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The Myanmar Exchange Rate: A Barrier to National Strength

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I. Summary

- Myanmar's overvalued exchange rate is undermining the national economy. The increasingly crippling effects of an overvalued kyat are being felt throughout the economy.
- Successful, fast-growing, and rapidly industrializing Asian countries have invariably employed undervalued exchange rates as an important component of their strategy to achieve economic strength. Since 1945, political leaders from Tokyo to Singapore have recognized that overvalued currencies are not an ingredient of national economic strength. Myanmar's economy risks again resembling that of a late nineteenth or early twentieth century Southeast Asian colony of Western imperial powers.
- Major causes of the overvalued exchange rate are: failure to unify the exchange rate, auctions of state land and firms, informal speculative capital inflows attracted by the high interest rates offered by Myanmar's banks and the expectation that the kyat will continue to appreciate in value, sales of high volumes of jade and other precious stones, and Myanmar's growing exports of natural gas.
- The problem of an overvalued exchange rate is having adverse consequences on Myanmar's exports, employment, economic growth, and efforts to reduce poverty. Not only do enterprises have little incentive to expand their capacity, but many enterprises face the prospect of closure within a few months or even weeks.
- The overvalued exchange rate increases the likelihood of greater foreign control of Myanmar's productive assets, including land and firms, and of the increasing concentration of wealth. These trends are the opposite of those seen in successful Asian economies and are not conducive to the achievement of national economic strength.
- Immediate intervention to reverse the overvaluation of the exchange rate is necessary.
- Over the longer term the Central Bank and Ministry of Finance should introduce policies to prevent sudden fluctuations in the exchange rate. Instability hurts investment.
- A managed floating exchange rate influenced by market forces will require unification of the exchange rate through elimination of an official rate.
- Current law appears to pose no barrier to direct, timely Central Bank intervention. This intervention could include kyat purchases of dollars at the market exchange rate. "Sterilization" of capital inflows used to purchase state assets such as land could be achieved if payment for those assets were received in dollars or if kyat proceeds were immediately converted to dollars at the market rate. Other measures to reverse the overvalued exchange rate such as spending budgeted government funds would also help address the problem.
- When it intervenes in the foreign exchange market, the Central Bank should consider the range of kyat exchange rates that would help farmers and firms regain competitiveness; at current prices that range might fall between 900-1000 kyat/USD.
- Inflation in Myanmar is caused largely by the printing of money to cover fiscal deficits; continuation of this practice makes maintenance of a fixed exchange rate impossible. A floating exchange rate can permit manageable levels of inflation and solution of the problem of an overvalued exchange rate.

II. Introduction

The exchange rate is one of the most important tools in economic development. In Myanmar, an overvalued exchange rate is currently undermining economic activity involving all tradable goods. If this situation persists, the country's industrial base will shrink, investors will be discouraged, unemployment will rise, poverty will deepen, more people will leave the country, the divide between rich and poor will grow, and national strength and the people's prosperity will be diminished if not destroyed.

Myanmar's overvalued exchange rate is inconsistent with the development experience throughout Asia since 1945. The sustained, rapid growth of the economies of Taiwan, Singapore, the Republic of Korea, and, more recently, of China and Vietnam, have been accompanied by measures to ensure undervalued exchange rates. These measures enabled development through rapid industrialization, rapid growth of manufactured exports, and the effective promotion of activities that substituted for imports.

Myanmar faces an urgent need to address the problem of an overvalued exchange rate. Otherwise, substantial economic damage will be unavoidable. Over the longer run, it will be important to establish mechanisms and procedures that keep the exchange rate at levels that maintain the economy's competiveness and promote the country's economic strength. This memorandum explains the causes of the current problem, the damage that is resulting, the measures needed to address the problem, and the benefits for the national economy of adopting those measures.

