of

essential infrastructure, such as electricity, water supply, waste-water treatment systems, internal roads, connections to highways/ports/airports, and telephone network; and the supply of sufficient administrative and supporting services.<sup>7</sup> In guaranteeing these minimum conditions for the smooth operation of IZs, almost every country has struggled to establish a solid management system for IZs and set up at least an autonomous authority for the promotion and management of IZs.

A considerable number of countries have experienced almost the same type of failures observed in Myanmar, i.e. these nations designated areas as IZs, levelled the ground, zoned the land and began to turn over the land (or the land-use rights) without providing a sufficient amount of infrastructure and services. Such IZs produce only a limited amount of demand and their high vacancy rate often plagues developers and the national government. In Indonesia there are currently 93 IZs, while there are 35 and 32 in Thailand and Malaysia, respectively. Not all of them were sufficiently equipped from the beginning when these countries started to develop their IZs in the 1960's and 1970's. In the 1980's, the gap between better-equipped IZs and underdeveloped IZs became obvious. Stagnation of several IZs raised certain scepticism concerning the utilisation of IZs for industrialisation. The lessons to be learned from the experiences of these countries is that certain levels of infrastructure and supporting services need to be provided as the minimum conditions for IZs, and governments which supervise the IZs should clearly acknowledge the importance of initial investment in establishing basic physical infrastructure and service infrastructure.

At most IZs in Myanmar, the allocated administrative staff is not only insufficient in terms of number but also in regards to authority. Their main task is practically limited to registration control of tenant firms, and they are not responsible for the overall management of the IZs. There is no central organisation or individual unit (except for a few exceptions) to formulate management policies and to offer promotion activities for Myanmar's IZs. For example, in Thailand, the Industrial Estate Authority of Thailand functions as the overall supervisor of all IZs in the country and each IZ organises an administrative office which provides coordination work, business promotion, and general management of IZ operation. Aside from these administrative staff, firms located in IZs often establish industrial associations within the estate in order to formulate collective action to improve the status of their IZ.

Also, it is often the case in IZs that tenant firms are able to enjoy some financial privileges or preferential tax status as incentives to move into such estates. In order to facilitate such a mechanism, however, a well-organised supervisory organisation and administrative staff at each IZ are essential. Financial and tax incentives should be designed cautiously in line with industrial policy and should be based on adequate studies on the respective industries. Without the

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<sup>7</sup> World Bank, *Export Processing Zone, Policy and Research Series 20*, 1992, p.4.

establishment of efficient administrative teams at respective IZs, any devised incentive scheme will fail to realise its initially intended results.

### **6.5 Policy measures to encourage IZ development**

The first priority for the government of Myanmar in developing IZs should be the careful review of development projects for IZs currently under construction. It is not the number or total area of developed IZs that is important for industries, rather the quality of each IZ is the most crucial issue. The ten IZs currently under construction must be equipped with all basic facilities necessary for business operations. If the funds are insufficient to cover the entire cost of accommodating basic facilities for all of these IZs, then some constructions should be postponed to a later date.

Among the 29 existing IZs in Myanmar, the best industrial estate can be said to be the Mingaladon Industrial Park in Yangon's east district which was developed jointly by a Japanese company and the DHSHD in 1992. Basic infrastructure including water supply, wastewater treatment plant, drainage, electric distribution facility, and telephone lines are all provided in the industrial park. The Mingaladon IZ is the only industrial estate in Myanmar equipped with a wastewater treatment system. And administrative staff are ready and prepared to provide all possible supports and services to the tenant companies. The level of infrastructure and services available at this IZ is certainly prominent in Myanmar, however it is still quite inferior compared to the international standards for industrial estates.

Considering the limited financial resources available to the Myanmar government, intensive rehabilitation of the Mingaladon IZ should be given the highest priority among investments for industrialisation. In the case of Mingaladon, the MIDC might initially concentrate on improvements of the power supply, which is a crucial shortcoming in the said IZ. Subsequently, the MIDC should formulate a mid- and long-term promotion policy for the IZ. Along with this, the MIDC could map out a vitalisation plan and execute it for the Mingaladon IZ, administrative staff should be better trained to provide sufficient basic services, and extended services should be created for promotion of the IZ.

The government of Myanmar is therefore recommended to select several other IZs, such as the Mandalay district, to rehabilitate and formulate IZ promotion policies for the basis of IZ management.

### **6.6 Toward possible Export-Processing Zones (EPZs)**

As was already emphasised above, the development and revitalisation of IZs is quite crucial as a primary driving force for industrialisation in Myanmar. Fundamental improvements in

facilities and basic supporting services available at IZs, as well as reinforcements in manpower for administrative staff should be implemented to fulfil the minimum requirements of tenant companies.

But such basic infrastructure and services alone cannot sufficiently attract FDI, which Myanmar must be determined to acquire for the vital progress of its industrialisation and for the stability of its macroeconomy. IZs are basically designed for the domestic industries. Thus, the rehabilitation/development could be focused on the quality of facilities and basic services that comply with the minimum requirements of tenant firms. However, for FDI companies that are in a very severe situation when assessed compared to investment costs and benefits in respective countries, other institutional and systemic aspects of corporate activities become very critical in their decision-making regarding investment.

As cited in the previous chapter, the present judicial system regarding foreign enterprises is not yet sufficient from the view of international standards. And the financial systems and institutions in the country remain underdeveloped in addition to the arbitrarily complicated exchange rate mechanism. Without efficient and liberal systems for remittance, profit reserve and fund raising, FDI companies will not decide to make large-scale investments in manufacturing in Myanmar. Meanwhile, comprehensive reforms in the legal framework for FDI firms and various amendments and adjustments of financial institutions and systems which comply with international standards must be implemented by the many Ministries and Agencies involved, and adequate time should be given for their completion.

Thus, it is suggested that the government of Myanmar promptly initiate preparation activities for the introduction of export-oriented SEZs or EPZ, and that projects for newly constructed IZs be reviewed and some of the existing IZs be rehabilitated<sup>8</sup>. Traditionally, EPZs are regarded as enclave areas that specialise in export-processing industries, which enjoy free trade status (at least they are provided with duty-free imports) as well as special incentives (such as export subsidies), preferential tax status (such as duty exemption and exemption from corporate tax for certain periods) and a special financial framework (such as usage of off-shore banking). But considering the limited fund resources available in Myanmar, brand new development of land as EPZs is not feasible. The conversion of selected existing IZs to EPZs must be an optimal solution.

And, as mentioned above, EPZs can serve as pilot cases to probe the effects of revised/sophisticated laws and promotion policies to encourage export/FDI businesses and economic liberalisation by limitedly introducing such measures in EPZs. However such limited implementation of revised/improved industrial policies and economic liberalisation of external

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<sup>8</sup> For details please refer to "Progress Report 3" by the Trade and Industrial Policy Working Group, pp. 58-59.

trade activities and FDI must be considered as a tentative measure in promoting export industries and in taking the first step toward bringing back FDI in Myanmar.

The immediate conversion of existing IZs to EPZs may also be a difficult task for the government of Myanmar, because a number of domestic-market-oriented companies are already located in existing IZs and such conversion first requires careful coordination, amendment, and harmonisation of general corporate laws and regulations for such existing tenant firms, as well as special treatment status for export-processing industries. Aside from the lack of such prior systemic/institutional adjustments, management of mixed firms requires highly sensitive management skills for the supervisory agency, however as mentioned above, there is currently a dearth of such skills at the MIDC and among administrative staff at respective IZs. Thus the introduction of an “EPZ” status as was executed in Vietnam, which is applied to export-oriented companies in the IZs that comply with specific criteria can also be a possible prospective measure in Myanmar.



**Historical and Institutional Background  
for Sustainable Development**



## **7. History Matters: The Origins of the Modern Economic Development of Myanmar**

### **7.1 Economic growth between 1860 and 1940**

The export of rice, together with bullion and other precious commodities, was banned under the kings of Myanmar. Nonetheless, the growth of rice exports was a clearly observable trend. The historian Michael Adas attributed the growth of rice exports not only to the policy of the British colonial government but also to the activity of the populace contrary to the regulations of the kings<sup>1</sup>.

Among the first measures undertaken by the British colonial government were the abolition of the ban on rice exports and the removal of restrictions on free trade, which early 19th-century travellers and merchants found pernicious. The officials of the British government also promoted public works such as the construction of transportation facilities and embankments in the delta region, and introduced revenue concessions with the aim of attracting migrants. These government measures, supplemented by the activities of private firms and individual merchants, encouraged economic development<sup>2</sup>. Myanmar became one of the largest rice exporters in the world in the late 19th century under British rule. The rice cultivating area increased from 1.7 million acres in 1870 to 10 million in 1940.

The economy of Myanmar rapidly expanded, stimulated by exports, accounting for about 40 to 50 per cent of net domestic production during British rule. In addition to rice, which was the largest export, teak, oil, lead and tin exports also increased, to comprise a further 40 percent of the total in 1938. The manufacturing sector however remained underdeveloped. The number of factories with 20 or more employees numbered only 1,027 in that year (1938), 67 percent of these consisted of rice and saw mills<sup>3</sup>.

The lack of development of manufacturing may be attributed to the structure of a pluralistic society. There was a sharp distinction between the Myanmarese, mainly engaged in agriculture in the rural area, and the foreign element, in the urban areas and engaging in commerce and, or, industry. A large proportion of forestry, oil and mining extraction operations was owned and operated by Europeans. In 1911, the number of Myanmarese workers employed in the oil and mining industries amounted to only 20 percent of the total number of workers in these sectors. Even in the rural area, overseas Indians and Chinese conducted the marketing and the milling of

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<sup>1</sup> Michael Adas, *The Burma Delta: Economic Development and Social Change on an Asia Rice Frontier, 1852-1941*, University of Wisconsin press, Michigan, 1974, pp. 28-38.

<sup>2</sup> *Ibid.*, pp. 28-38.

<sup>3</sup> Aye Hlaing, "Trends of Economic Growth and Income Distribution in Burma 1870 to 1940", *Journal of the Burma Research Society*, 47-1, 1964, pp. 30-32, 37-39.

rice. Indian moneylenders lent money to Myanmar farmers, and gradually came to own land through foreclosures of mortgaged property. Whereas the balance of trade was consistently favourable to Myanmar, net foreign lending, after deducting remittance overseas, was not much and did not contribute much to industrial investment<sup>4</sup>.

However, this is not to say that the Myanmarese people did not play any role in the country's economic development. Some capital formation did indeed take place. By the 1920s and the 1930s, a middle class emerged in the urban areas, consisting of traders, landowners, public employees, etc. It was they who took up the national movement for political independence, and supported regaining economic independence<sup>5</sup>.

## 7.2 The rise of nationalism and acceptance of socialism

In the early 1930s, nationalist sentiment came to the front, and the Do Bama Asiayon ("Our Burma Association", also called the Thakins) was organised by the younger generation of the middle class. General Aung San, U Nu, the first president of Myanmar, and General Ne Win were among them. The nationalist movement adopted socialism as its guiding principle, and this has had a lasting influence on the economy following independence.

Socialist literature, from Marx to Fabianism, was introduced to Myanmar by students who had studied in Britain. The members of the Thakhins party endeavoured to harmonise the ideas of socialism with Myanmar culture, as evidenced by the concept of "ko min ko chin" ("one's own king, one's own kind"). The concept, in essence, was a declaration to build a socialist state, rejecting not only British rule but also capitalism, which was closely associated with imperialism and colonialism. They firmly believed that the people of Myanmar should play the leading role in the country's economic activity. Accordingly, the nationalisation of economic operations run by foreign capital, and ultimately nationalisation of all the means of production was considered necessary in order to eliminate economic exploitation<sup>6</sup>. These ideas led to inward-looking economic policies after independence.

Subsequently the Revolutionary Council, in its declaration of "Burmese way to socialism", emphasised the people of Myanmar and their culture to the point of xenophobia). They emphasised self-reliant development, spurning dependency on foreign capital<sup>7</sup>.

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<sup>4</sup> *Ibid.*, pp. 44-49.

<sup>5</sup> Robert Taylor, *The State in Burma*, London, 1987, pp. 174-188.

<sup>6</sup> Kei Nemoto, "Biruma no nationalism – chukanso nationalist elite tachi no kiseki (Nationalism in Burma – orbit of middleclass nationalist elites)", *Iwanami koza tonan ajia shi* 7, (Iwanami texts series, History of Southeast Asia 7), Tokyo, 2002, pp. 228-229, 232-235.

<sup>7</sup> Nobuyoshi Nishizawa, *Myanmar no keizai kaikaku to kaiho seisaku – Gunsei 10nen no sokatsu* (The Economic Revolution and Open-door Policy in Myanmar), Keiso Shobo, 2000, pp. 14-15.

It was in this historical context that the 1947 constitution declared its intention to build a socialist state and, accordingly, ordered the nationalisation of important industries and the centralisation of economic planning in order to control the economy<sup>8</sup>.

### 7.3 Economic conditions after independence

The first economic plan called the Two-Year Economic Development Plan, was jointly written in 1948 by planning advisor J. S. Furnivall and economic advisor Dr. Hla Myint. It was incomplete because of a shortage of time and information and social disorder at that time. Subsequently, in 1951, Myanmar government entrusted Knappen Tippetts Abbeitt Engineering Company (or KTA for short), a US corporation, with investigating the natural resources of the country and drafting a comprehensive economic plan. KTA duly submitted an eight-year plan entitled Pyidaw tha (“to build a peaceful and quiet state”) translated into English as a “welfare state”. The three themes common to the two plans were: elimination of colonial influence, rehabilitation after the suffering of the Second World War, and the building of a socialist welfare state<sup>9</sup>.

