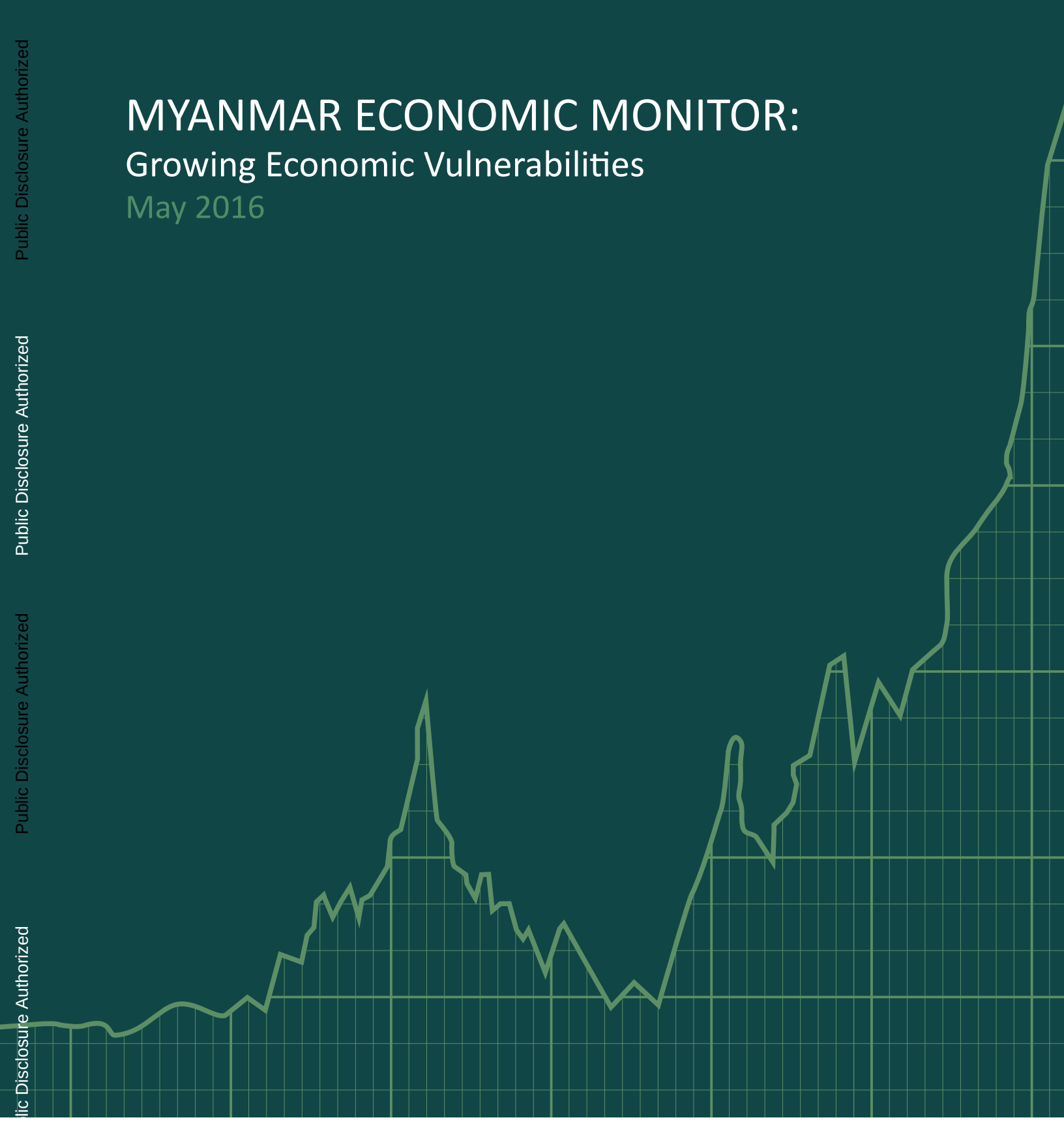
MYANMAR ECONOMIC MONITOR:

Growing Economic Vulnerabilities

May 2016



WORLD BANK GROUP
Macroeconomics & Fiscal Management

The Myanmar Economic Monitor (MEM) periodically takes stock of economic developments and highlights economic prospects and policy priorities in Myanmar. The MEM draws on available data reported by the Government of Myanmar and additional information collected as part of the World Bank Group's regular economic monitoring and policy dialogue. The MEM team is very grateful to the Ministry of Planning and Finance, the Ministry of Commerce and the Central Bank of Myanmar for their excellent collaboration, and to Ulrich Zachau (Country Director, South East Asia Country Management Unit), Sudhir Shetty (Chief Economist, East Asia and Pacific Region), Ahmad Ahsan (Lead Economist, EAP Chief Economist's Office), and Frederico Gil Sander (Senior Country Economist, Macroeconomics and Fiscal Management Global Practice) for their review and advice.

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Views expressed in the MEM are those of the authors and do not necessarily reflect the views of the World Bank Group, its Executive Directors, or the countries they represent; the Government of Myanmar; the UK Department for International Development; the Australian Department of Foreign Affairs and Trade; and the Kingdom of Denmark.

Abbreviations

CBM	Central Bank of Myanmar
CEIC	CEIC Data
CPI	Consumer Price Index
CSO	Central Statistical Organization
DICA	Directorate of Investment and Company Administration
EAP	East Asia and Pacific
ESIA	Environment and Social Impact Analysis
EU	European Union
FAO	Food and Agriculture Organization
FDI	Foreign Direct Investment
FOB	Free on Board
GDP	Gross Domestic Product
GOM	Government of Myanmar
IFS	International Finance Statistics
IMF	International Monetary Fund
kWh	Kilowatt hour
LIFT	Livelihoods and Food Security Trust Fund
MADB	Myanma Agriculture Development Bank
MEPE	Myanmar Electric Power Enterprise
MFTB	Myanma Foreign Trade Bank
MICB	Myanma Investment and Commercial Bank
MMcf	Million cubic feet
MALI	Ministry of Agriculture, Livestock and Irrigation
MOC	Ministry of Commerce
MOGE	Myanmar Oil and Gas Enterprise
NEER	Nominal Effective Exchange Rate
QSEM	Qualitative Social and Economic Monitoring
REER	Real Effective Exchange Rate
SEE	State Economic Enterprise
SEZ	Special Economic Zone
SOB	State Owned Bank
USDA	United States Department of Agriculture
WBG	World Bank Group
WDI	World Development Indicators

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Executive summary

Recent economic developments

After two years of strong economic growth and macroeconomic stability, Myanmar faced a more difficult economic environment in 2015-2016. The economy in 2013 and 2014 grew at an average of 8.5 percent per year, as reforms opened up the space for private investment, which averaged over 20 percent of GDP per year over this period. Public consumption also accelerated to help fill large gaps in service delivery, whilst increased domestic revenue and access to concessional finance helped to maintain fiscal discipline, with deficits below 3 percent of GDP. Even with rapidly growing demand, inflation in 2013 and 2014 averaged around 5.8 percent per year.

In 2015-2016, economic growth in Myanmar eased to 7 percent amid a supply shock from heavy flooding, a slowdown in new investment flows during an election year, and a more challenging external environment including lower commodity prices affecting Myanmar's main exports. Agriculture output growth is estimated to have slowed to 2 percent due to the floods, compared to 5.6 percent growth in the previous year. The historic elections of November 2015 created a general sense of economic optimism and private investors have remained upbeat. However, ongoing structural constraints, short-term exchange rate instability, rising inflation, and the political transition have contributed to a deceleration in new investment flows. These were exacerbated by tightening external financing conditions and declining global demand. Falling international commodity prices have also started to feed through to declining net exports.

These developments have brought to the fore a number of short-term economic vulnerabilities for Myanmar. The supply shock to agriculture contributed to a sharp rise in inflation, which peaked at 16 percent (year-on-year) in October 2015. Low productivity in the sector also means slower recovery, affecting the poor and vulnerable most negatively. Negative shocks to agriculture can exacerbate push relative to pull factors in rural-urban migration, the overall rate of which is increasing rapidly.[1] At the same time, Myanmar's light manufacturing sector, dominated by food processing, is facing more competition from cheaper imports, which affects its ability to create new employment. On the external accounts, the value of exports declined by 12 percent in nominal terms in the first three quarters of 2015-2016 compared to the same period last year due to the agriculture supply shock and declining commodity prices. This has contributed to a growing trade deficit and pressures on the exchange rate.

The institutional capacity and policy responses to deal with these macroeconomic shocks and imbalances have faced some challenges. On fiscal policy, pressures from a weakening Kyat and falling commodity prices led to a sharp increase in monetary financing of the deficit, which will have compounded underlying inflationary pressure. Treasury Bill auctions, which can help to absorb domestic liquidity, remain undersubscribed due to lower than expected discount rates. Concerns over the growing trade deficit seem to have prompted measures to contain the demand for foreign currency and imports. These include limits on the withdrawal of foreign currency, administrative delays and red tape in foreign transfers, and limits on importation of capital machinery. The volume of currency traded in the official foreign exchange auctions has gradually declined over the course of the year, and not offset by any major increase in activity on the interbank foreign exchange market.

1 WBG and LIFT, "A Country on the Move: Domestic Migration in Two Regions of Myanmar – A Qualitative Social and Economic Monitoring (QSEM) Thematic Study," (2016)

Economic outlook

As the economy recovers from its 2015-2016 supply shock and private investments begin to pick up again, real GDP growth in Myanmar is projected to rise to 7.8 percent in 2016-2017, and average 8.2 percent per year over the medium-term. The agriculture sector is projected to bounce back over the short-term, though there are downside risks from the effects of El Niño, which have created severe drought in early 2016. Investors' demand for services (e.g. transportation, distribution, information technology, communications and logistics) is expected to be the main driver of growth over the short to medium-term. Beyond this, infrastructure construction activity, particularly in the power and transport sectors, are expected to pick up pace and be major drivers of growth over the medium to long-term.

Inflationary pressures are expected to ease relative to 2015-2016, averaging 8.5 percent over the course of 2016-2017. This is linked to recovery from last year's agriculture supply shock, combined with projected low international commodity prices. International agricultural prices are projected to decline in 2016; the largest drop is for grains (-3.4 percent), which have a relatively big bearing for Myanmar.[2] Oil prices are projected to average US$37 per barrel in 2016, which should benefit Myanmar as a net oil importer.[3] Downside risks to this projection include continued monetization of the budget deficit and limited monetary policy capacity to mop up excess liquidity.

The Union Budget deficit is projected to average 3.5 percent of GDP over the medium-term. Oil and gas receipts are expected to decline due to a combination of falling production from existing gas fields and lower international commodity prices. At the same time, ongoing tax administration reforms should yield positive results for income tax collections. Government revenue could average around 14 percent of GDP over the medium-term. Spending pressures are likely to remain high with Myanmar's growing infrastructure bill, but also its rising recurrent needs to improve coverage and quality of public services.

Over the medium to longer-term, the manufacturing and processing sectors continue to hold strong promise as potentially important drivers of inclusive growth. Structural transformation towards higher value added manufacturing will depend in big part on the growth of supporting infrastructure and services, but also investment in skills. The garments sector could help address binding constraints in services and infrastructure that affect the manufacturing sector as a whole. This could lay the foundations for higher value addition, and avoid a low equilibrium dominated by trading, low value services, and basic assembly.

Policy priorities

Myanmar's economic prospects remain strong, with a premium on sound macroeconomic policies and institutions to help manage emerging challenges. In the short-term, this includes balancing *fiscal adjustment* for macroeconomic stability and *fiscal expansion* for public services and growth to help navigate the impact of lower commodity prices. On fiscal adjustment, one option is to improve the efficiency of capital spending. This might mean consolidating public investment projects and reallocating them to areas that help relieve constraints to growth (e.g. urban areas and emerging growth poles; transportation links that help connect economic centers; and social services in poorer, less densely populated areas). On fiscal expansion, one option could be to prioritize a reduction in revenue leakage from tax expenditures by adopting a clear and consistent policy for the granting of tax incentives to the private sector.

2 WBG, "Commodity Markets Outlook: Weak Growth in Emerging Economies and Commodity Markets," (Jan 2016)

3 Ibid.

Reducing the budget deficit and prudent public debt management could help reduce inflationary pressures, in addition to maintaining fiscal sustainability. In this regard, reversing and ultimately eliminating monetary financing of the deficit could be one of the top priorities for fiscal management. This would require continued efforts to develop domestic debt markets through the Treasury Bill auctions, and upcoming Treasury Bond auctions, including by allowing interest rates to better reflect market conditions. The government could also benefit from rebalancing its public debt portfolio towards longer-term and more concessional external financing. Although Myanmar is still classified at low risk of debt distress,[4] external vulnerabilities as illustrated by recent exchange rate and commodity price developments, may adversely affect public debt sustainability, particularly if it fuels more short-term domestic borrowing.

Staying the course on establishing a well-functioning exchange rate system is likely to be critical for Myanmar to keep benefiting from growing trade and investment opportunities. This means continued strengthening of official market mechanisms (i.e. foreign exchange auctions, interbank foreign exchange market) and maintaining exchange rate flexibility, even if this could imply further devaluation. The latter can be important for external competitiveness and balance. Maintaining fiscal discipline, as noted above, and further development of monetary policy tools to help mop up liquidity (e.g. deposit auctions),[5] could help offset potential inflationary effects of a weaker Kyat. The large current account deficit on the other hand, which is estimated at 7 percent of GDP in 2015-2016, does not necessarily pose immediate concerns for external sustainability. The deficit in 2015-2016 was driven by cyclical factors, moreover foreign direct investments, which depend on imports for building up productive capacity in the economy, are expected to pick up over the medium-term.

The Policy Watch section in this Myanmar Economic Monitor covers selected issues in access to electricity, and reform of State Owned Banks. Access to electricity remains a top priority for productivity and competitiveness in the economy. One of the main challenges in attracting investments into the power sector will be its financial viability. This critically depends on tariff policies both for gas supply to the power sector and for electricity distribution. The government could in this regard look into three policy options. The first is to consider a gas pricing framework that could better reflect the true economic cost of supply in Myanmar, which may imply lower domestic prices than export prices. The second is to study how electricity tariffs could better reflect the cost of supply. For 2015-2016, the overall tariffs are estimated to be below the cost of supply by about Kyats 300 billion. The third option is to look into targeted subsidies to address any household affordability concerns. A pro-poor targeted subsidies mechanism could usefully replace the prevailing non-targeted mechanism for electricity consumption.

Another priority area is the reform of State Owned Banks (SOBs) to promote transparency, stability and competitiveness of the financial sector. Although recent liberalization of the financial sector has helped to significantly expand the role of private banks, SOBs still account for slightly more than half of total banking sector assets. They share some common challenges including: low transparency; lack of modern technology and IT systems; unclear policy mandates; and lack of modern corporate governance. Reform priorities could include: (i) developing an appropriate ownership framework for SOBs to clarify policy mandates and ownership responsibilities; (ii) clarifying the legal framework for operations of SOBs to promote effective corporate governance; (iii) establishing a high level coordination mechanism to manage the reform process; and (iv) improving disclosure and transparency of SOB financial and operational performance.

4 IMF, "Staff Report for the 2015 Article IV Consultations – Debt Sustainability Analysis" (August, 2015)

5 IMF, "Staff Report for the 2015 Article IV Consultations" (August, 2015)

Economic growth

Following a strong take off soon after opening up, the Myanmar economy weathered some turbulence in 2015-2016 amid a more difficult economic environment. After growing at 8.5 percent per year in 2013 and 2014, growth in 2015-2016 eased to 7 percent due to a supply shock from flooding in July 2015, which led to inflationary pressures and deteriorating real household incomes. This was exacerbated by slowing investments due to ongoing structural constraints and the political transition; and a more challenging external environment, including declining international commodity prices, which have affected Myanmar's gas exports. A combination of these have contributed to rising inflation, exchange rate pressures, and widening macroeconomic imbalances. Expansion in services accounts for the resilience in growth, though these emerging challenges have brought to the fore short-term economic vulnerabilities for Myanmar.

Challenging external environment[6]

Growth in the global economy along with that of the East Asia and the Pacific (EAP) region have continued to slow down since October 2015. Economic activity eased in the Euro Area and the United States, whilst activity in Japan contracted in the last quarter of 2015. Growth in developing EAP slowed to 6.5 percent, down from 6.8 percent in 2014, mostly due to decelerations in China (6.9 percent growth in 2015 compared to 7.4 percent in 2014) and regional commodity exporters.

Despite the slowdown, the EAP region still accounted for almost two-fifths of global growth in 2015. At the same time, the EAP region, particularly among its larger economies, has seen a major shift in the demand-side drivers of growth. The increasingly challenging external environment has led to a substantial decline in the contribution of net exports to growth, and also some decline in the contribution of private investment. Domestic consumption continues to underpin economic expansion in these countries.

Demand easing over the short-term

Within this context, private demand in Myanmar has also eased, with the economy growing at an estimated 7 percent in 2015-2016, compared to 8.5 percent the previous year. Much of the easing is attributed to a flood-induced supply shock to agriculture, which has led to a rapid rise in inflation, resulting in declining household purchasing power and slower private consumption growth relative to 2014-2015. Public consumption on the other hand increased by around 14 percent in real terms in 2015-2016, partly in response to spending pressures arising from external shocks. Public investments across economic services (e.g. transportation, power, industry) increased by around 10 percent in real terms.

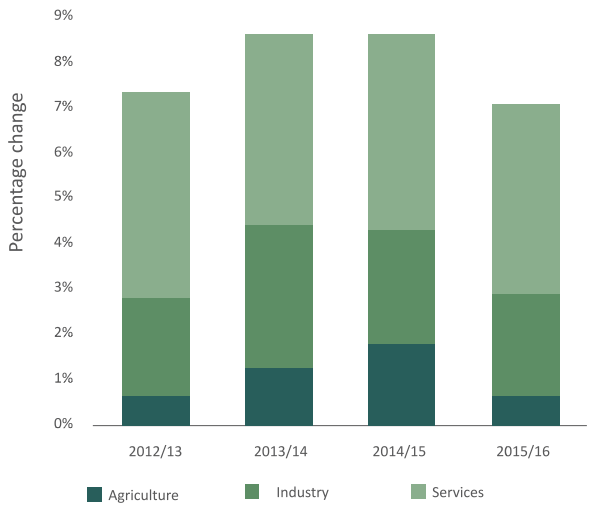
Private investors have remained upbeat, especially after the historic elections of November 2015, but new investment flows in 2015-2016 have decelerated. Both domestic and foreign investment commitments remained strong in the first three quarters of 2015-2016 (Figure 1). But after two years of very rapid growth, actual investments have moderated. Part of this is linked to some new investments being parked over the political transition. In addition, tightening external financing conditions combined with declining global demand have delayed some foreign investments, particularly in the tradable sectors. These issues were compounded by short-term

6 WB, "East Asia and Pacific Update," April 2016

Figure 1. Investment commitments Q1-Q3 (US$ m)

Sources: CSO, DICA

Figure 2. Sector contribution to growth (% change)



Sources: MOPF, WB Staff estimates

macroeconomic challenges including exchange rate pressures and rising inflation, in addition to ongoing longer-term structural constraints (e.g. electricity, access to finance, land).