III. Roots of the problem

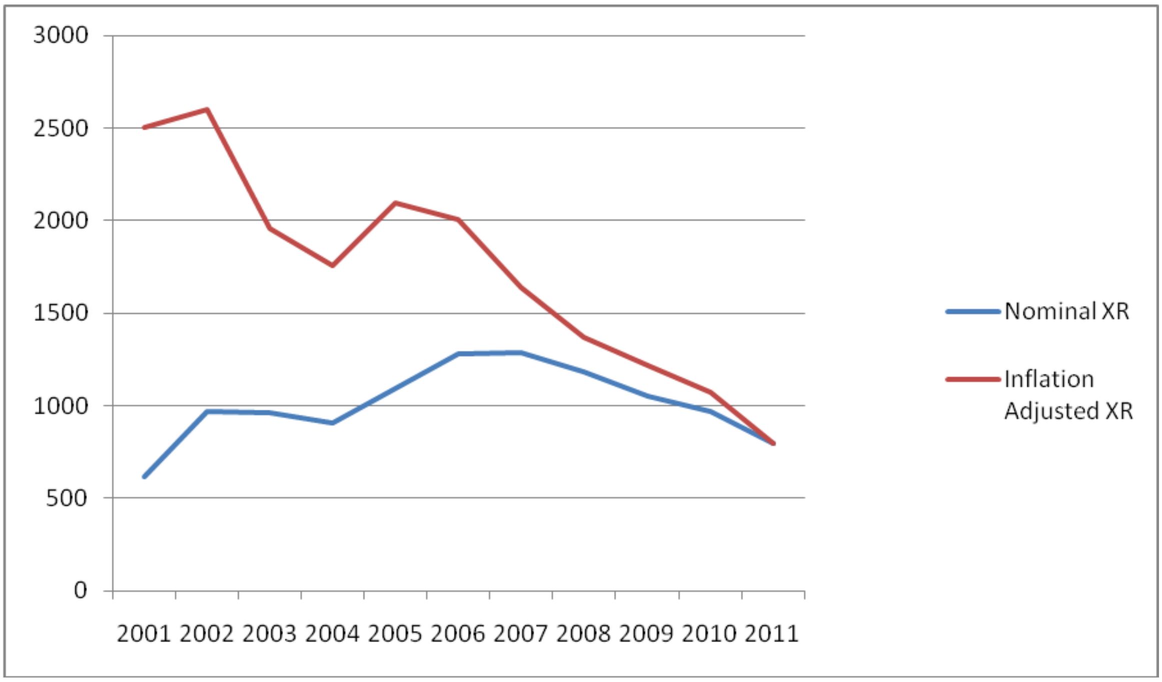
In the last five years, a combination of factors have led to the overvaluation of the exchange rate. The factors responsible for this serious situation include increasing revenues from the sale of natural gas, jade, and precious stones; a delay in the disbursement of budgeted funds since the establishment of the current government; the need by purchasers of state assets to buy kyat in order to make large payments to the government; and informal inflows of capital. These last mentioned speculative inflows are largely due to the high mandated interest rates on deposits in Myanmar banks. As these interest rates are higher than the rates in Myanmar's neighbors, and as there is a widespread expectation that the kyat will continue to appreciate, they constitute an incentive for the transfer of foreign funds to Myanmar and speculation in Myanmar's national currency. Several prominent Yangon bankers and leading members of the Myanmar business community have asserted to the research team that this phenomenon is already widespread.

The result of these developments has been a huge shift in the inflation-adjusted exchange rate; this shift has destroyed the ability of many firms and farms to compete. The graph below shows the inflation adjusted valued of the kyat; this value began to increase in 2002. It has moved from more than 2000 kyat per dollar in 2005 to about 800 today. (The price index is set so that 2011 = 100. Fewer kyat per dollar indicate an increasingly overvalued currency.) Increases in the productivity of Myanmar agriculture and fisheries, food processing, and light manufacturing such as garments and furniture making have not matched this large movement in the exchange rate. As the following sections indicate, the research team has learned that businesspeople, millers, traders, and farmers across Myanmar will face the need to suspend their activities unless the current trend in the exchange rate is reversed promptly. Indeed, many firm owners discussed their survivability in terms of weeks and not months under present circumstances.