Nationalisation was promoted for some industries as a means of moving away from colonial tradition. In the agriculture sector, land reform was initiated in 1954<sup>10</sup>, and the State Agricultural Marketing Board was established to take charge of marketing and exporting of agricultural products. In the forestry sector, the government took over foreign companies, and in 1948 established the State Timber Board with wide jurisdiction for the control, extraction, milling and marketing of forestry products. These reforms notwithstanding, efforts toward nationalisation during this period were moderate in degree. Farmers were left free to sell their rice to private merchants, and private enterprises, with permission from the State Agricultural Marketing Board, could freely export rice<sup>11</sup>.

Regarding the manufacturing sector, which had been left underdeveloped during the colonial period, attempts were made to diversify products exported and attain self-sufficiency in consumer goods. A plan was drawn up to construct three major industrial zones (namely, Akyab, Myingyan, and suburb of Yangon), closely linked to raw material producing centres and the establishment of 65 types of manufacturing plant. According to the plan a cement factory and a sugar mill were

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<sup>8</sup> Sections 14, 23, 30.

<sup>9</sup> Institute of Developing Economies, *Biruma no keizai kaihatsu* (Economic Development in Burma), 1961, pp. 13-14.

<sup>10</sup> Land reform encountered difficulties, for example conflicts over the distribution of land between farmers, exemption from expropriation for landowners etc. Accordingly land reform was halted in 1958. The total area exempted or reclaimed was only 334.6 million acres, less than 40 percent of the projected area. Many agricultural labours were unable to claim land.

<sup>11</sup> Institute of Developing Economies, *op.cit.*, pp. 32-33, p.358.

to be run as nationalised enterprises, and many small and medium-scale enterprises were to be developed in the textile and food-processing industries<sup>12</sup>.

The plan depended crucially on foreign exchange earned through the export of rice. Profits from the export of rice, collected by the State Agricultural Marketing Board, comprised approximately one third of total government revenue. However, international demand for rice declined drastically, following the end of the Korean War boom and improved food supply in the former rice importing countries, and the international price of rice fell. This meant that the plan to build the industrial zones had to be either revised or discarded. In the end, the plan could not be materialised<sup>13</sup>.

Whereas the average growth rate in real GDP reached 6.5% during 1950 to 1959, in 1959 it barely reached the average of the period before the Second World War. At the same time, consumption failed to recover the average level before the war<sup>14</sup>. It was against this historical background that the Revolutionary Council, the regime of General Ne Win, took over the role of “Burmanisation” of the economy.

#### **7.4 The Burmese way to socialism**

The Revolutionary Council took political control in 1962, and, under the slogan of the “Burmese Way to Socialism,” moved slowly forward with the creation of a state monopoly of external trade, the nationalisation of production and of agricultural produce procurement. It is true that the share of the private sector in value of output was as high as (approximately) 60 percent even in the 1970s, as the agricultural sector could be considered as part of the private sector. But the private sector was much regulated by the state, and the overprotected state sector tended to disadvantage the private sector. The average growth rate in real GDP was down to only 2.2 percent during the period from 1962 to the early 1970s, because of disruptions caused by abrupt nationalisation, stagnation in private enterprises, and the like. Taking into account population increase during the period, real per capita rate of growth was nil<sup>15</sup>.

Economic stagnation was ascribed to a slump in the production and export of rice. The volume of rice collected by the government declined after the establishment of the state monopoly of rice marketing, due mainly to the procurement price being too low. The amount of rice exported went down from 1.4 million tons in the early 1960s to 0.45 million tons in the 1970s (Table 7.1). The slump in rice exports, which accounted for half of the value of total exports, aggravated the

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<sup>12</sup> *Ibid.*, pp. 187-205.

<sup>13</sup> *Ibid.*, p. 7, p. 358.

<sup>14</sup> *Ibid.*, p. 29.

<sup>15</sup> Nobuyoshi Nishizawa, *op.cit.*, pp. 14-24.

balance of trade situation (Figure 7.1). The export share of GDP also began to go down, beginning in the 1960s (Figure 7.2). The government, which attempted to maintain the equilibrium of balance of trade, imposed restrictions on imports, both materials and equipment. This led to a decline of the utilisation rate of state enterprises. Official restrictions on imports encouraged the growth of black markets, where consumer goods had been imported illegally<sup>16</sup>.

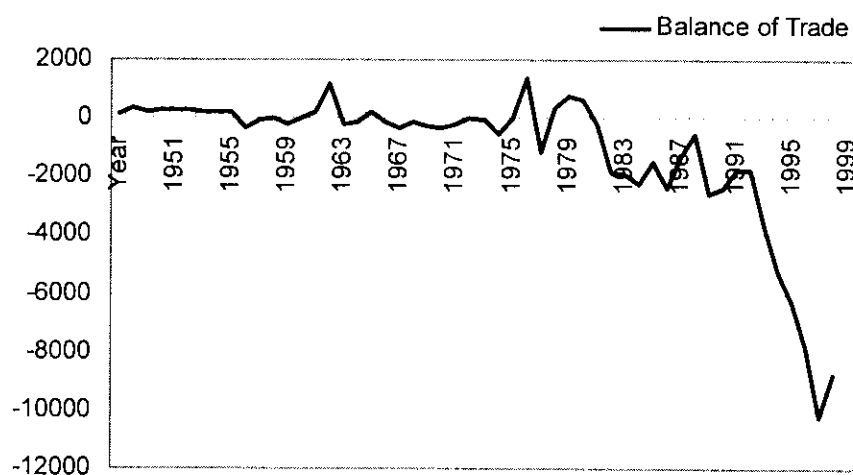
Table 7.1 Rice statistics: production, procurement and export

(average per year, polished rice in million tons)

	production	yield (kg/ha)	procurement (%)	exports	domestic consumption
1961/62-1964/65	4.93	1.01	2.34(47)	1.46	1.80
1965/66-1969/70	5.08	1.02	1.70(33)	0.70	2.37
1970/71-1974/75	5.40	1.08	1.24(23)	0.45	2.47
1975/76-1979/80	6.44	1.25	1.98(31)	0.49	2.98
1980/81-1984/85	9.24	1.82	2.64(29)	0.69	4.29
1985/86-1989/90	9.17	1.83	1.46(13)	0.34	4.40

Source: Teruko Saito, Seiji to keizai (Politics and Economic), in Tsuneo Ayabe and Yoneo Ishii eds, *Motto shiritai Myanmar* (For further knowledge about Myanmar), Kobundo, 1994.

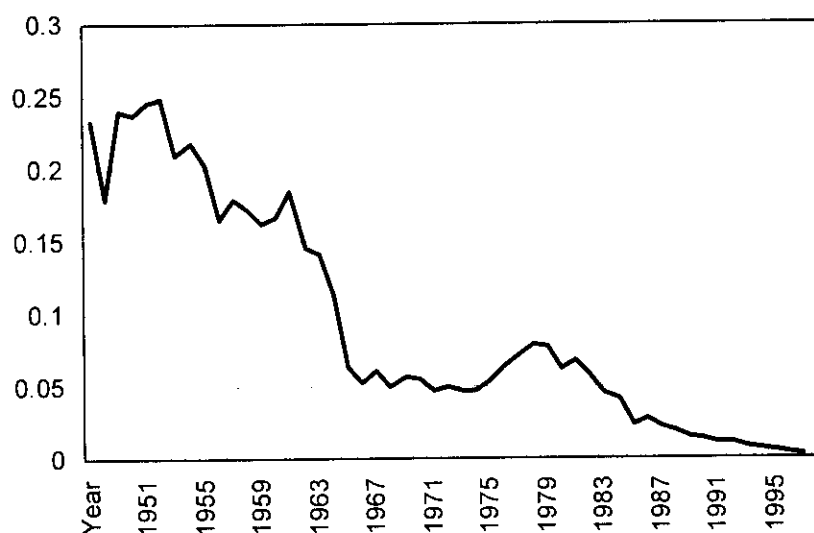
Figure 7.1 Balance of trade



Source: Teruko Saito and Lee Kin Kiong, *Statistics on the Burmese Economy*, Iseas, 1999, Table VII-9, p.185. Institute of Developing Economies, *Ajia doko nenpo* (Annual report of Asian trends), each year.

<sup>16</sup> Teruko Saito, Seiji to keizai (Politics and Economic), in Tsuneo Ayabe and Yoneo Ishii eds, *Motto shiritai Myanmar* (For further knowledge about Myanmar), Kobundo, 1994, p. 247.

Figure 7.2 Export share of GDP



Source: Teruko Saito and Lee Kin Kiong, *op.cit*, Table IX-4,p.216, IX-5,p.218, IX-6,p.220, IX-7,pp.222-223. From 1995-1999, Institute of Developing Economies, *Ajia doko nenpo* (Annual report of Asian trends), each year.

In order to revitalise the stagnating economy, the government modified the policy of the “Burmese Way to Socialism”. The Second Four-Year Plan, which began in 1974, was remarkable in that it called for the establishment of a commercially-motivated economic system, and indicated an intention of requesting external assistance. A bonus system was introduced in state economic enterprises, and HYV (high yielding variety) rice was introduced. During the period of the Second Four-Year Plan (1974-75 to 1977-78), an impressive rate of growth (4.8 percent in real terms) was achieved, mainly because of good weather and foreign aid<sup>17</sup>.

However economic growth reached a limit by the middle of the 1980s because of a lack of institutional reform. While the growth rate in real GDP of 5.5 percent was impressive for the first half of the 1980s, there was negative growth during the second half. Export performance was also disappointing. The deficit in the balance of trade exceeded 2,000 million kyats during this period, resulting in the decline of foreign exchange reserves to less than US\$ 30 million at one point (in 1988). This forced the government to increase its borrowing from abroad, raising Myanmar’s international debts from US\$ 1 billion in 1979 to more than US\$ 4 billion by 1988/89. To alleviate the problem, the government applied to the United Nations for “least developed country” status in 1986. This was granted in 1987<sup>18</sup>.

<sup>17</sup> Mya Than and Joseph L. H.Tan eds., *Myanmar Dilemmas and Options, The Challenge of Economic Transition in the 1990s*, Singapore: ISAS, 1990, p. 3.

<sup>18</sup> *Ibid.*, p. 4.



The “Burmese Way to Socialism” thus failed. The economic reason for the failure can be ascribed once more to rice. Whereas rice production increased with the introduction of HYV, rice exports failed to go up as expected because of increases in domestic consumption on the one hand, and in illegal exports on the other. The government accordingly strengthened the enforcement of rice procurement, while leaving the procurement price unchanged despite a rise in cultivation costs. This irritated the farmers, leading to the worsening of social disorder in the rural area. Under the circumstances, the government in 1987 deregulated the marketing and processing of major varieties of rice as well as other agricultural products. However this stimulated speculation while some farmers held back their rice from circulation with the result that the rice price soared. The rise in the price of the staple food item adversely affected the standard of living and led to social turmoil in 1988. The government then reinstated the procurement system for the sake of security<sup>19</sup>.

In 1987, the United Nations estimated Myanmar’s GDP per capita to be US\$ 200. However, this figure can only be accepted with reservations. First, as the state control of the economy intensified since 1960s, a large black market developed and illegal border trading prospered. However these activities were not reflected in official statistics. Second, many petty traders and craftsmen and women in rural areas (where about 70 percent of the population live) were not covered by the official figures. Their (so-called) “unofficial” activities flourished at the time of economic crisis as indicated by statistics<sup>20</sup>.

### **7.5 A turning point: the change from a planned economy to a market one**

In 1988, the State Law and Order Restoration Committee abolished the “Burmese Way to Socialism”, and announced, in its place, the following four economic objectives: (a) all round economic development based on the development of agricultural sector, (b) development of a limited market-oriented economic system, (c) introduction of technology and investment internally and externally, and (d) joint efforts by the state and the people to develop the national economy<sup>21</sup>.

In the beginning, the government liberalised exports and imports, and also legalised border trade. Following these policy changes, a large volume of consumer goods flowed in from Thailand and China. Hitherto chronic deficiencies in daily necessities were greatly ameliorated, and by 1993-94 the exporters and importers came to occupy half of registered private enterprises. The proportion of GDP contributed by the private companies was also raised by manufacturing and

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<sup>19</sup> Akio Takahashi, *Biruma deruta no beisaku mura – “shakaishugi” taiseika no noson keizai* (A rice producing village in the Burma delta – A case study of a village economy under the “socialist” regime), Tokyo: Institute of Developing Economies, 1992, pp. 3-6.

<sup>20</sup> Teruko Saito, *op.cit.*, pp. 246-241.

<sup>21</sup> Nobuyoshi Nishizawa, *op.cit.*, pp. 78-79.

mining activities. Moreover private enterprises expanded their share of the financial sector: 63 licenses were issued to private banking firms in 1996, of which 42 were of foreign origin<sup>22</sup>.

The enactment of the Foreign Investment Law in 1988 was an epoch-making event, as it aimed at the introduction of foreign capital for the first time since independence. At first, foreign investment was concentrated in the areas of exploitation of natural resources, such as petroleum and natural gas exploration and mining through joint ventures, and in the development of the tourist industry including hotels. However from 1995, investment from ASEAN countries increased in manufacturing and real estate businesses<sup>23</sup>.