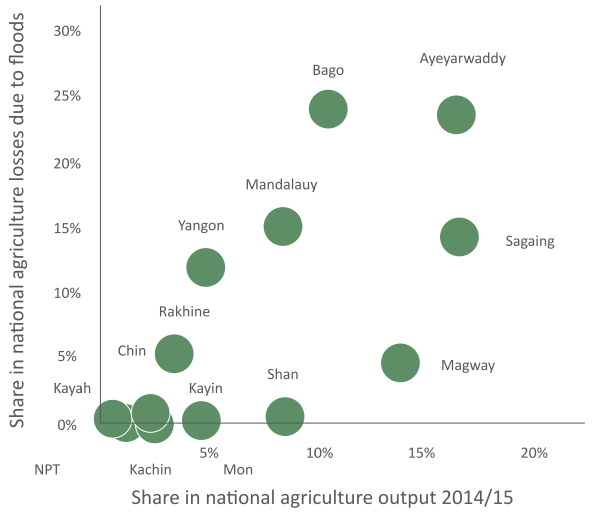
Agriculture affected by floods

Agriculture growth decelerated to 2 percent in 2015-2016 compared to 5.6 percent the previous year due to the impact of heavy rains between July and September 2015 causing widespread flooding and landslides. The sector contributed less than 10 percent of overall growth (Figure 2). Although the floods were geographically widespread, major agricultural producing areas were particularly badly hit (Figure 3). Damages from the disaster affected storage facilities with stocks of seeds; animals and livestock; aquaculture facilities and fisheries' ponds; and fishing equipment. Losses were generated from lower crop production, reduced output of meat and eggs, and contraction in fisheries' production. These in turn had knock on effects beyond agriculture in food processing, trading, and transportation services. A combination of all this will have negatively affected household incomes.

The resulting economic impact of the floods, as measured by the damage to physical assets and loss in production flows, is estimated at around 3.1 percent of 2014/2015 GDP, which is not insignificant when compared to other recent cases (Figure 4).[7] Over 80 percent of the value-added losses, estimated at 0.8 percentage points of GDP, come from the agriculture sector. Within agriculture, the largest impact has been on paddy production. The floods have impacted the main monsoon harvest, whereas the dry season production is estimated to drop due to water shortages caused by El Niño and substitution towards more profitable crops (e.g. beans and pulses).

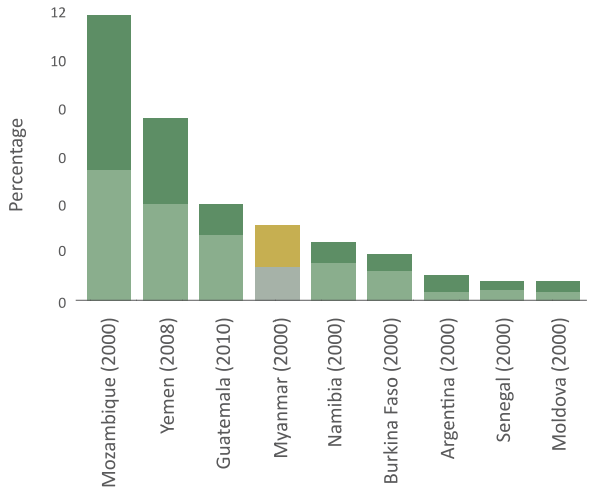
7 For a more detailed analysis on the impact of the floods, please see Government of the Union of Myanmar, "Myanmar – Post-Disaster Needs Assessment of Floods and Landslides," July-September 2015

Figure 3. Share of agriculture losses and output (%)



Sources: MOPF, WB Staff estimates

Figure 4. Flood impacts in selected countries (% of GDP)



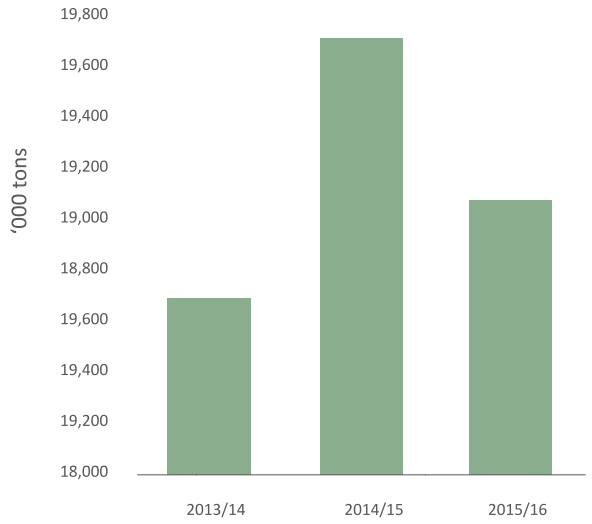
Sources: WB

Paddy production has contracted but it is difficult to estimate the exact magnitude. The US Department of Agriculture estimates a 3.2 percent decline in 2015-2016 (Figure 5). Rice price developments suggest a bigger decline. The wholesale price of Emata rice in Yangon in September-October 2015 averaged Kyat 498,200 per ton, which is 36 percent higher than the same period last year. Yet in US dollar terms, rice prices in Yangon have remained relatively stable, which suggests that the production shock combined with the weaker Kyat contributed to the sharp increase in prices. High prices in China attract more and more of Myanmar exports. In November-December, Myanmar prices converged with prices of its main export competitors – Thailand and Vietnam, so in theory they could compete on FOB basis. Yet, the large wedge with China prices (~ $250/ton) diverted exports from other locations to cross-border trade.

Beans and pulses, which account for around 50 percent of value added in crops, were not as badly affected by the floods. Beans and pulses are mainly planted during the cool off season and harvested between January and March. Only green gram is harvested throughout the year. Higher prices for beans and pulses, lower production costs compared to paddy, and lower water requirements have encouraged farmers to shift production towards these crops.

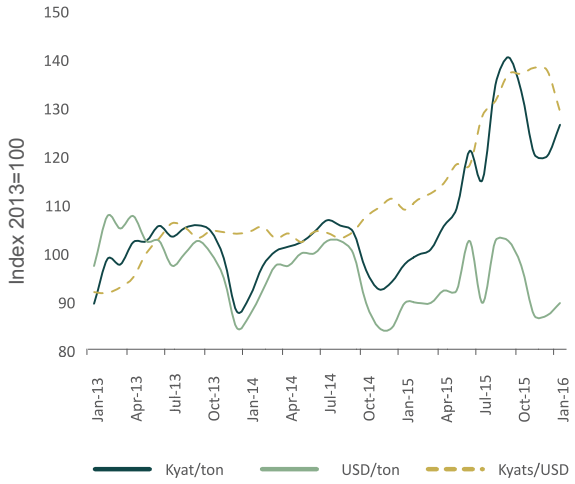
At the same time, a lack of access to quality seeds combined with price volatility have affected production potential. While the main 2015-2016 harvest for black gram and pigeon peas is yet unknown (February-March 2016), the decline in exports in 2015 points to production constraints. Between April and August 2015, Myanmar exported beans and pulses produced in 2014-2015. Starting from October 2015 it began to export green gram produced in 2015/16, though in lower volumes than during the same period of 2014. Production is estimated to have increased by 0.8 percent.

Figure 5. Paddy production, Myanmar ('000 tons)



Sources: USDA

Figure 6. Indices of rice prices and exchange rate, Myanmar



Source: FAOGIEWS

Domestic manufacturing facing more competition

Developments in the agriculture sector have had spillover effects on manufacturing and processing output. Around 60 percent of industrial output comes from manufacturing and processing, approximately 70 percent of which is from food processing. This in turn is dominated by rice milling, edible oils and snack foods. The sector therefore has a fairly narrow base, relying on high volumes and suffering from low value addition due to limited processing and packaging. Output is vulnerable to supply and price developments in the agriculture sector, and also to the cost of imported inputs.

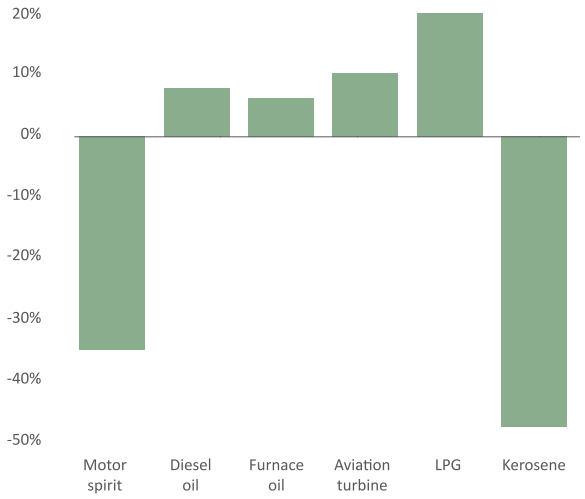
Domestic producers in the food processing industry are facing growing competition from cheaper imports. Their productivity and competitiveness are hampered by weak domestic supply chains and a lack of access to affordable finance. In addition, much of the inputs for domestically processed foods have to be imported

Table 1. Beans and pulses production, Myanmar

	2013/14	2014/15	2015/16
Production, '000 tons	**2,674**	**2,705**	**2,763**
Black gram (Matpe)	1,076	1,080	1,069
Green gram (Pedesein)	992	1,050	1,071
Pigeon peas (Pesingon)	579	575	587
Change from the last year, %	3.6	2.2	0.8
Exports, '000 tons (annual, FOB)	**1,301**	**1,459**	**951**

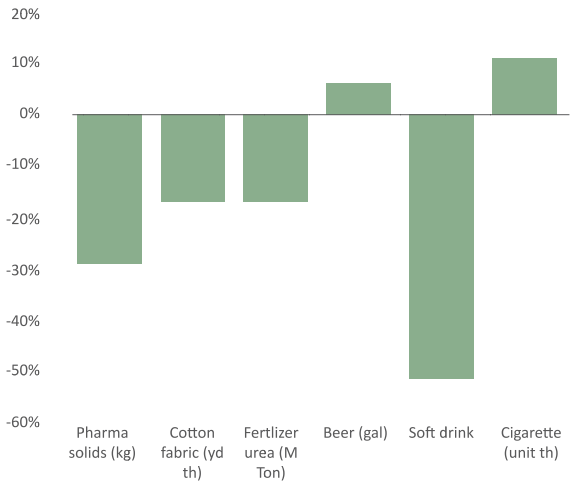
Source: WB Staff estimates based on data from MALI and MOC

Figure 7. SEE petroleum and petrochemical products 2014-2015 – 2015-2016 Q1-Q3 (% change, gal th)



Source: CSO

Figure 8. Industry output from selected SEEs 2014-2015 – 2015-2016 Q1-Q3 (% change)



Source: CSO

(e.g. flour, preservatives, packaging material), which are now more costly due to a weaker Kyat. Although exchange rate developments will have offset some of the price differential, domestic producers complain that unofficial, untaxed imports of processed foods through Myanmar's borders with neighboring countries are making it difficult for them to compete.

Data from State Economic Enterprises in manufacturing and processing, albeit a small share of total output, also point to declining production. For example, the Myanmar Petrochemical Enterprise, which is involved in the downstream production of petroleum and petrochemical goods experienced a 14 percent decline in output in the first three quarters of 2015-2016 compared to the same period last year (Figure 7). Similarly, output of selected manufacturing and processing products from SEEs operating under the Ministry of Industry has also fallen over the same period (Figure 8).

SEEs involved in commercial activities will find it increasingly difficult to compete in Myanmar's growing marketplace. This is reflected in the expanding operational deficits of SEEs under the Ministry of Industry (Table 2). Consumers and producers now have greater choice and access to better quality goods at a cheaper cost thanks to the gradual opening up of the economy to the domestic private sector and international trade. Restructuring, including privatization, of loss making SEEs involved in commercial activities, could potentially relieve fiscal burden and expand access to critical factors of production for the private sector, including prime industrial land.

Foreign investments in manufacturing and processing have begun to gradually take off in the Thilawa Special Economic Zone (SEZ). Investors are producing both for export (e.g. garments, electrical assembly, medical equipment) and domestic (e.g. agriculture machinery, fertilizer, pharmaceuticals, construction material, processed foods) markets. Recent macroeconomic developments including slowing external demand created some concerns for export oriented firms due to growing

Table 2. Industry State Economic Enterprises (Kyat million)

	2012-2013 PA	2013-2014 PA	2014-2015 PA	2015-2016 RE
Revenue	183,194	143,760	92,896	193,863
Expenditure	734,598	678,016	501,908	544,406
Recurrent	121,641	167,210	170,776	231,835
Capital	612,957	510,806	331,132	312,571
Operating balance	**61,553**	**(23,450)**	**(77,880)**	**(37,972)**

Source: MOPF, WB Staff estimates

uncertainties in external markets. Similarly for investors targeting the domestic market, exchange rate and inflation pressures have increased risks on returns to foreign investment.

But SEZ investors take a longer-term perspective. Despite growing competition and rising cost for skilled labor, Myanmar continues to benefit from a significant labor cost advantage relative to its competitors. A total of 7 factories in Thilawa have already started operations, another 16 are in the process of setting up their operations, and a total of 60 have reserved space. This is equivalent to 80 percent occupancy. These investments could generate up to 40,000 jobs.

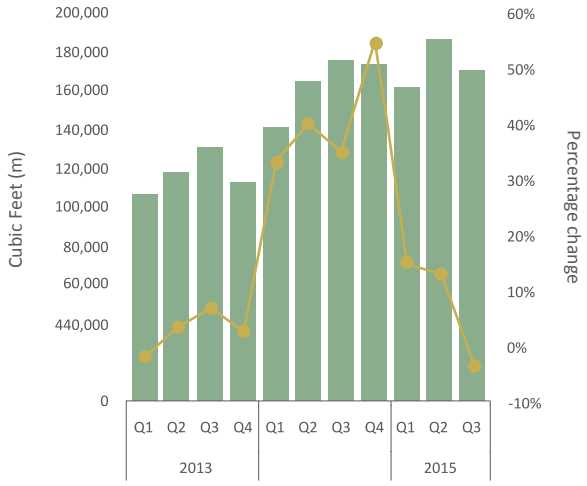
There has been a gradual easing in construction activity over the course of 2015-2016. The big construction boom of recent years was dominated by an expansion of the residential market, which in 2013 was estimated to account for around 40 percent of construction activity.[8] A combination of speculation and overheating in the residential segment has led to falling demand as reflected in declining sale and rental prices. The new Condominium Law, passed in January 2016, now allows foreign investors to invest in condominium projects, which could help bring in new capital.

More recently, there seems to be a gradual shift from residential towards infrastructure, commercial and industrial construction, though these are running into structural constraints. Access to long-term financing is a major issue, with a mismatch between the gestation period for projects and the terms and conditions offered by local banks. The latter lend mostly to short-term, lower risk, trading activities. Another constraint is electricity; large commercial and industrial units that have recently been completed have inadequate access to power. These issues are compounded by the sector's large dependence on imports of building materials. Although the cost of building materials has fallen internationally, the recent volatility in foreign exchange markets have made business planning more difficult and affected the pace of expansion.

Gas production edged up over the course of 2015-2016, helping to buffer some of the shock from falling gas prices. Gas production in the first three quarters of 2015-2016 was up 8 percent relative to the same period the previous year, when production shot up by 36 percent with the Shwe and Zawtika fields coming on stream (Figure 9). In 2015-2016, output from Shwe and Zawtika is expected to be up by 30 percent relative to 2014-2015, though output from the Yetagun and Yadana fields are expected to drop by 7 percent.

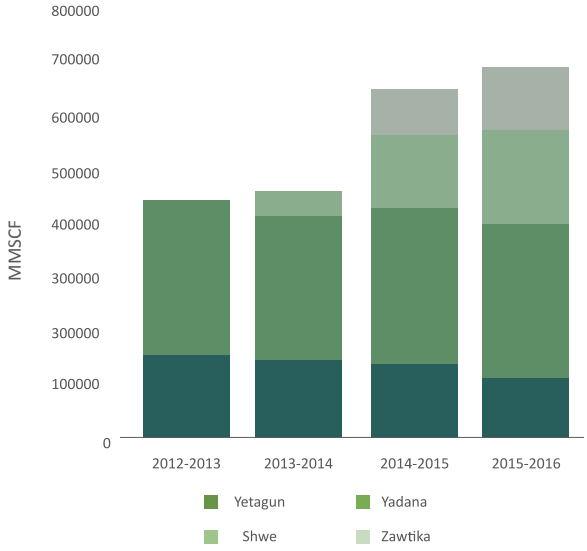
8 Oxford Business Group, "Improving regulations and standards for Myanmar's construction sector."

Figure 9. Gas sector output (cf m and % change yoy)



Source: CSO

Figure 10. Gas wellhead production (MMSCF)



Source: MOEE

Expansion of essential services

Around 60 percent of growth in 2015-2016 came from expansion in the service sector, which helped maintain resilience amid external shocks. Telecommunications services continued to grow, though rollout has been slower than planned. Telecom operators have faced challenges in importing equipment due to difficulties in accessing or remitting foreign exchange to external vendors. This has been ascribed to both policies to restrict withdrawal of foreign exchange, but also inefficiencies in the Myanma Foreign Trade Bank (MFTB) and the Myanma Investment and Commercial Bank (MICB), which still play a large role in foreign exchange transactions. Telecom operators have also faced challenges receiving clearances from multiple levels of government agencies for construction and layout of fiber optic infrastructure and towers.

The transparency, efficiency and stability of business regulations in particular areas may be affecting the pace of expansion in the service sector. For example, the process for issuing import licenses continues to create bottlenecks given the number of government agencies involved and the lack of coordination. Another example is the recent application of the outdated Stamp Duty Law that imposes a 1.5 percent tax on the value of new loan contracts. This can amount to a large, inefficient levy, which negatively affects foreign investments. Another example is last year's decision to introduce a 5 percent commercial tax on telecommunications and then postpone implementation till 2016-2017. This had important implications for telecom operators that had invested in reconfiguring internal systems to accommodate the new tax.

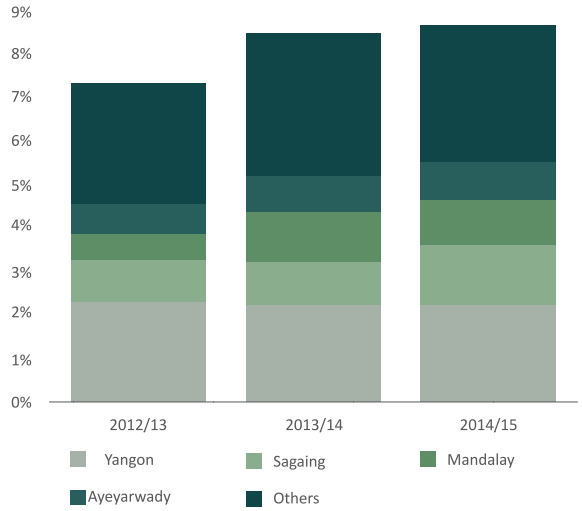
Structural change and labor migration

The pace and pattern of economic growth over the past 5 years have contributed to major shifts in the sector composition of GDP. Despite some increase in agriculture output in 2013 and 2014, the share of the sector has dropped from around 37 percent of GDP in 2010 to around 29 percent in 2015 (Figure 11). This has been offset by big gains in services (wholesale and retail trade, followed by

Figure 11. Sector composition of GDP (% share)

Sources: MOPF, WB Staff estimates

Figure 12. State/Region contribution to growth (% change)



Sources: MOPF, WB Staff estimates

transportation, and communications), which have been the biggest drivers of growth; and industry (manufacturing and processing, followed by construction, and energy, including gas).

