

Reforming the Banking System in Burma: A Survey of the Problems and Possibilities

by

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Abstract

A country's financial system plays a critical role in its economic development. It is the vehicle through which the means of exchange are created, resources are mobilised and allocated, risks are managed, government spending is financed, foreign capital is accessed, and it is via financial institutions that individuals can protect themselves against economic fluctuations. Notwithstanding this essential role, Burma has not had a properly functioning financial system for four decades. The present system, an unstable mix of monolithic state-owned institutions and a cohort of new private banks of dubious legitimacy, is a serious brake on Burma's economy. This paper examines the role financial institutions can play in a country's development, explores how Burma's current system falls far short of this ideal and broadly outlines how it might be reformed. It argues the case for the standard remedies professed by economists of liberalisation, stabilisation and privatisation but, critically, suggests that these must be preceded by more fundamental reforms that create the legal, regulatory and other infrastructure that are the prerequisites of a modern, and efficient, financial system.

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I. Introduction¹

In June 2002 the Financial Action Task Force on Money Laundering (FATF), an international body established in 1989 by the G7, declared Burma to be one of 16 jurisdictions it deemed to be 'non-cooperative'.² The same label was applied in 2001 and, indeed, in every year in which lists of non-cooperating countries and territories have been issued by FATF. Being so-listed is a serious matter since it obliges FATF member countries (which include all the major financial centres in Europe, the Americas and Asia) to adopt special measures against financial transactions involving listed countries - on the not unreasonable grounds that such transactions 'are more likely to be suspicious'. In the wake of the terrorist attacks on the United States in September 2001, however, the issue of money laundering has become an even more serious one. Identified as a source of finance for terrorism, the existence of substantial money laundering activity has become something of a 'red letter' issue in judging a country's standing as a responsible global citizen.

The existence of substantial money laundering is, unfortunately, only the most obvious of the problems inherent in Burma's financial system. Whatever the indicator chosen - from the value of the nation's currency to the ability of its banks to create credit - a tale of a system that barely (legitimately) functions is almost the exclusive narrative. Of course, this is consistent with the state of Burma's broader macro-economy which, as the most authoritative account yet to emerge notes, can only be regarded as 'a miserable failure' (Kyi *et al*, 1998)

Burma's financial system is, and will remain in the absence of fundamental reform, a serious brake on its economic development. As Seeger and Patton (2000, p.11) observe, a country's financial system functions not unlike the 'brain' of its economy, 'distributing capital to those enterprises likely to be profitable and grow, and facilitating restructuring and modernisation'. Larry Summers, the former Secretary of the US Treasury, prefers an automotive metaphor in his observation that the financial system provides the 'wheels' for a nation's economic development. Siegelbaum (1997, p.3) draws a lesson from over a decade of observing transition economies with the simple truth that 'experience does not teach us how to achieve growth in a market economy without sound banks'.

The purpose of this paper is to highlight some of the many problems in Burma's financial system and to suggest ways in which essential reforms might proceed. The focus will be on the banks since, as in many developing countries, financial institutions and markets outside the banks are greatly underdeveloped. Though there is some controversy over the issue, it is also likely that banks have distinct advantages

¹ Special thanks to Alison Vicary, Marianne Gizycki, Eric Snider, Zaw Oo, and David Arnott for their assistance on many matters during the writing of this paper. Responsibility for its contents, however, resides solely with the author.

² The FATF report naming Burma, 'Review to Identify Non-Cooperative Countries or Territories: Increasing the World-Wide Effectiveness of Anti-Money Laundering Measures', was issued on 21 June 2002. It can be found at <http://www.fatf-gafi.org/pdf/NCCT2002_en.pdf>.

over other institutions in countries such as Burma where complementary infrastructure is largely absent.³

The paper begins (Section II) by outlining, in a broad-brush way, the contributions the financial sector of a country can and *should* contribute to its economic development. In Section III the actual state of Burma's existing system will be examined against this ideal. Section IV outlines some of the reforms that must take place if Burma's financial system is to become a functioning one. It examines specific 'technical' reforms, but concludes that none of these will produce the desired outcomes in the absence of more fundamental reforms to the nation's political-economy. These will include a transition to a more democratic polity in which the rule of law is paramount, in which contracts are honoured and enforced, macroeconomic stability is pursued and appropriate financial and accounting regulations are in place - an institutional framework, in short, of 'good governance'. Section V concludes the paper.

II. The Role of the Banking System in Economic Development

Financial institutions play a central role in a country's economic development. In the field of 'information economics' - the revolution pioneered by the likes of Nobel laureates George Akerlof and Joseph Stiglitz - financial institutions resolve the problems that emerge from the fact that there are information asymmetries between contracting parties in credit markets.⁴ According to this literature, it is difficult for lenders individually to identify the quality and performance of borrowers. Financial institutions, however, have special skills and economies of scale in gathering this information. As such, they are better able to identify promising investment opportunities. Economy wide, financial institutions bring about an improved allocative efficiency of capital and improved economic growth.⁵

For developing countries, however, the role a well functioning financial system can play is more basic, yet more fundamental:

- Financial institutions, via their creation of monetary assets, provide the means to replace costly and inefficient barter. The most important of these 'monetary assets' is currency itself - usually the creation (the liability) of a country's central bank.

³ The issue over whether a country such as Burma should promote a bank-based financial system, or one that is based around markets, is not directly addressed in this paper. The author is of the view, however, that in Burma, equity (and other) financial markets will impose liquidity, legal, accounting and other expertise demands in excess of that possessed by the country - especially in the initial reform stages. Studies of other reforming countries generally suggest that the 'value-adding' of market-based financial structures increases with the level of economic development. For more on this issue, see Arestis, Demetriades and Luintel (2001).