Table 7.2 Direct foreign investment, by sector

(in million kyats)

	1989/90		1990/91		1991/92		1992/93		1993/94		1994/95		1995/96		1996/97	
	number	approved	number	approved	number	approved	number	approved	number	approved	number	approved	number	approved	number	approved
Agriculture							1	2.7							1	6.0
Fishery			4	77.3			4	5.8	2	7.6	3	148.2	2	13.1	2	17.5
Mining	1	54.1	4	55.1			4	33.4	2	20.9	1	0.5	15	155.8	15	178.3
Oil and gas	9	298.0	2	19.1			7	44.5	2	19.5	3	1,039.5	1	14.8	10	695.6
Manufacturing	6	15.8	6	42.7			4	13.3	9	17.8	20	76.7	4	21.3	29	923.6
Transport					4	5.9	1	1.0			2	1.3	4	118.9	3	47.9
Hotel and tourism	2	81.5	6	86.4			2	3.0	12	311.5	7	86.1	5	79.2	5	114.9
Real estate													6	251.5	8	623.5
Industrial complex construction													1	12.0	2	181.1
Construction															1	17.3
Others													1	1.7	2	8.6
Total	18	449.4	22	280.6	4	5.9	23	103.7	27	377.3	36	1352.3	39	668.3	78	2814.3

Source: Central Statistical Organization, *Statistical Yearbook*, 1997.

The effects of the reforms began to emerge after 1992, as shown by that year's rate of growth of 7.5 percent of GDP.

A five-year plan, lasting through 2000-01, was established in 1996, with the following four principles as its basic strategies: (a) realisation of the four economic objectives declared in 1988, (b) stable and sustainable economic growth, (c) the construction of a social and economic infrastructure, and (d) a balanced development of production, service and commerce.

Priority in economic development was given to the following sectors in the order: (i) agriculture, (ii) livestock rearing and fishery, (iii) mining, especially of oil and gas, (iv) transport and energy, (v) high-value-added and agro-based industries, and (vi) the export sector<sup>24</sup>.

<sup>22</sup> Akio Takahashi, "Myanmar – konnan na shijyo keizai e no iko (Myanmar – difficulties in the transition to a market oriented economy)", Younosuke Hara ed., *Ajia keizai ron* [Theory of Asian Economics], Tokyo: NTT Publishing Co., 1999, pp. 309-312.

<sup>23</sup> *Ibid.*, pp. 318-319.

<sup>24</sup> Nobuyoshi Nishizawa. *op.cit.*, p. 82.

Unfortunately the Asian monetary crisis of 1997 put a damper on these economic reforms. Closely connected with Thailand through the border trade and via the remittances of migrant workers, the kyat fell rapidly with that of the baht, draining foreign exchange reserves from US\$ 561 million, in early 1996, to US\$ 183 million (which equals the country's export earning for the 1.3-month period), in August 1996. The government had no choice but to regulate the remittance of foreign exchange and to introduce import licences for consumer goods<sup>25</sup>. The Myanmar economy was trapped in a vicious circle: government restrictions lead to a further decline in foreign investment and remittances from abroad, further deterioration in the balance of payments, unstable macroeconomic conditions, and increasing government restrictions.

## **7.6 Reform for development**

How can Myanmar get out of the vicious economic circle?

What we may learn from this brief historical overview of the economy is as follows. Myanmar has aimed at economic development based on its own export earnings, especially rice, with relatively little attention to foreign capital. This was remarkable. However, it met a series of difficulties because of the deterioration in the balance of trade. Attempts at preventing further deterioration in the balance of trade through additional regulations have had adverse effects.

In view of this, the introduction of foreign investment will benefit the country's economic development. So it would be advisable for Myanmar to return to the economic reforms adopted in 1988. However, we also learn from history a simple lesson, namely that an "open-door" policy by itself will not solve the problems of the economy in the face of market and government failures. In order to make the "open-door" policy effective and useful, structural adjustments will be necessary. It is in this context that the joint taskforce have prepared this report.

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<sup>25</sup> Institute of Developing Economies, *Ajia doku nenpo 1997*, (Annual report of Asian trends, 1997), 1998, pp. 438-443.



## 8. Legal Requirements to Support Economic Structural Adjustment in Myanmar

### 8.1 Introduction

In this paper, the actual legal environment for economic activities will be discussed in order to develop recommendations for the purpose of supporting the Economic Structural Adjustment in Myanmar.

On taking control in 1988, the SLORC (actual SPDC<sup>1</sup>) suspended the 1974 Constitution. As a result, there is no Constitution currently in place to set legal definitions on the economic activities of private sector. However the SLORC announced that all laws in place at the time they took power remain in force unless otherwise stated in SLORC Declaration and Orders. Thus, SLORC replaced the Constitution as the highest institutional body to guarantee the legal power of actually existing legal documents regulating economic activities. It means that SLORC control substituted for the rule of law<sup>2</sup>.

In July 1991 the SLORC formed a Law Scrutiny Central Board<sup>3</sup> charged with assessing all existing laws and appealing or amending those identified as non-beneficial to the state and the people. It seems that in fact, this body assessed laws of which contradicted or limited the development of a free market economy. Many laws have since been appealed and new laws enacted which allow economic activities in several areas (see annexure I and II). The SLORC informed UNHCR in March 1996 that so far 151 laws had been repealed though not specifying which ones<sup>4</sup>. SLORC and its successor SPDC enacted so far 134<sup>5</sup> laws since 1988 up to March 1997.

Although the new laws related to economic activities enacted after 1988, in an attempt to modernise the national economy, are generally in line with open market policy based on established legal discipline, very few amendments were introduced into basic inherited British laws related to private sector activities.

In ASEAN countries, as economies develop, legal institutions and property rights evolved to support transactions that increase in complexity and impersonality. Industrial and post-industrial economies require institutions that provide secure and impartial enforcement of economic rules

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<sup>1</sup> The State Peace and Development Council (SPDC) succeeded SLORC on November 15, 1997.

<sup>2</sup> Currently, there are no systematic and practicable administrative rules defining limits of power and responsibilities and lay down administrative procedure.

<sup>3</sup> The Board was chaired by attorney-general U Aung Toe.

<sup>4</sup> Currently, there is no official legal gazette, thus it is difficult to distinguish which laws are in fact in effect today.

<sup>5</sup> Based on compilation by U San Lwin, *General Index of Myanmar Laws, Yangon (annexure-1)*.

through the state guarantee. In this aspect, existing Myanmar legal documents inherited from former British colonialist administration did not follow the development of the economic changes disrupted by wars, socialist orientation and successive political turmoil.

The establishment of appropriate legal systems takes time, particularly when they must support rapid economic transition, from command to market systems, or from a pre-capitalist to a fully capitalist economy. Economic legal reforms in Myanmar may learn from China's 15 years of law making effort and Vietnam's 10 years struggles to establish the rule of law. Before 1985, "laws — administrative, criminal, civil, or commercial — were largely nonexistent in both countries.

Though, one advantage Myanmar has compared to neighbouring transitional countries is that the core legal framework, although in an old classical form, exists and applied to the business entities still in infant form of market economy. The laws are recognised and its basic concept is relatively well known among the business communities. However, because these were imported from outside, they have not always taken root in the real business practice. The already existing fundamental substantive and procedural legal base in Myanmar will facilitate the modernisation and adaptation by way of amendment, drafting and enactment of new laws.

Still, when considering the open nature of the market economy, the actual legal framework for economic activities in Myanmar remains hard and restrictive in an aspect of market entry and, on the other hand, insufficient when considering the flourishing and diversified needs influenced by economic globalisation. Legal reforms in the economic sector contribute to stronger protection of physical and intellectual property in Myanmar, and it will support the surge of domestic and foreign investments there.

## **8.2 Government and economy**

A market economy is not just an economic mechanism but is a legal regime; it requires a complex body of rules and regulations to ensure proper competition and effectiveness<sup>6</sup>.

Governments determine how well, or how poorly markets function. A core SPDC function is to establish a regulatory framework to facilitate the effectiveness of its economic policy objectives. Such a framework is directed at influencing the operation of the marketplace, and to guarantee sound market mechanism. The provision of a stable legal and regulatory framework for private sector activities together with key institutions building will produce a more effective investment environment by providing predictability and transparency.

However, any legal framework must be shaped and determined by the purposes and policies

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<sup>6</sup> Ronald H. Coase, *The Firm, the Market, and the Law*, Chicago: University of Chicago Press, reprinted, 1988.

of which it is meant to serve. In the case of Myanmar economic structural adjustment, relevant policies approved by the government aimed at promoting economy should be duly translated into a comprehensive set of laws for effective implementation by way of amendment or by enacting new laws. The legal framework affects economic performance through their impact on fiscal integrity, on predictability, and on the creation of an environment conducive to productive investment.

The development impact of predictability and the rule of law would be incomplete without strong commitment of the government for enforcement. In Myanmar, SPDC plays a significant role in determining both the structure of laws and their enforcement.

In this context, two of the published government economic policies in daily newspapers are:

- \* Proper evolution of the market-oriented economic system;
- \* Development of the economy inviting participation in terms of technical know-how and investments from sources inside the country and abroad

Thus, SPDC encourages the move toward a market economy underscoring the need to establish legal guidelines and well-defined investment rules in order to secure private and foreign investments. This move is highly appreciated yet the proper institutional capacity building and stable administrative procedures together with personnel training should be more focused to ensure predictability and stability of economic legal management. Well conceived, comprehensive legal and institutional framework is one of the main elements needed to encourage and facilitate dynamic, productive economic activity, including foreign and domestic investment and to protect the national economic interest when opening up to the global economic scene.

### **8.3 The legal framework for development**

The law is often ignored or assumed that they are fully defined when designing the economic policy. From the economist point of view, law is the given factor to elaborate comprehensive development plan. However, in developing countries and transitional economies, law is not the given factor but another factor requiring thorough review and development.

There does, appear to be evidence that (1) the impact of legal framework on economic performance is more substantial than some economic theory acknowledges, and (2) failure to meet minimal performance levels can cause both the public and investors to withdraw confidence.

The rule of law for economic prosperity<sup>7</sup> is of great importance. Economic policies always encounter uncertainties. Predictability by way of rule of law is essential for long-term capital investment. Market-based economies depend on legal regimes composed of property rights and

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<sup>7</sup> Economic prosperity is derived from adherence to the rule of law and to valued, institutionalised procedures that are considered morally proper and that generally include orderly, predictable administrative procedure.

the sanctity of contracts. A legal system and government administration in harmony with the market enhance predictability, calculability, and efficiency. This relationship reduces transaction costs and makes possible the interactive economic management needed for economic performance.

Legal factors needed for sound development of the economy are:

- Establishment of a comprehensive economic policy adapted to the availability of the national resource and its limitations
- Establishment of a predictable framework of law based on the above policy and government behaviour conducive of development, or minimal arbitrariness in the application of rules and laws
- Streamline excessive rules, regulations, licensing requirements, administrative guidance, and so forth, which impede the functioning of markets and encourage rent-seeking

When Myanmar decides on comprehensive economic structural adjustment, evolution of legal systems and institutions necessary for such a policy implementation should always be considered as indispensable factors for orderly economic development.

### **8.3.1 Predictability**

A major vehicle for predictability is well defined and protected legal rights, particularly property rights<sup>8</sup> and administrative procedures. The economy needs incentives to operate close to the stability of the market. Incentives depend on the structure of legal boundaries, which is determined primarily by the state.

When legal framework is incomplete, easily abrogated or unstable, the economy suffers. Failure of the state legal economic management alter investment in profoundly costly ways, affecting choice of technology and inputs, production processes, and social discount rates. The nature of investment, and sometimes its very presence or absence, depend on investors' reading of the likelihood of legal instability through decree or through suddenly implemented administrative intervention.

Some elements of the rule of law are needed to create a sufficient stable setting for economic actors such as entrepreneurs, farmers, workers and state entities. The development of a rule of law establishes the standards of accountability against which both public and private sector actions are measured. A rule of law implies standard operating procedures, clearly promulgated and indiscriminately applied rules, non-personalised decision making with modest levels of discretion, and regularised procedures for establishing and implementing policies.

In systems with high predictability, lines of authority are clear. It provides the conditions

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<sup>8</sup> Secured property rights enhance stability and predictability; they shape the "structural frontier" of an economy.



under which openness and transparency become the norm in public-private transactions. It permits assessment of economic opportunities and risks, to make investments of capital and labour, to transact business with each other, and to have reasonable assurance or recourse against arbitrary interference or expropriation.

Thus, the rule of law has an implication on all economic transactions and business activities.

This connection of the rule of law with efficient use of resources and productive investment, which must be understood and dealt with in highly specific and differentiated cultural and political settings, are the aspect most important to economic development.

Establishing the rule of law is a process involving effective communication of the content of the laws. It involves predictable and legally enforceable methods for changing the content of the laws, so that ad hoc decrees do not continually change the legal and regulatory environment, rendering both people and their property insecure. It also involves the effective enforcement of law through adequate budgets, salaries, staff, and workable institutions.

Five critical elements of the rule of law should be considered: (a) there is a set of rules known in advance, (b) the rules are actually in force, (c) there are mechanisms ensuring application of the rules, (d) conflicts are resolved through binding decisions of an independent judicial body, and (e) there are procedures for amending the rules when they no longer serve their purpose.

#### **(a) A set of rules known in advance**

A set of rules known in advance implies three elements: the existence of a coherent set of rules, their communication with accuracy, clarity, and effectiveness, and the application only of rules known in advance (non-retroactivity of laws). Communication and coherence are two elements with which the government should be concerned<sup>9</sup>.

In Myanmar, despite high level of literacy, multiple languages are spoken, and the media are often ineffective. Under these circumstances, there are obvious limitations as to how much laws can be known and understood by whole country. Thus effective communication measures should be more focused to disseminate information related to new laws. It is nevertheless essential that laws be as clear and explicit as is technically feasible.

To the extent that economic policies are in part implemented through rules<sup>10</sup>, SPDC needs to ensure that these rules are known by all possible means.

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<sup>9</sup> Many developing countries that were once colonies inherited rules for the communication of laws similar to those of the colonial power, under which governments' obligations to disseminate a new law were frequently limited to publishing it in gazettes; this left citizens with the burden of acquainting themselves with it.