Out of 14 States and Regions across Myanmar, the Regions of Yangon, Sagaing, Mandalay, and Ayeyarwady accounted for nearly two thirds of real GDP growth in the past two years. Yangon alone accounted for 25 percent of real GDP growth in 2014-2015 (with 14 percent of the total population), and Mandalay another 15 percent (with 12 percent of the population). Together, these two Regions are important growth poles for Myanmar. Over 90 percent of Yangon's economy and over 75 percent of Mandalay's economy is made up of industry and services. Ayeyarwady and Sagaing are major agriculture centers, though the share of agriculture in regional GDP has declined between 2011 and 2014 in both cases.

Together with these developments, Myanmar is experiencing high levels of migration out of rural areas, as illustrated by a recent World Bank study.[9] The study focuses on migration in Ayeyarwady and Magway, which are home to large numbers of Myanmar's rural poor and are also close to Yangon and Mandalay. One in five households in Ayeyarwady and one in four in Magway report having at least one household member currently migrating. Most of these are domestic migrants (91 percent in Ayeyarwady and 78 percent in Magway). Migration from villages in both Regions has increased rapidly in the past four years (Figure 13).

The migration rate for men is higher than for women, which nonetheless is also high. In Ayeyarwady, 60 percent of migrants were male, compared to 66 percent in Magway. Around 80 percent of migrants in each Region were between the ages of 11 and 30, with the vast majority in

9 WBG and LIFT, "A Country on the Move: Domestic Migration in Two Regions of Myanmar – A Qualitative Social and Economic Monitoring (QSEM) Thematic Study," (2016)

Figure 13. Households with a current or returned migrant by year of departure (%)

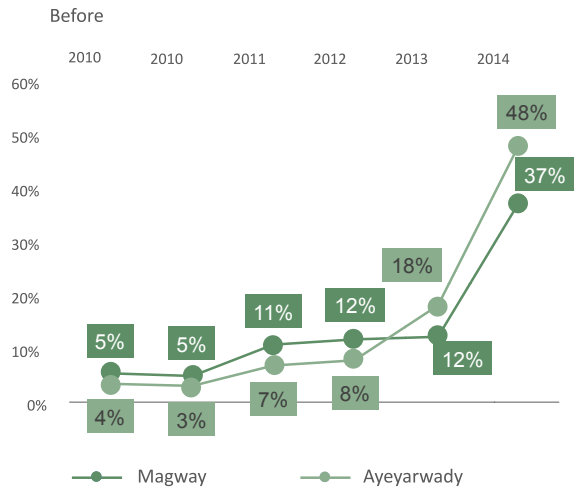
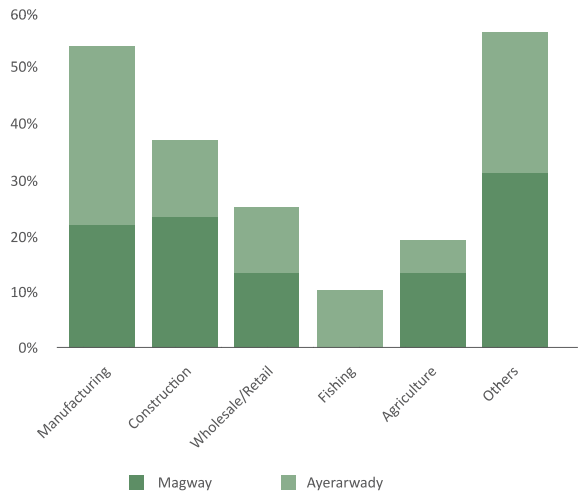


Figure 14. Employment in destination sites by sector



Source: WBG "A Country on the Move" (2016)

their late teens or early twenties. Migrants also tended to be better educated than non-migrants. In both Regions, landless households were more likely to have family members migrating than the rest of the population. Close to 60 percent of migrants from Ayeyarwady and around 24 percent of migrants from Magway moved to Yangon.

Migrants mostly found work in the informal labor market. They tend to work as casual laborers in restaurants, construction, and other low-skill employment. A quarter of male migrants worked in construction. Around 55 percent of female migrants in Yangon were employed in light manufacturing, particularly garments, which is sought after due to better pay, more regular, and longer-term work compared to alternatives.

The majority of migrants moved out of rural areas in search for more stable earning opportunities. In Ayeyarwady, households with more diverse income sources were less likely to migrate unlike landless households engaged in seasonal work and who were more vulnerable to income shocks. In Magway, small landholding households migrated less than the landless, because the former are able to generate income from their own agriculture or business, and from casual labor.

Push factors (i.e. conditions that drive people out of rural areas) *relative* to pull factors (i.e. conditions that draw labor to urban areas) may have been important drivers of rural-urban migration. This is reflected in migrants' motivation to move out of rural areas and their occupations in urban areas. This also manifests itself from qualitative research under the World Bank study, which finds that earning differentials between sending and destination locations may not be substantial, particularly when factoring in higher cost of living in urban areas. The real attractions are the certainty and regularity of urban jobs. The importance of push relative to pull factors may be driven by a combination of low agriculture productivity and rural economic opportunities on the one hand, and slow urban employment expansion relative to the supply of low skill labor on the other. This is not unusual for a country at Myanmar's stage of development.

Urbanization could be a big driver of economic opportunities if supported by sound urban planning, a conducive business climate, and policies to maximize benefits of agglomeration. These could be important to avoid risks of push factors becoming a drag on economic growth as cities become overcrowded and poverty rises as employment opportunities and public services struggle to keep pace with the increased inflow of migrants. Transforming rural-urban migration as a source of growth is likely to require continued efforts at enhancing agriculture productivity, increasing access to rural services, removing bottlenecks to the expansion of labor intensive manufacturing industries, and increased focus on urban planning and services.

Table 3. Myanmar Gross Domestic Product (Kyat billion)

	2013-2014	2014-2015	2015-2016
GDP (constant at 2010 prices)	**49,030**	**53,196**	**56,928**
Agriculture	15,346	16,209	16,533
Industry	13,964	15,190	16,374
Services	19,720	21,797	24,020
GDP (Nominal)	**54,756**	**63,323**	**75,431**
Agriculture	17,138	19,295	21,907
Industry	15,595	18,081	21,697
Services	22,023	25,947	31,828

Sources: MOPF, WB Staff Estimates

Table 4. East Asia and Pacific – GDP growth (2013-2015) (% change)

	2013	2014	2015
East Asia and Pacific[1]	**6.3**	**6.1**	**5.7**
Developing East Asia and Pacific	**7.2**	**6.8**	**6.5**
Papua New Guinea	5.5	8.5	8.5
Myanmar	8.5	8.5	7.0
Cambodia	7.4	7.1	7.0
Lao PDR	8.5	7.5	7.0
China	7.7	7.4	6.9
Vietnam	5.4	6.0	6.7
Philippines	7.1	6.1	5.8
Malaysia	4.7	6.0	5.0
Indonesia	5.6	5.0	4.8
Timor-Leste[2]	5.4	6.0	4.3
Fiji	3.5	5.3	4.0
Solomon Islands	3.0	1.5	3.3
Thailand	2.8	0.9	2.8
Mongolia	11.6	7.8	2.3
Memo: Developing East Asia exc. China	**5.1**	**4.6**	**4.7**

Source: WB East Asia and Pacific Update October 2015, April 2016
1/ Developing East Asia + NIEs + Korea 2/ Non-oil GDP

Table 5. Myanmar selected social indicators

	2013-2014	2014-2015	LMIC avg[1]
Population (million)	51.2	51.7	
Population Growth (% change)	1.02	1.01	1.5
Population Density (per square km)	76	76	142
Labour Force Participation Rate (%)	66.9	67.0	59.2
Adult literacy rate	89	90	73

Sources: CSO, WDI 1/ 2014 except adult literacy 2010

Foreign Trade and Investment

External trade and investment flows are progressively contributing to Myanmar's economic growth and its future growth potential. The contribution of net exports to GDP growth has historically been very low. But the role of exports in growth is steadily increasing and the opening up to imports has enabled access to much needed inputs for enhancing domestic productive capacity. Merchandise trade has increased from an average of 25 percent of GDP between 1986 and 2011 to nearly 50 percent in 2014-2015, comparable to other countries in the region soon after they liberalized. Increased openness has also led to growing external imbalances, with the current account deficit estimated at 7 percent of GDP in 2015-2016. In particular, a slowdown in exports in 2015-2016, together with a deceleration in foreign investment inflows, have created some concerns for policy makers, which are discussed further below.

Growing trade deficit

Myanmar experienced a growing trade deficit over the first three quarters of 2015-2016 driven mainly by a contraction in exports rather than strong growth in imports as in 2014-2015. The trade deficit in the first three quarters of 2015-2016 reached close to US$ 4.4 billion compared to US$ 3 billion over the same period last year (Figure 15). In the last three months of 2015, the trade deficit reached its highest level of any quarter in recent years. Imports in the first three quarters of 2015-2016 grew by only 2 percent in nominal terms relative to the same period last year. The value of exports in the first three quarters of 2015-2016 was on the other hand down 12 percent in nominal terms relative to the same period in 2014-2015 (Figure 16).

Figure 15. Trade flows and balance (US$ bn, quarterly)

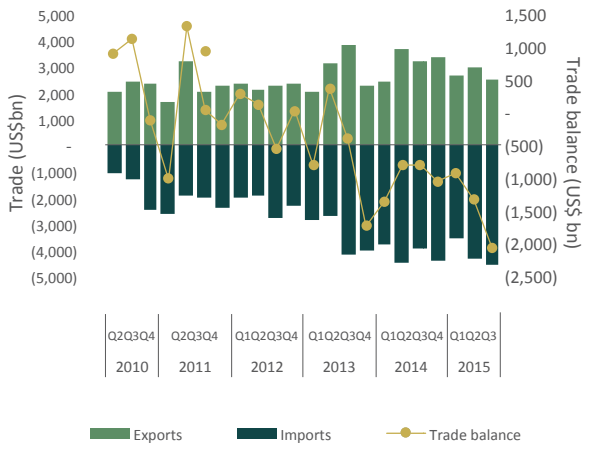
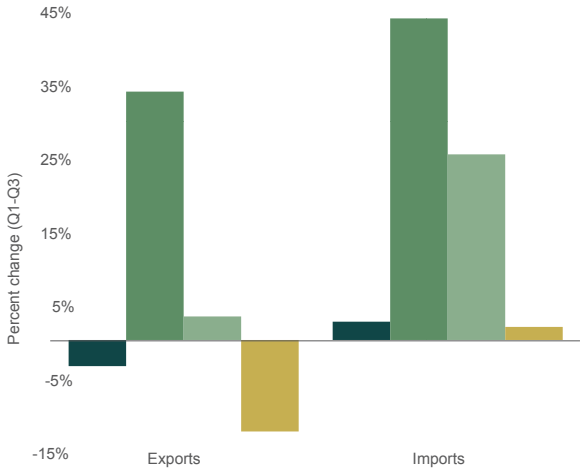


Figure 16. Trade growth (Q1-Q3. % change)



Source: MOC, Customs, CSO

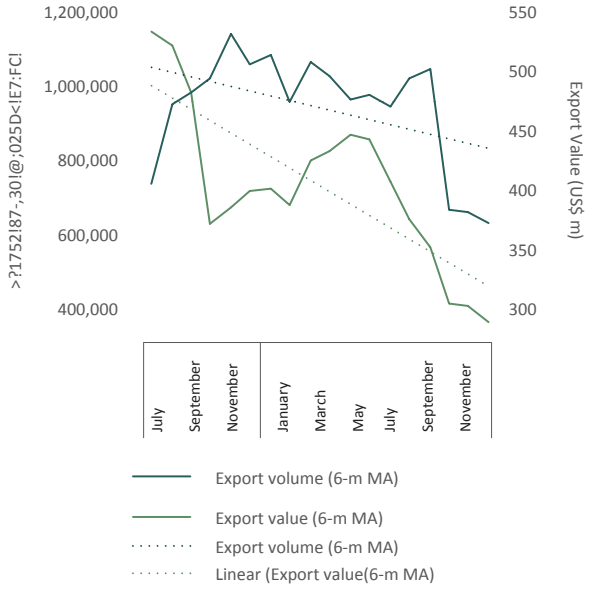
Contraction in exports

Both the volume and the value of exports have contracted due to cyclical factors associated with the large share of commodities in Myanmar's export basket. A combination of declining commodity prices and the devaluation of the Kyat against the US dollar, have led to a drop in the US dollar value of exports. The volume of non-gas and non-industry exports has also declined sharply, falling by around 23 percent in the first three quarters of 2015-2016 compared to the same period last year (Figure 17) due to the impact of floods on agriculture. In developing East Asia, export values have declined much more than volumes (Figure 18), which has been most marked for commodity exporters such as Malaysia and Indonesia.

The drop in international oil prices have started to feed through to Myanmar's gas exports, which contributed to roughly 25 percent of the drop in total exports between August and December 2015 (Figure 19). In the first three quarters of 2015-2016, gas continued to account for around 40 percent of total merchandise exports. Myanmar's gas export prices are revised every quarter by averaging selected heavy fuel prices and production cost indices over the previous 12 months. The effect of the sharp drop in heavy fuel prices that started in the summer of 2014 therefore began to feed through after 3 months, with full pass through after a 12-month lag. This is evident from the US dollar value of gas exports dropping more sharply than the volume of gas exports starting in mid-2015 (Figure 20).

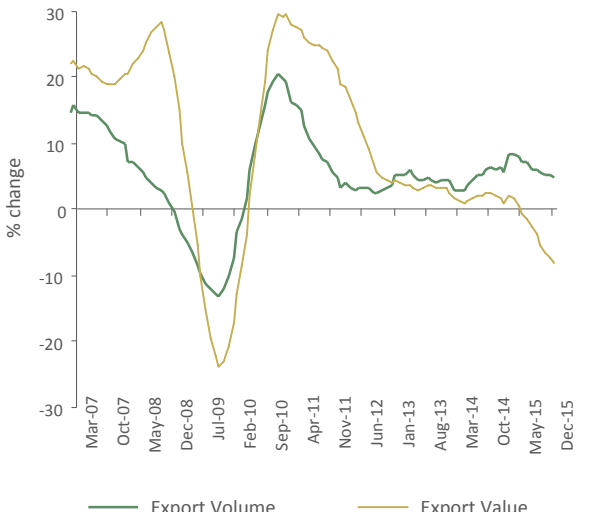
The agriculture sector also suffered a marked decline in exports due to the flood-related supply shock of 2015-2016 (Figure 21). There was a small recovery in the third quarter following the lifting of a rice export ban, including increased supply across the border to China. The volume of beans and pulses exports, which account for over half of agriculture exports, has also declined sharply, though offset to some extent by higher prices in 2015-2016. While the main 2015-2016 harvest

Figure 17. Myanmar non-gas and non-industry export volumes and values (6-m moving average)



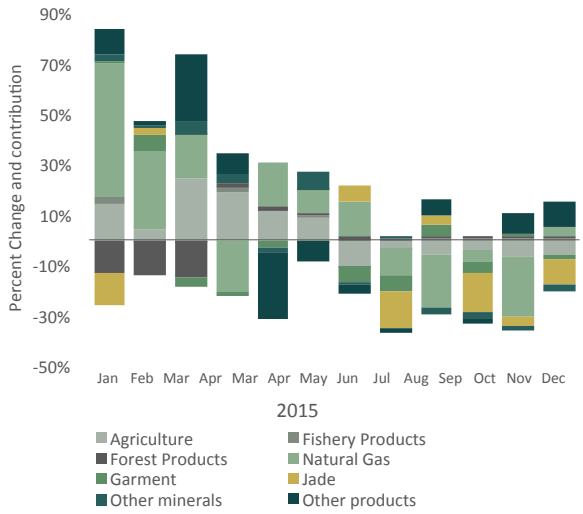
Sources: MOC, Customs, CSO

Figure 18. Developing Asia export volumes and values (yoy change in 12-month moving average)



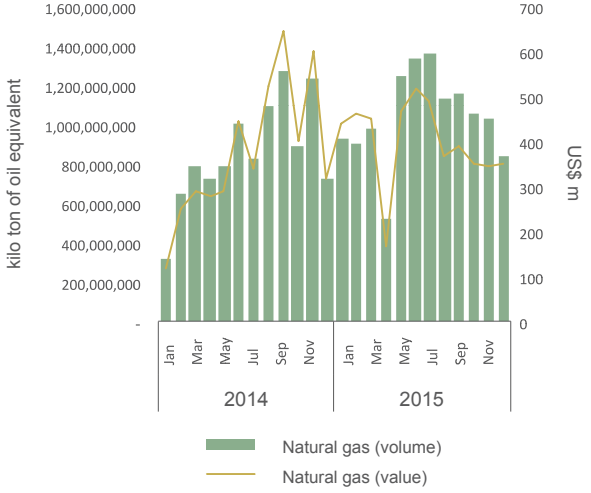
Sources: WB EAP Update, April 2016

Figure 19. Contribution to export growth (% yoy)



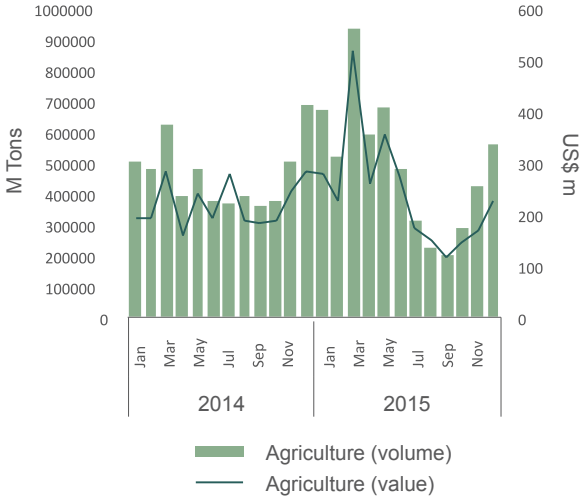
Sources: MOC, Customs, CSO

Figure 20. Volume and value of gas exports



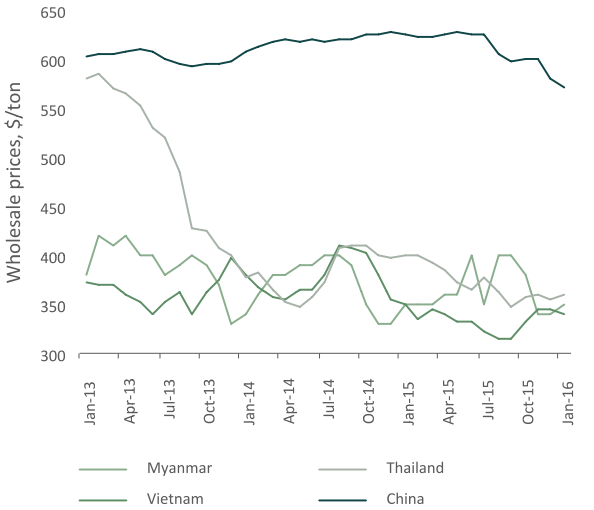
Sources: MOC, Customs, CSO

Figure 21. Volume and value of agriculture exports



Source: MOC, Customs, CSO

Figure 22.Wholesale rice prices



Source: FAO GIEWS

Table 6. Beans and pulses exports (Tons)

	January-March	April-June	July-September	October-December	Total
2014	328,260	431,610	205,041	191,510	1,156,421
2015	306,361	447,739	125,608	71,377	951,085

