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INTERNATIONAL PEACE

BANKING ON MYANMAR
A Strategy for Financial Sector Reform

Vikram Nehru

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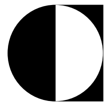

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CP 207

Contents

About the Author v

Acronyms vi

Summary 1

Introduction 3

The Legacy of the Past 3

The Current Structure of the Financial System 7

The Performance of Myanmar's Financial System 14

Recent and Ongoing Reforms 17

Key Components of a Forward-Looking Financial Sector Reform Strategy 21

Sequencing Reforms for Financial Sector Development 40

The Intersection of Financial Sector Reforms With Other Reforms 43

Notes 45

Carnegie Endowment for International Peace 48

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Acronyms

ASEAN	Association of Southeast Asian Nations
ATM	automated teller machine
CBM	Central Bank of Myanmar
FDI	foreign direct investment
GDP	gross domestic product
GIZ	Deutsche Gesellschaft für Internationale Zusammenarbeit (German Agency for International Cooperation)
IFC	International Finance Corporation
IGE	International Group of Entrepreneurs
IMF	International Monetary Fund
JICA	Japan International Cooperation Agency
KBZ	Kanbawza
MADB	Myanma Agricultural Development Bank
MEB	Myanma Economic Bank
MFI	microfinance institution
MFRS	Myanmar Financial Records Standards
MFTB	Myanma Foreign Trade Bank
MICB	Myanma Investment and Commercial Bank
MPU	Myanmar Payment Union
NGO	nongovernmental organization
SDB	state-owned development bank
SME	small and medium enterprise
UMEH	Union of Myanmar Economic Holdings Ltd.

Summary

Once the envy of Asia, Myanmar's financial sector is now a shadow of its former self. After decades of misguided junta-led strategies, state ownership, and policy shocks, confidence in cash as a safe asset and banks as trustworthy institutions has evaporated. Finance is a binding constraint on Myanmar's future development. The government needs a reform strategy that supports the financial sector's rapid development while ensuring its stability, efficiency, and accessibility.

Performance Challenges

- By most international standards, Myanmar's financial sector is small.
- Growth of the banking system is constrained by weaknesses in basic institutions and infrastructure.
- The central bank has no real-time link to receive financial data from banks, and it has limited capacity to analyze that information and provide effective supervision.
- Inhabitants of rural areas, especially farmers, have limited access to financial services in rural areas.
- Land is the preferred collateral, so lending is effectively restricted to landholders.
- State banks are inefficient and encumbered by government-imposed social responsibilities, making them uncompetitive against private banks.
- Most private banks are owned by commercial groups, and significant lending to related parties can mask large default risks.

Recommendations for Financial Sector Reform

Short Term (one to two years)

Build strong institutional foundations for the banking system. The sector needs modern clearance and settlement systems, a stronger central bank (especially in its ability to supervise), a money market, and fewer restrictions on opening bank branches.

Ensure that foreign investment in the banking system occurs slowly and in stages. A few foreign banks could be allowed to enter Myanmar's banking

system, but only under restrictive conditions, until the regulatory framework is stronger and domestic banks are more efficient and financially stable.

Adjust interest rates to ensure they are positive in real terms. The central bank should continue to set interest rates but adjust them as macroeconomic conditions demand.

Medium Term (three to five years)

Focus on broader structural changes. Policy priorities should include restructuring state banks by closing, merging, or transforming them into one—or at most two—state-owned development banks; revamping microfinance; developing a framework to manage systemic risks; establishing a government bond market; preparing for branchless banking; and installing a deposit insurance system.

Long Term (five to ten years)

Consider gradual and phased interest rate liberalization. Such liberalization should only occur when the banking system has stable financial foundations and the central bank provides effective supervision.

Develop the stock market. After the money and bond markets start to function smoothly, the government can turn to developing the stock exchange.

Introduction

The financial sector is the lifeblood of any country's economy, and its smooth functioning is central to the economy's rapid and inclusive economic growth. A well-functioning financial system must intermediate efficiently between savers and borrowers; manage risks prudently; provide a wide variety of financial services to firms, farms, and households; mobilize savings effectively; identify and lend for sound investments; remain robust in the face of shocks; and ensure that access to finance is available to all.[1]

Achieving these aims in Myanmar will require making gradual, steady, and transparent reforms to the current financial system to overcome the failings of the past, address the sector's weaknesses, and build on its strengths. Policymakers will need to display patience and flexibility—knowing that the pace of reform will need to match the country's availability of skills and its institutional capacity. Also, periodic shocks, whether originating at home or abroad, will require strategic adjustments and an occasional recalibration of priorities.

Myanmar needs a reform strategy to develop a stable and efficient financial sector that is supportive of rapid and inclusive growth.

Myanmar needs a reform strategy that reflects these principles. Crafting such an approach, even when the intention is not to provide a blueprint, involves identifying the key challenges facing the financial sector and finding ways to address them. The task is urgent and, where appropriate, the Myanmar authorities may wish to invite technical assistance from relevant international agencies.

A survey of Myanmar's financial sector—including the legacy of the past, the current components of the financial system, the key features of current financial sector policies, and ongoing reforms—highlights the many challenges it faces. They provide a starting point to identify elements of a financial sector reform strategy for Myanmar, together with how to sequence these reforms and manage their possible interaction with reforms in other parts of the economy.

The Legacy of the Past

Before 1963, Myanmar's banking system was the envy of Asia. The country had ten domestically owned banks and fourteen foreign-owned banks—the largest concentration of foreign banks in Southeast Asia. Among these foreign banks were such global giants as Chartered Bank,[2] National Grindlays Bank, and the Hong Kong and Shanghai Banking Corporation.[3]

Since then, however, Myanmar's financial sector has been buffeted by a series of policy shocks that have left a legacy of distrust in cash as a unit of value and in banks as a safe haven for financial assets. Many events—or shocks—have shaped the country's banking system, have affected the institutions that supported it, and ultimately have weakened formal financial intermediation to the detriment of private investment and growth. This section highlights six shocks that were of particular importance.

The first shock was the nationalization of the country's banks in 1963. After the military takeover in 1962, the new government promulgated an order nationalizing all privately owned banks on February 26, 1963. These private banks were eventually incorporated into four state-owned banks. The government followed this with the nationalization of most of the country's large enterprises. As a result, the number of state-owned economic enterprises grew rapidly, and by the early 1980s, their expenditures accounted for about 50 percent of gross domestic product (GDP). Most of these enterprises faced "soft budget constraints"—whereby managers had little incentive to make profits, given that the state banks were pressured by the government to extend loans to cover losses.

The second shock was the demonetization of 1985–1987. In 1985, the Ne Win administration introduced a 75 kyat note, which was followed by 15 and 35 kyat notes the next year. The 50 and 100 kyat notes in circulation at the time were demonetized following a grace period, during which citizens could exchange some of their old notes for new ones. But then, on September 5, 1987, the government issued a series of 45 and 90 kyat notes and demonetized the 25, 35, and 75 kyat notes.[4] This time, two-thirds of the value of all cash in circulation was effectively declared illegal, with no option to convert existing notes into the new currency. Students who could not pay their university fees mounted sporadic protests—and by 1988 this had snowballed into widespread protests, which ultimately forced General Ne Win to step down and triggered a bloody army crackdown on August 8, 1988.[5] Just as important, the demonetization instilled widespread reluctance to hold currency. Farmers hoarded crops, while others bought whatever physical assets they could afford—such as commodities (including gold), land, and even manufactured goods—with whatever little domestic currency they possessed.

The third shock was the partial liberalization in the 1990s. During the early 1990s, military leaders who succeeded General Ne Win in 1988 began to partially liberalize the domestic economy—and as part of this package, private banking returned. In 1990, the government promulgated the Central Bank of Myanmar Law and the Financial Institutions of Myanmar Law, and the first private bank (Myanmar Citizens Bank) commenced operations in June 1992. By the end of 1992, four private banks were in business, and another four joined them in 1993. By the end of 1997, Myanmar had 20 private banks.

The fourth shock was the crisis of 2003. In 2003, Myanmar suffered a major banking crisis. Given the lack of transparency at the time, its origins are

somewhat obscure. It started with the collapse of a number of trading companies that were acting as informal financial institutions. The contagion spread to the banks, which were subsequently instructed to pull back all their loans to increase their own liquidity—and this, in turn, created a real sector depression, which further eroded the value of financial assets. The entire banking system suffered an abrupt and massive withdrawal of deposits. The second-largest private bank in 2003, Yoma Bank, ultimately had to resort to receiving substantial support from the Central Bank of Myanmar (CBM) in order to meet its liquidity needs. As a result, Yoma Bank's operations were subsequently curtailed; but it was allowed to remain open purely for the transfer of remittances. It took Myanmar until 2007 to recover from this crisis.

External factors exacerbated the domestic causes of the crisis. On November 3, 2003, when the crisis was still ongoing, the Financial Action Task Force, an international initiative to prevent money laundering and counter the financing of terrorism, imposed "additional countermeasures" on Myanmar (then called Burma) because of the country's continuing failure to address "major deficiencies in its anti-money-laundering regime."[6] A week later, the U.S. Treasury announced that the Mayflower Bank and the Asia Wealth Bank were of "primary money-laundering concern," and the Treasury not only directed U.S. financial institutions to take "special measures" against these two banks but also took special actions itself on the grounds that the two banks were facilitating money-laundering operations for drug-trafficking organizations.[7]

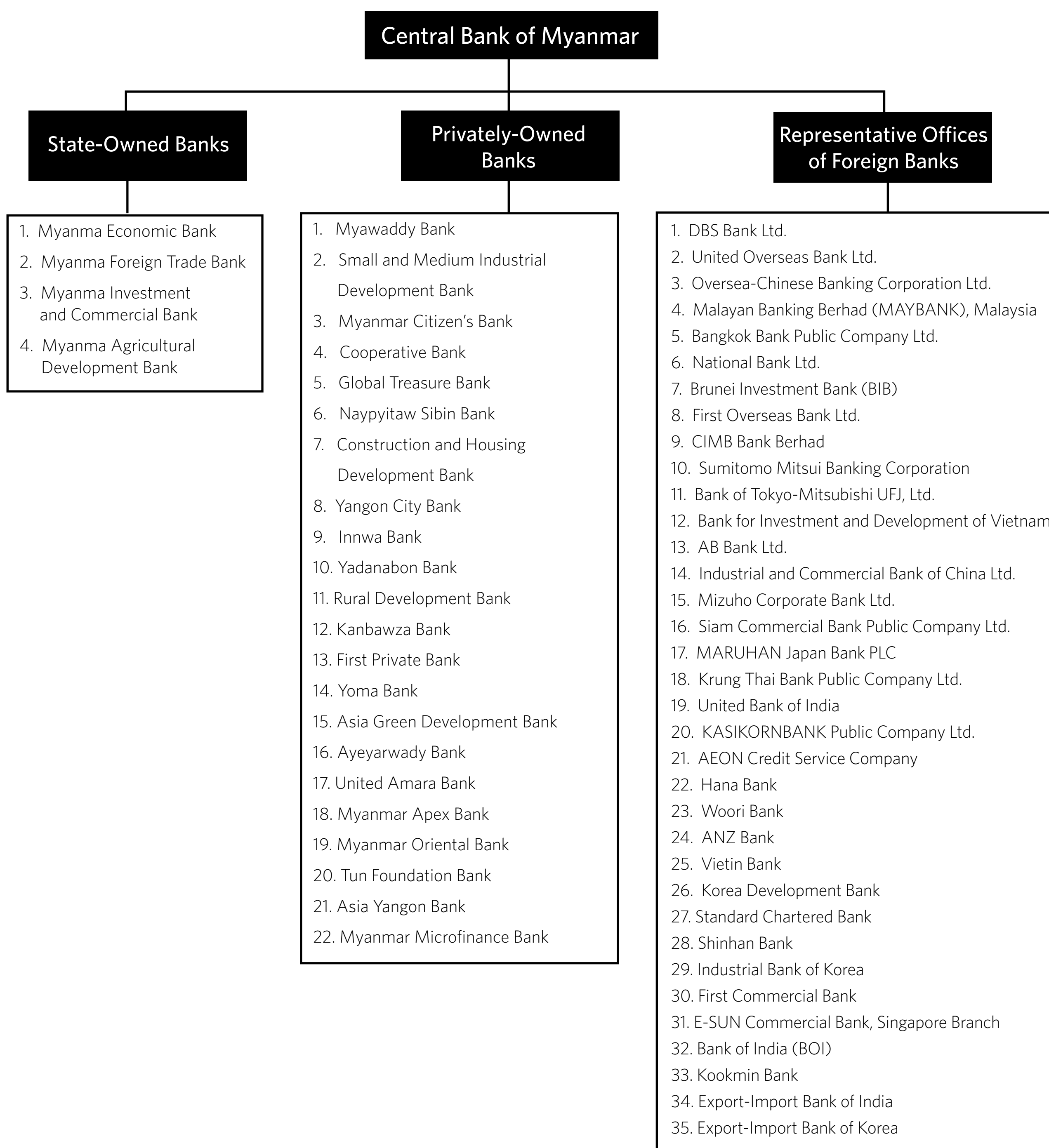
The fifth shock was the closure of Universal Bank in 2005. On August 5, 2005, the branches of the Myanmar Universal Bank were closed and sealed by troops, and its chairman and managing director were arrested; the bank was eventually absorbed by the Myanma Economic Bank (MEB). It is still not clear what prompted this government action. Some suggest that the bank was involved in money laundering, which the government wanted to stop. Others suggest the action was to punish the bank's owners for being too closely connected to the previous Burmese prime minister, who had just been deposed and arrested on corruption charges.[8]

And the sixth shock was the mini-crisis of 2012. On October 5, 2012, following a rumor spread through social media, there was a run on Myanmar's largest private bank, KBZ (short for Kanbawza) Bank. But prompt action by the CBM, including press statements emphasizing the financial soundness of all banks and the CBM's willingness to guarantee the finances of all banks, helped quell the panic. This episode was a reminder of the fragility of the banking system, but it also highlighted the important role that the CBM's policies can play in ensuring stability.