<sup>10</sup> Rules are understood here in a broad sense and include legislation, courts' decisions, guidelines, and regulations.

### **(b) Rules that are actually in force**

It is difficult for ordinary people and foreigners to understand which laws are actually in force in Myanmar excluding those enacted after 1988. A set of the Burma Code contains numerous laws enacted since colonialist period. A lot of those laws are not currently applied and not in force in reality and most important, it is unclear which ones should be complied. Several of those laws have been transplanted from British rulers and not properly adapted to the local situation, or to economic, social, and technological change. However, when a law is left in abeyance or is not respected, the remedy is not necessarily a new law.

An analysis of why the old law does not work will avoid placing yet another law on the books.

Laws, and a legal system, also require effective administration. This means that it encompasses procedures and institutions for modernising and implementing these rules. If these are lacking, laws most likely will be in force only on paper<sup>11</sup>.

As regards the coherence of rules, it is essential to conduct comprehensive legal assessment. In this aspect, experience of Law Scrutiny Central Board could be effectively revived and institutionalised.

### **(c) Ensuring application of the rules**

A fundamental aspect of the rule of law is that the state, too, should exercise power under the authority of law; that government officials should be subject to law just as private citizens are, and that their actions should derive from and be limited by specific legal authority.

The proper and consistent application of rules by government officials is the essential element for establishing legality in conjunction with the idea of justice-legitimacy.

Basic guidelines for the exercise of discretion require that any exercise of powers be based on reasons that are applied consistently, fairly, and impartially. They should also be related to a framework of purposes, policies, principles, and rules.

At times, the proper application of the rules is hampered by an overabundance of, in some instances, contradictory or old rules and regulations of which overwhelm the bureaucracy. There is a need to review, update, and simplify the legal systems. Such reforms of legal systems will improve the capacity of government to regulate the economy efficiently and to reach administrative decisions on the basis of a dear set of new and relevant laws.

### **(d) Conflict resolution**

The rule of law loses its conflict-resolving and confidence-inspiring function if there is no

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<sup>11</sup> This fact is largely known in former colony countries such as Indonesia and Philippines.

efficient and credible judicial system to assure that private contractual arrangements are respected and that the law is applied uniformly by the executive. It is evident that confidence in the enforceability of agreements is required for the proper functioning of an economy and for conducting efficient private economic activities.

The condition of the judiciary is generally precarious in ASEAN countries<sup>12</sup>. Often, the courts lack proper facilities, and there is an urgent need to improve the training of the persons involved in the administration of justice in the complex economic disputes. Despite all this, recognised arbitration proceedings outside the court system are not well developed. It is desirable to train judges in economics and business law and may recommend divisions of labour in the court system so that commercial matters would be effectively handled by specialised courts or arbitration centres.

#### **(e) Amendment procedures**

The rule of law is instrumental in creating a climate of predictability and stability. Rules that are constantly or arbitrarily repealed, amended, or waived undermine this. The perception of arbitrariness and subjectivity is created by ad hoc decisions, whereby laws are created, amended, or invalidated without known and established procedures. Laws created in this way will be perceived by those affected as not reflecting “due process.”

In particular, the economic reform policies introduced by any of the developing countries cannot be implemented effectively if these measures are not translated into workable rules and properly applied by functioning institutions. It is important that procedures for amending or repealing laws exist and are publicly known<sup>13</sup>. To improve the technical capabilities to draft procedural rules and regulations in the economic field, the projects to support governments’ legal offices (e.g., the attorney general, the ministry of justice, and so forth) and provision of training and technical assistance should be considered.

The elements of the rule of law discussed above are an important element of the procedural framework and institutional system with which if adhered to by the SPDC, encourages stability and predictability in the governments and elicits compliance with the rules.

Lately, Myanmar had been introducing reform elements for private sector development. However, contradictions and inconsistencies are sometimes encountered. The laws when established properly, reduce the role of the government in productive activities while retaining

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<sup>12</sup> This fact is specifically emphasised after 1997 Asian financial crisis. All the countries are currently tackling with this problem with which Myanmar can also join such an efforts by way of exchange of information or by participating in regional meetings.

<sup>13</sup> In the context of attempts to introduce legal reforms, the importance of appropriate procedural rules so that laws can be enacted or repealed is stressed.

its monitoring functions, introducing private ownership, and encouraging foreign investment through joint ventures.

Since Myanmar already enjoys an established law amendment procedure led by Attorney General Office, the only additional requirement will be training of related cadres in the modern business legal field.

### **8.3.2 Possible assistance in the legal field**

The legal and regulatory framework governing private sector activities in Myanmar should be thoroughly reviewed in details in order to streamline unused laws and revise other laws to reflect the policy change from a discretionary economy to a market economy system. In addition, institutional building and training of relevant government officials should be implemented to ensure proper management, implementation and enforcement of the economic legal system. Myanmar can explore maximum fruits from such an assistance based on Japan's extensive experience of modernising and adapting the domestic legal system in accordance with the economic realities and transfer of its legal policy formulation techniques and practices toward ASEAN member countries. Japan can assist the government to amend or prepare and implement key economic and financial legislation, to train lawyers in business law, and to establish a centre of economic law.

Possible areas could be as follows depending on the Myanmar needs and will for the assistance.

#### **A. Comprehensive Legal Needs Assessment**

- Assess needs for updating legal systems

Further research on the rule of law, to explore the minimal juridical conditions for broadly based economic development is needed<sup>14</sup>.

- Assess efficiency of dissemination of laws and its implications

Making comprehensive and timely dissemination of enacted laws by re-establishing an official gazette to publish and promulgate new laws and regulations

Building of a legal information system to make the law more accessible and better known within government itself and general public

- Assess procedure to ensure the consistency of laws

Legal assessment capacity building

- Assess constraints to the implementation of laws

Each agency should be equipped with necessary instrument to respond to the public all

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<sup>14</sup> Legal sector reviews is vitally important, with a view to removing impediments to private sector activity.

the necessary legal information and guidance

Strengthening the arbitration system and arbitral bodies to improve contract enforcement and avoid some of the constraints in the judicial system.

Encouraging extra judicial alternatives when legal systems are overburdened, such as commercial arbitration and other dispute settlements mechanisms

- Assess educational system and professional training

Improve the educational system and professional training to cope with the absence of organisations and mechanisms that analyse and disseminate legal information<sup>15</sup>.

Capacities need to be developed in the universities, in policy research institutes, in economic committees of legislatures, and in the media to understand about legal development issues, and in turn to contribute to broader public education.

Training the lawyers and the judiciary in modern international business and economic laws.

- Assess administrative capacity to implement the laws

The Administration must establish and observe set periods for handling requests<sup>16</sup>.

#### B. Specific focus area

Specific legal areas should be determined for human and institutional capacity building to ensure maximum impact to the modernisation of the economy.

By considering the urgent need to improve private sector activities, the substantive and procedural laws such as Company Act, Registration Act, Foreign Investment Law and sector specific laws and regulations related to an entry to the market should be placed as a priority.

Moreover, considering the rapid pace of globalisation of international trade rules and its implication for Myanmar in the context of ASEAN and WTO membership, a set of economic laws such as customs related laws, foreign exchange regulations, intellectual property laws, trade dispute regulations, investment related laws, technical standard regulations, service sector regulations and other related laws should be urgently and thoroughly established in view of further promotion of private investment and integration of the economy at regional and global level.

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<sup>15</sup> Building this capacity is a central aspect of developing an enabling environment for growth. Laws must be known, understood, and used effectively.

<sup>16</sup> Few laws or regulations stipulate that the Administration must respond within a certain period. As a result, the public is at the mercy of officials and is never certain as to when it will get a reply. The legal principle of implicit rejection needs to be established.

### C. Limitations

In undertaking the above work, SPDC will face some inherent limitations: those of any external agency, of its legal mandate, of its comparative advantage, and of the skills and resources available to it. Commitment of SPDC as well as Attorney General Office and related ministries is needed that they must bring to reforms in this area. Japan can assist and advise, but strong SPDC commitment to reform is desired to introduce sustainability in the changes that are brought about. Full ownership of reforms is as important in this area as it is with economic policy reforms.

With regard to the legal framework for development, major concern is its procedural and institutional aspects that may require also strong SPDC commitment.

## 8.4 Conclusion

Well-specified laws and regulations and enforceable judiciary —the rule of law— are clearly economic development issues and should be recognised as such, with the caution that the strong commitment of the government to ensure proper enforcement, critically affect how broad based development will be. The failure of proper enforcement, combined with opaque and highly discretionary regulatory procedures, can provide greater opportunities for high economic risk and inefficiency.

Strengthening the private sector, entrepreneurs and private associations to issue their opinions and wishes toward rule based market mechanism, will over time prove more effective to create workable and enforceable legal framework. The effective enforcement mechanism will result from a continued dialogue between Myanmar government and the private sector.

To prepare the country for further economic openness and integration of the economy at regional and global level, Myanmar should establish solid legal base to ensure and protect the right of private investors and to secure the national economic interest at the international negotiation stage.

Myanmar still reserves overwhelming advantage of possessing the comprehensive legal base for economic management compared to Vietnam and other transitional economies. By reviewing, amending and modernising such an inherited social infrastructure in accordance with a comprehensive economic structural adjustment policy, Myanmar will certainly recover influential economic power once possessed in the past.

## Annexure I

Some of the existing laws, enacted prior to the present Liberalised Market Oriented Economic System of Myanmar, either directly related to commercial cases are as follows:

- (1) Contract Act, 1872.
- (2) Negotiable Instrument Act, 1881.
- (3) Trade Disputes Act, 1929.
- (4) Arbitration Act, 1944.
- (5) Arbitration (Protocol & Convention) Act, 1939.
- (6) Myanmar Companies Act, 1961
- (7) Myanmar Special Companies Act, 1950.
- (8) Partnership Act, 1932.
- (9) Myanmar Copyright Act, 1914.
- (10) Myanmar Patents & Designs Act, 1945.
- (11) Myanmar Patents & Design (Emergency Provision) Act, 1946.
- (12) Sales of Goods Act, 1930.
- (13) Transfer of Property Act, 1882.
- (14) Transfer of Immovable Property (Restriction) Act.
- (15) Registration Act, 1909.
- (16) Registration (Temporary Provision) Act, 1947.
- (17) Payment of Wages Act, 1936.
- (18) Workmen's Compensation Act, 1924.
- (19) Myanmar Insolvency Act, 1920.
- (20) Myanmar Income Tax Act, 1922.
- (21) Land Custom Act, 1924.
- (22) Sea Custom Act, 1878.
- (23) Control of Imports and Exports (Temporary) Act, 1947
- (24) Limitation Act, 1908, and Its Amendment Law, 1977.
- (25) Bill of Landing Act, 1856.
- (26) Myanmar Registration of Ships Act, 1841 and its Amendment, 1986.
- (27) Sea Going Vessels Navigation Act, 1952.
- (28) Myanmar Carriage of Goods by Sea Act, 1925.
- (29) Myanmar Carriage by Air Act, 1935.
- (30) Myanmar Aircraft Act, 1934
- (31) Myanmar Aircraft Rules, 1937.

- (32) Myanmar Airways Act, 1952.
- (33) Carries Act, 1865.
- (34) Railways Act, 1890.
- (35) Myanmar Five Star Shipping Corporation Law, 1964.
- (36) Merchandise Marks Act, 1889.
- (37) Merchant Shipping Act, 1894.
- (38) Land Acquisition (Mines) Act, 1885.
- (39) Urban Rent Control Act, 1952.
- (40) Foreigners Act, 1864.
- (41) Foreigner's Extension Act, 1949.
- (42) Registration of Foreigners Act, 1949.
- (43) Registration of Foreigners Extension Act, 1949.
- (44) Succession Act, 1925.
- (45) Lower Burma Town and Village Lands Act, 1898.
- (46) Upper Burma Land and Revenue Regulation, 1889.
- (47) Foreign Exchange Regulation act, 1917.
- (48) Foreign Recruiting Act, 1874.
- (49) Revenue Recovery Act, 1890.
- (50) State Grant Act, 1895.
- (51) Hotel and Restaurant Tax Act, 1949 (enacted in Myanmar version).
- (52) Sales Tax, 1952 (enacted in Myanmar version).
- (53) Myanmar Income Tax Law, 1974.
- (54) Profit Tax Law, 1976.



## Annexure II

To be in line with the liberalised economic policy, new laws were enacted in accordance with changing business environments.

1. The Union of Myanmar Foreign Investment Law (1988)
2. State-Owned Economic Enterprise Law (1989)
3. Private Industrial Enterprise Law (1990)
4. Promotion of Cottage Industries Law (1991)
5. Myanmar Hotels and Tourism Law (1993)
6. The Forest Law (1992)
7. Commercial Tax Law (1990)
8. The Tariff Law (1992)
9. The Central Bank Myanmar Law (1990)
10. The Financial Institution of Myanmar Law (1990)
11. The Myanmar Agriculture and Rural Development Bank Law (1990)
12. Savings Bank Law (1992)
13. Laws relating to Fishing Rights Vessel (1989)
14. Laws relating to Acquaculture (1989)
15. Myanmar Marine Fisheries Law (1990)
16. Fresh Water Fisheries Law (1991)
17. The Myanmar Insurance Law (1993)
18. The Co-operative Society Law (1992)
19. Development of Border Areas Natural Places (1993)
20. The Science and Technology Development Law (1994)
21. The Insurance Business Law (1996)
22. The Myanmar Mines Law (1978)
23. Myanmar Citizens Investment Law (1994)
24. The Myanmar Accountancy Council Law (1994)
25. The Myanmar Gemstones Law (1995)
26. The Myanmar Pearl Industries Law (1995)
27. The Highway Law (2000)



## **9. On the Significance of Official Statistics Compilation for Economic Development**

### **9.1 *Raison d'être* of the official statistics**

Official statistics are one of the most important means for a government to grasp, control, manage and monitor aspects related to the country and its people. They also serve as a fundamental database which allows people to know about the social and economic status of their country, thereby encouraging them to contribute to the development of the nation with confidence and 'informed patriotism.' Moreover, via proper official statistics which are provided on a universal basis, foreign countries and people, including businesspersons, can come to know, understand and eventually develop a fondness for a country, which results in increased foreign economic investment and bilateral and international cooperation.