Source: SGS (Myanmar)

Table 7. Merchandise trade (US$ m)

	2014-2015				2015-2016		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Merchandise exports							
Agriculture	**595**	**654**	**719**	**1,023**	**890**	**442**	**539**
o/w Green Gram	75	59	53	172	116	48	55
o/w Matpe	121	87	80	182	252	95	32
o/w Maize	63	89	148	99	69	57	116
o/w Rice	108	136	144	144	136	51	136
Fishery products	**87**	**109**	**115**	**108**	**103**	**102**	**131**
Forest products	**11**	**15**	**30**	**38**	**42**	**50**	**56**
Industrial finished products	**1,232**	**1,927**	**1,667**	**1,699**	**1,386**	**1,639**	**1,399**
o/w Garment	188	327	258	251	146	226	202
o/w Natural gas	1,011	1,503	1,317	1,351	1,151	1,242	1,044
Minerals	**67**	**727**	**539**	**165**	**132**	**601**	**147**
o/w Jade	2	588	397	34	2	480	86
o/w Metals and ores	34	61	50	40	109	67	55
Other products	**433**	**207**	**89**	**328**	**84**	**140**	**194**
Merchandise imports							
Consumer goods	**590**	**685**	**921**	**717**	**732**	**755**	**868**
Industrial raw materials	**1,477**	**1,467**	**1,275**	**1,463**	**1,067**	**1,269**	**1,253**
o/w Iron and Steel materials	152	186	178	210	193	127	272
o/w Fertilizer	52	80	63	64	47	66	60
o/w Petroleum products	762	694	519	691	422	568	342
o/w Plastic raw materials	129	124	128	120	128	114	134
Investment products	**1,719**	**2,309**	**1,774**	**2,236**	**1,773**	**2,294**	**2,417**
o/w Iron and steel building materials	259	207	200	278	215	169	224
o/w Machinery	531	515	497	454	378	295	508
o/w Cement	75	68	92	113	92	70	67
o/w Electrical distribution equip.	33	63	65	76	49	68	121
o/w Vehicle and vehicle equip.	419	496	498	581	480	478	503

Sources: MOC, Customs

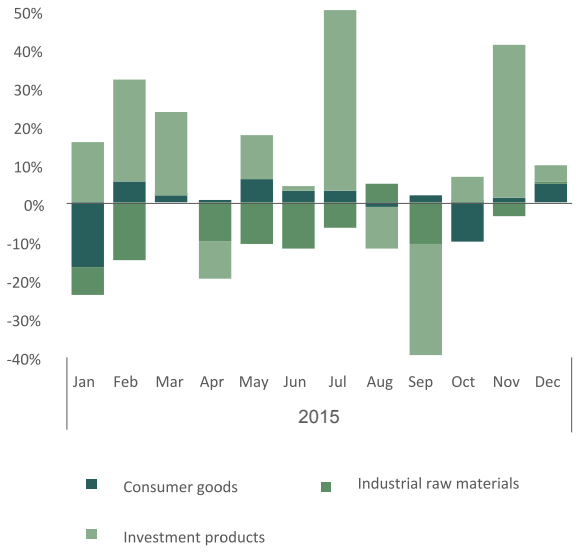
for black gram and pigeon peas is in February-March 2016, the decline in exports in 2015 (Table 6) points to production constraints. Between April and August 2015, Myanmar exported beans and pulses produced in 2014–15. Starting from October 2015 it began to export green gram produced in 2015–16, yet in lower volumes than during the same period of 2014 (Figure 21).

Although there are signs of growing investment commitments in the garment sector, exports in the first three quarters of 2015–16 declined by 14 percent relative to the same period in 2014-2015. This could be related to a combination of slowing external demand, currency devaluation (increasing cost of imported inputs), and structural constraints to expanding production. Garments currently only account for 7 percent of total exports. They have good potential to help Myanmar reduce dependence on primary commodity exports, though garment manufacturing is also highly dependent on imports (Box 1).

Deceleration in imports

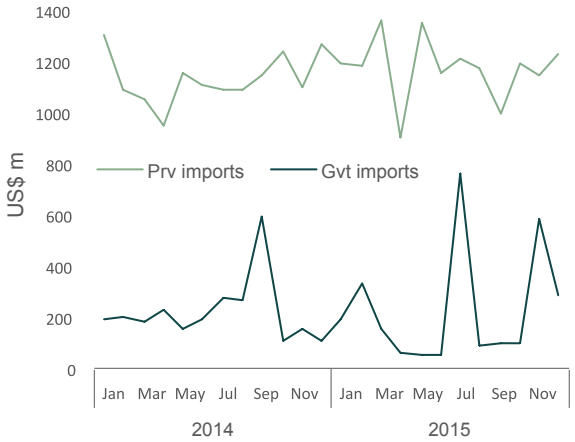
The marked deceleration in import growth is in line with slowing domestic demand. This is associated with a weakening of the Kyat, which has increased the cost of imports, and also to slower growth in private domestic and foreign investment demand, both of which have a high propensity to import. Data for the first three quarters of 2015-2016 show that the import of industrial raw materials were down 15 percent, which is linked to the slowdown in investment activity. The import of petroleum products fell by 30 percent, which accounts for over a third of industrial raw materials' imports and is also likely due to falling petroleum prices. Although investment products, which includes capital machinery, have seen some lumpy increases in July and November 2015 (Figure 23), overall machinery imports were down by 23 percent in the first three quarters of 2015-2016 relative to the same period last year.

Figure 23. Contribution to import (% yoy)



Sources: MOC, Customs, CSO

Figure 24. Private and Government imports (US$ m)



Box 1: Garments as a source of export growth and diversification

The garments sector in Myanmar offers good potential for export growth and diversification. Whilst still very small relative to its Asian competitors, Myanmar could become a major new sourcing hub for global brands in mid- to high-end international markets. Myanmar's garment exports have increased from US$350 million in 2010 to around US$1.5 billion in 2014-2015. Cambodia is about three times larger, Vietnam and Bangladesh 10-15 times larger, and China more than 100 times larger.

Given Myanmar's comparative advantage, it might make sense to import textile products (fabric), whilst developing domestic garment manufacturing capacity. The upstream textile sector (i.e. spinning fiber for yarn, weaving yarn to produce fabric, and dying and cutting fabric) is capital intensive, needs skilled technicians, and requires a competitive business environment to incentivize investment in machinery (capital-labor ratio of typically over US$50,000 per worker).

Downstream garment production on the other hand is very labor-intensive, has provided numerous Low Income Countries, a major source of employment. According to Myanmar's Garment Manufacturer Association (MGMA), employment could reach 1.5 million people within a decade.

Foreign enterprises are leading the establishment of new garment factories in Myanmar, benefitting from access to offshore financial services and a network of suppliers of intermediate inputs. In contrast, local companies are facing higher transaction costs from the underdeveloped financial sector at home, restricted access to foreign exchange, and import clearance procedures.

Myanmar's competitive labor costs provide a strong attraction for foreign investments in the garment sector. In China for example, wages in the main Export Processing Zones are said to range between US$300 and US$1,000 per month, roughly three times the level in Myanmar. While productivity is high in Chinese factories, the scope for further productivity increases in garment activities is limited by the lack of scope for mechanization and the already fast pace of operations in many factories.

But it is important to set industrial salaries at fair levels. This can have positive multiplier effects, including through remittances to poorer rural areas and increased private consumption. As noted earlier also, employment in the garment sector is highly sought after by rural migrants due to the stability of employment.

A big part of the domestic value addition from focusing on downstream garment manufacturing would come from wage employment and supporting services, including transportation, quality inspection and others. Outside of this, domestic value addition is relatively limited given high import content. The downstream garments sector is essentially assembling pre-cut pieces into garments, often under subcontracting arrangements known as "cut, make and trim" (CMT). It can nonetheless provide a very important opening to expand employment and accelerate.

Source: Myanmar Diagnostic Trade Integration Study (2016)

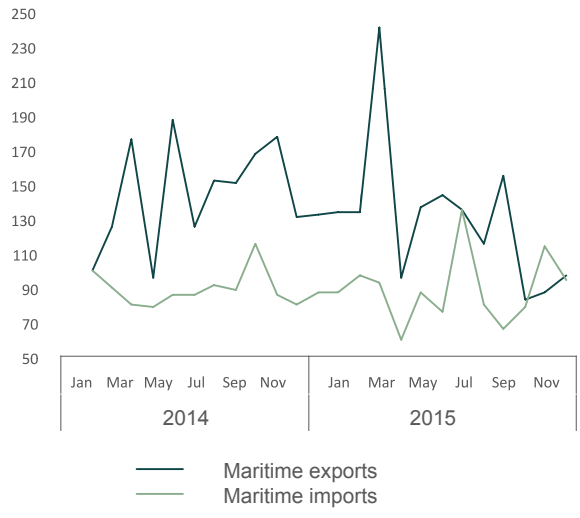
Private sector imports have decelerated significantly and government imports have contracted. Private sector import growth in the first three quarters of 2015-2016 decelerated to 5 percent relative to the same period in 2014-2015, when it grew by 30 percent compared to the same period in 2013-2014. The level of government imports have been more volatile. Despite fiscal expansion in 2015-2016, however, the overall level of government imports contracted by 21 percent in the first three quarters of the year relative to the same period in 2014-2015.

Aside from slowing domestic demand, however, there are signs that policy makers' concerns over a growing trade deficit have prompted measures to contain the demand for imports. Myanmar has come a long way in facilitating external trade by removing restrictions such as the "export first" policy requiring that imports be funded only out of export proceeds, and by opening up the foreign exchange market. Private sector actors however have in the past 8 months expressed concerns over growing administrative hurdles to importing. Many are linked to access to foreign exchange. State Owned Banks that are involved in foreign exchange settlements – namely the Myanma Investment and Commercial Bank and the Myanma Foreign Trade Bank – are slow in remitting funds for payments to vendors, including because of red tape and delays in transfer.

Administrative measures to contain imports could be highly counterproductive. The trade deficit does not pose any immediate concerns in terms of its impact on current account sustainability. The current expansion of the trade deficit is linked to cyclical factors (i.e. agriculture, commodity prices). Plus foreign direct investments are expected to pick when considering the significant spike in commitments over the past year. Although the deficit does affect the Kyat, major foreign investors are likely to be more concerned about a stable rather than a strong domestic currency, particularly if the latter is coming at the cost of trade flows. Moreover, companies investing in

Figure 25. Border trade (January 2014 = 100)

Figure 26. Maritime trade (January 2014 = 100)



Sources: MOC, Customs, CSO

export-oriented industries benefit from a weaker Kyat over the medium to longer-term. Policy transparency and stability can enable investors to factor in exchange rate developments into business planning. Volatility on the other hand can create uncertainty, which could hamper investor confidence.

There are also risks that restricting official trade could further fuel illicit border trade in light manufactures. Around one fifth of total official trade takes place through Myanmar's overland borders. Official cross-border trade has increased by 22 percent between 2014 and 2015 calendar years (Figure 25), whilst maritime trade has declined by around 3 percent (Figure 26). Over 80 percent of official overland border trade is with China, though cross-border trade with Thailand is also expanding rapidly with the opening of the portion of the Asian Highway linking Myanmar and Thailand.

Private businesses have reported that illicit trade in light manufactures (i.e. outside of illicit flows in gems and timber) seems to have increased. Obstructing imports could further exacerbate this, as traders try to circumvent restrictions, in addition to evading customs duties and commercial taxes. This not only affects government receipts negatively, but also harms legitimate domestic businesses that are undercut by smuggled goods. There are of course many other factors that fuel informal cross-border trade, which will need to be gradually addressed. But staying the course on important market reforms could also help.

Fiscal Policy

Growing fiscal stress in 2015-2016

The revised 2015-2016 Union Budget revealed growing fiscal stress, both in terms of a slowdown in projected revenue compared to 2014-2015 and rising expenditure pressures, linked to external shocks (Figure 27). On the revenue side, falling international commodity prices since August 2015 are projected to feed through to lower oil and gas revenue this fiscal year, cushioned to some extent by the devaluation of the Kyat against the US dollar and the steady increase in gas production. A stronger US dollar, however, has also increased the gas purchase bill for the domestic power sector financed out of the Union Budget. Spending pressures were compounded by the rehabilitation and relief needs of the July 2015 floods.

The revised estimates for the 2015-2016 Union Budget accordingly projected growing fiscal imbalances, though these should be offset to some extent by higher than expected revenues in the final outturn. The Union Budget deficit was forecast to increase from an estimated 1.8 percent of GDP in 2014-2015 to around 5.2 percent of GDP in the 2015-2016 revised estimates (Figure 28). The non-oil and gas primary deficit is projected to increase from 4.7 percent of GDP in 2014-2015 to 7.5 percent in the 2015-2016 revised estimates. This is an important indicator of fiscal effort and sustainability given the non-renewable and volatile nature of oil and gas receipts. It can provide a helpful anchor for fiscal policy in Myanmar.

Figure 27. Consolidated public sector spending and revenue

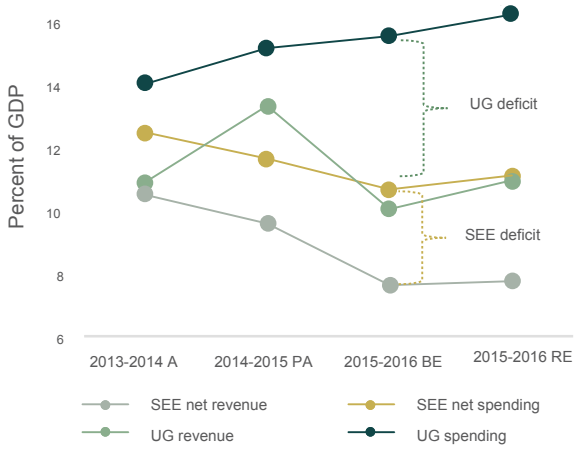
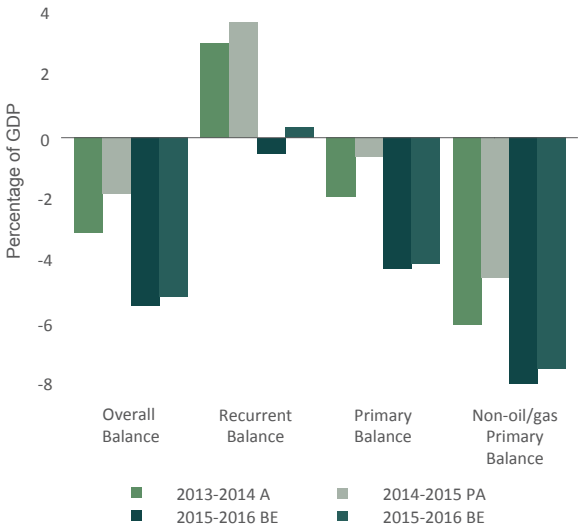


Figure 28. Fiscal balances (% of GDP)



Source: MOPF, CBM, WB Staff estimates

Figure 29. Net domestic financing (Kyat billion)

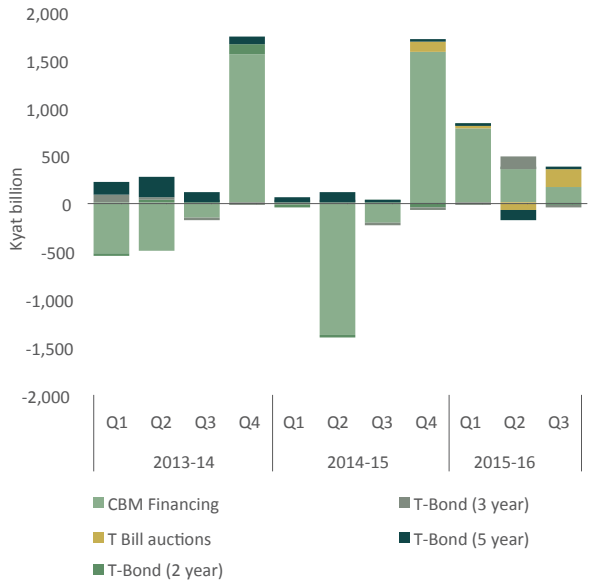
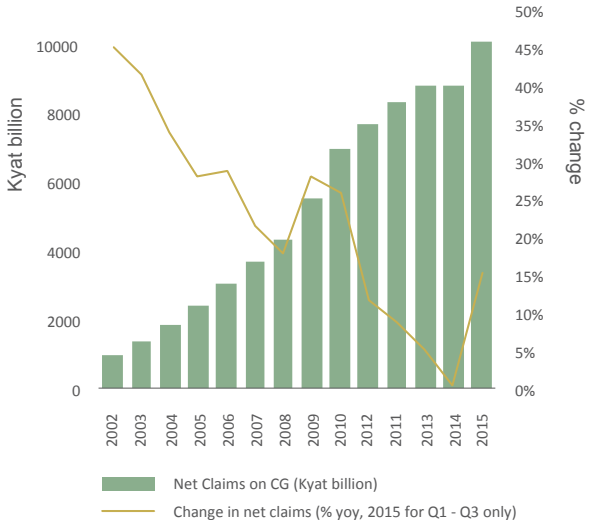


Figure 30. Net claims on government Q1-Q3 (Kyat million)



Source: CBM, MOPF, WB Staff estimates

Primary expenditures will have risen due to the above external developments and higher allocations to defense, health and education. This would translate to a widening of the primary deficit from 0.7 percent of GDP in 2014-2015 to 4.7 percent in the 2015-2016 revised estimates, but also a narrowing of the recurrent surplus from 3.7 percent of GDP to 0.2 percent over the same period. Maintaining a recurrent surplus is important to avoid borrowing for recurrent expenditures. Though, as discussed further below, a significant jump in revenue in 2015-2016 could help narrow fiscal imbalances.

Monetary financing pressures

Fiscal stress has led to increased monetary financing of the Union Budget deficit in the first three quarters of 2015-2016. Net monetary financing in the previous two years was negative in the first three quarters of the fiscal year, before picking up again in the last quarter (Figure 29). But in 2015-2016 it remained positive throughout this period due to the spending pressures noted above. Monetary financing had decelerated in recent years, thanks to improved revenue collection, and the government's policy to limit monetization and control inflation. In the first three quarters of 2015-2016, however, net borrowing from CBM increased by 15 percent since the end of the fiscal year 2014 – 2015. (Figure 30).

Efforts to diversify financing sources are under way, though domestic debt markets are still at a very early stage of development. The Treasury-Bill auctions initiated in January 2015 to raise short-term financing from the markets have been undersubscribed. Bids have amounted to less than half of what was offered, and a growing share is purchased on a non-competitive basis by State Owned Banks (Figure 33). The low bids are not due to tight liquidity conditions. The limited uptake is more likely due to lower than expected discount rates, averaging around 7.4 percent since January 2015, which translates to negative real return for investors after factoring in inflation.