The series of policy and internal shocks inflicted on Myanmar's financial sector has left several legacies of failure, the severest of which is a lack of public trust in the banking system. Consequently, the banking system is fragile and vulnerable to small shocks. At the same time, the CBM, which has only recently been made an independent institution, remains a product of its past. Not only

does it have a limited capacity, it has never had a mandate or the authority to oversee the state-owned banks. At the same time, it has been an institution suspicious of the private banking system and its motivations. This reflects itself in many direct CBM restrictions on private banking activity, including strict limits on the acceptable collateral for loans, loan maturity, interest rates and fees, branch openings, daily reporting of financials, and so on. This emphasis

Figure 1. **The Structure of Myanmar's Banking System**



on ex-ante controls has meant that the CBM has not developed the capacity to implement indirect prudential regulations that give banks discretion to intermediate funds within well-defined risk parameters and to ensure their adherence to such regulations through off-site and on-site supervision.

The Current Structure of the Financial System

Myanmar's financial system comprises four state banks, 22 private banks (of which eleven are really semi-government institutions), 35 foreign bank representative offices, one state-owned insurance company, twelve private insurance companies licensed only in 2013, and a nascent capital market (see figure 1 for the details).

The latest available data on bank assets (for 2010) show that while the four state banks dominate, the assets of the private banks now significantly exceed those of the state banks (see table 1).

Table 1. **Assets by Type of Bank, 2010**

Type of Bank	Number of Banks[a]	Assets (billions of kyat)	Assets (percentage of GDP)
State banks	4	1,037.56	3.07
Private banks	15	1,891.31	5.06
Representative offices	13	N.A.	N.A.

[a] As of the end of 2010.

Note: N.A. = not applicable.

Source: Win Htein Min, "International and Cross Border Bank Lending Implication in SEACEN: Balance Sheet Perspective in Myanmar," in *International and Cross-Border Bank Lending and Implications in SEACEN Economies: Balance Sheet Perspective*, eds. Reza Y. Siregar and Victor Pontines (Kuala Lumpur: South East Asian Central Banks, 2011), www.seacen.org/GUI/pdf/publications/research_proj/2011/rp83/rp83_complete.pdf.

State Banks

The four state banks are the Myanma Economic Bank, the Myanma Foreign Trade Bank (MFTB), the Myanma Agricultural Development Bank (MADB), and the Myanma Investment and Commercial Bank (MICB).

The **MEB** came into being on April 2, 1976, under the Bank Law of 1975, and subsequently assumed a new legal identity under the Financial Institutions Law of 1990, which superseded the Bank Law of 1975. The MEB shoulders several development and social functions on behalf of the government, and it

is the principal banking vehicle to lend resources at concessional interest rates to state-owned enterprises, cooperative enterprises, and other state banks and organizations (for example, the MADB; the Myanmar Small Loans Enterprise; and the Government Employees Bank, which provides interest-free housing loans for civil servants). It has increasingly been providing banking services to the private sector as well as foreign exchange and trade-related financial services, but close control by the Ministry of Finance and conservative lending practices (the loan/deposit ratio is low) has meant high losses. The bank also provides treasury functions as part of the Ministry of Finance and Revenue, which accounts for the MEB's extensive network of 320 branches, the largest in the country.

Like the MEB, the government established the **MFTB** under the Financial Institutions Law of 1990. The MFTB's mandate is to provide trade finance and foreign exchange related banking to the government, state-owned enterprises, and the members of the international community who reside in the country. The MFTB is also responsible for managing Myanmar's official foreign currency reserves. Before the recent economic reforms, its monopoly access to foreign exchange and its captive market meant that it did not need to compete for clients, and as a result its service standards were considered very weak even in Myanmar's uncompetitive banking sector. Now that the CBM will be responsible for managing its own foreign exchange reserves, and that most banks, including private banks, have access to foreign exchange and some have begun financing foreign exchange related activities, the MFTB's market has started shrinking and it has begun to lose its relevance. Although it currently enjoys a competitive edge through its more than 140 correspondent banking relationships worldwide, its private sector bank competitors are rapidly establishing and expanding their own overseas networks, and it is only a question of time before even this element of the MFTB's remaining competitive edge evaporates entirely.

The **MADB** is run by the Ministry of Agriculture and provides institutional credit to small-scale farmers in its capacity as a government agency. It was created under the Myanma Agricultural and Rural Development Bank Law of 1990, to provide "banking services" for agriculture, and it was given the specific task of promoting agricultural, livestock, and rural enterprises including processing and production. Legally, it is not obliged to follow the requirements of the Financial Institutions Law of 1990, but it does so in some key areas, including on the structure of interest rates. Clients receive 10 percent interest on their deposits and are allowed to borrow four times their savings at 15 percent interest, provided the funds are used for farm development. The MADB's loans are of three kinds—short term, which are designed to finance the cultivation of one crop; medium term, which are to be repaid in one to four years; and long term, which have a maturity of up to ten years (but these constitute a negligible share of the overall loan portfolio). Most short-term cultivation loans are offered to farmer groups that are jointly liable for repayment,

with peer pressure replacing collateral to encourage repayment. Term loans, conversely, are secured by collateral, which cannot consist of land, given that all land is the property of the state. Loan size is usually small in relation to farmers' needs, in part because of the limitations imposed by collateral requirements, but also because of the MADB's somewhat parlous financial condition. Being a part of the Ministry of Agriculture, the MADB encourages farmers to use their loans to purchase seeds, services, fertilizer, and equipment supplied by the ministry, rather than the private sector. The MADB's rural financing responsibilities require it to run fourteen regional offices, 164 branches, and 48 agency offices, most of which are also co-located with the ministry's offices and service centers.

The **MICB** was a part of the MEB until 1990, when it became a separate entity under the Foreign Institutions Law of 1990. With branches located mainly in Yangon and Mandalay, its primary focus is to serve the private sector, and its mandate is to provide loans denominated in the domestic currency for commercial, investment, and development activities, and to act as a banking intermediary for foreign investment activities.

The capital adequacy requirements for state-owned banks are lower than those for private banks, and state banks are not subject to on-site supervision, as private banks are (although no exceptions are made in regulations or instructions). State banks are not restricted in opening branches, whereas private banks are required to increase their capital each time they open a new branch). Managing directors of three state banks used to be on the Board of Governors of the CBM (together with the governor and one deputy governor)—and their authority occasionally exceeded that of the governor. This made it very difficult for the CBM to properly supervise the state banks.

The Financial Institutions Law of 1990 also included regulations that permitted the establishment and operation of private banks. This was the first of a three-stage reform program initiated in 1990 to liberalize private banking in Myanmar. The next two stages—which have not been implemented so far—involved permitting private banks to form joint ventures with foreign banks, and ultimately allowing foreign banks to operate independently.

It took until 1992 before the first private banks became operational.

Semi-Private Banks

It took until 1992 before the first private banks became operational, although not all private banks are fully private. For example, eleven of the 22 banks are semi-government institutions, and include the following.

Myawaddy Bank, which officially is a private bank, but is wholly owned by the Union of Myanmar Economic Holdings Ltd. (UMEH), a military-run conglomerate, which in turn is ultimately owned by Ministry of Defense and its retired staff. Forty percent of the UMEH's share capital is held by

the Directorate of Procurement of the Ministry of Defense, with the remainder of the shares allocated to serving military personnel, various armed forces' cooperatives and regimental associations, and veterans' groups. The UMEH's management resides with senior figures within Myanmar's armed forces. Myawaddy Bank's head office in Yangon is located in what was at one time the CBM Building, which is reflective of its close links to the military government before 2011. It does a substantial amount of its business with local and semi-government bodies—including the Yangon City Development Committee and the Border Areas Development Association. In 2005, Myawaddy Bank's semi-official status brought it under the purview of the United States' and the European Union's sanctions against Myanmar state-owned enterprises. These included travel restrictions for the bank's senior officials, along with prohibitions against U.S. and European individuals and entities investing in the bank.

The **Small and Medium Industrial Development Bank** is a public company with shares owned by the public, but it is managed by government officials (for example, its chairman is always the minister of industry) and most of its procedures are typical of a government organization. Originally the Myanmar Industrial Development Bank, it was founded by the Myanmar Industrial Development Council, which was set up in 1995 to promote industrial development zones. As a result, the bank mainly provides financing assistance for small and medium-sized enterprises (SMEs) in industrial zones throughout the country, usually through three-year loans at an annual interest rate of 8.5 percent. Collateral requirements are very similar to those of private commercial banks. The bank receives technical assistance from GIZ, the German technical assistance agency, and it recently signed a memorandum of understanding for cooperation with the Industrial Bank of Korea.

The **Myanmar Citizen's Bank** was the first so-called private bank to be established in 1991 following the promulgation of the Financial Institutions Law of 1990, and it began operations on June 2, 1992. In reality, however, it is government-owned, with the government's shareholding administered through the Ministry of Commerce. It is considered a medium-sized bank and is listed on the Myanmar Securities Exchange Center. As of January 2013, the bank has 255 employees and eight branches across the country.

The **Cooperative Bank** operates under the Ministry of Cooperatives and was the result of a merger of three cooperative banks in 2004. Its three predecessor banks—the CB Bank, established in 1992; the Co-Operative Farmers Bank, 1996; and the Co-Operative Promoters Bank, 1996—bequeathed to the Cooperative Bank several branches across the country, making it one of Myanmar's largest banks. The merger of the predecessor banks into the Cooperative Bank put it at the top of a pyramid of thousands of cooperative societies, most of which have ceased functioning. It is emerging as a dynamic bank, becoming the first to issue a cash card (that is, a prepaid travel card issued in collaboration with MasterCard, intended for Myanmar residents

traveling abroad), and installing the largest automated teller machine (ATM) network among all banks.[9]

The **Global Treasure Bank** (formerly the Myanmar Livestock and Fisheries Bank) operates under the Ministry of Livestock and Fisheries, but its loans now cover a wide range of sectors. The bank's board of directors has decided to change its name to the Treasure Bank. The bank has 60 branches nationally, and it has offered money remittances into Myanmar through Western Union since January 2013.

The **Construction and Housing Development Bank**, which has the support of the Ministry of Construction, is the latest bank to have received a banking license (in late 2013).[10]

The remaining semi-government banks are mostly city-based banks that partly operate as treasuries for local governments and municipalities. They include the **Yangon City Bank**, which is backed by the Yangon City Development Committee of the municipal authorities in Yangon; the **Innwa Bank**, which is owned by the Myanmar Economic Corporation, another corporation run and owned by current and former military officers; the **Yadanabon Bank**, a small bank with just one office; the **Rural Development Bank** (previously known as Sibin Tharyar Yay Bank), which mainly operates in border areas and is controlled by the central government; and the **Naypyitaw Sibin Bank**, which received its banking license in February 2013.

Fully Private Banks

The eleven remaining banks are *genuine private banks*. The first of these is the **KBZ Bank**, which is the largest among the private banks, with 100 branches (as of March 2013). It also recently opened an insurance company (IKBZ—see below). Started in Shan State in 1994, the KBZ is part of the Myanmar Billion Group, which has holdings in a wide variety of industries, including mining, trading, distribution, manufacturing, and most recently airlines (the bank bought an 80 percent holding in Myanmar Airways International in 2010, and launched its own airline—called Air KBZ—in 2011). The bank is rapidly modernizing, extending its widespread domestic remittance services to overseas customers, providing credit card and ATM services, and improving service standards. Although it was the object of a bank run triggered by social media in 2012, it emerged relatively unscathed and is now considered among the most efficient and rapidly growing banks in Myanmar.

First Private Bank was the first genuinely privately owned bank to be set up in 1992. It has emerged as one of the most profitable and dynamic private banks in the country.

In 2003, **Yoma Bank** was the second-largest private bank, but following the banking crisis of that year it had to resort to using significant amounts of emergency financing from the CBM and consequently had its operations restricted to remittance transfers. Those restrictions were removed only late in

2012, and Yoma Bank has since resumed normal operations. It is now in the process of filling its loan book and should soon be an important competitor in the private banking system.

The **Asia Green Development (AGD) Bank** was one of four "crony banks" hastily given a banking license just before the military handed over power to a civilian government in 2010. The bank has rapidly grown into one of Myanmar's important private banks and is part of the Htoo Group, possibly Myanmar's largest conglomerate, which is owned by Tay Za—arguably Myanmar's richest businessmen and possibly its most influential one politically. The U.S. Treasury had previously sanctioned him and described him as a "notorious henchman and arms dealer." But in 2013, the U.S. Treasury issued a general license to the Asia Green Development Bank, one of four such Myanmar banks (the others being MEB, MICB, and Ayeyarwady Bank), that allows them to transact business with U.S. companies.

Ayeyarwady Bank (or AYA Bank) is another "crony bank" that received a license to operate in 2010. Owned by Zaw Zaw and part of the Max Myanmar Group, the bank had earlier been a target of U.S. sanctions; but earlier this year it was allowed to transact business with U.S. companies. It now has 48 branches and is growing rapidly.

United Amara Bank was the third "crony bank" given a license in 2010 and is owned by Nay Aung as part of the IGE (originally "International Group of Entrepreneurs") conglomerate, which has interests in oil and gas, gasoline retailing, banking, agriculture, timber, and other sectors.

Myanmar Apex Bank is the fourth and last of the four "crony banks" that received their banking licenses in 2010. Owned by Chit Khaing as part of the Eden Group, the bank has 20 branches and is rapidly modernizing its operations.

Myanmar Oriental Bank was established in 1993 and is owned and run by and for the Chinese community in Myanmar. Although not among the largest private banks in Myanmar, it is one of the most transparent, regularly publishing its financial statements, reflecting its professional management and its desire to eventually become a joint venture with a foreign bank.