Myanmar's unofficial exchange rate has fluctuated over the past decade. In 2001 the rate averaged 620 kyats to the dollar and then rose to 970 kyats to the dollar in 2002. It peaked at close to 1300 in 2007 and has recently traded around 800 kyats. During this time (2001-2011) the price index, as measured by the Yangon CPI, has risen by 500%, or 20% per year.

The exchange rate of a nation normally follows differences in inflation between that nation and its trading partners. In 2002, the Yangon price index rose 57% while the kyat to dollar exchange rate depreciated by 56%. Overvaluation of the kyat has occurred even though inflation in Myanmar has remained higher than in the country's trading partners. Inflation in Myanmar's trading partners was very low, and so this change was normal.[1] Until about 2006, the inflation-adjusted kyat (see Figure 1) stayed in a range of 2000 to 2500, which helped Myanmar remain economically competitive.

Figure 1. Appreciation of the kyat, 2001-2011



Source: International Monetary Fund

IV. The damaging effect of an overvalued kyat on development and industrialization

An overvalued kyat lowers the cost of imports while making Myanmar's exports and import substitutes more expensive and less competitive. Producers of import substitutes face increased competition from imports with lower kyat prices even as their local costs (especially wages) increase. Import substituting industries such as food processors, consumer goods makers, and even garment

[1] The unofficial market rate is the nominal exchange rate, recently about 800 kyat to one US dollar. Economic activity, however, depends on the exchange rate corrected for differences in inflation rates in Myanmar and its trading partners.

manufacturers focused on the local market thus face collapse. At the same time, exporters of both primary commodities and manufactured goods face falling kyat revenues for their products. The dollar receipts for exports yield fewer kyat even as local costs continue to rise because of inflation. This pattern of deindustrialization and falling revenues from most exports is a common problem in countries with strong mineral export revenues. It is called “Dutch Disease”.[2] This disease is characterized by an overvalued exchange rate accompanied by high inflation and the resultant damage to economic activity in tradable sectors. No country with Dutch Disease has ever developed a strong economy without curing the disease first.

A. Myanmar agriculture

The overvalued exchange rate already shows signs damaging Myanmar’s agriculture, one of the most important sectors for the country and its people.

Some types of agricultural production, such as monsoon rice, are less affected by exchange rates. Farmers will continue to farm (although their children may migrate, and millions of them have), and little besides rice grows during the monsoon. Falling paddy prices may, however, lead farmers to broadcast seed instead of transplanting, or to use less fertilizer. Lower yields and outputs in the Myanmar farm sector will result. Summer rice output is likely to be significantly affected by changes in paddy prices. Farmers with whom the research team spoke from the Ayeyarwady, Bago, Sagaing, and Mandalay regions suggested that, if paddy prices continued falling, they would plant less area and apply fewer inputs. Farmers suggested that summer paddy production shrinkage of 50% to 70% was possible for a 20-25% decline in paddy prices. One reason for this shrinkage is that wages are relatively high and cannot be easily reduced. If kyat wages drop below current levels, workers tend to migrate, sometimes to the city but often to other countries. If the exchange rate moves to 700 kyat to the dollar, it is likely that there will be a large drop in rice output, perhaps 10-15% unless world rice prices in dollars rose to offset the overvalued kyat.[3] For many farmers, even the current exchange rate is depressing rice output.

The significant export orientation of Myanmar’s bean and pulse sector makes it particularly vulnerable to the consequences of an overvalued exchange rate. In conversations with the research team, leading bean and pulse traders in Upper Myanmar sharply contrasted today’s situation with that of 2009, when market speculation brought crisis to the sector. While that crisis affected only a narrow range of firms, the exchange rate overvaluation today jeopardizes the incomes of traders and farmers across the sector. The team heard reports that Indian buyers were curtailing or suspending their activities in the Myanmar market for beans and pulses.