For example, as early as 1871, only three years after the Meiji Restoration, the Japanese government established the Statistics Division in the Central Administrative Office. Furthermore in 1947, just two years after Japan's defeat in World War II, systems for official statistics in Japan were reconstructed in line with the new Statistics Law and the new Statistics Commission, which produced development, utilisation and transparency of official statistics. The reconstruction of systems for official statistics in China after the Cultural Revolution is yet another example. Needless to say, success stories have been associated with the development of official statistics in both Japan and China.

In this context, official statistics need to be compiled/produced sufficiently in both quality and quantity in order to formulate infrastructure for the social and economic development of the country. The quality of official statistics is measured in terms of integrity, accuracy, reliability, timeliness, relevance, and international and time-scaled comparability/consistency. Their quantity meanwhile is measured by frequency and magnitude of data collection, as well as amount and detail of statistics compiled/produced. Statistics should not only be compiled and produced sufficiently, but also must be released to the public in a timely fashion and in a fair manner, without reservation or distortion, and should be disseminated widely both inside and outside of the government and both domestically and internationally.

### **9.2 Current status**

#### **9.2.1 Data collection and compilation**

There exist two methods of data collection: 1) the use of administrative records, and 2) direct statistical censuses and surveys. In Myanmar, a considerably large amount of statistics is collected by various Ministries through their respective administrative channels, which reflects

the former centrally-planned economy that once prevailed in the country. The Myanmar statistical system has been decentralised. The role of the Central Statistical Office (CSO) of the Ministry of National Planning and Economic Development (MNPED) has been limited, although the Central Statistical Authority Act (Act No. 34 of 1952) stipulates that the CSO shall (a) develop a comprehensive, efficient and reliable statistical system for social and economic policy, effective planning and administration; (b) review and advise on all statistical operations of the Union Government whether performed for statistical, administrative, or other purposes; (c) coordinate and integrate statistics and statistical operations; establish, prescribe and maintain the highest statistical standards; and (e) organise and conduct social and economic censuses or surveys; and have access to any relevant record or document to obtain any information or report for the purpose of collection of any statistics under this Act.

The statistical system of a country depends on its current situation and historical background, and can comprise various forms. What matters most though is that official statistics are compiled/produced sufficiently in terms of quality and quantity as stated above. In this context, JICA's Mission for the Project Formulation Survey in the Statistical Sector, which visited Myanmar from April 3 to May 1, 2001, reported the following observations:

- (1) The CSO cannot necessarily be said to be functioning as the central statistical authority in Myanmar as is stipulated in the Central Statistical Authority Act.
- (2) The Population Census, the most important element in any statistical system, was conducted in 1973 and 1983 by the Ministry of Immigration and Population, however it has remained suspended for nearly twenty years.
- (3) Statistics are considerably developed in the areas of agriculture, forestry, fisheries, health, and education. And information compiled by the CSO on trade, vital statistics, household economy and retail prices is also in considerably better shape. On the other hand, statistics on national accounts do not seem to be adequate enough since they are measured only from the production side, and they have not been transformed to the 1993 United Nations SNA (System of National Accounts). Another particularly weak area is that related to business establishments. Information on manufacturing establishments is presented in the "Review of the Financial, Economic and Social Conditions" compiled by the MNPED, but no statistics are available for other sectors such as commerce and services.
- (4) Certain statistics have become obsolete or have been suspended. For example, the latest labour force statistics are for 1990; the latest available Review of the Financial, Economic and Social Conditions is for 1997/1998; and some of the sensitive figures related to finance and investment and similar areas have not been presented in the Statistical Yearbook for recent years.

- (5) Statistical surveys were not conducted systematically, but rather sporadically in the past, sometimes funded by international organisations such as UNICEF, UNDP and FAO. Furthermore, over the past few years their cooperation has been inactive due to political reasons.

Some of the members of the Taskforce have found through their study in Myanmar that certain statistics are either unreliable or just simply unavailable. Others say that population statistics compiled from the Vital Registration System cannot be regarded as reliable, and that the Population Census should be conducted to grasp an understanding of people's geographical distribution and their characteristics which are the most important information aspects for any work or project.

### **9.2.2 Data release and dissemination**

Statistics should not be kept secret or confined within restricted circles of organisations or people, and instead should be released and disseminated to various users including government officials, politicians, academicians, businesspersons and the general public. Statistics that are well compiled and widely disseminated make it easy and feasible for politicians, officials and businesspersons inside and outside of the country to make economic and social policies and to formulate cooperation and investment projects. Furthermore, such statistics enable academicians to analyse the current conditions of the country and allow the general public to be aware of these conditions, which is crucial to form a prosperous and democratic country in the international community. Free and unrestricted access to official statistics is a common practice among countries that have a democratic and market-economy system, and such nations are prospering these days.

The CSO compiles and publishes statistical compendia such as the Statistical Yearbook, the annual Statistical Abstract, and the bi-monthly Selected Monthly Economic Indicator. It is also in charge of compiling the annual Foreign Trade Statistics of Myanmar, the annual Vital Statistics Report, the biennial Agricultural Statistics, and the biennial Statistical Profile of Children and Women. As to statistical surveys conducted by the CSO, reports have been well published after the surveys. They include household economy (for the first time in 1958, and recently in 1989, 1997 and 2001), bi-weekly retail prices, the Private Industry Survey of 2001, and the Sample Survey on Evaluation of the Completeness of the Vital Registration System in Myanmar of 1995. Still, it has often been observed in Myanmar that statistics are difficult to obtain in published form even when they are compiled, although data are granted/surrendered if the user visits and asks/demands the organisation concerned.

Statistics should be opened to the public, and made more available and obtainable by publishing more statistical reports. One idea in this regard would be to let the CSO compile and

publish statistical publications for specialised fields such as health and education, just like the biennial Agricultural Statistics which the CSO compiles and publishes using data provided by the Ministry of Agriculture.

### **9.3 Statistical development**

A cooperation program on statistics has already been initiated between the two countries mainly to improve the capability of the Central Statistical Organization (CSO). Here, in accordance with the requests and priorities of the CSO, emphasis has been placed on (a) computer equipment and technologies, (b) survey methodologies on business establishments, household economy, prices and housing, and (c) training of government statistical personnel in Japan and Myanmar.

In this context, it is advisable for the time being that the following be implemented:

- (1) Myanmar's official statistics should be thoroughly reviewed and improved upon, taking into consideration the review and the comments already made.
- (2) They should be opened to the public, and made more available and obtainable by publishing more statistical publications on specialised fields via collaboration between the CSO and other statistical departments.
- (3) Providing statistics online from databases would be very beneficial to users.
- (4) So-called entrusted tabulation services might be provided by the CSO utilising its computer equipment and statistical human resources to produce statistics from administrative records which have been left unprocessed so far.
- (5) In areas where data are scarce, unavailable or unreliable, direct statistical censuses and surveys should be newly conducted by the CSO at appropriate periods of time.
- (6) The importance of staff training and the transfer of technologies should be emphasised.

In parallel with the above actions, efforts for the systematic development of official statistics could be pursued in the following way:

- (1) A systematic development strategy should be established for official statistics in accordance with other development plans as well as international statistical standards, and the Central Statistical Authority Act should be reviewed and revised accordingly.
- (2) The CSO should be well organised and strengthened so that it functions as the central statistical authority in Myanmar.
- (3) The two fundamental censuses, i.e. the Population Census and the Business Establishment Census should be conducted in order to produce basic data needed for any works/projects as well as to provide central sampling frames indispensable for various sample surveys.

- (4) The roles and responsibilities of the CSO and other statistical departments should be reviewed taking into consideration the situation where privatisation and deregulation will lead to a shift in data collection from administrative records to direct censuses and surveys in the long run.
- (5) The Central Statistical Authority Act should guarantee the independence of official statistics from other administrative or political affairs especially by specifying the obligation of the CSO and other statistical departments to release statistics to the public without delay, reservation or distortion, and by strictly restricting access to statistics prior to their release to the minimum.





# Appendices



## **Appendix A**

### **Determinants of the Parallel Exchange Rate**

#### **A1. Introduction**

Myanmar has a parallel exchange rate system. While the official rate has remained pegged to the US dollar at 6.6 kyat per dollar, the parallel (market) rate has depreciated sharply especially since the Asian economic crisis of 1997. The parallel exchange rate is said to have reached 1,000 kyat per US dollar at the end of April 2002, and reportedly was close to 850 kyat/US dollar in September. The market rate is more than 100 times weaker than the official rate, and this discrepancy level between the official rate and the parallel rate is extraordinarily high compared to the historic experiences of other countries.

This large discrepancy is clear evidence of inflationary policies; namely, (1) finances are extremely low and fiscal deficits have been financed automatically by credit expansion by the Central Bank of Myanmar (CBM), (2) automatic deficit financing raises domestic inflation, and (3) domestic inflation causes depreciation of the parallel exchange rate.

The objective of this chapter is to examine the influence that fiscal deficit has on the parallel exchange rate. The organization of this chapter is as follows; in section 2 we investigate the correlation between fiscal deficit and money supply, in section 3 we analyze the link between money supply and inflation, and in section 4 we examine the influence that inflation has on the parallel exchange rate. Section 5 is the chapter's conclusion.

#### **A2. Fiscal deficit and money supply**

In this section, we investigate the correlation between fiscal deficit and money supply.

Table A1 shows data on fiscal deficit and money supply in Myanmar from FY 1995-96 to FY 1999-00. All of the data is from the Asian Development Bank.

Table A2 shows a coefficient of the correlation between fiscal deficit and the growth of broad money supply, narrow money supply and government credit respectively. From Table A2, we can see that fiscal deficit and the growth of broad money supply and government credit are highly correlated. These results show that fiscal deficits have been financed by credit expansion by the CBM.

#### **A3. Money supply and Inflation**

In this section, we analyze the link between money supply and inflation.

To analyze the connection between the two, we postulate a simple quantity theory of money supply;

$$p_t = -k + m_t - y_t \quad (1)$$

where  $p_t$  denotes the logarithm of the Consumer Price Index (CPI) in Myanmar at time  $t$ ,  $m_t$  denotes the logarithm of money supply in Myanmar at time  $t$ ,  $y_t$  denotes the logarithm of the real GDP in Myanmar at time  $t$ , and  $k$  is Marshall's  $k$ .

From equation (1), we obtain an equation for regression;

$$p_t = a + \beta_1 m_t - \beta_2 y_t + u_t \quad (2)$$

where  $u_t$  denotes an error term. Note that, however, each time series in equation (2) may be a non-stationary variable which has unit roots, therefore, estimating equation (2) directly causes a "spurious regression" problem.

If each variable is non-stationary but not cointegrated for each other, a difference model could be used for regression;

$$\Delta p_t = \beta_1 \Delta m_t - \beta_2 \Delta y_t + v_t \quad (4)$$

where  $v_t$  is an error term defined by  $v_t = u_t - u_{t-1}$ .

On the contrary, if each variable is non-stationary and cointegrated for each other, an error correction model (ECM) suggested by Engle and Granger (1987) must be used for regression;

$$\Delta p_t = \beta_1 \Delta m_t - \beta_2 \Delta y_t + \beta_3 EC_{t-1} + w_t \quad (5)$$

where  $EC_{t-1}$  is an error correction term defined by  $EC_{t-1} = p_{t-1} - \alpha - \beta_1 m_{t-1} - \beta_2 y_{t-1}$ , and  $w_t$  is an error term defined by  $w_t = u_t - \alpha u_{t-1}$ ,  $0 < \alpha < 1$ .

We assume here, in the absence of monthly GDP data, that real GDP is constant over time (therefore,  $\Delta y_t$  drops out), reflecting the low economic growth in Myanmar.

We created a sample period from January 1988 to November 2001 using monthly data. Data on CPI and money supply is from IMF, *International Financial Statistics*. We used M1 and M2 for data on money supply, and denoted their logarithm as  $m_{1t}$  and  $m_{2t}$ , respectively.

First, we conducted unit root tests for each time series,  $\{p_t\}$  and  $\{m_t\}$ . Table A3 shows the results of Augmented Dickey-Fuller (ADF) test (Dickey and Fuller (1979) (1981)) for each time series. A constant term and a trend term were not included in the estimated equation, and lag length was determined according to Akaike's Information Criterion (AIC). Table A3 shows that each time series is  $I(1)$  variable with a unit root under the 5 percent significant level.

Next, we conducted cointegration tests. Table A3 shows the results of Engle-Granger (EG) cointegration tests (Engle and Granger(1987)). A constant term and a trend term were not included in the estimated equation, and lag length was determined according to AIC. Table A3 shows that  $\{p_t\}$  and  $\{m_{1t}\}$  and  $\{m_{2t}\}$  are cointegrated under the 5 percent significant level. These results mean that CPI and money supply have a long-term relationship.

From the above results, we used the ECM for regression. Table A4 shows the results of ECM estimation. Table A4 tells us that in both regressions, coefficient  $\Delta m_t$  is statistically significant under the 5 percent significant level, which highlights the significant influence of money supply on inflation.