The **Tun Foundation Bank** is an unusual financial institution, which devotes its net after-tax income to health and education charities. Although not in the forefront of growth and efficiency among private banks in Myanmar, it is nevertheless a respected institution that seeks to ensure that its operations are within the letter and the spirit of the law.

The **Asia Yangon Bank** is a small bank that specializes in wholesale banking—namely, it services large corporate clients, mid-sized companies, real estate developers, and investors.

The **Myanmar Microfinance Bank** was recently established (July 2, 2013) and is putting in place its financing arrangements. The bank was established by Cambodia's Acleda Bank, which has an excellent microfinance track record in its own country. It is being supported by the International Finance Corporation (IFC), a member of the World Bank Group, with a $2 million loan.

Other Parts of the Financial System

Myanmar does not yet permit foreign direct investment (FDI) in banking, and as a result Yangon has 35 representative offices of foreign banks, which provide liaison support to clients operating in the country. Perhaps the most visible of these offices is that of Standard Chartered, which, in an agreement signed between President Thein Sein and the British minister of trade and investment, is working with the British government to develop capacity in Myanmar's financial sector through education, training, and technology development.[11] The CBM is actively considering the entry of foreign banks and has engaged an international consultant firm to help decide on the terms and conditions of entry, the number that should be permitted to operate in the country, and the criteria for choosing among the many foreign banks eager to start operations in Myanmar.

Trade financing is conspicuous by its absence in Myanmar. Foreign banks are unprepared to accept letters of credit issued by Myanmar banks (initially because they were prohibited to do so by the sanctions, but also because of concerns about the creditworthiness of Myanmar banks). Now the IFC and the private and financial sector arm of the Asian Development Bank are actively considering guarantee facilities that would extend the creditworthiness of their balance sheets to Myanmar banks that provide trade financing.

There are very few formal nonbank financial institutions in the country. The Ministry of Finance's Insurance Business Supervisory Board regulates the insurance industry, but state-owned Myanma Insurance—Myanmar's only formal insurance company until 2013—performs the board's work, including the regulatory oversight of the sector. In 2013, the board granted domestic operators twelve new licenses (to provide a range of services similar to Myanma Insurance): Aung Myint Mo Min Insurance Co. Ltd.; Aung Thitsar Oo Insurance Co. Ltd.; Ayeyar Myanmar Insurance Co. Ltd.; Capital Life Ltd. Insurance Application; Citizen Business Insurance Co.; Excellent Fortune Insurance Company Ltd.; First National Insurance Co. Ltd.; Global World Insurance Co. Ltd.; Grand Guardian Insurance Public; IKBZ (International Kanbawza) Insurance Public Co. Ltd.; Pillar of Truth Insurance Co. Ltd.; and Yang Insurance Global Co. Ltd. Eleven of them have already started operations.

Finally, Myanmar has a nascent capital market. An estimated 60 to 70 private companies in Myanmar have shares issued to the public and permit over-the-counter trading in their shares. Shareholders can visit a company's offices to buy or sell shares or to receive company performance updates. Under the law, only Myanmar citizens are permitted to buy or sell shares. None of these companies, however, uses the Myanmar Securities Exchange Center, which was established in 1996 as a joint venture between the Myanmar Economic Bank and Japan's Daiwa Institute of Research. So far, only two companies have been listed on the exchange—Myanmar Citizen's Bank and the Forest Products Joint Venture Corporation—both of which are semi-government

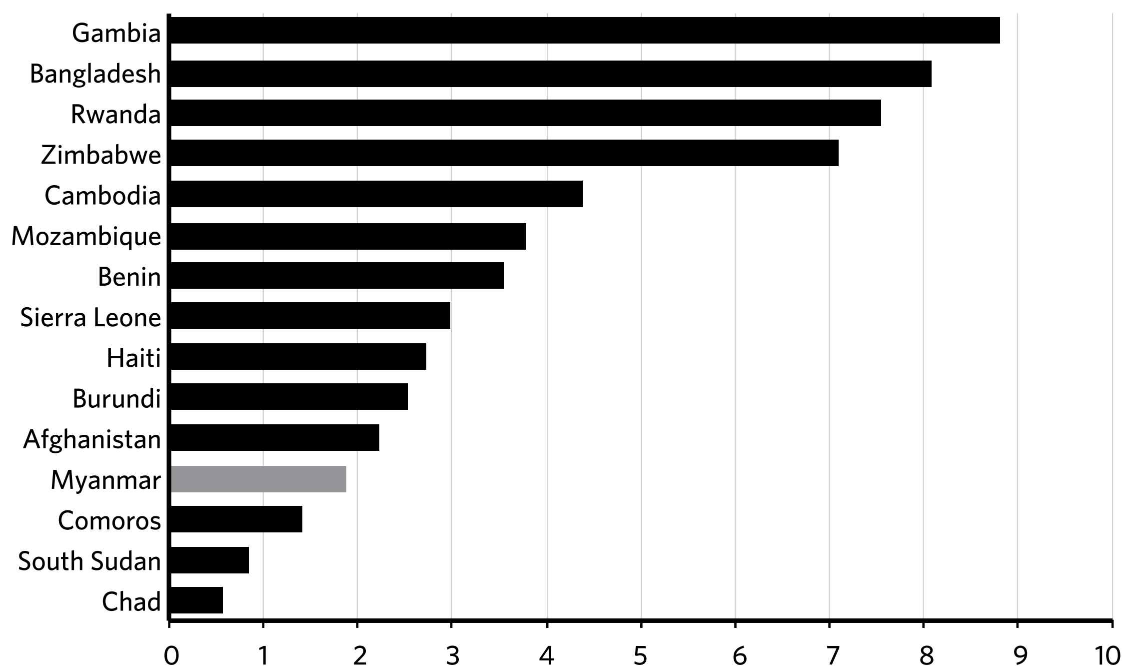
institutions (the latter is the commercial arm of the Ministry of Environmental Conservation and Forestry). There is virtually no trading of shares. The Tokyo Stock Exchange Group Inc. and Daiwa Securities Group Inc. were chosen in 2012 to help Myanmar set up a stock exchange by 2015.

The Performance of Myanmar's Financial System

If judged by the number of branches and ATMs—or by the amount of deposits, loans, foreign exchange transactions, fund transfers, and remittances—there is every indication that Myanmar's financial sector has been growing rapidly. Unfortunately, it is difficult to be precise about the rate of expansion because data are scarce. Although banks submit data daily, weekly, monthly, quarterly, and annually to the CBM, these data are not made available publicly. What is clear, however, is that the genuinely private banks have made up the dynamic portion of the financial system, with the result that the 22 private and semi-government banks together have recently outstripped the four state banks in total financial assets.

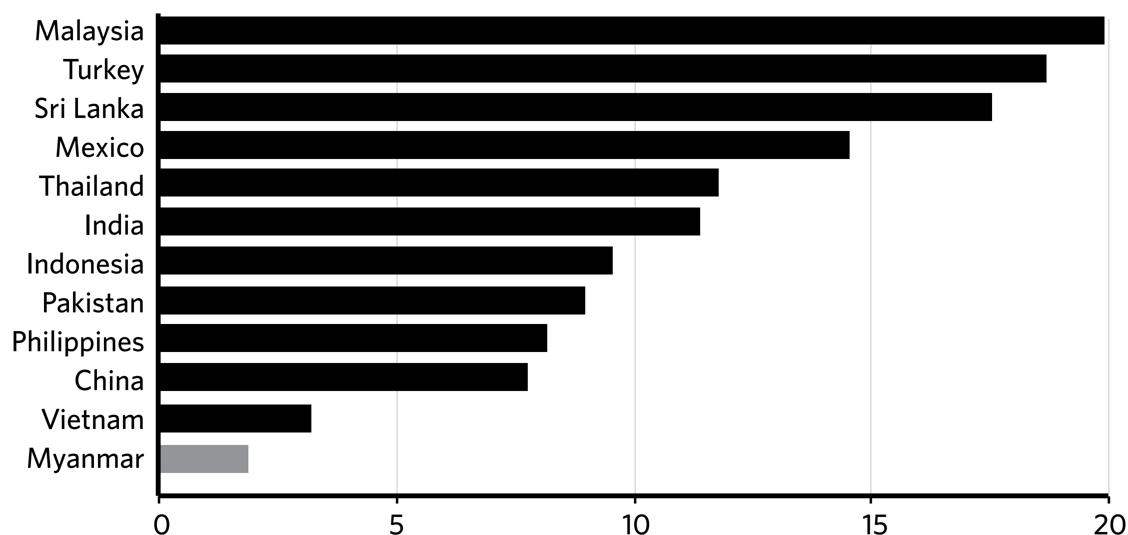
However, this rapid growth is from a small base. By most international standards, Myanmar's formal financial system is small, whether measured by bank assets as a share of GDP, number of bank branches per 100,000 people, or number of bank loans per 1,000 people (figures 2, 3, and 4). Decades of state ownership and policy shocks imposed on the system have led to a lack of confidence in cash as a safe asset and in banks as institutions capable of protecting financial assets. People in rural areas have limited access to banking services—and bank lending to agriculture is largely restricted to the MADB, which covers only a small share of the financing needs of farmers.[12]

Figure 2. **Commercial Bank Branches (per 100,000 adults) Low-Income Countries (2012)**



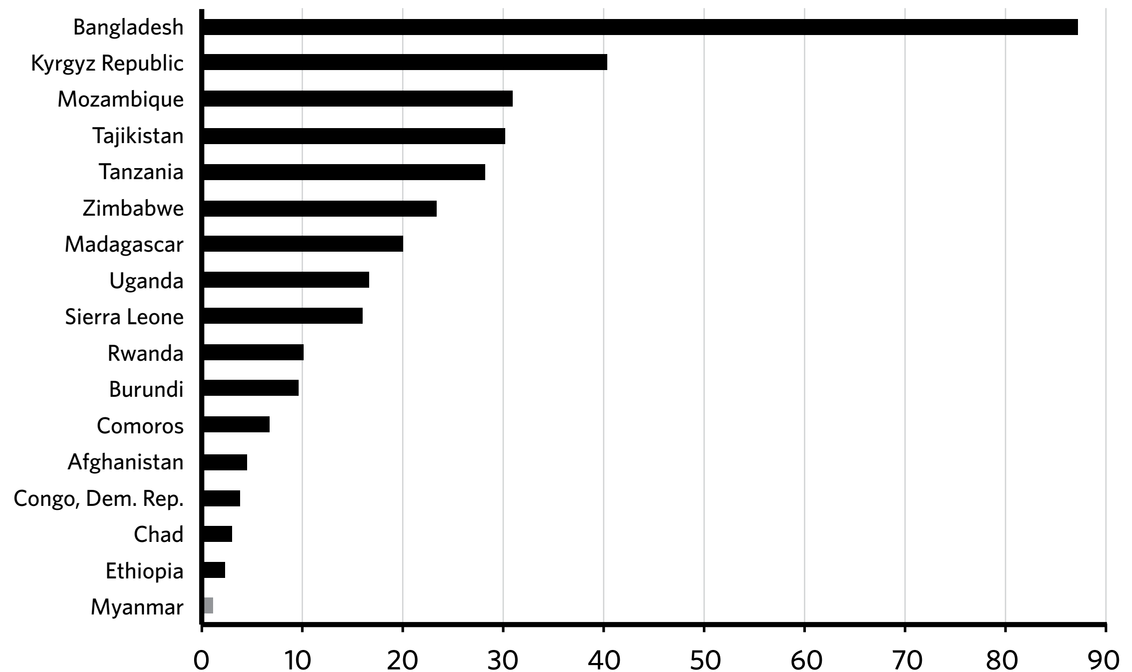
Source: World Development Indicators, World Bank

Figure 3. **Commercial Bank Branches (per 100,000 adults) Middle-Income Countries vs. Myanmar (2012)**



Source: World Development Indicators, World Bank

Figure 4. **Borrowers From Commercial Banks (per 1,000 adults) Low-Income Countries (2012)**



Source: World Development Indicators, World Bank

Collateral-based lending, and the predominance of land as the preferred collateral of choice, inevitably restricts lending only to those with land holdings and effectively excludes all others. Recently, however, the authorities have expanded collateral options to include key agricultural export goods. Private banks manage risks by adjusting the value of the loan to the estimated value of the collateral. This ratio can be as low as 30 percent, although most banks use 50 percent, and in some cases where the borrower is considered particularly creditworthy, the ratio can be higher. In the event of default, banks have successfully taken defaulters to court to acquire the collateral, but some banks require a presigned sale deed of the collateral, which can then be redeemed in the event of default (although this also requires court approval).

State banks are encumbered by social responsibilities imposed by the state—and dynamic private banks are rapidly eroding their market share of lending to businesses. Indeed, despite privileged treatment by the authorities—for example, interest income on deposits with state banks is nontaxable, state banks are not subject to oversight by the CBM, state agencies are required to conduct their financial transactions through state banks, and so on—state banks are unable to compete with their private sector competitors. Furthermore, state banks have little incentive to manage risk—in part, because their lending is

largely at the direction of government, but also because government guarantees ensure that banks will be recapitalized in the event of insolvency.

Private banks also have their shortcomings. Most are owned by closely integrated private commercial groups, and consequently their loan portfolios tend to be concentrated within the group and can mask large risks. The CBM faces considerable challenges in implementing regulations that restrict lending to related parties, which include a 20 percent single-borrower limit and a 20 percent related-party borrower limit. In addition, borrowers that do not belong to bank-owning conglomerates—especially microenterprises, small enterprises, and medium-sized enterprises—find it difficult to access finance from the formal banking system and must resort to borrowing from informal sources, where loans are usually available at higher interest rates and with shorter maturities.