B. Manufacturing and industrial development

The overvalued exchange rate threatens Myanmar’s ability to emerge as a strong, industrial economy. Successful garment business and furniture makers face the same problems that summer paddy

[2] In the Netherlands, the exchange rate stayed level but inflation increased and farm and factory output fell. In Myanmar, the combination of capital inflows and raw material exports has strengthened the nominal exchange rate even while inflation has remained high. This is an even more intense and harmful version of Dutch Disease.

[3] When world rice exports jump, there is a tendency in some rice exporting countries to restrict exports and keep local rice prices below world rice prices. This helps urban consumers and other rice buyers and hurts rice farmers and those whom they employ. Periodic export bans also hurt the reputation for reliability of the rice exporting nation.

growers confront. Reducing wage rates is unrealistic but the overvalued kyat makes wages in dollars more expensive. These firms receive their revenues in dollars; they must therefore slow production or consider ending production and moving their factories to other countries in the region. Numerous factory owners told the research team that an exchange rate approaching 700 would cause a significant fraction of Myanmar's manufacturing exporters to shut down. Even the current rate threatens many exporters with closure. Further, overvalued exchange rates rule out investments to expand industrial production. Not only do they threaten the two million jobs in manufacturing today, and the welfare and well-being dependent on those jobs, but they also make it impossible for Myanmar to lay a solid foundation for growth as a strong industrial economy.

All Asian economies that grew fast used manufactured exports to propel their growth. South Korea, Taiwan, Thailand, Indonesia, Vietnam, China and Malaysia all kept their currencies from getting "too strong" and depressing their manufacturing sectors.

C. Inflation

Inflation imposes real burdens both on an economy's producers and on its poorest members. In the minds of foreign investors, high inflation rates and rapid fluctuations in exchange rates are taken as a sign of poor economic management. For this reason fast-growing, rapidly industrializing Asian economies have attached great importance to combating inflation. An overvalued exchange rate combined with inflation is particularly destructive. Inflation drives up the cost of production. Inflation in Myanmar is largely due to rapid increases in money supply. While real increases in output can grow sustainably at 6-8% per year, Myanmar's money supply has generally grown at 25% or so per year. As a result, prices in Myanmar rise by 15-20% per year. Slower increases in the money supply and interest rates on kyat deposits that exceed the rate of inflation could bring the inflation rate to single digits. With lower inflation, interest rates will drop. An overvalued exchange rate is a barrier to this sequence of desirable developments.

V. Overvalued kyat + inflation = national economic weakness

Some sectors manage to do well in the face of overvalued exchange rates and inflation, but these are not sectors that have brought sustainable development and rapid industrialization to any country. These sectors include those, such as construction or services, that are not traded, and those, such as monsoon paddy, gems, and natural gas, in which natural resources play a major role. An overvalued kyat in the current inflationary setting will result in more outmigration of labor, a concentration of output in raw materials as great as or greater than that of the colonial period, and the stunting of the manufacturing sector's growth.

There is no doubt that sanctions impose a considerable burden on Myanmar's economy and on the efforts of its people to enjoy decent livelihoods. The problem of an overvalued exchange rate is independent of the problem of sanctions. It should be understood as the cause of an additional heavy burden on the national economy and on the country's people. Furthermore, the problem of an overvalued exchange is one whose solution is exclusively in the hands of Myanmar's government.

The overvalued exchange rate is driving many Myanmar firms out of business. If they are forced to sell their assets, the buyers will be people with capital and access to bank loans. These buyers will include foreign investors, wealthy local citizens, and Myanmar people serving as fronts for foreigners.

These circumstances also mirror the economic and social order of the colonial period. An overvalued exchange rate also brings increasing concentration of the ownership of land and other assets. This outcome contrasts with the development experiences of rapidly industrializing Asia economies, in which national growth has brought increasingly equitable distributions of wealth and a large, dynamic local business class.

VI. Solving the problem

To prevent further severe damage to its economy, the Myanmar government needs to address the problem of an overvalued exchange rate immediately. It should significantly increase the supply of kyat relative to dollars in the economy. Over the longer term Myanmar needs institutions and procedures through which to maintain exchange rates at levels that sustain the countries international competitiveness and promote prosperity and strength. Such levels are essential for generating the conditions to support the expansion of exports, the development of infrastructure and industry, the promotion of employment and the reduction poverty, and prosperity in a strong national economy.