Next, we performed another test on the link between money supply and inflation for the same data set. We postulated the following relationship:

$$\Delta p_t = \alpha + \sum_{i=0}^n \beta_i \Delta m_{t-i} + u_t \quad (6)$$

$$\beta_i = \omega_0 + \omega_1 i + \omega_2 i^2 + \dots + \omega_p i^p$$

where  $\alpha$  is a constant term, and  $u_t$  is an error term.

We estimated equation (6) using a traditional Almon polynomial lag model. We incorporated twelve month lags ( $n = 12$ ) and assumed that the lag coefficients could be approximated by a two-order polynomial ( $i = 2$ ).

As shown in Table A5, the results indicate that an increase in M1 leads to higher inflation with a lag of two to seven months. The results show that expansionary monetary policy has played a decisive role in raising inflation.

#### **A4. Inflation and the parallel exchange rate**

In this section, we examine the influence that inflation has on the parallel exchange rate. Namely, we investigate empirically whether the parallel market rate in Myanmar reflects the difference between domestic and foreign inflation rates. If the parallel rate is determined by the inflation difference, the purchasing power parity (PPP) condition will hold true.

Figure A1 shows the parallel rates (the left axis) and CPI [Jan 1997=100] (the right axis). Figure A2 shows the rate of depreciation for the parallel rate and the difference between domestic and US inflation rates. These figures seem to highlight that the parallel rate movement could be explained by price levels. We will analyze whether the PPP condition holds true in Myanmar.

PPP is a simple relation linking national price levels and exchange rates. In its simplest form, PPP asserts that the rate of currency depreciation is approximately equal to the difference

between domestic and foreign inflation rates. Therefore, PPP implies

$$e_t = p_t - p_t^* + u_t \quad (7)$$

where  $e_t$  denotes the logarithm of the parallel rate in period  $t$ ,  $p_t^*$  denotes the logarithm of US price levels in period  $t$ , and  $u_t$  is an error term which represents the deviation from PPP in period  $t$ . Therefore, we obtain a level model for regression;

$$e_t = \beta_0 + \beta_1 (p_t - p_t^*) + u_t \quad (8)$$

If PPP holds, then this model requires  $\beta_0 = 0$  and  $\beta_1 = 1$ . Note that, however, each time series in equation (8) may be a non-stationary variable which has unit roots, therefore, estimating equation (8) directly cause a “spurious regression” problem.

If each variable is non-stationary but not cointegrated for each other, a difference model could be used for regression.

$$\Delta e_t = \beta_1 \Delta (p_t - p_t^*) + v_t \quad (9)$$

where  $v_t$  is an error term defined by  $v_t = u_t - u_{t-1}$ .

On the contrary, if each variable is non-stationary and cointegrated for each other, ECM must be used for regression;

$$\Delta e_t = \beta_1 \Delta (p_t - p_t^*) + \beta_2 EC_{t-1} + w_t \quad (10)$$

where  $EC_{t-1}$  is an error correction term defined by  $EC_{t-1} = e_{t-1} - \beta_0 - \beta_1 (p_{t-1} - p_{t-1}^*)$ , and  $w_t$  is an error term defined by,  $w_t = u_t - au_{t-1}$ ,  $0 < a < 1$ .

We created a sample period from January 1997 to February 2002 using monthly data. Data on the parallel rate of Myanmar is from Ebashi (2002); data on the CPI of Myanmar is from IMF, *International Financial Statistics*, and the Central Statistical Organization, *Selected Monthly Economic Indicators*; and data on the CPI of the US is from IMF, *International Financial Statistics*.

First, we conducted unit root tests for each time series,  $\{e_t\}$  and  $\{p_t - p_t^*\}$ . Table A6 shows the results of ADF for each time series. A constant term and a trend term were not included in the estimated equation, and lag length was determined according to AIC. Table A6 shows that each time series is variable with a unit root under the 5 percent significant level.

Next, we conducted cointegration tests. Table A6 shows the results of the EG cointegration

tests. A constant term and a trend term were not included in the estimated equation, and lag length was determined according to AIC. Table A6 tells us that  $\{l_t\}$  and  $\{p_t - p_t^*\}$  are not cointegrated under the 5 percent significant level, but are cointegrated under the 10 percent significant level. These results show that PPP holds true and that there exists a long-term relationship between price levels and the parallel rate in Myanmar and the US.

From the above results, we used both the difference model and the ECM. Table A7 shows the results of the difference model and ECM. Table A7 tells us that in both regressions, coefficient  $\beta_1$  is statistically significant under the 5 percent significant level, and Table A7 shows that in the null hypothesis  $\beta_1 = 1$  is not rejected. These results show that the PPP condition holds true for Myanmar.

## **A5. Conclusion**

In this paper, we found empirically that fiscal deficit and money supply growth are highly correlated, which is clear evidence that the CBM finances fiscal deficits. Moreover, we found that inflation in Myanmar is significantly influenced by monetary growth, and the movement of the parallel rate in Myanmar is well explained by the difference in inflation rates.

These results mean that the depreciation of the parallel exchange rate in Myanmar is due to expansionary fiscal and monetary policy. Therefore, the key for stabilizing the parallel exchange rate depends on whether the authorities can conduct tight fiscal and monetary policy, and in particular, fiscal deficit is the foremost concern of macroeconomic instability in Myanmar. This imbalance needs to be resolved in an appropriate way in order to realize macroeconomic improvement.

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Table A1. Fiscal deficit and money supply

	Kyat (million)				
	1995/96	1996/97	1997/98	1998/99	1999/2000
Fiscal deficit	39,494	52,090	58,307	93,877	110,532
Broad money supply	211,540	293,824	382,643	488,246	646,037
Narrow money supply	152,605	205,577	272,672	325,637	409,654
Government credit	173,180	206,029	251,533	302,696	365,311

Source: Asian Development Bank

Table A2. Coefficient of correlation between fiscal deficit and money supply

	Fiscal Deficit
$\Delta$ Broad money supply	0.91
$\Delta$ Narrow money supply	0.56
$\Delta$ Government credit	0.93

Table A3. Unit root test and cointegration test

variables ( $x_t$ )	test statistics	p-value	lags( $p$ )
$p_t$	3.96647	1.0000	3
$m_{1t}$	5.48457	1.00000	3
$m_{2t}$	7.92890	1.00000	2
$\hat{u}_{1t}$	-2.36599**	0.017330	3
$\hat{u}_{2t}$	-2.50388**	0.011874	7

(1) sample period : Jan 1988-Nov 2001

(2) estimated equation :  $\Delta x_t = \delta_0 x_{t-1} + \sum_{i=1}^p \delta_{1,i} x_{t-i} + \varepsilon_t$ (3)  $\hat{u}_t$  is a residual in the cointegration regression :  $p_t = (\alpha + \beta_2 \bar{y}) + \beta_1 m_t + u_t$ 

(4) \*\* indicates that the null hypothesis with unit roots can be rejected at the 5 percent significant level.



Table A4. ECM

Variable	M1		M2	
	Coefficient	Standard Error	Coefficient	Standard Error
$\Delta m_t$	0.378151***	0.062608	0.476144***	0.069078
$EC_{t-1}$	-0.057585***	0.019077	-0.054662***	0.021023
$R^2$	0.017205		0.017254	
$\bar{R}^2$	0.011101		0.011150	
Durbin-Watson	1.36837		1.51358	

(1) sample period : Jan 1988-Nov 2001

(2) estimated equation :  $\Delta p_t = \beta_1 \Delta m_t + \beta_2 EC_{t-1} + w_t$

(3) \*\*\* indicates statistical significance at the 5 percent level.

Table A5. Almon polynomial lag model

Variable	M1		M2	
	Coefficient	Standard Error	Coefficient	Standard Error
constant	6.57E-03	7.48E-03	0.012228	0.013239
$\Delta m_t$	0.06306	0.046928	0.090248	0.072406
$\Delta m_{t-1}$	0.079395**	0.037	0.07909	0.058253
$\Delta m_{t-2}$	0.090033***	0.030855	0.067698	0.05087
$\Delta m_{t-3}$	0.094971***	0.028161	0.056073	0.049037
$\Delta m_{t-4}$	0.094212***	0.027718	0.044215	0.050161
$\Delta m_{t-5}$	0.087754***	0.028083	0.032124	0.051843
$\Delta m_{t-6}$	0.075598***	0.028276	0.019799	0.052708
$\Delta m_{t-7}$	0.057743**	0.027946	7.24E-03	0.05234
$\Delta m_{t-8}$	0.03419	0.027343	-5.55E-03	0.051158
$\Delta m_{t-9}$	4.94E-03	0.027362	-0.01858	0.050495
$\Delta m_{t-10}$	-0.03001	0.029459	-0.03183	0.052625
$\Delta m_{t-11}$	-0.07066	0.034979	-0.04533	0.060011
$\Delta m_{t-12}$	-0.11701	0.04437	-0.05905	0.07392
$R^2$	0.10292		0.017045	
$\bar{R}^2$	0.084736		-2.88E-03	
Durbin-Watson	1.57516		1.4647	

(1) sample period : Jan 1988-Nov 2001

(2) estimated equation :  $\Delta p_t = \alpha + \sum_{i=0}^{12} \beta_i \Delta m_{t-i} + u_t$   
 $\beta_i = \omega_0 + \omega_1 i + \omega_2 i^2$

(3) \*\* and \*\*\* indicate that the null hypothesis with unit roots can be rejected at the 5 percent and 10 percent significant levels, respectively.

Table A6. Unit root test and cointegration test

variables ( $x_t$ )	test statistics	p-value	lags ( $p$ )
$e_t$	2.10692	0.99285	2
$p_t - p_t^*$	0.97533	0.9125	3
$\hat{u}_t$	-1.78792*	0.070132	2

(1) sample period : Jan 1997-Feb 2002

(2) estimated equation :  $\Delta \hat{u}_t = \delta_0 \hat{u}_{t-1} + \sum_{i=1}^p \delta_{1,i} \hat{u}_{t-i} + \varepsilon_t$

(3)  $\hat{u}_t$  is a residual in the cointegration regression :  $e_t = \beta_0 + \beta_1 (p_t - p_t^*) + u_t$

(4) \* indicates that the null hypothesis with unit roots can be rejected at the 10 percent significant level.

Table A7. Difference model and ECM

Variables	Difference model		ECM	
	Coefficient	Standard Error	Coefficient	Standard Error
$\Delta (p_t - p_t^*)$	0.794464**	0.303601	0.929622***	0.33339
$EC_{t-1}$			-0.065114	0.064098
$R^2$	0.038354		0.044522	
$\bar{R}^2$	0.038354		0.028048	
Durbin-Watson	2.10743		2.17382	

(1) sample period : Jan 1997-Feb 2002

(2) estimated equation :  $\Delta e_t = \beta_1 \Delta (p_t - p_t^*) + v_t$  for difference model

$\Delta e_t = \beta_1 \Delta (p_t - p_t^*) + \beta_2 EC_{t-1} + w_t$  for ECM

(3) \*\* and \*\*\* indicate that the null hypothesis with unit roots can be rejected at the 5 percent and 10 percent significant levels, respectively.

Figure.A1

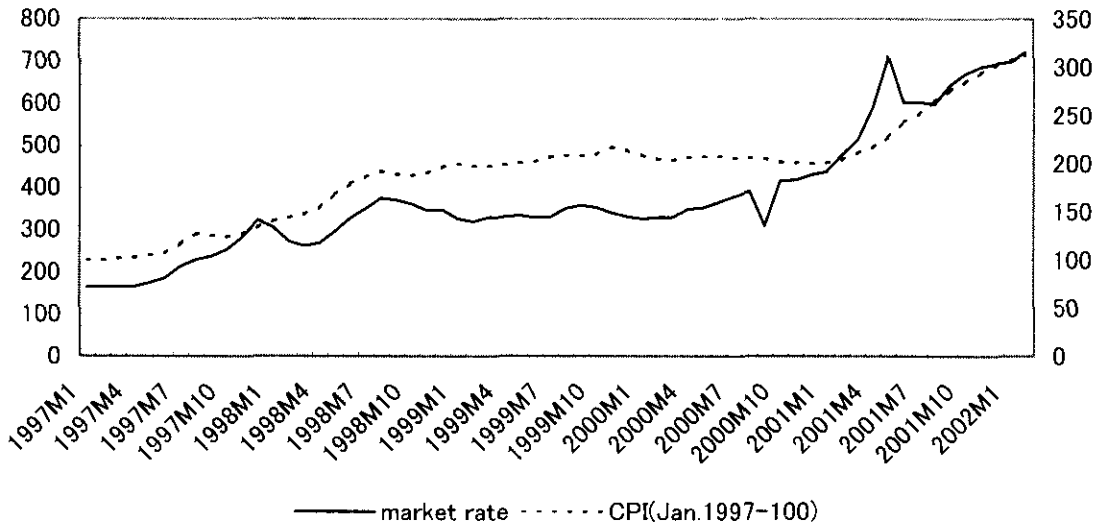
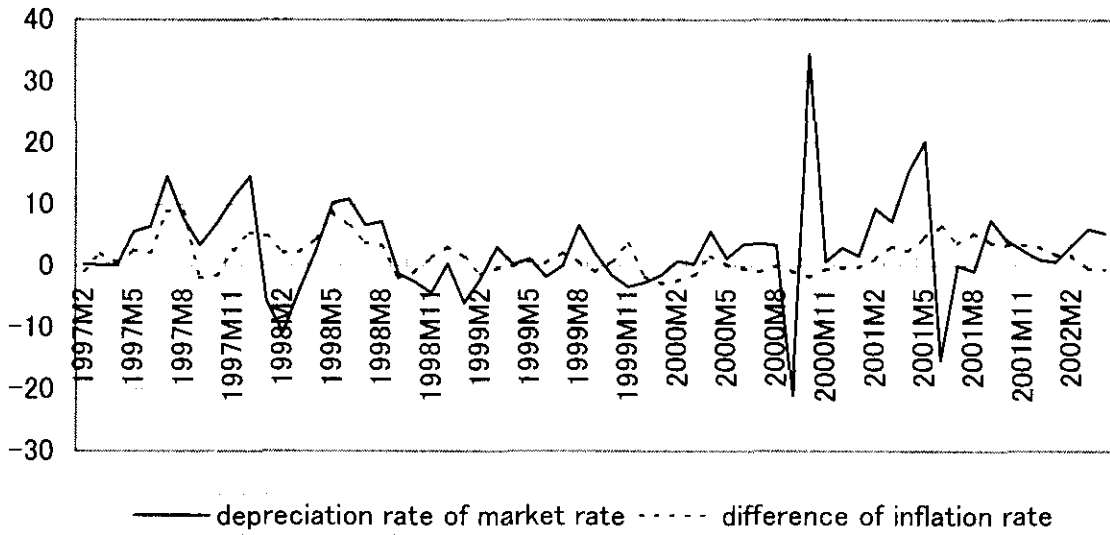


Figure.A2





## **Appendix B**

### **Unification of Exchange Rates in Vietnam**

#### **B1. Introduction**

Vietnam has made substantial progress in the transition to a market economy since the end of the 1980's. This progress includes exchange rate unification, tax reform, restructuring of state-owned enterprises, modernisation of the financial system, and liberalisation of trade systems.