The growth of the financial system in general, and of the banking system in particular, is constrained by weaknesses in basic institutional systems and infrastructure. The financial system especially needs an automated payments clearance system, a money market system for modern liquidity management, and an electronic real-time data system connecting banks with the CBM. Payments are predominately cash-based and often involve the physical movement of large amounts of cash across the country; progress on an interbank payments system has begun, but check clearing between banks is still manual, and the system for Real Time Gross Settlement is still in its planning stage. An informal (and unregulated) payments network predates the banking system by some thirty years. In what is called the Hundi system, dealers facilitate payments through business or family networks, primarily between Myanmar and the rest of the world.[13] There is no credit information system, and the CBM's off-site and on-site supervision capabilities are only just being developed. Finally, the reporting systems of the banks and the CBM are done via facsimile, with no online real-time link; the CBM's capacity to analyze and digest these data is limited; and none of this information is made public. The absence of well-functioning institutional infrastructure and information systems limits financial development; poses a constraint to the CBM in monitoring, analyzing, and supervising the banking system; and impedes liquidity and cash management in banks. The lack of debtor information also leads banks to base their lending on collateral and guarantees and limits lending to small borrowers.

The financial system especially needs an automated payments clearance system, a money market system for modern liquidity management, and an electronic real-time data system connecting banks with the CBM.

Recent and Ongoing Reforms

In a relatively short period of time, the government has made considerable progress in implementing reforms that will have a significant effect on financial sector development. These include policy changes affecting the financial system

directly as well as those that affect it indirectly. The most significant example of the latter is the liberalization of the foreign exchange market. A foreign exchange auction is conducted every day, and the resulting official exchange rate has converged to the "curb market" rate. The relatively free availability of foreign exchange has increased business opportunities for banks, as it has for the entire economy. Since October 24, 2011, the CBM has granted licenses to private banks for the operation of foreign exchange counters, and since November 25, 2011, it has also given foreign exchange dealer licenses (including an interbank foreign exchange market and currency remittance service for Myanmar citizens living abroad). Similarly, a new FDI law has been approved, and accompanying rules and regulations have been issued. The law protects foreign investors from nationalization during the life of their projects and for any extension period approved by the Myanmar Investment Commission.

In addition, the government has approved important new laws that will contribute to the country's financial infrastructure. On July 12, 2013, Myanmar's president approved the new Central Bank Law, which repeals the Central Bank of Myanmar Law of 1990. But the rules, regulations, bylaws, orders, and directives issued under the repealed law will remain in force until a new body of associated regulations is issued. The main feature of the new law is that the CBM will be an autonomous body independent of the Ministry of Finance and will have two main objectives: to promote efficient payment mechanisms, and thus to ensure the liquidity, solvency, and proper functioning of the financial system; and to foster the monetary, credit, and financial conditions that are conducive to sustainable economic development. In its furtherance of these objectives, the CBM will be able to independently adjust interest rates, and to conduct currency and exchange operations. It will be responsible for the supervision of banks only—nonbank financial institutions and microfinance institutions will remain under the supervisory authority of the Ministry of Finance. A nine-member governance board has been established, chaired by a newly appointed CBM governor. Board members must be nominated by the president's office and approved by Parliament. The newly independent CBM also plans to double its staff and to set up new departments. There will be four committees—in charge of financial stability, monetary policy, payment systems, and foreign exchange management.

The new law and its accompanying regulations will allow the CBM to revise its earlier practice of implementing prudential regulations through direct interventions often requiring ex-ante approvals and to replace them with indirect approaches, such as on-site and off-site supervision, real-time electronic data transfer, and ex-post penalties against violations of CBM requirements. The new CBM regulations will also need to end the earlier practice of discriminating against private banks and providing financial support and regulatory forbearance in favor of state banks. For example, capital/deposit ratios are currently applied only to private banks, not state banks. Deposit interest income from state banks is tax-free. State banks are not required to report their

financials as often as private banks. Private banks are effectively locked out from lending to agriculture because the state-owned MADB operates as an agency of the Ministry of Agriculture and bundles inputs provided by state-owned enterprises (for example, seeds and fertilizer) and financing, and the ministry buys the final agricultural product.

On July 31, 2013, the government enacted the new Securities Exchange Law, which provides the framework for the establishment of a stock exchange. The new law establishes the Securities and Exchange Commission, the main regulatory body to supervise the securities market; lists the licenses needed for businesses dealing in securities (brokerages; underwriters; investment advisers and company representatives); allows the establishment of an over-the-counter market; lists actions considered in violation of the securities law (such as insider trading) and the associated penalties; and provides for the establishment of a securities depository and clearing agency. The law will now need to be accompanied by a new company law that provides for improved corporate governance and accountancy standards, a robust regulatory and reporting framework, and a level of transparency that will give domestic and international investors adequate information for investment decisions.

A revised Financial Institutions Law is also being drafted, with the assistance of the World Bank, to replace the Financial Institutions Law instituted in 1990. The law is expected to set out the licensing requirements for private banks, corporate governance arrangements, and the conditions for foreign investor participation in Myanmar banking.

Thanks to these and other reform initiatives, an overall policy framework for the banking system is gradually taking shape that is broadly consistent with international norms and practice. The challenge increasingly will not be the regulatory framework itself but the capacity of government institutions—especially the CBM—to implement the new laws and regulations and to ensure they are followed in spirit and to the letter by all banks, both state and private. Private banks have already been given increased freedoms to set up branches, buy and sell foreign exchange, hold foreign exchange assets on their balance sheets, and in some cases even lend indirectly to the agricultural sector. These freedoms appear to be piecemeal and not only need to be enshrined in new regulations but also need to apply to all banks equally.

Other CBM policies and regulations governing bank operations may change from time to time, depending on the circumstances and requirements; these include the following:

- A 10 percent risk-weighted capital-adequacy ratio, which is reasonably cautious (although definitions of bank capital, risk weightings, and nonperforming loans are not yet based on international standards).
- A maximum loan-to-deposit ratio of 80 percent, applicable only to private sector banks, had been in effect but was recently abolished.

- A cap on deposits equivalent to ten times paid-up capital. This was initially set at seven times following the 2003 crisis and relaxed to ten times in 2006.
- A single-borrower limit and a single related-party lending limit set at 20 percent of the bank's capital base.
- A reserve requirement equivalent to 10 percent of total deposits.
- A minimum liquidity ratio equivalent to 20 percent of deposits (in addition to the CBM's 10 percent required reserve requirement).
- Maintenance of a general reserve account equal to paid-up capital, to be funded by 25 percent retention of net profits (until the requirement is met).
- General provisioning of 2 percent of total loans; and loan loss provisioning equal, respectively, to 50 percent and 100 percent of doubtful and bad loans.
- Loan maturities of more than one year are not permitted, but borrowers are permitted to roll loans for a further two years.
- Collateral is required for all lending. Collateral can consist of property (land and buildings) or gold and, recently, key agricultural export commodities.
- Interest rates for both deposits and lending are regulated by the CBM. Current lending, deposit, and CBM rates are set, respectively, at 13 percent, 8 percent, and 10 percent. CBM regulations actually permit banks to set deposit rates within a range around prescribed levels, but complaints by smaller private banks unable to compete against larger, more modern ones led to "informal" CBM instructions that any variation around the central rates would not be countenanced.

A concerted effort is being made to improve the country's financial infrastructure. The International Monetary Fund (IMF) continues to provide technical assistance to strengthen the CBM's capacity (for instance, two resident advisers are assisting the CBM with foreign exchange market development and bank supervision), as well as to reorganize the Ministry of Finance, now that it is faced with the task of reabsorbing all the treasury functions currently being conducted by the banking system.[14] In addition, the World Bank and IMF are helping to prepare a financial sector development master plan that includes a financial sector development strategy; the Japan International Cooperation Agency (JICA) is helping to develop a CBM electronic network, clearance, and payments settlement system; and the Tokyo Stock Exchange and Daiwa Institute of Research Ltd. have been tasked with development of the stock exchange. Moreover, Myanmar is receiving technical assistance support from the Japan–Association of Southeast Asian Nations (ASEAN) Technical Assistance Fund to enhance the development of a bond market.

The Myanmar Payment Union (MPU) has been established, with sixteen of the nineteen private banks as members, and with a small number of retailers also on the system. The MPU is already offering a network of ATMs that permit the easy withdrawal of cash for customers of participating banks. The

plan is for the MPU to link with international card networks, such as VISA, MasterCard, the Japan Credit Bureau, and China Union Pay, all of which have signed agreements with local banks. In a recent development, the CBM has for the first time approved the issuance of a prepaid, internationally accepted debit card by a (semi-official) private bank—Cooperative Bank—which is collaborating with MasterCard. Other banks have also applied to introduce similar prepaid debit card services.

The newly established Myanmar Microfinance Supervisory Enterprise has been authorized to issue licenses to new microfinance companies—domestic and foreign. It has issued 166 licenses so far, of which 50 are licensed to issue credit as well accept deposits from the public (effectively making them banks). According to the IFC, Myanmar has about 2.8 million microfinance clients, with total loans outstanding of about $242 million. The MADB possesses the largest domestic microfinance loan portfolio ($86 million); and the United Nations Development Program's microfinance arm, PACT, is the largest nongovernmental organization (NGO) in the sector, with $29.5 million in loans outstanding. Only three foreign microfinance companies have been given a license, including Acleda Bank of Cambodia, which has started operations in partnership with the IFC. A number of NGOs operate microfinance projects, such as Proximity Designs, which received a $2 million grant from the Norwegian government to expand its operations. Some international NGOs operating microfinance projects, such as World Vision, are considering applying for a commercial license. With a commercial license, microfinance institutions can receive equity investments from domestic and international partners to expand their loan portfolios.

Key Components of a Forward-Looking Financial Sector Reform Strategy

This section identifies the key components and priorities of a forward-looking financial sector development strategy—building on the initiatives already under way. The focus is on three key objectives that must underpin the financial sector's development strategy: increasing financial sector efficiency, stability, and inclusion.

Policies to Increase the Efficiency of the Banking System

The highest priority in the financial system is to build strong institutional foundations for the banking system that will improve the efficiency of financial transactions and improve their safety and security. In many ways, this is the most difficult aspect of financial sector development because it requires patience, consistent effort, and, perhaps most important, a change in the attitude and culture of the government, the CBM, and private commercial banks.

Given the enormity of the challenge, the authorities should tap the international community to help build domestic capacity. But there should also be a clear understanding on both sides that except in very few situations, international expertise should not substitute for domestic expertise, but instead be tasked with transferring skills and systems that build domestic capabilities. With these considerations in mind, the priorities in increasing financial sector efficiency include the following.

Automate the clearance system. JICA has been tasked by the government to implement the automation of the CBM clearance and payments settlement system. If the proposal is approved, JICA will soon be issuing a request for proposals, and the system is expected to be operational by 2015. Currently, clearance is manual and, as a result, most transactions in Myanmar are done in cash. Banks spend much time moving large amounts of cash from bank to bank, from branch to branch, or to and from the CBM—and much time and manpower is devoted to counting money at each point (which, despite counting machines, is prone to errors). Introducing a clearance system for checks and/or electronic transfers will improve banking efficiency significantly.

Automate the payments system. This is also being implemented with the help of JICA, in tandem with the clearance system, and is due to be operational by 2015. The payments settlement system and the clearance system need to be fully consistent to ensure that banks make transfers immediately after checks and/or transfers are cleared.

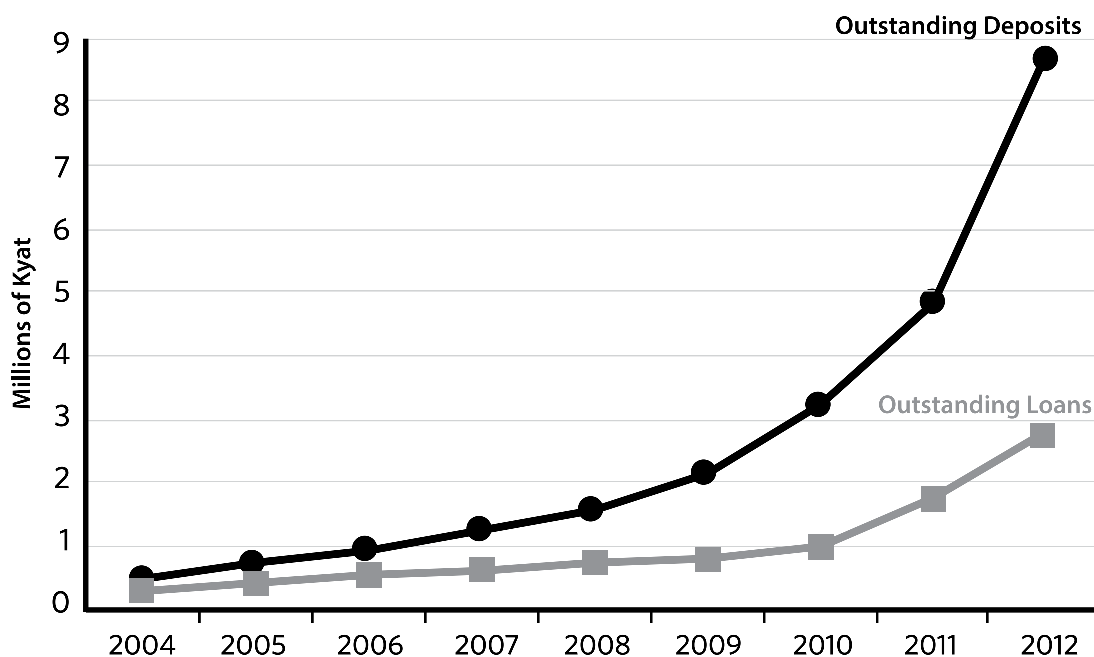
Money market system. The challenge in the money market system is the excess deposits in the banking system (see figure 5). Yet the deposit and credit auction system is not working because the budget for it is not adequate. The CBM offers banks the opportunity to deposit excess liquidity for fourteen days at an interest rate capped at 4 percent on account of budget limitations. The low interest rate provides little incentive for banks to avail themselves of the CBM's deposit facility—especially because banks have other ways to use their excess liquidity, including purchasing treasury bonds from the CBM.