Figure 31. Treasury Bonds outstanding (Kyat million)

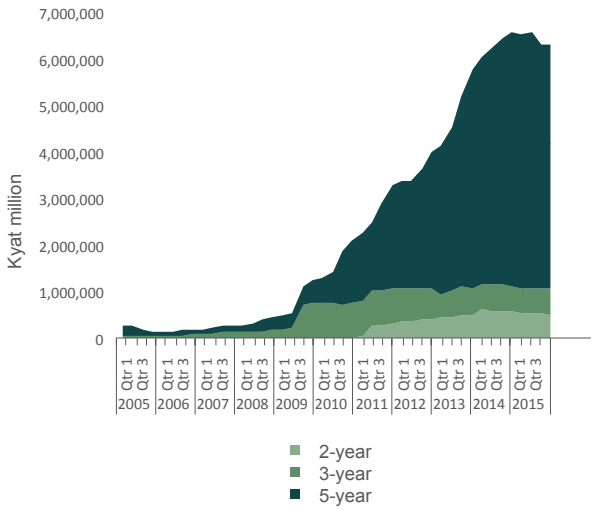
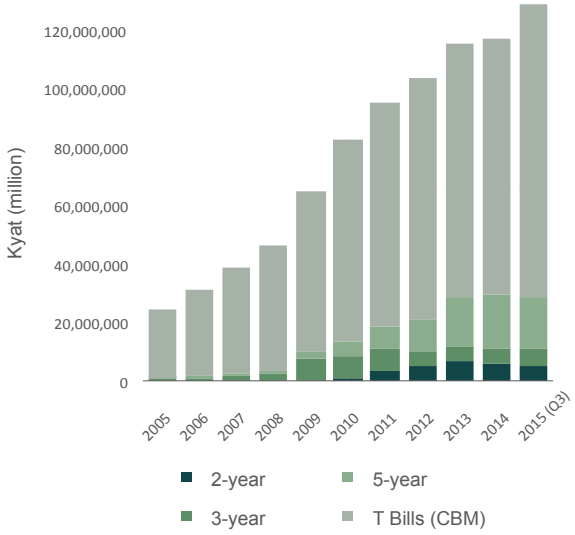


Figure 32. Outstanding domestic debt (Kyat million)



Source: CBM, MOPF, WB Staff estimates

The government has made efforts to shift from short towards more medium-term financing through Treasury Bonds, which is more closely aligned with infrastructure financing needs. Financing from medium-term Treasury-Bond subscriptions – particularly 5-year maturity ones – has grown quickly in the past two years (Figures 31 and 32). From the 2016-2017 fiscal year, the government plans to introduce Treasury-Bond auctions. Myanmar's domestic debt portfolio however remains largely dominated by short-term borrowing from CBM. Moving towards longer-term financing instruments is critical for Myanmar's public investment needs in transportation, power and other infrastructure. Though given the current situation of the relatively shallow domestic debt markets, the government will need to consider alternatives such as long-term external debt on concessional terms.

External debt disbursements have started to pick up gradually, though accounted for a relatively small albeit growing share of net financing in 2013-2014 and 2014-2015. This relatively low contribution is partly because Myanmar has only recently started to reengage with external creditors, including International Financial Institutions and other concessional lenders. Although commitments have picked up rapidly, disbursements will follow with a lag as individual external debt instruments are mostly linked to specific projects, rather than general capital expenditure. Implementation of these projects, and therefore loan disbursements, can be slow in the initial preparatory phase, before they begin to pick up over the medium-term. Although external debt has exchange rate risks, most of the external borrowing is at lower cost and longer maturity, therefore lower refinancing risks, compared to domestic financing.

Figure 33. Treasury Bill auction results (Kyat billion)

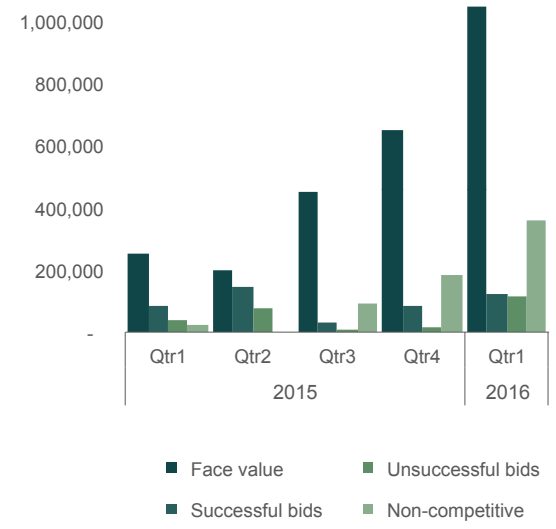
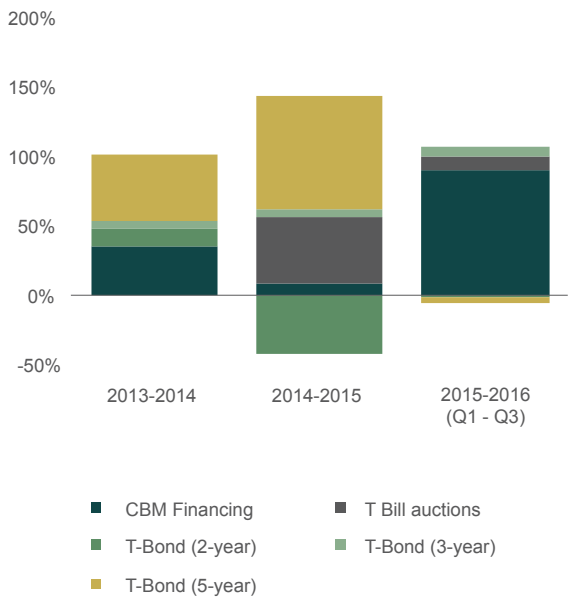


Figure 34. Share of net financing (%)



Sources: CBM, MOPF, WB Staff estimates

Figure 35. Breakdown of tax receipts (% of GDP)

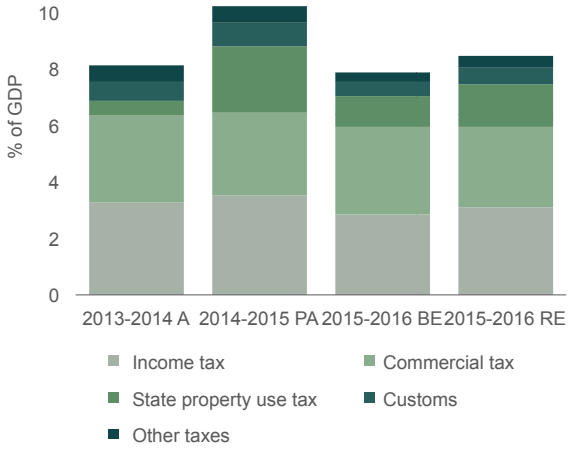
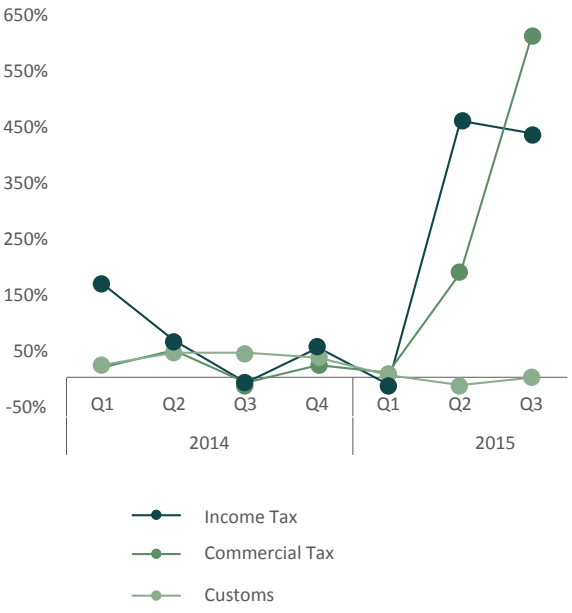


Figure 36. Tax and customs collections (% change yoy)



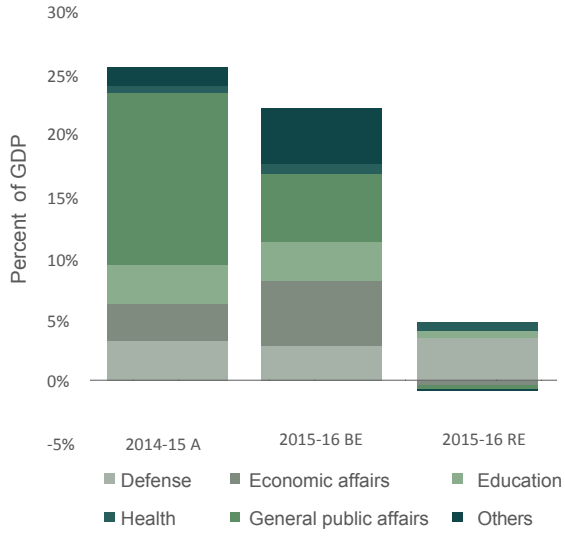
Sources: MOPF, CSO/IRD, WB Staff estimates

Table 8. Union Government Revenue (% of GDP)

	2013-2014 A	2014-2015 PA	2015-2016 BE	2015-2016 RE
Union Government Revenue	**10.8**	**13.3**	**10.0**	**11.0**
Tax	**8.1**	**10.3**	**7.9**	**8.5**
Income tax	3.3	3.5	2.8	3.1
o/w SEEs	1.1	1.2	0.9	0.9
Commercial tax	3.1	2.9	3.1	2.8
o/w SEEs	0.8	0.7	0.8	0.6
State property use tax	0.5	2.4	1.1	1.5
Customs	0.7	0.8	0.5	0.6
Other taxes	0.6	0.7	0.3	0.4
State lottery	0.1	0.0	0.0	0.0
Non-tax	**2.6**	**2.8**	**1.9**	**2.0**
Other non-tax	1.2	1.4	0.9	1.0
SEE transfers	1.4	1.4	1.0	1.1
Grants	**0.1**	**0.3**	**0.3**	**0.5**

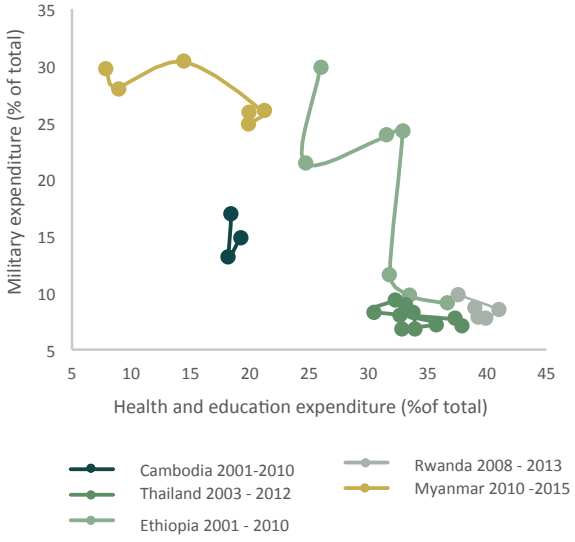
Source: MOPF, WB Staff estimates

Figure 37. Contribution to expenditure growth (% change)



Source: MOPF, WB Staff estimates

Figure 38. Military vs. health and education expenditure (% of general government expenditure)



Source: MOPF, WDI, and WB Staff estimates

Adjusting to declining windfall payments

Although Myanmar's Union Budget is not heavily resource dependent, oil and gas revenues are sufficiently important to impact on fiscal vulnerabilities. General government receipts are projected at around 11 percent of GDP in 2015-2016, dropping from 13.3 percent in 2014-2015 when the government received windfall telecom license payments. Taxes account for three quarters of general government revenue (Figure 35), and non-tax income for around 20 percent. Oil and gas revenues, which are estimated at around 17 percent of total revenue in 2015-2016, are projected to decline from 2.2 percent of GDP in 2014-2015 to 1.9 percent in 2015-2016 (Table 8). Volatility in oil and gas receipts due to price, quantity and/or exchange rate developments, therefore can have significant implications in Myanmar for adjustment to spending plans and/or the overall public debt burden.

At the same time, and despite the external shocks faced by the economy, tax collections could have risen rapidly over the course of 2015-2016. This could be linked to tax administration reforms introduced in the past two years, including self-assessment for income tax by those registered in the Large Taxpayers' Office. Large taxpayers were able to self-assess one year ago and had to set up advanced payments for the fiscal year beginning in April 2016. Therefore payments into the Union Budget in 2015-2016 could have increased. Often such reforms are also accompanied by a jump in commercial, and other consumption-related taxes, which seems to have also been the case in Myanmar. This may contribute to a consolidation in the deficit compared to the revised 2015-2016 estimates of November 2015 discussed above.

Adjustments to government expenditures

Emerging spending needs in 2015-2016 were accommodated through an increased spending envelope and some spending adjustments across the revised 2015-2016 Union Budget. The total spending envelope increased by around 4 percent relative to the original budget. Planned spending on defense went up by 14.7 percent, health by 11.2 percent, and education by 5.1 percent. Given the relatively large share of defense spending in the Union Budget, this was the largest contributor to the overall increase (Figure 37). There have been some cutbacks in economic affairs; general public services; recreation, culture and religion; and social protection. Though these have been relatively small. Within government functions, capital spending went up by 9 percent, including a 25 percent increment for defense; recurrent spending on the other hand went up by 2 percent, including an 18 percent increase for health.

Priority health and education spending have seen large increments over the past 5 years, and whilst spending is still below needs, the pattern of further increases deserve close consideration. The share of health and education spending has increased rapidly from 8 percent of the Union Budget in 2010 to around 20 percent in 2015. Part of this was financed out of reallocations from expenditure on defense and general public services (Figure 38). More and better spending on school stipends and basic healthcare packages are helping to improve human development outcomes. Increased spending on social assistance, which is currently estimated at 0.02 percent of GDP compared to an average of 1.1 percent of GDP across Low Income Countries, could have a big impact on the ability of the poor and the vulnerable to access services.

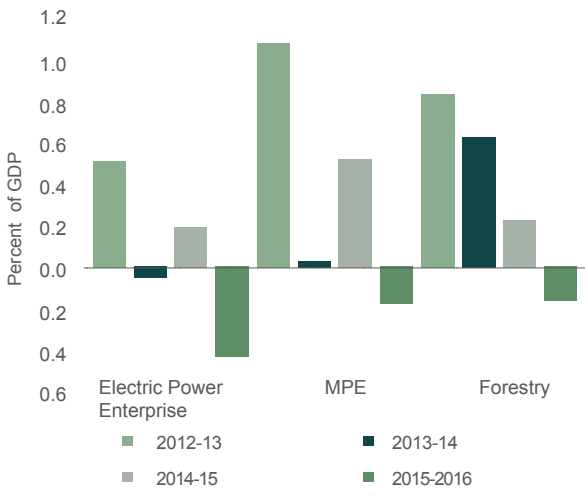
Not all rapid increase on health and education programs, however, are equally effective. For example, more resources for building health facilities in rural areas could be constrained by public investment management capacity. Similarly

increased spending for teacher recruitment could be constrained by the availability of qualified instructors. The alignment of the Union Budget with development priorities should therefore not just be judged by the overall pace of reallocation of spending to the social sectors. More rapid reallocations could be offset by higher level of inefficiencies. The pace of reallocations depends greatly on country-specific economic, institutional and social factors.

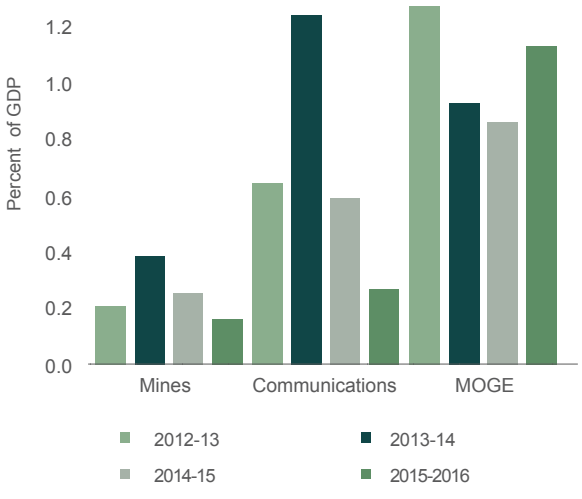
Growing operational deficit of State Economic Enterprises

The operational surplus of SEEs as a whole has declined relatively sharply due to a combination of exchange rate devaluation and falling commodity prices. The exchange rate devaluation has increased the Kyat cost of gas purchase for the power sector. In the absence of an upward adjustment in electricity tariffs, this has sharply increased the operational deficit of the Myanmar Electric Power Enterprise (Figure 39). Similarly the drop in international commodity prices has also affected the profits of Myanmar Petroleum Enterprise, which in the 2015-2016 revised estimates also recorded a large deficit. At the same time, however, the operating surplus of the Myanmar Oil and Gas Enterprise (MOGE) is expected to increase, which suggests that the drop in gas prices may have been offset by exchange rate and production changes.

Figure 39. Operational balance of selected SEEs (% of GDP)



Sources: MOPF, WB Staff estimates



Sources: MOPF, WB Staff estimates

Table 9. SEE payments to Union Budget (% of GDP)

	2012-2013 PA	2013-2014 PA	2014-2015 PA	2015-2016 BE	2015-2016 RE
Total	**3.9**	**3.2**	**3.3**	**2.6**	**2.6**
Economic affairs	**3.1**	**2.6**	**2.6**	**2.1**	**1.9**
o/w oil and gas	2.1	1.8	1.7	1.4	1.2
Environmental protection	**0.2**	**0.2**	**0.2**	**0.2**	**0.3**
General public services	**0.6**	**0.4**	**0.5**	**0.3**	**0.4**

Source: MOPF, WB Staff estimates

External developments aside, however, policies linked to the management of SEEs within the government's overall fiscal framework may require careful review. For example, one of the factors explaining the decline in SEE payments into the Union Budget (Table 9) is that several SEEs are now being absorbed into their parent ministries as administrative units. Those that are profitable are still required to pay taxes to the Union Budget, but as administrative units, they are no longer liable for contributions out of their profits. Another issue is the treatment of net profits (i.e. post taxes and contributions). Currently SEEs are able to retain more than half of net profits. This could be sizeable, particularly for enterprises operating in the hydrocarbon sector such as MOGE. Given the current context, however, it may be better to consolidate net profits in the Union Budget, and channel any investment needs of SEEs through the same.