Prior to the reform, Vietnam maintained a system of multiple exchange rates with different rates for trade transactions within the central plan, for invisible transactions, and for trade transactions outside the plan.

In addition, as balance of payment deficits were large and the central bank did not have sufficient reserves to meet the demand for foreign exchange at the official rate, the parallel market became well developed with an exchange rate that was substantially more depreciated.

These systems caused large distortions in the structure of relative prices and hidden transfers among the various economic sectors, particularly because the various exchange rates were overvalued. As a result, imports were able to generate large profits based on the difference between import prices and domestic prices, while exporters required budgetary support in the form of subsidies to offset losses on low procurement export prices.

#### **B2. Exchange rate system reform**

Unification of exchange rates in Vietnam was implemented in 1989.

First, multiple official exchange rates were unified. In September 1988 the authorities devalued the exchange rate for trade transactions within the central plan, from D225 per US dollar to D900 per US dollar. The exchange rate for most invisible transactions was devalued and unified with the exchange rate for trade transactions outside the central plan in November 1988, from D368 per US dollar to D2,600 per US dollar; the rate was subsequently devalued four more times to D3,500 per US dollar in March 1989. Finally, in March 1989, the authorities unified the two existing official exchange rates of D900 per US dollar and D3,500 per US dollar and raised the rate to D4,500 per US dollar, close to the parallel market rate.<sup>1</sup>

Exchange rates were stable against the US dollar, within the range of about D10,500 to D11,500 per US dollar.

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<sup>1</sup> To be more precise, the authorities adjusted the unified official exchange rate at irregular intervals to maintain the official rate within a range of 10-20 percent of the parallel market rate through August 1991, and by March 1992, the official and the parallel exchange rates were unified effectively, with the premium below one percent.

In addition, in order to bring a large portion of foreign exchange transactions into the official market, administrative controls on the holding and use of foreign exchange and trade were liberalised, and foreign exchange trading floors were introduced.

The new unified exchange arrangement is a managed float. All foreign exchange transactions must take place at the rate established in the trading centres, with a maximum margin for the buying and selling rate of 0.5 percent on either side of the fixed reference rate, which is adjusted daily in line with market developments as reflected in the actual closing rate of the preceding day.

### **B3. Other macroeconomic reforms**

In accordance with the unification of exchange rates, other macroeconomic reforms including tax reform, restructuring of state-owned enterprises, modernisation of the financial system, and liberalisation of trade were implemented.

The key to a successful unification of the exchange rates in Vietnam has been the consistency between fiscal and monetary policies and the exchange rate policy. The devaluation of the official exchange rate was backed by cuts in budget deficits and a tightening of domestic credit. Even though the rate of inflation did not immediately fall to a low level, it eventually declined substantially over time, and the authorities accommodated inflation sufficiently through periodic devaluations to avoid severe overvaluation.

#### **B3.1 Tax reform**

Vietnam started to modernise its tax system in the late 1980's to raise fiscal revenues and to introduce elements of a modern tax system for a market economy.

Prior to the reform, three fourths of all revenues comprised transfers from state enterprises, collected in the form of turnover tax, profit tax, commodity tax, and depreciation allowance.

During the period from 1989-91, a number of laws were enacted to replace the old decree-based taxes.

A new turnover tax enacted in July 1990 covered a broad range of products including producer inputs, consumer goods, and services. The profit tax, which comprised taxation on enterprises, was enacted in 1990 and imposed essentially the same schedule for both state and non-state enterprises and the rate structure was simplified. There were also import and export duties, agriculture land use tax, and tax on the transfer of land use rights and natural resource tax, and land and housing taxes.

As a result of these reforms, fiscal revenue increased from 13 percent of GDP in 1988 to 24 percent in 1994 and more than 80 percent of total domestic revenues came from tax collection.

### **B3.2 Reform of State-Owned Enterprises (SOEs)**

Unusual for transition economies, in Vietnam the performance of SOEs surpassed that of private sector enterprises. Against a background of sound SOE activities, the authorities pursued a number of policies to reform the SOEs to achieve greater efficiency, profitability, and more market-oriented behaviour.

First, SOEs were granted greater autonomy in making decisions on pricing, production and investments.

Second, the SOEs were made subject to hard budget constraints to induce profit-maximising behaviour. Most subsidies to enterprises were cut following the price liberalisation and unification of the exchange rates in early 1989. Bank credit was limited to profit-making enterprises.

Third, competition between enterprises was encouraged by allowing private sector enterprises equal access to credit, creating a legal framework, subjecting all enterprises to uniform tax rules, and allowing all enterprises to establish direct trade links.

At the start of the reform, budget subsidies outweighed tax payments, however, revenues from SOEs began to increase and SOEs became significant net contributors to the state budget.

### **B3.3 Monetary policy reform**

The State Bank of Vietnam progressively gained the ability to control the monetary aggregates during the first half of the 1990's. Vietnam had succeeded in bringing inflation under control and stabilising the exchange rate. The CPI inflation rate declined from about 400 percent in 1988 to five percent in 1993. This was due to the introduction of tight monetary policy.

Monetary control was facilitated by the introduction of credit ceilings in 1994, improvements in the required reserve arrangement, and a reduction in the role of state bank refinancing.

### **B3.4 Financial sector reform**

Banking reforms implemented from 1988-92 contributed to solid macroeconomic performance. Vietnam initiated banking reforms in 1988-89, when the mono-bank system was split into a two-tier banking system, consisting of the State Bank of Vietnam as the central bank and four state commercial banks. In 1990, entry into the banking system was liberalised. In 1991, interbank markets were initiated for both foreign exchange and short-term domestic funds, and guarantees were introduced to secure lending.

Due to these financial sector reforms, the banking sector expanded considerably and banks began offering a broader range of services. Domestic currency deposits increased significantly. A smaller proportion of total credit was directed to the state enterprise sector.

### **B3.5 Trade reform**

Prior to the reform, foreign trade in Vietnam was subject to central planning and was carried out by a few foreign trade organisations that had a monopoly over trade in certain commodities. Exports were discouraged through overvalued exchange rates and low procurement price, while imports were impeded by a quota system, permits and licenses. At the end of 1980, Vietnam adopted a market-oriented, export-led growth strategy. With the liberalisation of the trade and exchange regimes and the adoption of an appropriate exchange rate policy, exports and imports began to expand rapidly in the late 1980's.

First, non-tariff barriers were lowered. From 1988-1999, import quotas, permits, and licenses were liberalised.

Second, in the late 1980's, duties on exports and tariffs on imports were lowered and rationalised.

Third, foreign trade was decentralised. In 1988, restrictions on the establishment of foreign trade organisations were eliminated. As a result, the total number of foreign trade organisations increased.

As for foreign direct investment (FDI) policy, there were no supporting legal frameworks for FDI in Vietnam before 1987.

The Foreign Investment Law enacted in 1987 offered generous tax concessions and duty exemption, welcomed foreign investment in all economic sectors except in defence industries, imposed no minimum capital requirements, permitted 100 percent foreign ownership, and guaranteed the unrestricted repatriation of capital and profits. In addition, the approval process was simplified.

The growth in FDI in Vietnam has been impressive. Actual FDI amounted to about 1.5 percent of GDP during 1988-1990, rose to 2.5 percent of GDP from 1991-1993, and climbed further to four percent and seven percent of GDP in 1994 and 1995, respectively.

### **B4. Conclusion**

The experiment of unifying the exchange rates in Vietnam was a very successful one. The key to the successful unification of exchange rates in Vietnam has been the consistency between fiscal and monetary policies and the exchange rate policy. The devaluation of the official exchange was backed by cuts in budget deficits and a tightening of domestic credit.



Table B1. Exchange Rates before/after the Unification (Against the US Dollar)

(before)

	-3 years (1985)	-2 years (1986)	-1 year (1987)	Unification (1988)
Official Rate*	15.00	80.00	368.00	4,500.00
Market Rate*	320	450.00	N.A.	5,000.00

(after)

	Unification (1989)	+1 year (1990)	+2 years (1991)	+ 3 years (1992)
Official Rate*	5,375.00	8,125.00	11,500.00	10,565.00

\* End of period

Table B2. Economic Indicators before/after the Unification

(before)

	1985	1986	1987	1988
Exports *	875	783	752	880
Imports *	1,916	2,155	1,753	1,898
Current Account Balance**	▲1.1	▲8.2	▲9.2	▲16.9
Fiscal Balance**	▲10.3	▲5.0	▲5.5	▲8.3
Reserves*	16.00	16.60	15.00	15.00
(months of imports)	N.A.	N.A.	1.5	1.5
GDP Growth***	5.7	3.4	3.9	5.1
Consumer Prices***	91.6	487	301.0	308.0

\* Millions of dollars \*\* Percent of GDP \*\*\* Percentage change

(after)

	1989	1990	1991	1992
Exports *	1,946	2,404	1,970	2,475
Imports *	2,565	2,752	2,239	2,535
Current Account Balance**	▲9.8	▲3.1	▲2.2	▲0.7
Fiscal Balance**	▲7.1	▲7.3	▲2.9	▲1.7
Reserves*	N.A.	113.60	N.A.	465.00
(months of imports)		N.A.		9.6
GDP Growth***	7.8	4.9	6.0	8.6
Consumer Prices***	95.8	36.4	83.1	37.6

\* Millions of dollars \*\* Percent of GDP \*\*\* Percentage change



## **Appendix C**

### **Unification of Exchange Rates in China**

#### **C1. Introduction**

In 1978, China started gradual reforms of its economic system.

Since then, China's economy has been significantly liberalised, modernised, and opened and integrated to the world economy. At the same time, the former central planning system and many of the distortions were eliminated. As a result, rapid growth with high increases in productivity, real GDP and living standards has been attained.

#### **C2. Unification of exchange rates**

The transition to a market-determined exchange rate system in China was gradual, spanning a period of 15 years.

The traditional arrangements in China were based on three key elements; an exchange retention quota system, varying types of arrangements for trading retention quotas, and a dual exchange rate system.

During the period from 1986-93, China maintained a dual exchange rate system, with an official rate that was adjusted periodically and a more depreciated market-determined rate set by the Foreign Exchange Adjustment Centres, the so-called swap centres or swap market.

Under this system, domestic enterprises were required to surrender their export receipts at the official rate, but allocated a certain percentage of surrendered foreign exchange in the form of retention quotas, that entitled the holder the right to purchase foreign exchange at the official rate for imports or debt service payments. The quotas were initially low at around 25 percent, however they were later increased in 1988. In 1991, a complex system of quotas differentiated by regions, industrial sector, and types of export was streamlined with the introduction of a uniform quota of 80 percent for general commodities. Foreign funded enterprises were allowed to retain all of their foreign exchange.

In December 1991, all domestic residents were allowed to sell foreign exchange at the swap rate at designated bank branches, however, the purchase of foreign exchange and the quotas remained subject to the approval of the State Administration of Exchange Control (SAEC). Henceforth, access for purchases required approval by the SAEC, and guidelines were set according to priority lists issued by the SAEC. The priority lists were varied across the swap market.

After July 1993, foreign exchange was sold at the swap market rate, reducing the amount of foreign exchange allocated at the official rate.

Intervention in the swap market was conducted at branches of the SAEC. Due to the fragmentation of markets, the exchange rates among the swap centres were divergent and arbitraging these divergences became difficult. To promote the flow and allocation of foreign exchange funds among regions through a market mechanism and to be able to intervene effectively in exchange markets, it was necessary to integrate regional swap markets into a single swap market. It was determined that this single market would be located in Shanghai, which was handled by the China Foreign Exchange Trade System (CFETS). The regional swap centres were made into branches of Shanghai's swap centre. And buyers and sellers in centres outside of Shanghai were linked electronically on-line to the Shanghai market. Market interventions and bid/offer submissions took place at the Shanghai market.

In January 1994, the official and swap market exchange rates were unified at the prevailing swap market exchange rate, the issuance of retention quotas was terminated, and the requirement to obtain prior approval from the SAEC when purchasing foreign exchange was abolished along with the priority lists.