Next steps include the introduction of market-based monetary instruments (such as CBM bills issued through auctions) that assist banks (and eventually nonbank financial institutions) in managing their liquidity based on price incentives. The CBM's primary objective should be to encourage banks to trade money and other liquid financial instruments among themselves; only when these prove inadequate should the CBM provide funds through its own liquidity facilities.

Repurchase agreements (or repos) will be a key instrument in money markets and an important method by which the CBM can exert indirect monetary control and influence liquidity in the financial system.[15] Repos become particularly important when counterparty credit risks are high (as they are in Myanmar) because they are a form of collateralized lending.

The repo market, however, requires an underlying legal structure. Participants should meet key prudential financial criteria—such as minimum

Figure 5. **Outstanding Loans and Deposits of Commercial Banks in Myanmar**



Source: Financial Access Survey, International Monetary Fund

capital requirements and the ability to meet mandated liquidity ratios—and should be subject to CBM oversight. The CBM should also apply reserve requirements as an initial means to control liquidity, and design a framework whereby banks can access the CBM's standing liquidity facilities if their efforts in the interbank market are not successful. The money market will develop as the CBM buys and sells these short-term instruments, adjusts the appropriate level of required reserves in line with macroeconomic needs, and alleviates systemic liquidity shortages when they arise. The IMF and the World Bank are providing technical assistance to the CBM on all these initiatives.

Credit information system. One of the most important market failures in financial markets is asymmetric information between lenders and borrowers. One way to partially correct such asymmetry is to have a credit information system in which all banks have secure access to a smoothly functioning interbank information system that shares accurate and up-to-date data on the outstanding stock of debt of individual debtors, terms of loans, collaterals pledged, and repayment records. Myanmar does not have such a system, nor has any work yet begun on one. A modern, credit-based economy requires access to complete, accurate, and reliable information concerning borrowers' payment histories. Key features of a credit information system need to include the legal framework (credit information systems should enjoy legal protection sufficient

to encourage their activities without eliminating incentives to maintain high levels of accuracy). In addition, measures are necessary to safeguard the information contained in the credit information system, and there should be incentives to maintain the integrity of the database. The information collected and distributed by credit information systems should only be available to advance public policies. Those with their credit details in credit information systems should have access to their information and be able to dispute inaccurate or incomplete information. Mechanisms should exist to have disputes investigated and have errors corrected. Finally, the law underpinning the credit information system should permit regulators to assess an institution's risk exposure and to impose sanctions for violating any laws and should be sufficiently stringent to encourage compliance.

Financial accounting standards. The Myanmar Financial Records Standards (MFRS) have already been issued, but they are not being enforced. Without the use and enforcement of MFRS, the CBM's supervision of banks becomes very difficult. It is critically important that all banks and firms use accounting systems that meet the MFRS so that balance sheet, profit and loss, and income and expenditure data, as well as all typical financial ratios, are based on the same definitions. Although the CBM's supervisors analyze the daily, weekly, monthly, and quarterly financials to make sure that the banks are abiding by the CBM's prudential regulations, the absence of standards makes it difficult to know that the numbers being analyzed truly reflect the banks' actual conditions. In addition to ensuring that all banks use the MFRS, it is important that the CBM requires all banks to make public their audited balance sheets and income statements, to post them on the banks' websites, and to issue them in printed form for the public, stakeholders, and relevant parties. The 1990 Financial Institutions Law does not have any requirements for this, and the new Financial Institutions Bill will need to correct this oversight. Once the CBM has real-time electronic access to the accounts of commercial banks (which should be part of the JICA-supported clearance and payments settlement system), CBM supervisors will be in a better position to focus on analyzing the submitted data to obtain a better understanding of the banks' financial positions, the riskiness of their portfolios, and their solvency and liquidity. In addition, introducing MFRS in corporate accounts would significantly improve the ability of commercial banks to assess their credit risks.

Enhance the role of FDI in deliberate steps. Currently, foreign banks can only have representative offices and the financial institutions law forbids FDI in banks. Virtually all foreign investors and foreign traders use foreign banks based abroad to finance their operations in Myanmar. Although this could continue, it obviously limits and impedes foreign investments in Myanmar and prevents state-of-the-art financial services from entering Myanmar's financial system and benefiting households and firms. The authorities have engaged a foreign consultant to help them decide how many foreign banks should be allowed to enter the domestic banking system and on what terms. The authorities are considering

various possibilities, including strategic partnerships, joint ventures, and finally full ownership. Many private domestic banks are keen to enter into partnerships or joint ventures with foreign banks to get access to new technology, training, finance, external retail branch networks, and better management.

The authorities should base their decisions on the role of FDI in Myanmar's banking system on a clear understanding of the advantages of FDI in the financial sector and the systemic financial sector risks that the immediate entry of foreign banks could induce. International evidence shows that FDI in the banking sector can offer important benefits, but it can also introduce risks.[16] The presence of foreign banks can help build a more robust and efficient banking system by introducing international practices and standards; by enhancing the quality, efficiency, and breadth of financial services; and by accessing more stable sources of funds. These benefits could be substantial, provided the regulatory and institutional framework for the financial system is strong. If the framework is weak, however, the benefits and costs of FDI depend on how it is phased in and on what other reforms, particularly of the regulatory and institutional framework, accompany it. Countries with successful experiences opened up to foreign banking only after they already had well-developed institutional capacity and they were already engaging in rapid domestic deregulation. Successful examples are mainly of middle-income and advanced economies, such as Argentina, Spain, Ireland, and Portugal. There are no examples, however, of low-income countries that have opened their banking sector successfully to FDI, except with numerous restrictions and limits.

Many private domestic banks are keen to enter into partnerships or joint ventures with foreign banks to get access to new technology, training, finance, external retail branch networks, and better management.

It follows that for the time being, the Myanmar authorities may wish to err on the side of caution when considering the entry of foreign banks. The institutional infrastructure and regulatory framework for banking remain weak and will take years to strengthen. The premature entry of foreign banks could potentially lead to a rapid shift in the depositor base from domestic banks to the new foreign bank entrants, placing domestic banks at risk of financial distress and possibly also placing the solvency of the entire domestic financial system at risk.

That does not mean, however, that FDI in banking should not be encouraged altogether. On the contrary, the authorities should encourage domestic banks to pursue strategic partnerships and joint ventures with foreign banks. Some of these cases may involve accepting foreign share capital in an existing domestic bank. In others cases, a new joint-venture bank could be established (although the government would need to take care that the number of new banks is kept in check—see below). It is possible that in the first few years, no foreign banks will be eager to assume the role of minority shareholder in a Myanmar bank. This should not discourage the government. With further stabilization and reform of the banking system, foreign interest in joint

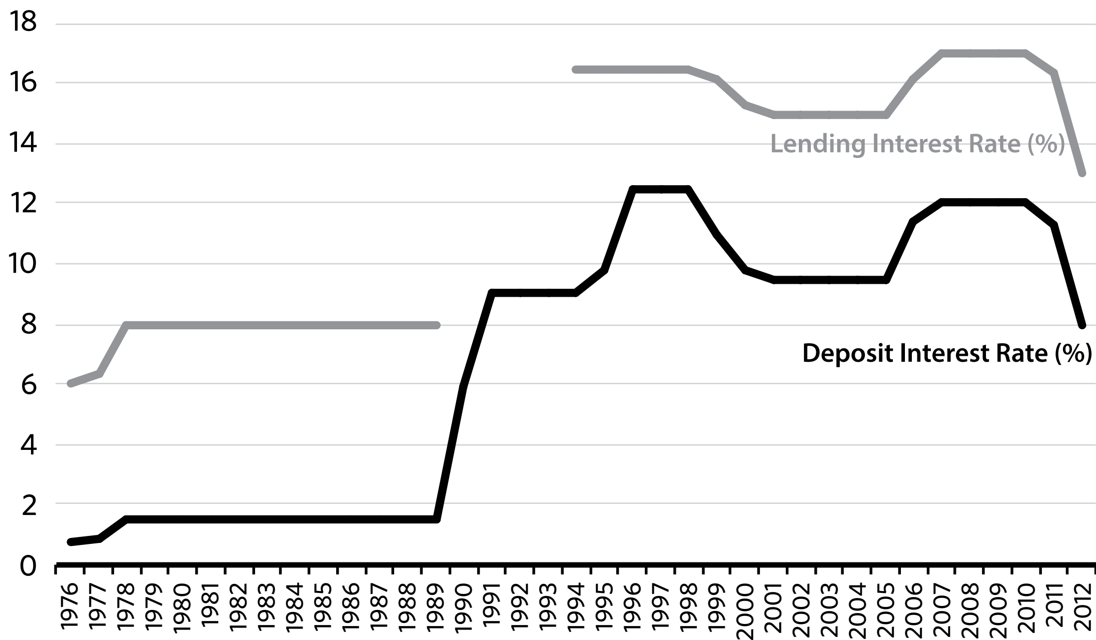
ventures will pick up. In the meantime, the government, using the support of bilateral donors as well as the World Bank and the Asian Development Bank, should contract foreign banks to provide technical assistance and training to Myanmar bank personnel and management. In subsequent years, when the authorities are convinced that the regulatory and institutional framework is in place and that domestic banks are financially sound, they may consider licensing majority foreign-owned bank operations in Myanmar.

If the authorities allow full foreign ownership of banks immediately, then it would be prudent to impose certain restrictions on their operations. Most important, foreign banks should be restricted to only serving the foreign investor community and barred from retail banking, including deposit mobilization. In this context, the CBM should also be fully aware of the risks posed by foreign subsidiary banks if their parent bank gets into financial difficulties (the case of Eastern Europe during the recent global financial crisis demonstrates the risks posed by foreign bank subsidiaries). The growing complexity and interconnectedness of financial institutions, coupled with the lack of effective cross-border resolution regimes, tend to compromise the ability of both home and host authorities to cope with the failures of large international banks. Globally, a number of policy options have been proposed to address this problem, including measures to contain the negative externalities arising out of size and interconnectedness, improving the capital and liquidity buffers held by such institutions, and enhancing their resolvability. The lessons learned during the financial crisis lean in favor of the domestic incorporation of foreign banks, which would ensure that there is a clear delineation between the assets and liabilities of the domestic bank and those of its foreign parent, and would clearly provide for ring-fenced capital and assets within the host country.

Interest rate policy. Currently interest rates are fixed (see figure 6). Banks can borrow from the CBM at its reference rate of 10 percent. Deposit rates are set 2 percentage points below the reference rate (8 percent), and lending rates are set 3 percent above (13 percent). Treasury bond rates are also linked to the reference rate—8.5 percent for two years, 9 percent for three years, and 9.5 percent for five years. Although the CBM's regulations allow banks to compete within a narrow band around these interest rates, in reality the CBM requires strict adherence to the actual rates (banks are expected to compete on service standards, not interest rates). The fixed interest rate structure has meant that real interest rates have been very volatile (given the variance in inflation rates, see figure 7). The fixed interest rate structure also permits banks to use their excess liquidity to purchase treasury bonds, but liquidity shortages are somewhat more difficult to manage in the absence of a secondary market.

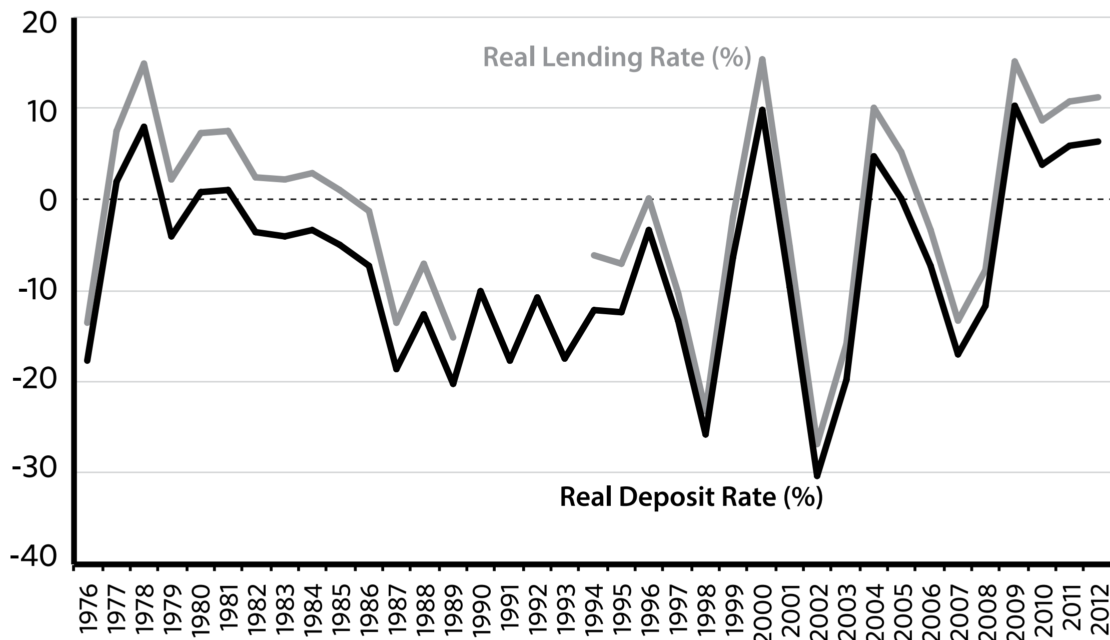
It is best if the CBM does not initially change its approach to setting interest rates (although it should adjust this structure from time to time to reflect macroeconomic conditions and monetary policy objectives). Its focus instead should be on building the financial system's infrastructure, including its own supervision capabilities. Liberalizing interest rates too early in the absence of

Figure 6. **Lending and Deposit Interest Rates in Myanmar (1976–2012)**



Source: World Development Indicators, World Bank

Figure 7. **Real Lending and Deposit Interest Rates in Myanmar (1976–2012)**



Source: World Development Indicators, World Bank

a strong financial infrastructure and supervision and risk management system can lead to risky bank behavior and exacerbate systemic risks. The appropriate sequence should be for the CBM to stick to the current practice of establishing the interest rate structure, as it is doing now, but taking care to make sure that depositors earn positive real returns on deposits and that banks have an adequate intermediation margin. After some years, with the development of the CBM's capabilities and a suitably strong financial infrastructure, the CBM could consider replacing a fixed interest rate structure with a floor for lending rates and a ceiling for interest rates—which will gradually introduce some competition between banks on the price of capital (at the margin). Finally, after what could be more than a decade or two of strong financial sector development, the government could consider liberalizing lending rates first—and then, at a later date, liberalizing deposit rates. But this last stage is not something that should concern policymakers today.