Table 10. Fiscal operations (% of GDP)

	2013-2014 PA	2014-2015 PA	2015-2016 BE	2015-2016 RE
Consolidated public sector				
Revenue	**21.3**	**22.9**	**17.7**	**18.7**
Expenditure	**23.2**	**23.5**	**23.6**	**24.7**
Recurrent	14.8	16.3	16.9	17.4
Capital	8.4	7.2	6.7	7.3
Balance	**(1.9)**	**(0.6)**	**(5.9)**	**(6.0)**
SEE operations				
Revenue	**13.7**	**12.9**	**10.2**	**10.4**
Revenue (net of transfers to GG)	10.5	9.6	7.6	7.7
Expenditure	**12.5**	**11.6**	**10.7**	**11.1**
Recurrent	**10.2**	**10.0**	**9.0**	**9.3**
Recurrent (net of transfers to GG)	7.0	6.7	6.3	6.7
Capital	2.3	1.6	1.7	1.8
SEE operating balance	**3.5**	**2.9**	**1.3**	**1.0**
Union Government				
Revenue	10.8	13.3	10.0	11.0
Tax	8.1	10.3	7.9	8.5
o/w oil & gas	1.7	1.7	1.5	1.5
Non-tax	2.6	2.8	1.9	2.0
o/w oil & gas	0.5	0.4	0.4	0.3
Grants	0.1	0.3	0.3	0.5
Expenditure	14.0	15.2	15.6	16.2
Recurrent	7.9	9.6	10.6	10.7
o/w interest	1.2	1.2	1.2	1.1
Capital	6.1	5.5	5.0	5.5
Union Government Balance	**(3.1)**	**(1.8)**	**(5.5)**	**(5.2)**
Recurrent Balance	3.0	3.7	(0.5)	0.2
Primary Balance	(1.9)	(0.7)	(4.3)	(4.1)
Non-oil/gas Primary Balance	(6.1)	(4.7)	(8.3)	(7.5)
Net Financing	**3.1**	**1.8**	**5.5**	**5.2**
External	0.3	0.2	0.6	0.5
Domestic	2.8	1.7	5.0	4.7

Sources: MOPF, WB Staff estimates

Inflation, monetary and exchange rate

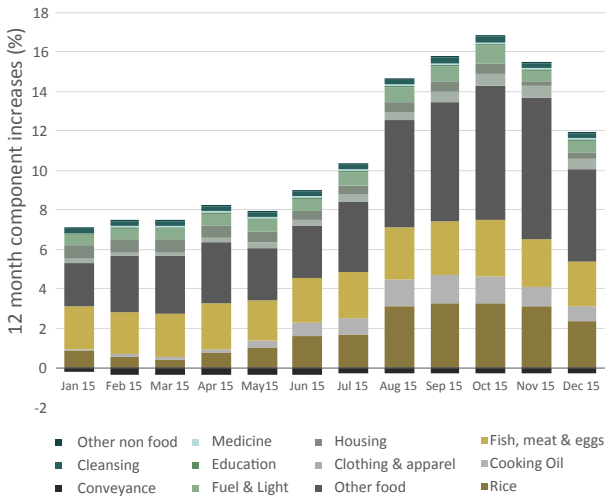
Growing inflationary pressures

Inflationary pressures have picked up rapidly over the course of 2015-2016. The prices of staple and processed foods have increased sharply due to supply pressures linked to the July 2015 floods and exchange rate depreciation. Inflation rose persistently from the beginning of the year before peaking at 16 percent in October 2015. Core inflation (excluding food and energy) also peaked in October at 8 percent before slowing to 5.2 percent at the close of the year. Significant inflation pressure as well as price volatility contrast with most countries in the region and reflects Myanmar's challenging circumstances: an important supply-side shock and sharp exchange rate correction following real exchange rate appreciation pressure amid past expansionary monetary and fiscal policies. The Central Bank has adjusted down the Kyat-Dollar exchange rate and the Kyat has also depreciated against the currencies of all major trading partners.

Food components drove inflation in 2015 due to both flood and exchange rate depreciation. In particular, the contributions of rice and cooking oil prices increased substantially (Figure 40). Cooking oil and milk products, on the other hand, constitute the largest share of food imports and domestic price increases reflected exchange rate depreciation. The contribution of fish, meat and eggs remained steady in line with world prices. Subsequent exchange rate appreciation saw inflation pressure, as well as food price pressure, abate. Nevertheless, food inflation pressure remained high at the end of 2015.

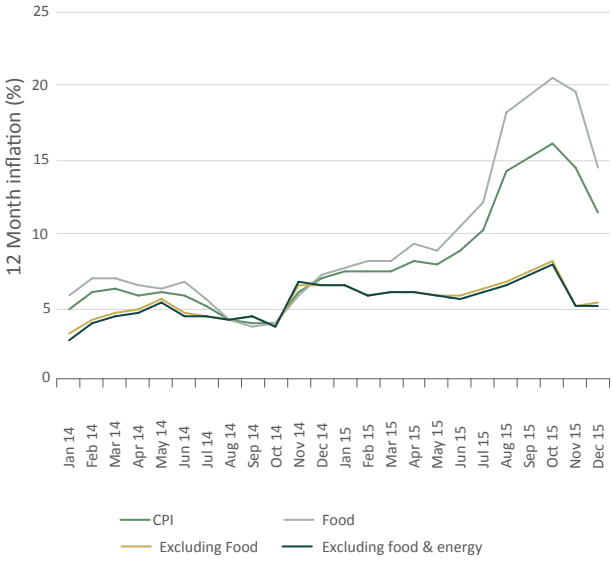
Housing cost increases show signs of slowing amid indications of excess supply in some segments of the residential market. Housing price increases have slowed continuously from 26 percent in beginning of the year to 9.7 percent at the close of the year. Prior to this, housing cost had been a major driver of non-food inflation due to supply shortages in the rental market amid heightened

Figure 40. Inflation contribution by component



Source: CSO, WB Staff estimates

Figure 41 . Inflation dynamics



demand for commercial and residential real estate from foreign investors and donors.

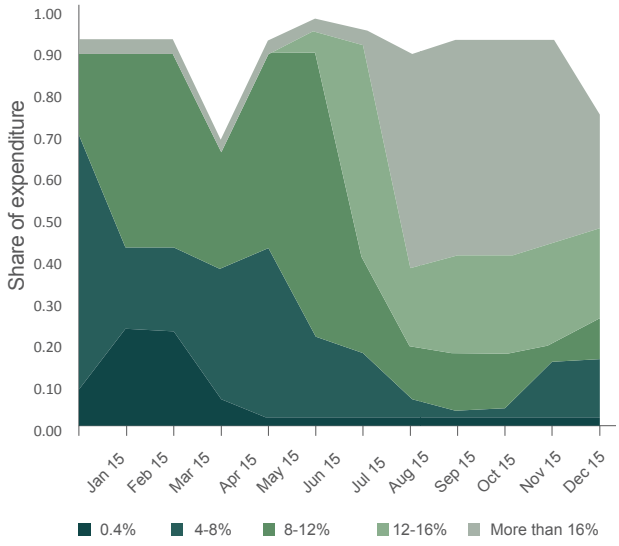
Core inflation (i.e. CPI excluding food and energy) accelerated somewhat in 2015, peaking at 8 percent in October 2015 towards the end of the year. The large divergence between core and overall inflation that began in May and culminated in September 2015 underlines how inflation has mostly been driven by the rise of food prices *relative* to non-food prices rather than a broad-based rise in prices across all components normally seen in demand-led inflation. At the same time, pressures on underlying inflation were likely exacerbated by the recent increase in monetization of the deficit.

There is a risk that prolonged supply-side price pressure may feed into second-round inflation and lead to accelerating core inflation should inflation expectations become unanchored. However, compared to the devaluation episode of October 2014, as opposed to the recent episode, the relationship between core inflation and overall inflation seems to have weakened probably due to the relative prominence of supply-side shocks.

The following chart plots the evolution of the distribution of price increases in the monthly component data over the past year (Figure 42). The chart shows the percentage of the components each month, weighted by their share in the consumption basket, for which prices grew between 0 and 4 percent (at an annual rate); between 4 and 8 percent; between 8 and 12 percent; between 12 and 16 percent; and more than 16 percent. Components with negative growth are omitted and hence account for the "missing" expenditure share in the graph.

Approximately 60 percent of price increases in January 2015 were mostly in the range of 4-8 percent and reflects underlying demand-led inflation. However, beginning in July 2015, the dispersion of price components increased significantly with rising shares of price component increases in the higher brackets of 12-16 percent and above 16 percent. This greater dispersion is consistent with supply-side price shocks that affect only certain prices. Supply-side shocks tend to be short-term and as such, price pressure should begin to abate if inflation expectations remain anchored.

Figure 42. Evolution of the distribution of price component increases



Sources: CSO, WB Staff estimates

Slight deceleration in overall money growth

After a period of strong money growth in previous years amid expansionary monetary and fiscal policies, overall money stock (M2) growth has decelerated due to demand moderation, particularly in terms of credit to the private sector, which nonetheless remains high. Overall money growth reached a five-year peak growth rate of 48 percent in 2012-2013. Money growth is expected to have moderated in 2015-2016 amid a slowing economy. Price pressure brought about by a supply side shock has started to abate. Moderated monetary expansion and sound monetary policy can help ensure that first-round supply-side price increases do not feed into underlying inflation. Nevertheless, policy challenges remain, including the inflationary monetary financing of the budget.

In the past two years, monetary expansion was driven by a shift in the contribution to growth in money stock from public to private sector demand as economic reforms took hold. Recent monetary developments suggest a rebalancing between private and public sector demand. Credit to the private sector has slowed in 2015-2016 though remains high (28 percent year-on-year growth in November 2015) while Net Foreign Assets have continued to expand. Public sector financing needs have historically been a major driver of reserve money growth and a major contributor to inflation in Myanmar. These needs, were, and still are largely met through short-term CBM financing. A policy priority for the government has been to reduce highly inflationary monetary financing of the budget and replace it by developing deep and liquid domestic debt markets.

Recent exchange rate developments

The Myanmar Kyat experienced a sharp devaluation between June and September 2015, before gradually stabilizing in the third quarter of 2015-2016. Myanmar's currency depreciated more quickly than that of its trading partners in 2015 (Figure 43). The Nominal Effective Exchange Rate (NEER) – an index of the Kyat against a weighted average of currencies of Myanmar's trading partners – fell 14 percent in 2015 compared to a 27 percent nominal depreciation in the Kyat against the US dollar over the same period.

Myanmar's trading partners also experienced currency depreciation due to a combination of the general strengthening of the US dollar and slowing exports, particularly among commodity exporters. The Kyat's relatively steeper decline is a result of imbalances in the exchange rate system as the official supply of US dollars fell short of demand particularly in the latter half of 2015, and and also due to growing trade imbalances. Malaysia's Ringgit experienced a similarly big drop in its NEER due to declining commodity exports.

A devaluation of the Kyat in July 2015 helped improve external competitiveness. The Real Effective Exchange Rate (REER) – an index of the Kyat against currencies of all trading partners, adjusted for trade weights and relative inflation – dropped by 11 percent in the first 5 months of 2015-2016 (Figure 44). The devaluation was important to help maintain external competitiveness.

Since the beginning of 2016, the Kyat has started to regain strength, partly due to lower seasonal demand for imports. Between January and March 2016, the Kyat appreciated seven percent in nominal terms against the US dollar. Seasonal factors, including lower import demand during the Chinese New Year was highlighted as one factor behind this.

Constraints on foreign exchange transactions

The volume of currency traded in the official foreign exchange auctions has gradually declined over the course of the year. The level of bids submitted by commercial banks has been relatively steady reflecting strong effective demand for foreign exchange (Figure 47). However, the gap

Figure 43. Nominal Effective Exchange Rate

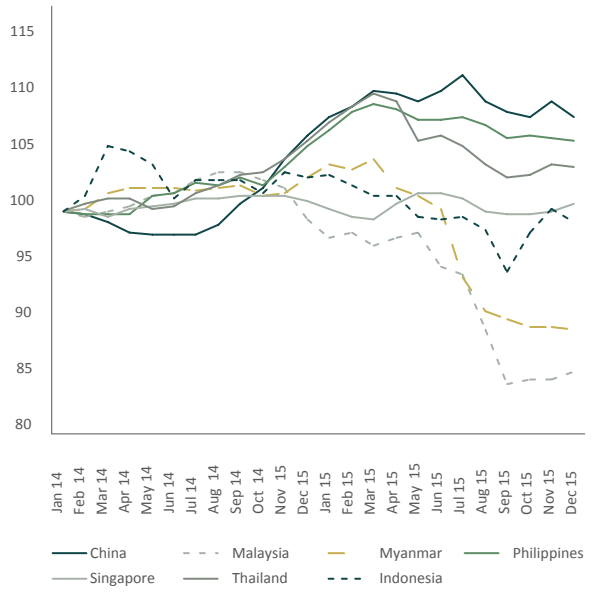
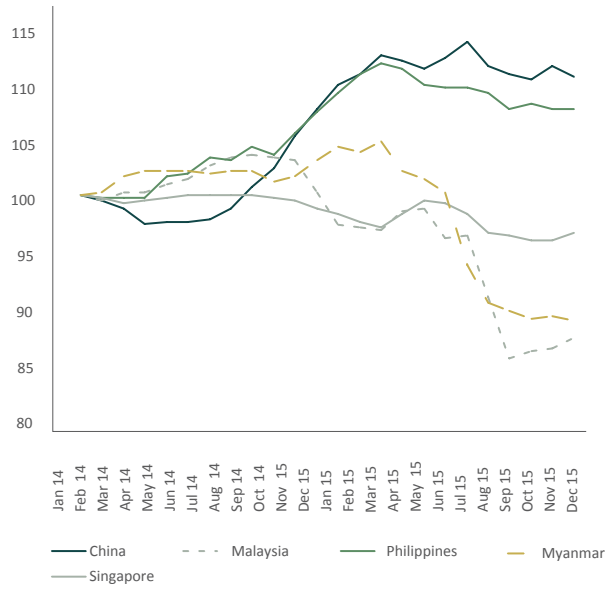


Figure 44. Real Effective Exchange Rate



Source: Central Statistical Organization, CEIC, IFS, World Bank staff estimates.

between successful bids on the one hand and US dollars sold by the Central Bank on the other (i.e. unsatisfied demand) has been fairly significant. This may be a reflection of lower foreign exchange reserves – estimated at 2.9 months of import cover in November 2015 – resulting from a slowdown in foreign investments.

The introduction of the interbank foreign exchange market could also help explain some of the decline in trades on the foreign exchange auctions, though activity on the interbank market has also not been that significant (Figure 35). The Central Bank's US dollar purchases on the other hand has remained relatively steady and increased sharply in the last quarter of the fiscal year, possibly reflecting a policy to shore up foreign exchange reserves (Figure 49).

There are also some indications that effective demand for foreign currency is being contained by various measures, which may also partly explain some of the recent appreciation in the Kyat. Traders have complained about indirect controls including delays in making external transfers electronically, and red tape to justify payments to external vendors. This has frustrated the demand for foreign exchange from importers that need to make payments and foreign firms that need to repatriate revenue earned in Kyat.

In addition, State Owned Banks are responding to demand for foreign exchange by handing over cash to importers, which in turn cannot be used to settle foreign payments. This has raised commercial banks' foreign exchange exposure risk. This has pushed commercial banks to physically ship cash abroad to their nostro accounts.

A well-functioning exchange rate system is at the heart of Myanmar's ability to take advantage of trade and investment opportunities. Reforms in the exchange rate arrangements and lifting of exchange restrictions (Box 2) have helped increase trade flows over the past five years, which are contributing to economic growth. However, direct and indirect measures to prevent the currency from further depreciating could be hampering the proper functioning of the official exchange rate system.

Figure 45. Range of Kyat-USD Parallel Rate

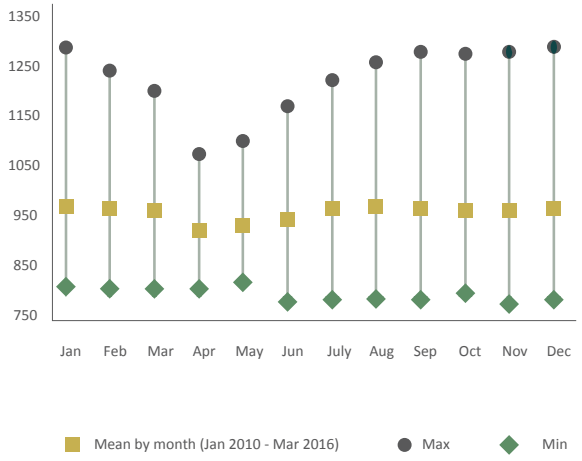
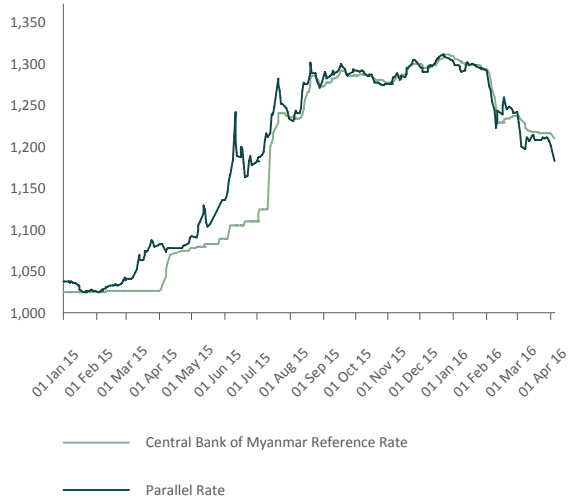


Figure 46. Official and Parallel Exchange Rates



Source: IMF, Naungmoon.com, Central Bank of Myanmar

Figure 47. Bids and offers submitted daily at the foreign exchange auction

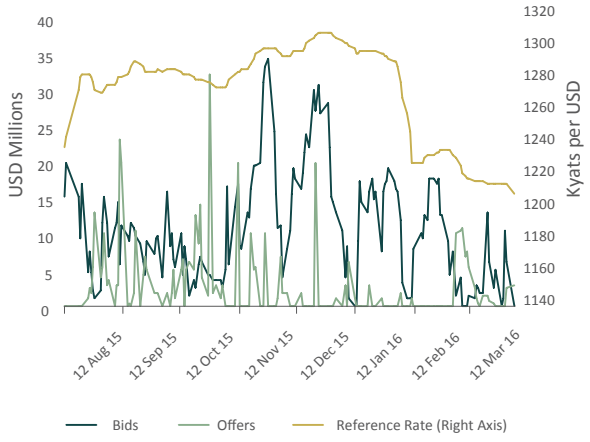
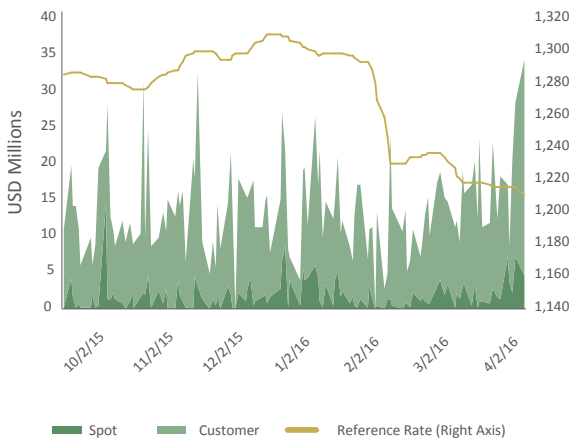
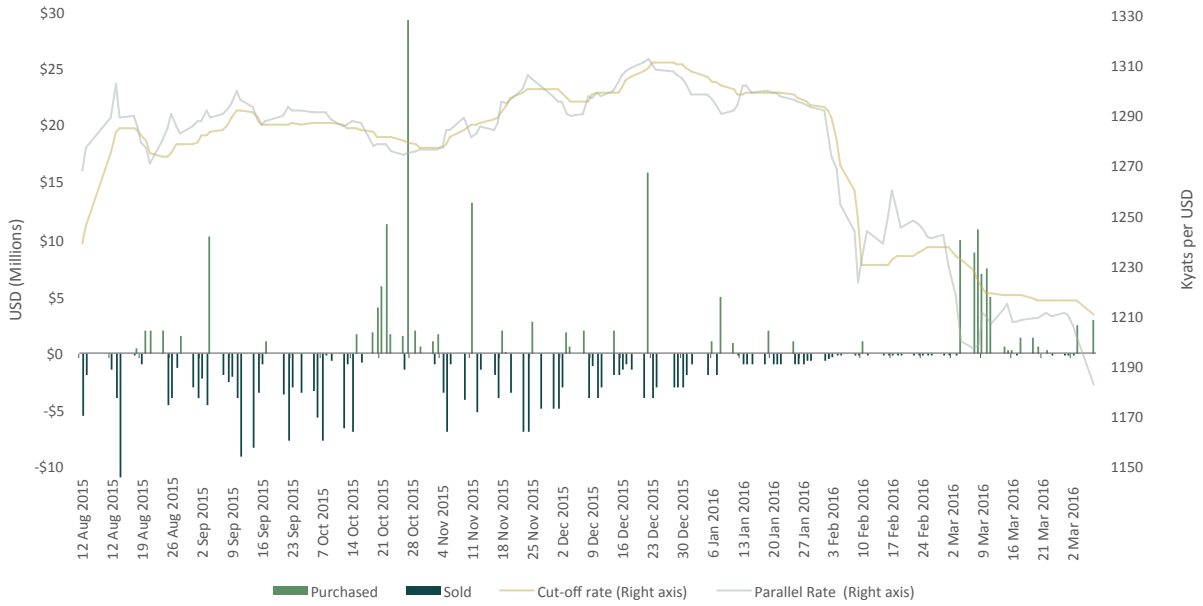


Figure 48. Total daily turnover in the interbank foreign exchange market



Source: Central Bank of Myanmar

Figure 49 . Daily Auction Results



Source: Central Bank of Myanmar

Box 2. Exchange rate reforms

Liberalizing foreign exchange transactions: Until private banks were granted authorized dealer licenses in November 2011, only two state-owned banks, Myanma Investment and Commercial Bank (MICB) and Myanma Foreign Trade Bank (MFTB) could carry out foreign exchange transactions. Money changer licenses were granted to non-bank businesses and companies beginning in December 2011 and within a year, there were 150 money exchange counters throughout Myanmar by 136 companies indicating a rapidly growing demand for such services. Authorized dealer license holders are banks that are allowed to conduct wholesale noncash transactions. Money changer license holders, on the other hand, are only allowed to deal with foreign currency transactions in cash and traveler's checks.