*The new unified exchange arrangement is a managed float. At the start of trading each day, the People's Bank of China (PBC) announces a reference rate based on the average of the buying and selling rates against the US dollar at the close of the previous day's trading. Movement of the renminbi against the US dollar is limited to 0.3 percent on either side of the reference rate, with the PBC intervening in the interbank market through purchases and sales of foreign exchange to keep the exchange rate within the limit.*

During the first six months of 1994, the exchange rate remained stable at about 8.7 renminbi per US dollar, and the foreign exchange holding of the PBC rose.

### **C3. Other macroeconomic reforms**

#### **C3.1 Tax reform**

China launched a major program of tax reform in early 1994.

Before the reform, the tax system lacked autonomy and transparency.

State-Owned Enterprises (SOEs) paid three different kinds of taxes prior to the reform; an enterprise income tax, special levies on profits, and an income adjustment tax. The enterprise income tax was levied on the profits of enterprises, and tax rates were varied among enterprises, depending on their size and form of ownership. Special levies on profits were a charge for the initial capital invested in SOEs, which increased the tax burden of SOEs. The income adjustment tax was aimed at creating a level playing field among SOEs, as a uniform income tax would result in unequal levels of profit retention among SOEs. The income adjustment tax was discretionary and differentiated.

In the second half of the 1980's, the contract responsibility system (CRS) was introduced mainly for large and medium-sized SOEs. Under the CRS, an enterprise's tax payment was determined by tax contracts instead of laws, leaving an element of bargaining in the fiscal process. Tax contracts gave greater autonomy and financial accountability to SOEs by leaving larger funds at their disposal, and adjusted the relative after-tax profit retention among SOEs. Applicable taxes under the contracts were paid instead of enterprise income tax and income adjustment taxes. The CRS was extended to a large number of industrial SOEs. However, non-industrial SOEs, collectives, and private enterprises were not covered by the CRS and they continued to pay the income taxes discussed above. The failure of the tax system to expand into the growing and booming non-state sector resulted in not only a lack of revenue but also an unequal distribution of the direct tax burden.

Tax system reform was implemented in 1994. The main objectives of the reform were: to improve revenue by widening the tax base; to simplify the tax structure by unifying the tax code, and make it more transparent; and to equalise the tax burden on enterprises. The CRS was abolished at the beginning of 1994. The existing enterprise income tax on SOEs, collectives, and private enterprises was merged into a uniform domestic enterprise income tax. All forms of ownership were treated equally. And all special levies on enterprise profits were abolished.

Regarding indirect taxes, there existed three main types of indirect taxes; a product excise tax, the VAT, and a business turnover tax. These taxes were essentially similar. The product excise tax was levied on imports, purchases of agricultural products, and the manufacture of six categories of products. The VAT was levied on commodities not covered by the product excise tax. The business turnover tax meanwhile was levied on services, wholesales and retail trade.

Due to the reform of the tax system, indirect taxes were greatly simplified with the introduction of a broad-based VAT, which covered production, wholesale, retail trade, and imports. A standard rate was applied to most goods and services, while a lower rate was applied to selected items. In addition to the VAT, the product excise tax and the business turnover tax were also simplified.

### **C3.2 Reform of State-Owned Enterprises (SOEs)**

The overall financial performance of the SOE sector had remained weak, and the losses of the SOEs had continued at a very high level. SOE losses were financed by budgetary subsidies and bank loans. The weakness in SOE performance was mainly due to structural factors, including administrative control on prices, a lack of managerial autonomy and accountability, rigidities in wages and employment, overstaffing, and the heavy burden of social benefits.

Reform in the SOE sector was a gradual one and mainly focused on increasing managerial autonomy.

In 1984, autonomy for above-target output in terms of price setting, output sales, and input purchases was permitted. In addition, as discussed above, profit remittance of SOEs was replaced by the enterprise income tax payments in the second half of the 1980's. SOEs were allowed to retain most of their after-tax profits and depreciation funds. The CRS, in which enterprises could determine their output condition and taxes based on contracts with the government, was introduced for large and medium-sized SOEs in 1986. In 1992, regulations which stipulated non-interference by the government in SOE operations, were issued. Though enterprises were granted greater autonomy, they were also expected to be accountable for their performance, and inefficient and loss-making enterprises were restructured or closed down.

The governance structure, form of ownership, and management rights of SOEs were also changed. Greater flexibility in mergers and horizontal integration was provided. Corporate forms of ownership and management were also introduced. In 1990, provisions for limited liability private companies were introduced and share-holdings were allowed for SOEs. In late 1990, stock exchange floors were established in Shanghai and Shenzhen.

Reforms of the labour and employment system were also initiated, providing greater flexibility at the enterprise level in selecting workers and wages. Reforms of social benefits, including unemployment benefits, pensions, and health care, were also begun.

### **C3.3 Monetary policy reform**

Since the initiation of market-oriented reforms in China, the role, instruments, and conduct of monetary policy has changed significantly, as has the banking and financial systems. In 1984, a two-tier banking system was created and the PBC was established as a central bank. The PBC was responsible for the conduct of monetary policy and supervision of the financial system, while policy and commercial lending operations were assigned to four specialised banks. In addition to the four specialised banks, the commercial banking system also consists of several national and regional universal banks and three development banks. Besides these, there exists a network of about 53,000 rural credit cooperatives (RCCs) and 4,000 urban credit cooperatives (UCCs). There is also a large network of nonbank financial intermediaries (NBIFs).

Prior to the reform, monetary policy was implemented through the credit plan and the cash plan. The credit plan specified the amount of credit needed by enterprises to implement their output targets. The cash plan complemented the credit plan.

The credit plan was implemented through ceilings on credit of the specialised and universal banks. Prior to 1988, the credit plan covered the domestic currency operations of only the specialised and universal banks. Since then, credit planning has been broadened to include credit extended by NBFIs. However, it excludes credit to the government. Monitoring of the credit

ceilings of individual bank branches are conducted by both the local branches of the PBC and the headquarters of the specialised and universal banks. Because the process in which the credit plan was formulated retained several elements of bottom-up exercise and credit to the government was excluded from the credit plan, the planned limits on credit expansion were breached frequently. Therefore, it was difficult for the PBC to adapt the plan to take into account the changing macroeconomic circumstances. Moreover, the implementation of monetary policy was also weakened, because monitoring credit expansion by NBIFs was difficult.

In addition to direct credit controls, there existed indirect controls, such as PBC lending, reserve requirements, and interest rates, however these indirect controls were also inefficient.

The purpose of PBC lending is to fill the gap between bank deposits and credit plan targets and to manage overall bank liquidity through the granting of short-term credit.

Bank deposits, including demand and time deposits of specialised and universal banks as well as RCCs and UCCs are subject to a reserve requirement. In general, banks hold deposits at the PBC well in excess of the reserve requirement. Several factors may account for this. First, reserve requirements were imposed at the level of the individual bank branches, therefore, shortfalls in one branch cannot be offset against excesses in another. Second, interbank markets remained localised and fragmented. Third, structural problems in the payments and settlement system require each bank branch to hold relatively large amounts of excess reserves for operational purposes. These excess reserves mean that small changes in reserve requirements would be ineffective, because banks would be able to comply with them without changing the amount of lending. Moreover, they signify that banks can draw down these deposits to generate a rapid expansion of credit when the demand arises. These factors weakened and complicated monetary management, since they complicate the predictable relationship between reserve money expansion and broad money growth.

The effectiveness of interest rates as an instrument of monetary policy was limited because SOEs – the largest borrowers from the banking system – faced soft budget constraints, therefore, were unresponsive to changes in lending rates. Furthermore, changes in interest rates were, in general, subject to State Council approval, making the process time-consuming and subject to political consideration. In addition, the PBC lacked administrative independence from the State Council at the national level, and PBC branches were vulnerable to pressures from local governments to permit local banks to extend credit beyond the planned ceilings at the local level.

The main objectives of the reform were: (1) to grant the responsibility of formulating and implementing monetary policy, without interference from other government agencies, to the PBC; (2) to commercialise the banking system, so that the state-owned banks would operate on

a commercial basis, while policy-based lending would be undertaken by newly created policy banks; and (3) to establish financial markets with strengthened prudential regulation and supervision, so that open market operations would be enabled to become the main instrument of monetary policy.

To set up a strong central bank, the new central banking law, which spelled out the central bank's main objectives and responsibilities and greater autonomy of action, was enacted in 1994. The objective of monetary policy is primarily to maintain the stability of the currency and financial systems, thereby creating conditions that will foster sustainable economic growth. In addition, the ability of local PBC branches to extend credit was terminated, thus reducing its vulnerability to the influence of local governments. The primary responsibilities of these branches will include supervising banks in their jurisdiction, collecting data, and conducting research.

To increase the competitiveness of the banking system, policy-based lending was separated from commercial activities of the specialised banks. In addition, the RCCs and the UCCs were transformed into cooperatively owned commercial banks. Three newly created financial institutions conduct the policy-based lending activities.

In order to foster the development of well-functioning money markets, the authorities aimed to create a market for short-term treasury securities, to break down the segmentation of the existing interbank money market, to promote the development of the national interbank market to liberalise interbank interest rates, and to strengthen the regulation and supervision of the interbank market. These measures will allow open market operations to become the main instrument of monetary policy.

### **C3.4 Trade policy reform**

In China, the trade system was liberalised and gradually integrated to international markets, over a span of 15 years. As a result, China's share of trade in GDP has increased, along with its share of world trade.

Before the reform, nearly all foreign trade was subject to planning and was carried out through a small number of foreign trade corporations (FTCs).

In 1991, mandatory planning for exports was abolished, and budgetary subsidies to FTCs for exports were also eliminated. Mandatory planning for imports meanwhile was reduced to cover only about five product groups. Imports falling within the mandatory planning category considered to be of national importance were placed under a canalisation scheme, that is, restricted to a small number of FTCs. At the end of 1993, 14 products accounting for less than 20 percent of total imports were under canalisation. In 1994, all remaining mandatory planning for trade was eliminated and canalisation was limited to just a few products.



In addition, prior to the reform, a substantial proportion of imports regulated by license and other forms of control, including quota controls, still remained. During 1993, 53 product categories accounting for 30 percent of total imports were subject to licensing. In 1993 however, import licensing was removed for nine product categories, and then subsequently for another three product categories in 1994. In the same way, at the beginning of 1993, the number of export products subject to licensing was also reduced.

Moreover, before the reform, China's import tariff rates were relatively high and were dispersed among goods, causing an inefficient allocation of resources. At the end of 1993, tariffs were lowered with the average tariff rate dropping from 39.9 percent to 36.4 percent.

As for FDI, various types of Open Economic Zones (OEZs) played a key role in enhancing FDI. These zones offered tax incentives and a more advanced infrastructure compared with other regions. The business environment in these zones was more liberal than elsewhere.

In 1979, the Foreign Investment Law, which defined the legal framework for foreign investment, was enacted, and in 1980, four Special Economic Zones (SEZs) were set up. Other types of OEZs in the form of open cities emerged in 1985, and several of them were combined to form larger open areas. These cities and areas were authorised to establish Economic and Technology Development Zones (ETDZs), which provided conditions similar to those in SEZs. Additional ETDZs were also approved in border cities and inland provincial capitals.

Both local governments and firms in the zones were granted autonomy in investment decisions and in dismissing employees and hiring workers on short-term contracts. Restrictions on domestic and external trade were reduced. Most of the above-mentioned zones applied lower income tax rates. In addition, SEZs and other types of OEZs offered more generous exemptions and reductions on tariffs and indirect taxes.

As a result, provinces with large FDI tended to grow more rapidly than other regions.<sup>1</sup>

#### **C4. Conclusion**

Since the initiation of reforms in the late 1970's, China's economy has been significantly liberalised, modernised, and opened and integrated to the world economy. At the same time, the former central planning system and many of the distortions were eliminated. As a result, rapid growth with high increases in productivity, real GDP and living standards has been attained. These reforms include unification of multiple exchange rates, tax system and SOE reform, and liberalisation of trade and FDI.

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<sup>1</sup> For instance, Guangdong Province, where the first three SEZs were established, increased its share in total output from five percent in 1983 to more than nine percent in 1995.

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Table C1. Exchange Rates before/after the Unification (Against the US Dollar)

(before)

	-3 years (1990)	-2 years (1991)	-1 year (1992)	Unification (1993)
Official Rate	4.78	5.32	5.51	5.76

\*Rate in Foreign Exchange Adjustment Centres

(after)

	Unification (1994)	+1 year (1995)	+2 years (1996)	+ 3 years (1997)
Official Rate	8.62	8.35	8.31	8.28

Table C2. Economic Indicators before/after the Unification

(before)

	1990	1991	1992	1993
Exports *	51,519	58,919	69,568	75,659
Imports *	42,354	50,176	64,385	86,313
Current Account Balance**	3.9	3.8	1.8	▲2.0
Fiscal Balance**	▲2.1	▲2.4	▲2.3	▲2.0
Reserves*	14,700	24,900	21,200	23,000
(months of imports)	4.2	6.0	4.0	2.8
GDP Growth***	4.1	8.2	13.0	13.5
Consumer Prices***	2.1	2.7	5.4	13.2

\* Millions of dollars \*\* Percent of GDP \*\*\* Percentage change

(after)

	1994	1995	1996	1997
Exports *	102,600	126,100	128,100	182,700
Imports *	95,300	108,800	110,100	136,500
Current Account Balance**	1.4	0.2	0.9	4.1
Fiscal Balance**	▲2.7	▲2.1	▲1.7	▲1.8
Reserves*	53,500	76,000	107,700	143,400
(months of imports)	5.9	6.7	8.4	10.3
GDP Growth***	11.8	10.5	9.6	8.8
Consumer Prices***	21.7	16.7	8.4	2.8

\* Millions of dollars \*\* Percent of GDP \*\*\* Percentage change



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