Consolidate the number of commercial banks. Myanmar's commercial banking system currently has 24 banks (if one includes the Microfinance Bank, which was established recently) and could add an additional two (a Construction and Housing Development Bank and a Livestock Development Bank). Are more banks better than fewer banks? Research on this issue conducted in financial systems across many countries suggests that the authorities need to balance the increased competition that comes with more banks in a financial system with the economies of scale that come with larger-sized banks and the franchise value of banks that can affect their approach to risk taking. If franchise values decline too much, then banks can become risk prone just to survive in a highly competitive environment, and this could generate systemic risks.[17] In this sense, the financial sector is very different from other services and goods sectors. Given Myanmar's stage of development, the number of commercial banks appears to be more than ample. Not only would it not make much sense at this stage to allow more bank entrants; it would be appropriate for the authorities to encourage mergers between banks to reduce the number of banks—starting with the state banks (see below).

Apply regulations equally to state and private banks. As noted above, with weak CBM oversight and supervision, it would be inappropriate to allow banks to compete for deposits and borrowers on the basis of interest rates—this will avoid excessive risk-taking and lower the probability of bank failures. At the same time, however, banks must be allowed to compete on the basis of service standards and fees. An important component of bank income accrues from fees for remittances, whether domestically or internationally. The CBM has fixed the remittance fee at 0.125 percent of the transfer amount—but such fees could be subject to competition between banks. Similarly, to encourage competition between banks, the CBM and the government should ensure that the rules under the Financial Institutions Law be applied equally to state banks and private banks. There is no reason for the MEB, MICB, or MFTB to be treated differently when it comes to prudential risk ratios or the tax treatment

of income from deposits. Another way in which the CBM could help reduce costs and encourage competition would be to allow banks that bid successfully at the foreign exchange auction to indicate an account of their choice where the auction-bought foreign exchange should be deposited. At present, the auction proceeds are deposited at the head office account of the private banks—when the money is needed outside the country to pay for import purchases of bank clients. There are other similar low-cost solutions that would significantly increase the efficiency of the banking system. To find them, the CBM should regularly consult with the private banks and with representatives of the public (and enterprises) to seek such solutions.

Audit and restructure state banks. Currently, there are four state-owned banks, and careful consideration needs to be given to their role in Myanmar's future banking system. In due course, the authorities should return the central banking and treasury functions performed by these banks to the CBM and to the Ministry of Finance, so that the state banks can focus on their banking activities.

In addition, the government should initially subject all four state banks to thorough financial and performance audits, including portfolio reviews and stress tests, conducted to international standards with a view to their restructuring and rationalization. Once the results of the portfolio review are known, the government could, jointly with the international financial institutions, prepare a restructuring and rationalization strategy that would reorganize the four state banks into one, or perhaps two, state development banks—or, alternatively, into one credit guarantee agency. The state development bank (or banks), or the credit guarantee agency, should be designed to support underserved but high-priority areas of the economy that can yield high financial and social rates of return—for instance, the agricultural sector or small and medium enterprises in manufacturing or services. There are many possibilities, and all should be considered.

Each of these restructuring possibilities has merits and drawbacks, and a couple approaches are worth mentioning. For example, the MADB could be separated from the Ministry of Agriculture and restructured into a separate state development bank (see the section below on state development banks), with a capital-adequacy ratio meeting the CBM's standards and focused solely on supporting small-scale agricultural borrowers. Or the MADB could be closed, and the government could transfer its responsibilities to the microfinance banking system (see below) as well as to the remaining private and state banks.

Similarly, the MFTB (which would need to return the external reserve management functions to the CBM) could transfer its international fund transfer responsibilities entirely to the private banks, now that they have their foreign exchange licenses, are developing their correspondent banking networks abroad, and are operating in the same space as the MFTB. The government may still want its official international financial transactions to flow through a state-owned bank, and this could be done either through the MICB or the MEB (see the next paragraph).

Finally, a thorough assessment of the financial condition of the MICB and MEB would provide the relevant information to determine whether (and how) they should be restructured, or perhaps merged. The new entity should no longer provide commercial banking services (which should be provided by private commercial banks only), but instead should focus solely on development banking (see below). Finally, the CBM should subject them to the same prudential standards and supervision oversight as are required for the private banks. Good examples of other countries adopting similar reforms are Vietnam, when it applied the Asian Development Bank's resources to audit two state banks before restructuring them, and Indonesia, where donor resources were used to finance audits of state and private banks before their closure or restructuring.

Policies to Promote the Financial System's Stability

Strengthen CBM supervision capacity. The CBM's bank supervision department has fewer than 20 bank supervisors (split equally between on-site and off-site supervision duties). Not only does the CBM need more supervisors; it needs to train all the supervisors in the latest bank supervision techniques. This will take time, but the demand for high-quality supervision capacity is urgent. The CBM, with the support of grant funding from the donor community, should therefore seriously consider hiring 20 world-class supervisors from neighboring Asian countries (and who thus are familiar with Asian conditions). These supervisors could be contracted for a period of about five years to kick-start the CBM's supervision capacity (and the adherence of banks to the MFRS), and to train CBM supervisors, who can then take over all supervision responsibilities within the five-year period.

Streamline regulations. The thrust of the CBM's reform strategy for its banking regulatory framework will need to be from direct and ex-ante oversight and approvals of transactions to indirect and ex-post supervision to ensure that banks are operating responsibly and within CBM guidelines. More regulations do not necessarily translate into more stability, and could instead smother banking development. What is needed is smarter regulation, and one way to achieve this would be to conduct an audit of all banking regulations and eliminate those that serve little purpose—for example, eliminate all restrictions that impede private banks from lending to agriculture, and eliminate restrictions on opening new branches (including incremental capital and staffing requirements). This will be an ongoing process that could be supported by advisers from the international financial institutions as well as from other central banks.

Develop a risk management framework (including a resolution framework and process for insolvent banks). A key part of ensuring the stability of the financial system is to allow the orderly exit of financial institutions that become insolvent and have little chance of regaining solvency. The authorities should not wait until insolvent institutions become illiquid and precipitate a systemic crisis; nor should they try to prop up institutions with open-ended financial

support (whether from the budget or from the CBM's liquidity facilities) or to curtail competition to protect the viability of certain banks. Instead, the CBM or the Ministry of Finance should consider establishing a department that can assist in the winding down of unviable banks in an orderly fashion, ensuring that depositors (especially small depositors) are protected in the process, and that any risks do not get transferred to other banks or financial institutions. Such a department could also be responsible for restructuring state banks to make them viable (see above).

Establish a deposit insurance system. Depositors have limited information about the risk and value of bank assets, and in times of crisis this can lead to bank runs and a contagion of the crisis, spreading from one bank to the next. Deposit insurance can limit the risk of bank runs by guaranteeing depositors that they will receive some, or all, of their deposited funds if their bank becomes insolvent or illiquid.[18] Myanmar's deposit insurance system is currently the responsibility of the state-owned Myanma Insurance Agency (which is also responsible for licensing other insurance agencies and supervising their activities). The Myanma Insurance Agency may have experience in standard insurance activities (such as life and health insurance), but it has limited experience with deposit insurance—where the risk cannot be calculated with typical actuarial tables but rather discerned with a deep understanding of how banks function and where risks are likely to emerge. For this reason, deposit insurance agencies are typically separately funded agencies that work closely with the CBM.

Clearly, deposit insurance alone cannot be a panacea for banks' financial instability. On the contrary, deposit insurance will be unsuccessful without effective bank supervision, emergency liquidity lines, and strong prudential standards implemented by the CBM. At the same time, if the CBM were to provide deposit insurance protection, it should design it such that it encourages prudential standards and discourages risky behavior—in particular, moral hazard. The CBM can achieve this by introducing penalties for risky behavior by bank owners and management; and deposit insurance protection, if available, should only cover small savers, placing shareholder equity at stake in the event of bank insolvency. To further avoid moral hazard, not only should the government refrain from issuing guarantees on an ad hoc basis for favored private or public projects; it should also insist that adequate, risk-based premiums are collected to finance any provision of a deposit protection service. In Myanmar, where bank supervision and other prudential mechanisms are weak or largely absent, deposit insurance—albeit limited in what it can do—can still contribute to the stabilization of the banking system. At the same time, it is also important to remember that deposit insurance protection with low levels of coverage and/or partial insurance may not be effective in preventing bank runs.[19]

All this suggests that Myanmar should be cautious about introducing deposit insurance without carefully considering its parameters and arrangements.

Without the necessary supervisory and financial underpinnings and adequate market discipline, the government could incur substantial fiscal losses in the event of a financial crisis. The best course would be for the government, with the help of the donor agencies or the international financial institutions, to study the feasibility of a deposit insurance program in Myanmar, borrowing from good practices in other developing countries at a similar stage in their financial development. A further possibility would be to explore the possibility of a deposit insurance protection service backed by an option to draw down a contingent loan from one of the international financial institutions.[20]

Capital market development. In low-income countries, the banking system tends to dominate financial intermediation between savers and investors. Over time, however, savers in search of higher returns and users in search of cheaper capital develop direct contacts, which eventually lead to the formation of capital markets. And with respect to capital markets, the money market precedes all others, given its central role in transmitting information about interest rates. The development of a government bond market tends to follow the creation of money markets, and corporate bond and equity markets should only be developed once government bond markets are well established. Policies to develop capital markets should observe this same sequencing. Rushing these three stages can lead to instability, because risks can spread rapidly from one market to another. It is important that sequencing be done right so that the risks of each market can be managed once they are established before embarking on the next stage of capital market development. The time horizon for all three stages to be completed could range from a decade to several decades.

Capital markets take a long time to develop because they require a number of prerequisites: exchange, clearance, and settlement systems; money market infrastructure; a legal system to enforce contracts; timely information about financial soundness and the future prospects of companies; and adequate corporate governance standards that give investors confidence that their investments will not be stolen.[21] Measures that have long gestation periods need to be initiated early, such as developing a domestic investor base, developing an auction system and a secondary market for treasury bonds (including an electronic securities depository), restructuring weak financial institutions, and building a robust financial infrastructure (including a legal, accounting, and insolvency framework). The capacity for prudential supervision—it helps prevent risky market practices and fraud—also needs to evolve with the pace of financial sector development.

Those policies that are most supportive of capital market development tend to cover market infrastructure, transparency, and corporate governance. The authorities should keep listing standards high at all times—especially when the infrastructure to support financial disclosure is weak and well-trained legal, accounting, insolvency, and securities personnel are scarce. All the accounts of both financial and nonfinancial institutions need to meet international

accounting standards (in the interim, MFRS would do), and these accounts should be audited and made publicly available in accordance with the law.

Policies to Make the Financial System More Inclusive

Branches. Increasing the branch network of the banking system is an important dimension of increasing access to finance. The current distribution of branches across the country understandably favors urban areas because they reach the most customers and reduce the unit costs of banking. This comes at the cost of neglecting rural areas. Increasing the size of the branch network is important—but it is not the only answer. Myanmar's banks are also considering other, more innovative approaches—such as telebanking and mobile banking (see below). Although the CBM has significantly eased the regulatory requirements for opening new branches, there remains considerable room for reform. For example, there is no need to ensure ex-ante that the ratio of the capital base to the number of branches is kept constant (which requires banks to inject more capital each time they open a branch)—after all, the CBM already has many other prudential regulations to safeguard the risk profile of banks. Another unnecessary requirement is the physical inspection of a new branch before approval is given. All this does is to increase opportunities for corruption. Because commercial banks must compete on service standards, the CBM needs to recognize that commercial banks—especially private commercial banks—have every incentive to decide where best to locate their branches and to ensure appropriate banking standards. The CBM should focus on the overall prudential standards for the banks, and occasionally in its on-site inspections, should visit banks to see whether their systems meet the CBM's standards.

State-owned development banking. A key challenge facing Myanmar's policymakers is to increase access to financial services for small firms and farms, as well as individuals and households—especially their access to credit. The 2003 banking crisis and other shocks to Myanmar's financial system have led to an understandable emphasis on stability and prudence on the use of collateral to underpin all loans. Consequently, however, banks deny loans to those that do not own land, even if their investments could potentially generate high rates of return—while giving the lion's share of loans to those that own land (and arguably are in least need of financing).

Myanmar's president has placed considerable emphasis on extending loans to those that cannot afford collateral—and serious consideration is being given to a state-owned credit guarantee agency that will underwrite loans to small enterprises. Such agencies are only one of many kinds of specialized state-owned development banks (SDBs). They are established in the belief that investments yielding high social returns can sometimes be ignored or under-serviced by the private sector because of unattractive private returns or because of undue risk aversion (for example, Gabon Development Bank and Banco Nacional de Desarrollo Agrícola in Honduras). They can specialize in one

sector, cut across many sectors, or focus purely on external trade as export-import banks. Today, there are about 750 such SDBs around the world with different characteristics and varying ownership patterns—private, public, and mixed.[22] To develop viable and sustainable business models, a growing number of publicly owned SDBs fund commercial activities while retaining government ownership and focusing on national development (examples include the Malian Banque Nationale de Développement Agricole and the National Bank for Development in Egypt).[23]

International experience shows that only those SDBs (including credit guarantee agencies) with clearly defined mandates, high corporate governance standards, strong risk management capability, proper regulation and supervision, and a strong management team have been successful (see box 1).[24] In fact, in the past, several SDBs around the world have failed due to an unviable business model, poor lending decisions, weak management, a large share of nonperforming loans, undue political interference, capture by interest groups, and a lack of well-defined mandates.[25] Exemplars of failed development bank are four that collapsed in Indonesia on account of bad loans in the 1998 financial crisis: Indonesia's Development Bank BAPINDO (Bank Pembangunan Indonesia), Bank Dagang Negara Indonesia (BDNI), Bank Bumi Daya (BBD), and Bank Expor-Impor.