Controlling informal trade payment channels: Enactment of the Foreign Exchange Management Law in August 2012 followed by Rules and Regulations in September 2014 lifted restrictions on import and export payments, and transfers abroad. In addition, authorized dealer license holders are allowed to open bank accounts abroad (also known as nostro accounts) with a requirement that balances of those accounts be reported to the Central Bank on a designated schedule. The law also allows citizens to open foreign currency bank accounts (in USD) at authorized private banks in Myanmar. These are efforts to limit informal international funds transfers that were commonplace before the reforms. The informal system involves importers and exporters opening up bank accounts in a third country where the transfer happens. However, indications are that these arrangements still exist for trade payments and border trade.

Foreign Exchange Auctions and Interbank Foreign Exchange Market: The Central Bank of Myanmar (CBM) adopted a managed float exchange rate regime in April 2012 and began holding two-way multiple price foreign exchange auctions (in U.S. dollar) every business day. Banks holding authorized dealer licenses are eligible to participate and that includes three state-owned banks. The cutoff rate at the auction is the reference rate for that day and a variation of +/- 0.8 percent from the reference rate is allowed for licensed foreign exchange dealers. Information on the auction including volume and price of bids and offers are uploaded to the CBM website on the day of the auction (Figure 48). Participating banks are not announced publicly and there are concerns that state owned banks do not participate in the auctions despite having the funds to do so.

At least one business day before the auction, CBM publicly announces the time and place, bid requirements, settlement period, and other information as necessary. On the day of the auction, banks submit bids to purchase USD from CBM and/or offers to sell USD to CBM. CBM then determines the cutoff rate. Until December 2014, bids that were above the cutoff rate and offers that were below the cutoff rate were satisfied in full while bids at the cutoff price were prorated. However, USD is now allocated on the basis of amount bid as opposed to price as mentioned above (Annual Report on Exchange Arrangements and Exchange Restrictions, IMF 2015). In other words, CBM determines the cut off rate as well as the amount of USD to be sold and purchased. Thus, not every bid that is above the cutoff rate and every offer that is below the cut off rate will be satisfied.

The interbank foreign exchange market began in August 2013 and is expected to replace the current auction system once it is fully developed. Authorized dealers are eligible to participate and there is no intervention from CBM. However, only a few private banks participate and there is minimal participation from state owned banks. Low volume of transactions also indicate that the uptake has been slow (Figure 35).

Since switching from an overvalued pegged exchange regime existed since 1977 to a managed float in 2012, the official rate and informal market rates have been moving closer, though there are indications that the reference rate follows the parallel market, instead of the other way round.

Economic outlook

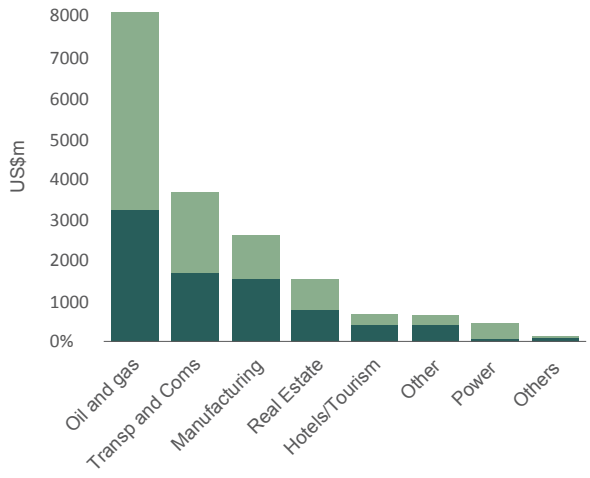
Gradual recovery in growth

Real GDP growth in Myanmar is projected to rise to 7.8 percent in 2016-2017, and average 8.2 percent per year over the medium-term. Private investment should continue to expand at a steady pace, particularly given the very rapid accumulation of investment commitments in the past two years. Foreign Direct Investment commitments over this period have reached close to US$ 17 billion, nearly half of which is in the oil and gas sector (Figure 50). An important share of this FDI will be channeled to imports of equipment, machinery, construction materials, and external technical services. Value addition over the short-term is expected to come from FDI needs for domestic services, and growth in employment in those services. This in turn is expected to continue driving strong growth in private consumption. Public consumption and investment are also expected to grow, as the new government focuses on its pledge to improve the delivery of public services.

On the supply side, the agriculture sector is projected to recover from its supply shock over the short-term, though there are downside risks from effects of El Niño, which have created severe drought in early 2016. As reported in the last Myanmar Economic Monitor, floods, unlike other natural disasters, tend to have a positive impact on economic growth over the medium-term. This is integrated in the forecast for 2016-2017, which estimates that agriculture growth should pick up to 4.5 percent in real terms.

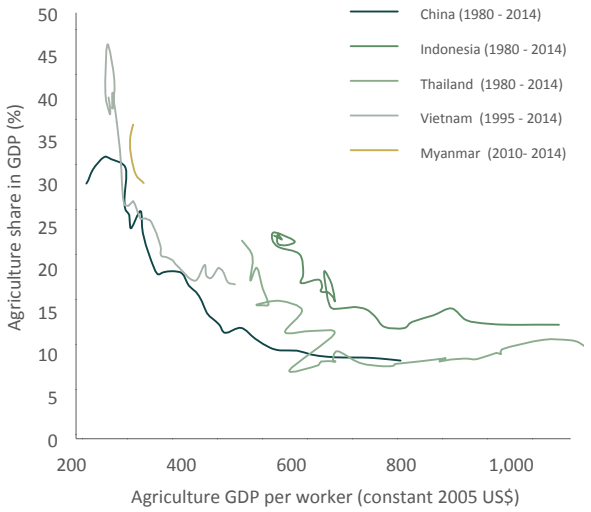
Continued agricultural expansion however will require increased attention on boosting productivity through in particular enhanced supply of technology, seeds and extension programs; and greater foreign investment in agriculture production. Without this, there are significant downside risks to medium-term growth. Agriculture productivity and structural transformation towards industry and service

Figure 50. FDI commitments by sector



Source: DICA

Figure 51. Agriculture productivity and structural transformation



Source: WDI and WB Staff estimates

led growth go hand in hand as illustrated by the experience of countries in the region (Figure 51).

The services sector is projected to continue to be the major driver of growth over the short to medium-term. As noted above, the continued expansion in private investments will be dependent on the availability of a whole range of services including transportation, distribution, information technology, communications and logistics. Existing levels of internal and external trade are already stretching the capacity of these services, but there are signs of increased investments in these areas. Myanmar is also expected to continue building on the good foundations laid for expansion of tourism activity.

The supply of banking services are also expected to increase, particularly in the range of products available to corporate and retail sectors. Corporate banking activities of recently licensed foreign banks are expected to rise with FDI flows. But retail banking is also expected to expand rapidly through mobile banking services. Experience from other countries suggests that mobile banking services could grow exponentially, particularly given the very low levels of financial inclusion at the moment in Myanmar. This can have important growth impacts through greater efficiency in financial transactions, including between urban and rural areas, and increased investment in small and medium-enterprises.

Over the medium-term, infrastructure construction activity is expected to pick up pace and contribute to economic growth. The power sector in particular is poised for substantial growth. This includes a 225 MW combined-cycle gas turbine project (the Myingyan Independent Power Producer (IPP) project). This helps create a public-private partnership framework to enable quality power developers to invest in Myanmar. The sector is seeing increased interest from gas, hydro and solar developers and several gas and solar projects have recently advanced to Memorandums of Agreement ("MOAs") and have signed power purchase agreements ("PPAs"). A signed PPA would enable a project to reach financial close and to commence construction. The development of the hydro sector will take longer with feasibility studies and environmental & social impact assessments ("ESIAs") currently underway.

The transportation sector, particularly ports, is also attracting private sector investment. There are efforts underway to mobilize funds from international lenders to support the expansion of Myanmar's leading container terminal, Myanmar Industrial Port ("MIP"), located in Yangon. MIP is one of two major container ports in Myanmar and a key trade gateway that handled more than 400,000 twenty-foot equivalent units (TEUs) annually in the year ended March 2016 or 40% of the country's container traffic. MIP is growing rapidly in line with Myanmar's container market, underpinned by the country's strong economic growth. Feasibility studies are underway for Myanmar's first deep-sea port and additional ports are being developed in Thilawa and along the Ayeyarwady River.

Prices projected to stabilize

Inflationary pressures are expected to ease relative to 2015-2016, averaging 8.5 percent over the course of 2016-2017. This is linked to recovery from last year's agriculture supply shock, combined with projected low international commodity prices, and falling monetization of the deficit. International agricultural prices are projected to decline by 1.4 percent in 2016; the largest drop is for grains (-3.4 percent), which have a relatively big bearing for Myanmar.[10] Oil prices are expected to recover slightly, after going below US$30 per barrel in mid-January 2016. Oil prices are projected to average US$37 per barrel in 2016, which should benefit Myanmar as a net oil importer.[11] More generally, the price of imported

10 WBG, "Commodity Markets Outlook: Weak Growth in Emerging Economies and Commodity Markets," (Jan 2016)

11 Ibid.

raw materials and intermediates are projected to remain well below previous levels.

Downside risks to this projection include continued monetization of the budget deficit and the Central Bank's limited ability to mop up excess liquidity. As noted in the section on fiscal policy, despite efforts to reduce Central Bank financing, external shocks and the lack of alternatives makes the budget deficit vulnerable to monetization. Continued efforts at developing domestic debt markets, and access to foreign concessional financing, can help to contain these pressures, which otherwise can be a big driver of inflation. The former is also important to help absorb liquidity and reduce growth in money supply. Whilst the expected pick up in foreign investments should help stabilize the exchange rate, monetary policy should also help to sterilize expansion of the monetary base from accumulation of net foreign assets.

Fiscal space for service delivery and growth

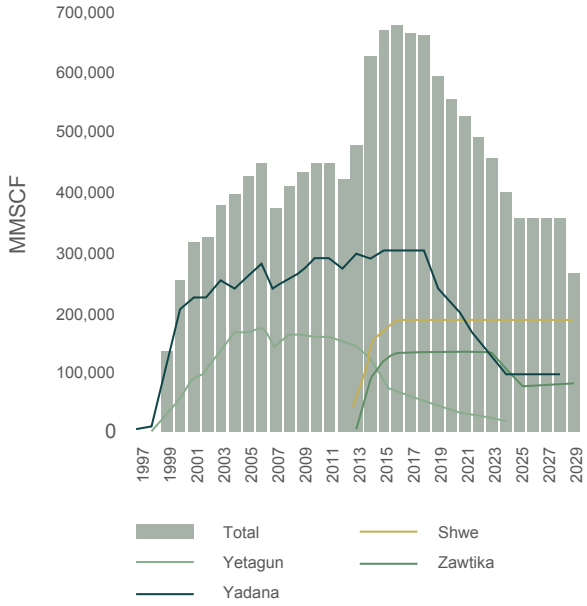
The Union Budget deficit is projected to average 3.5 percent of GDP over the medium-term. Oil and gas receipts are expected to decline over the medium-term due to a combination of falling production from existing gas fields (Figure 52) and the lagged effect of lower international commodity prices (Figure 53). At the same time, however, ongoing tax administration reforms – in particular the implementation of self-assessment for Large Taxpayers, which started last year, and for Medium Taxpayers, which is expected to start this year – should yield positive results on income tax collections. Government revenue could average around 14 percent of GDP over the medium-term. Spending pressures are likely to remain high with Myanmar's growing infrastructure bill, but also its rising recurrent needs to improve coverage and quality of public services.

Nevertheless recent macroeconomic developments call for increased attention on the balance between fiscal expansion for service delivery and growth, and fiscal adjustment for stability. The last joint IMF-WB Debt Sustainability Analysis assessed Myanmar at low risk of debt distress. At the same time, there are external vulnerabilities as illustrated by recent commodity price developments, which may adversely affect public debt sustainability, particularly if it leads to more short-term domestic borrowing. Additionally, a lack of long-term domestic financing sources also increases refinancing pressures (Figure 54). It could therefore be important to create fiscal space from, among other things, capital spending efficiency, improved net fiscal impact of SEEs, tax system efficiency, and prudent debt management including a significant reduction in non-concessional borrowing.

Ongoing current account deficit

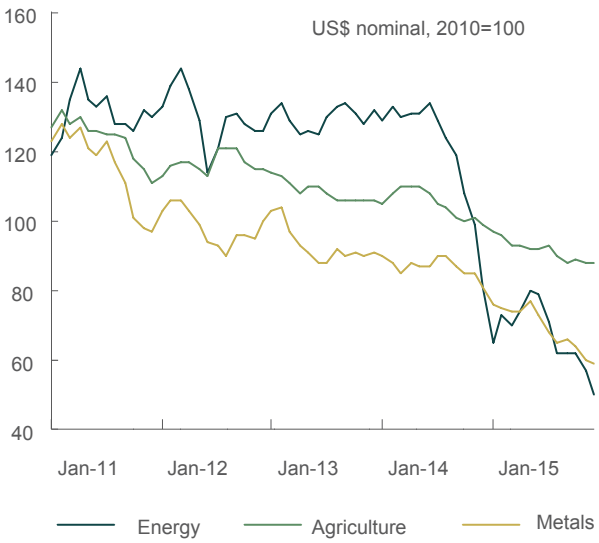
The current account deficit is likely to remain large over the medium-term due to a combination of slowing gas exports, slowing demand in China, and large investment-related import needs. The gas sector will see declining production until new fields come on stream. There is also discussion of using more gas for domestic consumption rather than exports, and possible options to import gas to cover any shortfall for the domestic energy sector, which would further widen the trade deficit. Myanmar has strong links with China through FDI, trade, and tourism, though any impact is likely to come mainly from trade channel if demand for natural resources, including gems, decline. The impact of Chinese slowdown on dampening commodity prices more generally would also affect the value of Myanmar's exports. Though Chinese consumption remains strong, therefore tourism and agriculture should not suffer much.

Figure 52. Gas production by field



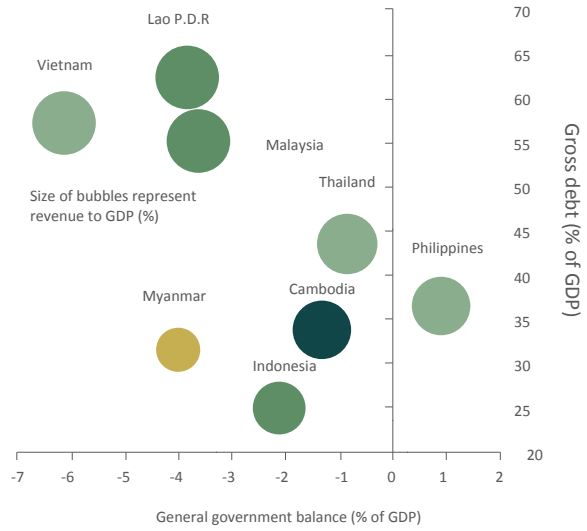
Source: MOEE

Figure 53. Commodity price indices (monthly)



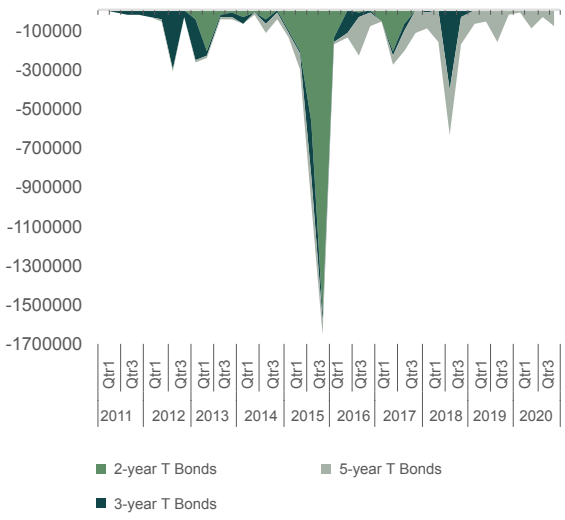
Source: WB CMO

Figure 54. General government balance, revenue and debt, 2014 (% of GDP)



Source: MOEE

Figure 55. Redemption of government bonds



Source: WB CMO

Longer-term growth from manufacturing

Over the medium to long-term, the manufacturing and processing sectors continue to hold strong promise as potentially important drivers of inclusive growth. Structural transformation towards higher value added manufacturing will depend in big part on the growth of infrastructure and services as discussed above, but also investment in skills. The garments sector could help address binding constraints in services and infrastructure that affect the manufacturing sector as a whole, whilst also absorbing unskilled labor. This could be important to gradually move up the value chain, and avoid getting stuck in a low equilibrium dominated by trading, low value services, and basic assembly.

The various Special Economic Zones (SEZs), that are either starting operations or planned, could help catalyze foreign investments, but SEZs also have long incubation periods. The global slowdown presents risks but also opportunities for Myanmar to create investment opportunities by harnessing its comparative advantage, and SEZs can play an important role in this. At the same time, a recent World Bank study finds that the biggest SEZ success stories like in China and Malaysia started slowly and took at least 5 to 10 years before they began to build momentum.12 Moreover, the big challenge for SEZs is going beyond the static benefits of investment and employment within SEZ enclaves, often by targeted incentives, to contributing to inclusive growth in Myanmar. This means integrating SEZs into the domestic economy, both in terms of linkages with the domestic private sector but also driving economy wide reforms (Box 3).