Solution to the problem of an overvalued exchange rate requires the unification of exchange rates and the abolition of the official rate. In the period immediately preceding the Asian financial crisis of 1997, Myanmar planned unification of the currency. While it was possible to avoid taking that step then, exchange rate unification is a matter of the highest urgency today. Eliminating the official rate and allowing the Central Bank to manage exchange rates would bring Myanmar's Central Bank into line with most other Asian central banks.

Existing provisions of laws relating to the activities of the Central Bank and of other banks make possible a range of measures to address the overvalued exchange rate. Following unification of the currency, the Central Banks or state banks could purchase dollars at market rates to increase the supply of kyat and reduce the volume of dollars in circulation.[4] Similarly, disbursement of planned expenditures for the current fiscal year would also increase the supply of kyat in the economy and help reduce the overvalued exchange rate.[5]

As discussed above, one of the root causes of the problem of an overvalued exchange rate is the demand for kyat in order to pay for state assets including land. Restrictions on making such payments in dollars and other foreign currencies should be eliminated.

Independent Central Bank control of the supply of kyat and ability to tighten credit will allow it to prevent the kyat from becoming too undervalued. This would mean that large fiscal deficits could no longer be financed by printing money. A stronger national economy would, however, permit lower fiscal deficits and the issuance of bonds.

The research team recognizes that proposals to unify the exchange rate have met with resistance in the past. Discussions with a range of businesspeople and policymakers have led the team to the conclusion that there can be no resolution of the problem of an overvalued exchange rate without

[4] In addition, issuing foreign dealer licenses to private banks would add one more instrument to deal with the overvalued exchange rate.

unification of the currency. The team is encouraged by the existence of a detailed plan, previously prepared by the Central Bank, to unify the exchange rate.

Success in solving the problem of Myanmar's overvalued exchange rate should in turn lead to the broad-based budgetary, financial, and monetary reforms necessary to sustaining an exchange rate that makes the Myanmar economy competitive. These reforms will not be easy. Procedures will have to be modified, the capacity of the staff involved will have to be improved, and the needed changes will have to be adapted to the institutional circumstances in Myanmar. Again, there is a host of international experience particularly from other Asian countries to provide the necessary framework and guidance for these reforms.

VII. Conclusion: threats and opportunities

For decades the central objective of Myanmar's governments and economic policymakers has been the achievement of a strong, diversified, and industrializing economy. The overvalued exchange rate undermines pursuit of that objective. Nevertheless, the objective remains as relevant today as in the past. Myanmar needs to follow the example of Asian economies that have successfully made use of their opportunities and achieved national economy strength.

The current five year trend in the nominal exchange rate combined with inflation has destroyed the competitiveness of much domestic economic activity in Myanmar. There is now a crisis. Immediate solution of the problem of an overvalued exchange rate, with the initial target of a rate of 900 to 1000 kyats to the dollar, is necessary to prevent firm closures and large increases in unemployment, along with increased indebtedness among farmers and rising poverty.

This solution requires unification of the currency. There is a clear consensus, shared by the research team and a number of the most informed observers of the Myanmar economy that this step should precede all others. Following unification, a range of other important policy interventions will immediately become possible. The Central Bank can buy dollars with kyat in order to move the nominal exchange rate to its desired level. Such other measures as spending more budgeted funds, allowing dollar purchases of state assets including land, and permitting state and private banks to deal in foreign currency at market rates will also help resolve this problem. In the longer run, using taxes or bond sale proceeds to fund government spending instead of printing money will make maintaining moderate monetary growth, low inflation, and a competitive and stable exchange rate easier.

[5] Exchange rate unification might have implications for the way in which natural gas revenues were split between the Ministry of Finance and any off-balance-sheet accounts. The same split (or a different one) could be negotiated, but it would become an explicit and transparent matter.