The biggest challenge development banks tend to face is the ability to manage risks (see box 1 for good practices in this regard). This reflects the difficulties they face throughout the entire lending cycle, which includes an assessment of their prospective clients' creditworthiness, the absence of accounting standards, the way risks are assessed, and the capability to enforce contracts, collect loans, or execute collateral. Other big challenges they tend to face are financial

Box 1. State-Owned Development Banks: Lessons of Experience

Despite the wave of privatization of state-owned development banks (SDBs) since the 1980s, SDBs still comprise, on average, 25 percent of the total assets of banking systems around the world. In developing countries, their market share tends to be higher. Governments have established SDBs to provide credit and other financial services to individuals, firms, and strategic sectors of the economy that private financial institutions were unable or unwilling to serve to the extent desired by policymakers. During the global financial crisis in 2008–2010, however, SDBs acquired a new role—providing countercyclical credit to private borrowers that were temporarily unable to access loans from private banks or capital markets.

An SDB is a state-owned financial institution, which has the mandate to promote socioeconomic development by financing specified economic activities, sectors, or markets. The classic justification for SDBs is that they achieve public policy goals by correcting market failures that restrict credit to areas of the economy considered important for development and social welfare. SDBs are often expected to correct market failures that restrict credit in sectors of the economy that policymakers consider strategically important. The traditional target sectors tend to be infrastructure, agriculture, and SMEs. Other—less frequent—target sectors have been renewable energy, climate change adaptation and mitigation, education, low-income housing, microenterprises, innovation, and production chains.

The raison d'être of SDBs is to correct for information asymmetries, which occur when banks cannot obtain accurate and verifiable information about the ability and willingness of borrowers to repay a loan. A common example is small borrowers, which may not have financial statements (let alone ones that are audited) and thus lack adequate information to demonstrate their

creditworthiness. Another market failure could be the absence of systems guaranteeing compliance with financial contracts (most tend to be slow, costly, or inefficient), especially because the costs of contract compliance are higher for small borrowers than for large firms. A third market failure is the externalities associated with lending to a particular sector for which private banks often overestimate the risk or underestimate the benefits or both, such as the agricultural sector or small and medium enterprises in manufacturing and services.

The best way to resolve market failures is through regulatory reforms that improve market information, increase creditor rights, ensure contract compliance, promote innovation, and expand collateral options. Governments should consider SDBs a temporary solution to increase access and serve a neglected sector while broader financial sector reforms mature. SDBs must therefore be a complement, not a substitute, for systemic financial reforms. Without systemic financial reforms, SDBs could crowd out private banks, incur financial losses and drain the budget, or have little development impact. To combat pressure from political interests to maintain SDBs even after they cease to be useful, the government could create sunset clauses by law, stipulating when an SDB should close or make it costly to extend its existence.

SDBs do not have to provide financing directly—they can instead guarantee private lending to target sectors. State-owned credit guarantee agencies are common in several countries. Such agencies have several advantages. First, they encourage competition between private banks, which helps ensure the most efficient lending outcomes. Second, the credit guarantee reduces the burden on the borrower to offer collateral. Third, the government can serve several target sectors through one institution and can therefore concentrate scarce expertise and ensure sound risk management. Finally, as conditions change and new priorities emerge, credit guarantee agencies can accordingly alter the guarantee choices they offer private banks without incurring significant adjustment costs.

Most SDBs are capitalized through tax revenues, although low-cost foreign loans and aid (such as from the World Bank or the Asian Development Bank) can also be used. Budgetary sources of finance increase the financial autonomy of SDBs, avoid competition with other regular sources of bank funding (such as deposits and bonds), and allow SDBs to provide long-term finance for development projects at below-market rates. Indeed, SDBs that are able to separate subsidies from their financing sources can function more as development agencies than as financial intermediaries. For example, if government financial support is in the form of an initial endowment, then SDBs will have an incentive to provide their services in a financially sustainable manner. In addition, limiting the ability of SDBs to assume financial liabilities, including by taking deposits, may limit the potential fiscal costs for the government down the road.

Many failures of SDBs in the developing world have been caused by weak risk assessment capabilities, poor management, inadequate monitoring capacity, poor lending decisions, a high proportion of nonperforming loans, undue political interference, capture by interest groups, a lack of well-defined mandates, widespread corruption, and negative real interest rates leading to open-ended state subsidies. In contrast, international experience shows that successful SDBs usually have clearly defined mandates, high corporate governance standards, strong risk management capability, proper regulation and supervision, a strong management team, and financial and legal arrangements that minimize budgetary support.

International experience also shows that good-practice policies applied to SDBs tend to increase their probability of success. For example, a government should legally oblige the SDB to achieve a minimum return on capital. It should transfer SDB management to the private sector and protect it from political influence by guaranteeing independence. Governing boards should be made up entirely of independent, professionally qualified members. The governing board could establish incentives supportive of good development outcomes through performance contracts and key performance indicators. It should insist that management use sunset clauses when launching a new program. Laws should explicitly prevent the government from bailing out the SDB in case of failure. Management should encourage the private sector to share the risk of lending to underserved markets. And it should use promarket instruments when supporting SDBs.

In conclusion, SDBs in Myanmar can potentially play a role in broadening access to finance and be a vehicle for countercyclical monetary policy. The legal, institutional, and incentive framework, however, needs to be crafted carefully to increase their probability of success and to minimize their burden on the treasury. The government must also create organizational capabilities to manage these institutions professionally and without political interference and implement promarket programs that supplement private sector initiatives, not substitute for them.

self-reliance (more than 60 percent of development banks surveyed around the world recently reported that they were reliant on annual budgetary subsidies), the flexibility to acquire appropriate skills and professional managers, and political interference in decisionmaking.[26]

This is not to say that development banks cannot be successful. In fact, several successful SDBs in other countries have made a development impact and have remained financially sound. Their experiences suggest some innovative ways that SDBs can improve the chances of success, which include introducing a legal obligation to achieve a minimum return on capital; placing the development bank in the private sector under a management contract; adopting legislation preventing the government from bailing out the development bank in case of failure; sharing with the private sector some of the risks of lending; and placing independent and qualified finance professionals on the board of directors.[27]

The government needs to link its decision to establish a development bank with its program to restructure state banks. Those state banks that will continue in existence will need to be transformed into development banks—leaving all commercial banking to the private sector. If the government does decide to proceed with a development bank arrangement (such as a credit guarantee program for SME lending—see box 2), it should do so in partnership with organizations such as the IFC or the Asian Development Bank, and build on the experience of other Asian countries (such as Thailand, Malaysia, and Indonesia).

Microfinance. According to one estimate, there is more than four times as much demand for microfinance in Myanmar as there is supply, which means that fewer than 20 out of 100 potential microfinance clients have access to formal financial services, with most people relying on family savings or costly alternatives such as informal moneylenders.[28] It is not surprising, therefore, that the government has placed a high priority on delivering microfinance,

Box 2. Financing Small and Medium-Sized Enterprises

Using the SDB framework, countries have two options. The first option is to set up an SDB specialized in SME financing; the second is to require all banks to include SME financing as part of their operations. The second option would include setting up a government SME financing agency that would offer one of three services: support direct lending for SMEs through banks using direct subsidies channeled through the budget, provide credit guarantees to banks offering SME finance, or provide equity financing to SMEs instead of credit guarantees. In all cases, the low-cost financing of SMEs through credit, guarantee, or equity lines is meant to overcome market failures that otherwise exclude SMEs from access to formal finance. Banks or SDBs then refinance themselves through the budgetary mechanism, through CBM credit lines, or through credit lines financed by bilateral or multilateral financial institutions.

SDBs can provide SMEs with working capital and investment loans and loans denominated in local or foreign currency, as well as equity financing or even venture capital funds. Whatever the type of financing, SDBs need to acquire specialized knowledge of SMEs and the sector into which they are lending, in part to keep the cost of lending within reasonable bounds (because the fixed

costs of information are high and loan amounts tend to be small) and to keep the nonperforming assets ratio within required prudential limits.

There is no consensus on the advantages or disadvantages of credit guarantees or direct lending. Both tend to suffer from the same challenges of high fixed information costs, large losses from nonperforming assets, and management of programs and institutions.[a] A useful mechanism to consider for exporting SMEs is for SDBs to guarantee letters of credit based on confirmed export orders and buyer letters of credit. But developing such a system requires considerable knowledge and expertise, and links with foreign banks in the major export markets. All this suggests that Myanmar should focus initially on pooling expertise and systems in one SDB, make it a center of excellence, and then after a few years review the experience to decide on next steps.

Experience from other countries—for example, India (Industrial Development Bank of India) and Malaysia (Industrial Development Finance Berhad)—also suggests that SME finance needs to be accompanied with technical assistance for project development and project design to ensure that the financing is productively and efficiently used.

[a] United Nations Conference on Trade and Development, *Improving the Competitiveness of SMEs in Developing Countries: The Role of Finance to Enhance Enterprise Development* (Geneva: United Nations Conference on Trade and Development, 2001).

for which it enacted the new Microfinance Law in November 2011 (together with Notification 277 and accompanying instructions). The agency designated to license new microfinance institutions (MFIs)—the Myanmar Microfinance Supervisory Enterprise—has already licensed 142 microfinance providers, of which three are foreign and 50 have also been given a license to collect deposits (which effectively makes them banks). The capital requirements for deposit-taking MFIs—at $30,000—is very low and, if improperly managed and supervised, could cause insolvencies among microfinance agencies in the future. Moreover, these new microfinance providers are already entering a crowded market. State banks, cooperatives, international and national NGOs, international organizations, specialized agricultural development companies, informal lenders, semi-formal village revolving funds, and community funds are already in the business of providing microfinance (figure 8).[29] Some 2.8 million borrowers are already reached by these agencies. The government may, therefore, want to pause in issuing licenses, study the microfinance sector more carefully, review the current institutional arrangements for licensing and supervision, and rethink its strategy to provide a sustainable system of microfinance.

Branchless banking. Although increased branch banking will extend access to finance, recent innovations in branchless banking have the potential of allowing Myanmar to leapfrog over other countries and provide its people with access to finance more rapidly and cost-effectively. Branchless banking includes a range of options that are not mutually exclusive: ATMs, or bank branches in a box; banking vans, or bank branches on wheels; in-store point-of-sale systems

Figure 8. **Microfinance Providers in Myanmar**

Category	Individual Institutions	Number of Branches / Outlets	Number of Borrowers	Outstanding Loan Portfolio (in Kyats)
State-Owned Bank	MADB[1]	205	1,420,000	84,000,000,000
	MSLE[2]	143	208,778	31,341,790,000
Private Bank	MLFDB[2]	53	N/A	N/A
Non-Governmental Organization	PACT - UNDP[3]	105	365,410	52,701,000,000
	PACT MFI[3]	16	57,128	4,234,502,910
	GRET MFI[4]	4	6,155	840,041,000
	Save the Children MFI[5]	N/A	7,737	367,747,782
	World Vision MFI[6]	12	13,282	1,910,033,328
	Proximity Design MFI[7]	8	16,000	3,113,831,000
	AMDA[8]	N/A	1,510	55,109,960
	Total[8]	N/A	1,197	165,077,000
Cooperatives	Central Cooperative Society MFIs[9]	46	32,851	1,125,690,000
	Financial Cooperatives–Union of Savings and Credit Federation[9]	1,625	476,632	16,500,000,000
Specialized Agricultural Companies	Rice Specialization Companies[10]	38	57,502	20,092,708,226
	Other Agri Specialized Companies[10]	22	140,000	20,000,000,000
Women's Union[11]		16	4,800	48,000,000
Union Solidarity Development Association[12]		N/A	N/A	N/A
Community Based Organizations[12]		N/A	N/A	N/A
TOTAL		**2,293**	**2,808,982**	**236,495,531,206**

Source: Eric Duflos, Paul Luchtenburg, Li Ren, and Li Yan Chen, *Microfinance in Myanmar: Sector Assessment* (Washington, D.C.: Consultative Group to Assist the Poor and International Finance Corporation, January 2013), 9, www.cgap.org/sites/default/files/Microfinance%20in%20Myanmar%20Sector%20Assessment.pdf. © CGAP and IFC. Used with permission.