12 WB, "Special Economic Zones: Progress, Emerging Challenges, and Future Directions," (2011)

Box 3. SEZs and inclusive growth

Critical to SEZs' ability to contribute to inclusive growth is their degree of integration in the domestic economy. Countries that have been successful in deriving long-term economic benefits from their SEZ programs have established the conditions for ongoing exchange and technology transfer between the domestic economy and SEZ-based investors. This includes investment by domestic firms into the zones, forward and backward linkages, business support, and movement of skilled labor and entrepreneurs between the zones and the domestic economy.

The case of the Dominican Republic illustrates how SEZs had a transformative impact in terms of investment, exports and jobs. However, the enclave nature of the zone regime, including reliance on fiscal incentives and wage restraint, failed to promote higher productivity and competitiveness across the economy as a whole. Whilst targeted incentives can catalyze investments, they are not sustainable and do not address the critical productivity bottlenecks (e.g. implementing wage restraint rather than productivity and labor market rigidities).

The cases of Shenzhen, Republic of Korea, Malaysia and others on the other hand illustrate how ongoing exchange between SEZs and the local economy can be critical in promoting skills development. This was facilitated by various means including training programs for SEZ-based employees, who eventually left to work in local companies, or placement of SEZ-based personnel in local suppliers' factories to advise on efficiency and production. Local authorities helped facilitate links with local suppliers to enable backward linkages.

Successful SEZs also helped to test politically sensitive economic reforms and then implement them more broadly beyond the SEZ boundaries. China's SEZs were used to test liberal economic reforms and to introduce them to the wider economy in a gradual way. Therefore, whilst integration of SEZs in the domestic economy will ultimately determine their ability to contribute to structural transformation, their enclave nature can also enable the implementation of more sensitive reforms.

Table 11. Selected Economic Indicators, Projections 2015-2017[1]

	2014	2015 e	2016 f	2017 f	2018 f
Real gross domestic product	8.5	7.0	7.8	8.3	8.4
Agriculture	5.6	2.0	4.5	5.5	5.5
Industry	8.8	7.8	7.9	8.5	9.0
Services	10.5	10.2	10.0	10.1	9.9
CPI Inflation, period average	5.9	11.3	8.5	6.3	5.7
Current account balance, % GDP	-6.3	-7.9	-7.0	-5.6	-5.4
Fiscal balance, % of GDP [2]	-1.8	-3.1	-3.3	-3.7	-3.5
Revenue	13.3	13.1	13.6	14.0	14.6
Expenditure	15.2	16.2	16.9	17.6	18.1

e = estimate.

f = forecast.

1/ In annual percentage charge percent, unless otherwise noted

2/ Fiscal year, April 1 - March 31, Union Government

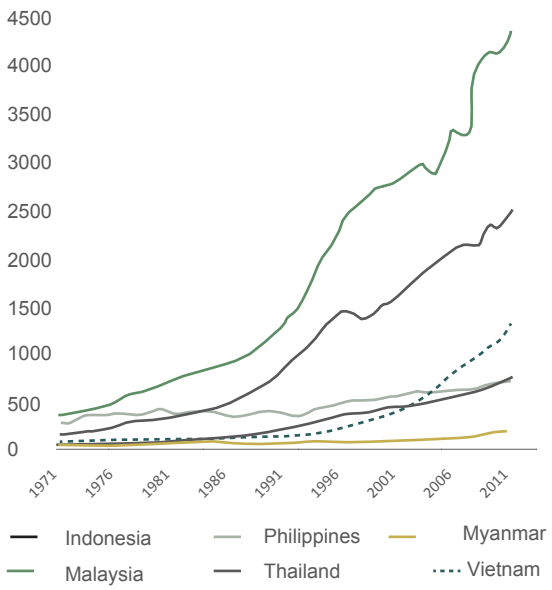
Policy Watch

Access to energy and the efficiency of the financial sector have both been highlighted by the private sector as major constraints to productivity and competitiveness. The Policy Watch in this Myanmar Economic Monitor covers selected issues in these two policy areas. On energy, it discusses reform of tariff policies both for gas supply to the power sector and for electricity distribution; their criticality in terms of the financial viability of the power sector; and thereby its ability to attract much needed investments to expand access to electricity. On financial sector policy, it focuses on the reform of State Owned Banks to enhance transparency, stability and competitiveness of the financial sector.

The crossroads of Myanmar's energy sector policies

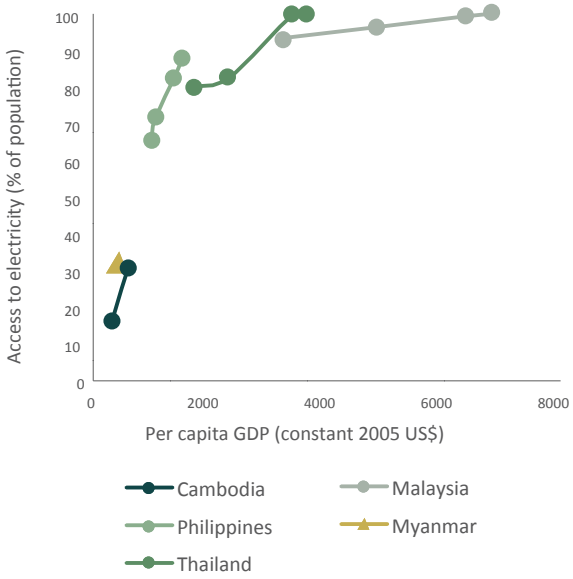
The relative impact of increasing access to energy on productivity, competitiveness and inclusive growth in Myanmar could be very significant. Access to affordable power is not only critical for the expansion of productive sectors, but is also vital for the delivery of public services in urban and rural areas. At present two-thirds of the population is not connected to the national electricity grid, and 84 percent of rural households lack access to electricity. A 2014 Enterprise Survey indicates the lack of electricity access as the third most cited constraint for firms doing business in Myanmar.

Figure 56. Access to energy – Electric power consumption (kWh per capita)



Source: MOEE

Figure 57. Access to electricity (% of population)in selected countries 1990-2012



Source: WB CMO

Electricity consumption (kWh per capita) in fast growing countries in the East Asia region has expanded rapidly in the past 40 years, whilst it has remained depressed in Myanmar falling to among the lowest levels in the world (Figure 56). The experience from other countries demonstrates how, with the right policies, access to energy could be expanded quite quickly within a relatively short period of time (Figure 57).[13]

Expanding access to electricity is likely to depend on both investments in energy supply and in the power sector. For energy supply, the latest oil and gas bid round from 2013 has started to attract several billions of dollars of investment commitments for gas exploration over the coming decade. Investments in the power sector on the other hand will be in the order of around US$2 billion per year. The total cost of Myanmar's National Electrification Plan, including investments in transmission and distribution required to meet new demand, is estimated at about US$10 billion over the next 15 years. Furthermore, during this period, another US$20 billion of investments in power generation will be required to meet rapidly growing electricity demand.

One of the main challenges in attracting these investments is likely to be the financial viability of the power sector, which critically depends on tariff policies both for gas supply to the power sector and for electricity distribution. Gas price in Myanmar has been administered by the Government. The current domestic gas pricing framework follows export parity price, where the export pricing framework was established over fifteen years ago. This domestic pricing framework does not account for economic value added from supplying gas in Myanmar, which sometimes results in nominally higher domestic gas price. The Government could revisit the domestic gas pricing framework to take account of the current and future domestic economic value-added of gas supply.

The new gas pricing framework could potentially benefit from a holistic gas pricing strategy covering the gas sector, the electric power sector (the largest gas user) and the industrial sector. In essence, the domestic gas price could usefully reflect the economic cost of supply in Myanmar, which means domestic price could be lower than export prices, and reflect the benefits from economic value added of gas supply. When the domestic gas price is set too high, this can encourage energy and electricity suppliers/users to switch to other energy sources, including higher carbon sources such as diesel and coal. An updated domestic gas pricing framework could allow the Myanmar authorities to enhance the electricity tariff structure, which is a crucial factor toward achieving universal access to electricity by 2030.

Electricity tariffs on the other hand could better reflect the cost of supply and support new investment. Myanmar's prevailing electricity tariffs are unbalanced, ranging from 35–150 kyats per kilowatt-hour. The prevailing residential tariffs (35–50 kyats) are substantially below the cost of supply, meaning that all residential customers are being cross-subsidized by non-residential customers (75–150 kyats). For FY 2015-2016, the overall tariffs are estimated to be below the cost of supply by about 300 billion kyats. This gap largely resulted from no changes in users' tariff since April 2014, an increase in domestic gas price from $5 per million British thermal unit (MMBtu) to $7.50 in 2015, a depreciation of the Myanmar kyat during the fiscal year, and the addition of about 145 MW of gas-fired power plants during the fiscal year.

13 WBG, "Energizing Myanmar: Enhancing Access to Sustainable Energy for All," (2016)

Any policy to raise electricity tariffs however would need to take account of household affordability concerns and better target energy subsidies. A quantitative Integrated Households Living Conditions Assessment from 2009 indicates no clear affordability concern for households with electricity access. Grid households spent 1.4 percent of total expenditures on electricity, compared with 2.2 percent for those with private suppliers. In addition, a 2014 qualitative survey administered by the World Bank indicates that Government electricity tariffs are affordable by many rural households, except the poorer groups.

Both urban and rural households currently without electricity would likely benefit from financial support to connect to electricity services. A pro-poor targeted subsidies mechanism could usefully replace the prevailing non-targeted, open-ended mechanism for electricity consumption. In practice, this means that electricity tariffs for all blocks could at least cover the variable cost of supply (e.g. the average cost of fuel/hydro power). And electricity tariffs for large users could include a fixed cost component of supplying electricity (e.g. investment cost in power lines) and a variable cost component on electricity consumption.

Myanmar already has a very clean and green electric power system, comprising 2/3 hydro power and 1/3 gas-fired thermal power. Moreover, other clean renewable power from solar and wind resources will be added to the supply mix in the coming years. Thanks to high liquidity in the global natural gas markets, a strong potential to import competitively-priced electricity, continuing lower cost of solar and wind power, expected improvement in Myanmar's power grid, and the potential for new gas find in the coming decade, Myanmar is in an advantageous position to continue pursuing clean and green electricity supply options. In the coming five years, Myanmar could supplement domestic gas supply with flexible imported liquefied natural gas (either direct import to Myanmar or indirectly via China and/or Thailand).

Reforming Myanmar's State Owned Banks

Myanmar is looking to reform its state-owned banks (SOBs) to promote transparency, stability and competitiveness in the financial sector. SOBs play a significant role in Myanmar's financial sector and economy. Although recent liberalization of the financial sector has helped to significantly expand the role of private banks, SOBs still account for a significant share of total banking sector assets. There are 4 main SOBs: Myanma Economic Bank (MEB), Myanma Agricultural Development Bank (MADB), Myanma Investment and Commercial Bank (MICB) and Myanma Foreign Trade Bank (MFTB).

Currently, although SOBs compete with private commercial banks, they also feature as vehicles for public policy, and have a distinct governance framework. Each of the SOBs was formed under a law or evolved into an independent entity on the basis of an official decree. None of the SOBs publish accurate financial data. The Ministry of Planning and Finance (MOPF) carries out ownership functions over SOBs, which until the adoption of the Financial Institutions Law, operated in practice largely outside of the Central Bank's supervision. The SOBs also implement government policies, helping to support target industries, rural incomes, the agricultural sector, and other policy areas.

While the current situation for the four state-owned banks vary significantly, they share a number of common features and characteristics. All have benefitted from special advantages provided by the Government, which has created a number of distortions. Main challenges include: (i) low level of transparency on the operations and financial performance of state-owned banks; (ii) need for modernized technology and IT systems; (iii) unclear policy mandates; and (iv) need for skills development in areas such as such as management, credit and lending, risk management, auditing and accounting.

In addition, the state-banks on the whole do not follow modern corporate governance practices. Improved corporate governance has the potential to improve efficiency and competitiveness, instill financial discipline, allow easier access to the capital market, and, when needed, facilitate greater private sector participation. The underlying goal of these improvements is to reorient the state's role away from day-to-day management of SOBs towards exercising its shareholder rights based on sound corporate governance principles.

Myanmar could therefore benefit from accelerated SOB reform. The main rationale for the reform of the sector is to:

(i.) Reduce vulnerabilities and strengthen the stability of the banking sector: At present, the four state-owned banks operate largely without banking supervision.14 This heightens risks to the stability of Myanmar's financial system, and could also reduce the ability of CBM to take prompt actions if needed. Apart from that in the event of an SOB failure, an implicit guarantee is likely to be assumed.

(ii.) Reduce fiscal risks: The SOBs in Myanmar have benefitted from a privileged position in the financial sector for several decades through government subsidy and monopoly of certain sectors; however the costs and benefits of this to the state have not been quantified. Good international practice calls for review of the overall objectives of state-ownership and policy mandate of the various banks to help increase transparency of state holdings in the financial sector. The rationale for government subsidies for loans, particularly by MEB and MADB, could be evaluated taking into account Myanmar's new economic policy framework and the Government's current social and economic policy goals.

(iii.) Improve accountability and enhance the transparency and governance of state-owned banks: At present, none of the SOBs publish clear finance statements or annual reports. The goal would be to improve accounting, disclosure, and board practices to help strengthen overall performance, financial sustainability, accountability and credibility.

To address the above challenges, the Government could consider initiating a set of policy and institutional reforms related to Myanmar's SOBs. Simultaneous implementation of reforms for the four key institutions could promote consistency in the approach and promote certainty across the entire system. The Government could in particular consider a two-pronged approach to address the issues in relation to SOBs. This might involve: (i) developing a comprehensive sector-wide policy and strategy; and (ii) identifying specific reform or restructuring plans, as the case may be, for each individual state-owned bank. Priority policy reforms and next steps to advance the agenda could include:

(i) **Establishing a clear policy framework:** At present, the Government of Myanmar owns a large stake of the financial sector through the four SOBs, and could benefit from an overall policy framework and ownership structure that promote effectiveness and accountability. Going forward, the Financial Regulatory Department's (FRD) capacity to fulfil its mandate as the designated government agency overseeing state-owned banks will be important. As part of the overall reform, this might involve clear definition of the public policy mandate of SOBs and identification of MOPF's responsibilities as the main shareholder. More specifically, the focus could be on whether the banks are delivering value to the taxpayers by meeting their objectives in the areas of focus (such as expanding finance for agriculture, housing, small business credit). Specific immediate measures might include:

14 Despite the fact that the banking law fully authorizes the CBM to license and supervise MEB, MICB and MFTB.

- At the national level – developing a policy statement, a strategic framework for state-owned banks;
- At the owner/company level – establishing a clear relationship between the SOBs and the MOPF/MALI as owners, the channels of accountability and the degree of autonomy (e.g. performance agreement, shareholders agreement)
- At the company level – establishing a Board of Directors that is able to act independently from the controlling shareholder and to act in the best interest of ensuring the long term sustainability and value of the company.

(ii) **Carrying out a special financial audit and operational assessment of the state-owned banks to ascertain their true financial condition.** The approach to the four SOBs would invariably differ. Two SOBs in particular could be prioritized: MADB and MEB. MEB's wide branch network and role in government payments are essential to Myanmar's economy at this stage of financial sector development. MADB serves as the main vehicle to reach many of the rural population and those involved in the agricultural sector. Since the four SOBs each have different legal frameworks and policy mandates, they will need to be dealt with individually. The specific immediate measures to proceed could include:

- Assessment preferably with external technical assistance from an advisory firm.
- Develop individual bank restructuring or reform plans. Decisions should follow the assessment and development of a high level policy framework and strategy.

(iii) **Establishing a high level coordination mechanism to manage the reform process:** International good practices have demonstrated the need for an effective coordination mechanism to carry out state-bank reform and high level political commitment. This is likely to be essential in Myanmar as SOB reform would require the involvement of multiple government agencies. A specific immediate measure might be to:

- Establish high level committee to guide SOB reform, clarify overall goals, and define roles and responsibilities.

(iv) **Clarifying the legal framework for operations of state-owned banks:** The goal would be to review in a comprehensive fashion the broad framework for SOBs' operations and identify the set of reforms needed to establish a conducive legal and regulatory framework for effective state-owned bank governance. Specific immediate measures might include:

- Review legal framework for each SOB to determine next steps to amend legal status (i.e., corporatize, restructure, reform, or resolve as appropriate),

(v) **Improving disclosure and transparency:** As part of the medium term reform agenda, tools, reporting mechanisms, and arrangements need to be developed to be able to publish improved data on the SOBs' financial and operational performance. Specific immediate measures might include:

- Publishing Government's holdings of the financial sector and policy framework.
- Publishing annual reports for the four SOBs in a timely fashion on the relevant websites or or through newspaper or print.
- Publishing of financial statements for the four SOBs in accordance with international standards. This would require capacity building for SOBs related to auditing and accounting.

Box 4. Myanmar's State Owned Banks

Myanma Economic Bank (MEB). MEB was established in 1976 and provides commercial banking services as well as development and policy loans to state enterprises, including the MADB to support agricultural development. MEB has an extensive branch network covering virtually all townships with 327 branches in 296 locations and as such currently plays an important role in financial inclusion, particularly in rural areas. MEB also handles government accounts and payments and acts as an agent of the Central Bank. MEB is the largest state-owned bank and Myanmar's second largest bank in terms of assets with a book value of over USD 1.3 billion in 2014. MEB is fully owned by the Ministry of Planning and Finance and supervised by the CBM.

Myanma Agricultural Development Bank (MADB). MADB is the second largest SOB. At the end of 2012, MADB served 1.87 million customers, mostly smallholder farmers, and had a network of 206 branches (which accounted for 23 percent of all bank branches in Myanmar). MADB was established in June 1953 by the Government to support the development of agriculture, livestock, and rural enterprises in Myanmar. It is currently owned and supervised by the Ministry of Livestock Agriculture and Irrigation (MALI). Most MADB loan products are designed to cover the short-term working capital needs of farmers, such as purchase of seeds, fertilizers, and pesticides; payment of salaries for farm workers; and lease of agriculture equipment. MADB lends at subsidized interest rates, following the lending policies and programs issued by MALI.

Myanma Investment and Commercial Bank (MICB). Established in 1990, MICB is a specialized state-owned institution under the Financial Institutions Law, which initially performed commercial banking functions as a branch under the Myanma Economic Bank (MEB). Later, MICB split from MEB to become a stand-alone bank with headquarters in Yangon and a branch in Mandalay, the second-largest commercial hub in the country. MICB's main business is extending banking services to private companies, including foreign joint ventures, both in local and hard currencies. The bank is fully owned by the MOPF. MICB has some similar functions with MEB and MFTB. An estimated 25 percent of foreign exchange transactions by value in 2011 were made through MICB, while the rest are done by MFTB.15

Myanma Foreign Trade Bank. (MFTB). MFTB was established in 1954, as the Foreign Department within the State Commercial Bank. The MFTB is wholly owned by MOPF and supervised by the CBM. MFTB's mandate is to provide "international banking services" for the state as well as the co-operative, join venture, and private sectors. The major international banking services include foreign exchange, export-related transactions, import-related transactions, guarantees, and inward & outward remittances. In recent years, the bank has been the main provider in the international banking services in Myanmar with the largest volume both in term of trade- and non-trade related transactions. MFTB has provided its international banking and financial services through its correspondent banking network of over 263 banks in 54 countries. Until recently, MFTB enjoyed a monopoly on providing international banking services. The bank also services foreign currency deposits in both interest bearing 6-months fixed deposit and non-interest bearing current account for its clients, including GOM.

15 Thein, 2011, MICB annual report 2013

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