Average Loan Outstanding (in Kyats)	Number of Deposit Accounts	Total Savings (in Kyats)	Average Deposit Size (in Kyats)	Regulated	Supervisory Agency
59,155	1,720,000	86,891,840,000	50,519	Yes	Ministry of Finance and Revenue
150,120	N/A	N/A	N/A	Yes	Ministry of Finance and Revenue
N/A	N/A	N/A	N/A	Yes	Central Bank of Myanmar
144,224	420,133	10,930,000,000	30,000	No	N/A
74,123	N/A	N/A	N/A	Yes	Microfinance Supervisory Enterprise
136,481	*Non-deposit taking MFI*			Yes	Microfinance Supervisory Enterprise
47,531	7,737	25,975,513	3,357	Yes	Microfinance Supervisory Enterprise
143,806	N/A	N/A	N/A	Yes	Microfinance Supervisory Enterprise
194,614	N/A	N/A	N/A	Yes	Microfinance Supervisory Enterprise
36,497	N/A	N/A	N/A	No	N/A
137,909	N/A	N/A	N/A	No	N/A
34,267	32,851	340,340,000	10,360	Yes	MSE / Central Cooperative Society
34,618	476,632	24,200,000,000	50,773	Yes	Central Cooperative Society
349,426	N/A	N/A	N/A	No	N/A
142,857	N/A	N/A	N/A	No	N/A
10,000	N/A	N/A	N/A	No	N/A
N/A	N/A	N/A	N/A	N/A	N/A
N/A	N/A	N/A	N/A	No	N/A
119,763	**2,657,353**	**122,388,155,513**			

Note: It should be noted that overall data availability and accuracy is low, so the above figures should be read with some caution. 1. Data as of March 2012 provided by MADB. 2. Data as of March 2011 from CBM. 3. Data as of September 2012 from UNDP for PACT UNDP and as of end October 2012 from PACT MFI. 4. Data as of October 2012 from GRET. 5. Data as of October from Save the Children. Savings are from members only. 6. Data from World Vision MFI, November 9, 2012. 7. Data from Proximity Design, October 2012. 8. Data as of end-September 2009 from ACTED and Banking With the Poor Network (2009). 9. Data as of May 2012 from CCS. Data for Microcredit Cooperatives as of September 2011. 10. Data as of September 2011 from Myanmar Rice Association. 11. Estimates provided during interview with MADB, June 2012. 12. No data available.

that permit cashless payments using credit, debit, or prepaid cards; Internet banking, permitting virtual connections with banks and their branches; banking agents, that is, outsourced bank branches; and mobile telephone banking, a bank branch in one's pocket. Each of these channels has been proven in the marketplace and is used to varying degrees in many countries.[30] In some cases, these channels have induced *channel substitution*—whether because of greater convenience or lower cost to the user, it has shifted transactions that would otherwise have gone through a bank branch.

An analysis of branchless banking gives clear evidence of its many benefits—and many of Myanmar's private banks are gearing up to introduce various combinations of the above-noted branchless banking channels. Although still in its infancy, the MPU (as described above), with seventeen private banks as members, is already providing a platform for spreading an ATM network. Some banks have formed partnerships with credit companies to introduce credit card services, and the point-of-sale network, albeit still very small, is set to grow rapidly. And now that Myanmar's telecommunications sector has issued two licenses for mobile telephony—to Norway's Telenor and Qatar's Ooredoo (formerly Qtel)—and mobile phone connections are poised to expand rapidly, banks will be able to explore other branchless banking avenues (including telebanking, banking agents, and in-store point-of-sale systems).

What is the role of government—and regulation—in supporting the growth of branchless banking and in ensuring that its expansion does not threaten the stability of the banking system? As the rapid expansion of Kenya's M-PESA system of branchless banking has shown, expanding access need not result in financial instability if appropriate regulatory and supervisory safeguards are combined with market liberalization policies. One particular issue needs careful handling: Knowing your customers' requirements for financial institutions should continue to be emphasized to ensure that Myanmar complies with international standards for anti–money laundering and for combating the financing of terrorism initiatives.

Kenya's experience has also shown that when developing the policy framework for branchless banking, all the relevant departments of government (CBM, Ministry of Finance, Ministry of Communications, and Ministry of Planning and Economic Development) must ensure close dialogue with the private sector.

Sequencing Reforms for Financial Sector Development

The previous section highlighted important financial sector reform priorities and, where appropriate, indicated their interconnections with one another. Not all these actions can be implemented at once, however. Indeed, Myanmar's capacity constraints in all spheres, including in the financial sector, make it

imperative for the authorities to sequence reforms carefully. The country cannot afford to implement reforms in the wrong order, as these will simply lead to wasted effort. There may be considerable pressure from different quarters—not least from influential bankers themselves or from the international donor community—to rush the reform process, but policymakers will need to focus on the national interest and on what makes most sense in Myanmar's unique circumstances. For example, it would make little sense to open the financial sector prematurely to 100 percent foreign-owned banks without first having a strong regulatory structure and building competitive and financially sound domestic banks. Similarly, premature interest rate liberalization without a well-functioning supervision system and well-established, well-understood prudential norms would only lead to excessive risk taking that could eventually cause a financial crisis.

For Myanmar to develop a stable and efficient financial sector that can support its long-term development, it should focus first on establishing strong foundations—namely, a legal and institutional structure that will provide financial institutions with regulatory clarity and CBM services that will facilitate the efficient real-time clearance and settlement of interbank claims and permit sound liquidity management. Many of these initial capacity-building initiatives are eminently feasible, and the authorities can implement them with the help of the international community, notably the international financial institutions (the IMF, World Bank, and Asian Development Bank) and key bilateral aid agencies, especially JICA, the UK Department for International Development, and the Australian Agency for International Development.

To this end, the government should focus on the following reforms in the *short term*, namely, over the next twelve months or so:

- Start training banks and nonfinancial corporations based in Myanmar to adopt the MFRS and have a clear deadline for the adoption of the MFRS by all banks and corporates by 2015.
- Initiate the implementation of the CBM's electronic system for the automated clearance, payments, and settlements system.
- Confirm donor funding and recruit international expertise to strengthen the CBM's Supervision Department.
- Prepare the legal and regulatory ground for an interbank market for liquidity management.
- Develop market-based CBM liquidity facilities to assist banks during periods of systemic liquidity shortages.
- Finalize and enact the Financial Institution Law—which should include clarification on the role of FDI in the financial sector, exit policies and arrangements for banks, financial reporting requirements, the use of MFRS, and the like.

- Maintain the current interest rate policy—however, the CBM should adjust the level of deposit and lending rates as macroeconomic conditions demand, in order to ensure that they are positive in real terms and that the intermediation margin is adequate for banks to earn a reasonable return on their capital.
- Permit commercial banks to compete on service standards and fees, including fees for remittances.
- Initiate an audit of state-owned banks—preferably by international auditors (with financing from donors).
- Audit financial regulations to determine which regulations can be eliminated safely.
- Refrain from establishing more commercial banks for the time being.
- If foreign-owned banks are given licenses to operate in Myanmar, they should either be restricted to joint ventures with local banks or, if wholly foreign owned, restricted to serving only the foreign investor community; wholly foreign-owned banks should be barred from retail banking for the time being.
- Remove any unnecessary constraints on branch expansion by commercial banks.
- Initiate a study of the legal, regulatory, and institutional needs to support the rapid expansion of branchless banking.
- Review the microfinance institutions sector and the appropriateness of the current legal, supervisory, and licensing system. Temporarily stop the issuance of MFI licenses until the way forward is clear.

These reforms, if implemented over the short term, will provide the foundations for the next generation of *medium-term* financial sector reforms, which the government should implement over the subsequent three years, and could include the following actions:

- Enforce the MFRS for banks (which should be the responsibility of the CBM) and nonfinancial corporations (which should be the responsibility of the Directorate for Investment and Company Administration in the Ministry of Planning and National Development).
- Fully implement the interbank electronic clearance, payments, and settlement system.
- Introduce an auction system and a secondary market for treasury bonds.
- Introduce an interbank market to permit better liquidity management.
- Develop a market-based government bond market and develop benchmark interest rates.

- Launch an intensive capacity-building program with international expertise to boost CBM supervision capabilities.
- Study the introduction of a deposit insurance arrangement.
- Relaunch a redesigned microfinance strategy.
- Introduce regulations for branchless banking.
- Maintain the current policy of fixed interest rates for at least three years (adjusted as appropriate for macroeconomic conditions), but assess the appropriateness of, and prepare for, moving to the second stage of interest rate liberalization—namely, a floor for lending rates and a ceiling for deposit rates.
- Based on the audit results for the four state-owned banks, work with the World Bank and the Asian Development Bank to prepare a state bank restructuring strategy. Allow one, or at most two, SDBs to survive. Give them clear mandates, adequate financial resources, independent and professional management, a corporate governance framework that protects them against political interference, and an incentive structure that encourages them to achieve their mandate, but with prudent financial management.

The Intersection of Financial Sector Reforms With Other Reforms

Financial sector reforms will be taking place alongside reforms in other sectors, and it is important that reforms across different sectors be coordinated well. Thus, reforms of monetary and fiscal policies will have a bearing on the pace and sequencing of financial sector reforms. Similarly, reforms in the real sector (such as trade, agriculture, land, manufacturing, and investment licensing reforms) should be undertaken in coordination with financial sector reforms. Ideally, real sector reforms should precede financial sector reforms, so that any changes in relative prices do not weaken banks' portfolios. In Myanmar's current situation, however, pragmatism demands that the government move ahead with financial sector reforms even as it is implementing real sector reforms.

Fiscal reforms will be critical for the smooth development of the financial sector for several reasons. First, better fiscal performance places less pressure on the banking system to perform quasi-fiscal functions. It is better that government agencies implement development programs with high social but low financial rates of return, and good fiscal performance ensures that they can be financed through the budgetary system. Second, good fiscal performance allows targeted lending programs through the banking system to use budget-financed interest rate incentives rather than administratively suppressed interest rates, which impose a tax on depositors. Third, smaller fiscal deficits reduce the likelihood of "crowding out" the private sector as more financial resources can be channeled through the banking system to private

businesses rather than to government. This helps the government avoid the forced placement of government debt in banks (which taxes the banking system rather than encourages it). Fourth, a greater availability of fiscal resources will give the government more options when it comes to restructuring state bank balance sheets and, if some need to be closed, assisting with meeting their outstanding net liabilities. Fifth and finally, sound fiscal management can prove helpful in times of financial crisis, when the government may need to recapitalize a bank for strategic purposes and systemic stability.

Notes

1 For a detailed discussion of the role of the financial sector in developing countries, see Niels Hermes and Robert Lensink, eds., *Financial Development and Economic Growth* (New York: Routledge, 2013).
2 Chartered Bank became Standard Chartered Bank after merging with the Standard Bank of South Africa in 1969.
3 The ten Burmese banks were Innwa Bank, Export Import Bank, Union Cooperative Bank, Rangoon Bank Ltd., Burmese National Bank, Myanmar Eastern Bank, Burmese Economic Bank, Myanmar Central Commercial Bank, Tavoy Bank, and Upper Burma Bank. The fourteen foreign banks were India Central Bank, Chartered Bank, Habib Overseas Bank, India Overseas Bank, Mercantile Bank, United Commercial Bank, Punjab National Bank, India State Bank, Hong Kong and Shanghai Banking Corporation, National and Grindlays Bank, Communication Bank, China People's Bank, Netherlands Trading Association Bank, and the Overseas Chinese Banking Corporation.
4 The reasons behind the move were many. One was to lower inflation by reducing the stock of money in circulation. Another was to render worthless stockpiles of notes held by insurgent groups. A third was to destroy the black market. Unfortunately, demonetization achieved none of these aims, but did succeed in causing widespread distress among the general population.
5 See "The Repression of the August 8, 1988 (8-8-88), Uprising in Burma/Myanmar," Online Encyclopedia of Mass Violence, www.massviolence.org/The-repression-of-the-August-8-12-1988-8-8-88-uprising-in?cs=print.
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11 Min Thuya, "UK Govt, Standard Chartered Bank Look to Build Myanmar's Financial Sector," Mizzima, July 19, 2013, www.mizzima.com/business/investment/item/9713-

uk-govt-standard-chartered-bank-look-to-build-myanmar-s-financial-sector/9713-uk-govt-standard-chartered-bank-look-to-build-myanmar-s-financial-sector.

12 Renate Kloeppinger-Todd and Tun Min Sandar, "Rural Finance in Myanmar," Background Paper 3, January 22, 2013, commissioned as part of a Strategic Agricultural Sector and Food Security Diagnostic for Myanmar, led by Michigan State University in partnership with the Myanmar Development Resource Institute–Centre for Economic and Social Development (MDRI-CESD).

13 Sean Turnell, *Fiery Dragons: Banks, Moneylenders and Microfinance in Burma* (Copenhagen: NIAS Press, 2009).

14 International Monetary Fund, "Myanmar: Article IV Consultation and First Review Under the Staff-Monitored Program," August 2013.

15 Repurchase agreements are the sale of securities combined with an agreement for the seller to buy back the securities at a later date at a higher price, with the difference in the sale and the repurchase price being the implicit interest rate.

16 Stijn Claessens, Asli Demirgüç-Kunt, and Harry Huizinga, "How Does Foreign Entry Affect the Domestic Banking System?" *Journal of Banking and Finance* 25 (2001): 891–911.

17 Gerard Caprio, "Safe and Sound Banking: Role for Countercyclical Regulatory Requirements?" Finlawmetrics 2010 Conference Paper, February 1, 2010, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1545870. Also see Maria-Eleni Agoraki, Manthos D. Delis, and Fotios Pasiouras, "Regulations, Competition and Bank Risk-Taking in Transition Countries," Munich Personal RePEc Archive, June 1, 2009, http://mpra.ub.uni-muenchen.de/16495/1/MPRA_paper_16495.pdf.

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20 A contingent development loan drawdown option would give the Myanmar authorities the option of drawing down an international financial institution (IFI) loan to finance the deposit insurance program if there were to be an insurance claim on the program in the event of sudden withdrawal of deposits from one or more domestic banks. Although IFIs have provided contingent loans for other purposes (for example, to protect against a surge in international interest rates), there have been no loans thus far to protect against sudden deposit withdrawals. There is no reason, however, why one cannot be designed provided the IFIs are satisfied with the broader reform program in the financial sector.

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28 The term "microfinance" applies to financial services provided to low-income individuals, households, farms, and firms. See Eric Duflos, Paul Luchtenburg, Li Ren, and Li Yan Chen, "Microfinance in Myanmar: Sector Assessment," International Finance Corporation Advisory Services in East Asia and the Pacific and Consultative Group to Assist the Poor, January 2013.
29 Duflos et al., "Microfinance in Myanmar: Sector Assessment," 9.
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