⁴ Akerlof and Stiglitz won the Nobel Prize for Economic Science in 2001. For more on the contribution of their 'revolution' to economics, see the citation on the Nobel website, <<http://www.nobel.se/economics/laureates/2001/ecoadv.pdf>>.

⁵ Once regarded as irrelevant in promoting economic growth, and even endogenous to it, in recent years the economics literature has highlighted the role in which the development of financial institutions can play in the development of economies more broadly. For a taste of some of this literature, see Beck, Levine and Laoyza (2000), King and Levine (1993), Levine and Zervos (1998), Rajan and Zingales (1998) and Wurgler (2000).

- Monetary assets - in essence 'money' - are highly productive. Money solves the barter problem of a 'double coincidence of wants' and so allows more transactions (economic activity) to take place.
- Money allows for the division of labour - the source of increasing returns and growth since Adam Smith.
- Financial institutions allow the accumulation of saving in a money, rather than physical, form. Without financial institutions, investment would likely only take place in the sector that saved an equivalent surplus.
- Most importantly, financial institutions create credit. This provides the means through which growth is financed. Credit permits an economy to expand in response to developments in the 'real' economy (technical progress), which could otherwise be stymied by barter or a purely commodity currency system. With a properly functioning financial system, then, savings do not have to occur to 'finance' investment.
- Financial institutions solve the liquidity mis-match problem between savers (who generally want ready access to their money) and borrowers (who, especially in the case of investors, generally need a longer-term commitment of funds).
- Financial institutions allow the pooling of risks. As such, they reduce the risks to individuals of innovation.
- Financial institutions allow the aggregation of funds for investment - the latter (for most projects) being invariably larger than the savings of a single individual.
- The mobilisation of savings in financial institutions allows individuals to 'inter-temporally' smooth consumption, protecting them against economic fluctuations.
- Financial institutions allow for specialisation - creating knowledge and transferring risk to those best able to deal with it.

Such 'stylised facts' as to the contribution of the financial sector to development are backed up by history. As the World Bank (2002, p.75) notes, there is 'ample' evidence as to the 'critical role' taken by banks in the industrialisation of England, the world's first industrial country, and (even more so) in the countries that followed it along this path.⁶ Perhaps more surprising, however, and certainly counter to much of the rhetoric in the development discourse, is that financial 'deepening' (that is, the extent of financial sector development) is 'associated with improvements in income distribution'. According to the World Bank (2002, p.75), citing empirical studies such as that of Dollar and Kraay (2000), the 'evidence suggests that measures of financial development are positively and significantly correlated with the share of income of the bottom quintile of the income distribution'. Finally, according to the 2000 Nobel Laureate in economics, Amartya Sen (1999):

The availability and access to finance can be a crucial influence on the economic entitlements that economic agents are practically able to secure. This applies all the

⁶ Landes (1998, p.264) maintains that financial institutions played a much more significant role in the development of the countries that followed England into industrialisation - than was the case for England itself. He is especially impressed with the role they played in Germany:

In Germany...the bank...came into its own, founding and financing industry, supervising performance, promoting innovation. These new institutions combined investment, commercial and deposit banking... The best of them gathered technical intelligence and served as consulting bureaus.

way from large enterprises (in which hundreds of thousands of people may work) to tiny establishments that rely on microcredit

III. Burma's Banking System

Against the theoretical ideal above, Burma has not had a properly functioning financial system for four decades. The coup that installed the military dictatorship of General Ne Win in 1962 ushered in a program that, under the label of 'the Burmese way to socialism', installed some of the worst excesses of Stalinist economics. In 1963 the financial system was nationalised, and in 1969 all of the nationalised banks were merged into a collectivised institution, 'The Peoples' Bank of the Union of Burma'. It shortened its name in 1972 to the Union of Burma Bank. In 1975 this monolith was broken up five ways: 1) the Union Bank of Burma was established as the central bank; 2) the Myanma Foreign Trade Bank was created as a monopoly to deal with all foreign exchange transactions; 3) the Myanma Economic Bank was formed as the primary deposit-taking and general banking institution; 4) the Myanma Agricultural Bank was formed to service agriculture; and 5) insurance services were allocated to a state monopoly, the Myanmar Insurance Corporation (Pierce 1997, p.441).

The coming to power in 1988 of the State Law and Order Restoration Council (SLORC), supposedly brought with it a change in the direction of Burma's economic trajectory in which the free market was to be encouraged. To this end, SLORC passed a series of laws that were ostensibly about 'liberalising' the financial sector. These laws, the most important of which was the Financial Institutions of Myanmar Law and the Central Bank of Myanmar Law (both 1990), established the Central Bank of Myanmar (CBM) as the new central bank and gave it powers to supervise banks and to establish a program of reform.⁷ This program envisaged that liberalisation would proceed in three phases:

Phase 1: Allow domestic private banks and allow foreign banks to open representative offices.

Phase 2: Allow selected domestic banks to form joint ventures with foreign banks.

Phase 3: Allow foreign banks to begin operations in their own right.⁸

No timetable was established for the program. By 1992, however, the first domestic private banks had been established and the first foreign bank representative offices had opened.

From this promising start financial sector reform in Burma, like reform in every other aspect of the nation's political economy, has made very little headway. Though Phase

⁷ Details of these laws, and the 'official line' on Burma's financial system generally, can be found via the website of Burma's embassy in Geneva: <www3.itu.int/MISSIONS/Myanmar>. The information seems to have been supplied by Burma's Ministry of Finance and Revenue.

⁸ *ibid.*

1 of the program was more or less successfully implemented in terms of its limited goals, phases 2 and 3 have yet to be embarked upon. Together with a great many other limitations to the operation of foreign investors in Burma (examined below), foreign banks remain restricted to a representative office role only and many of these have subsequently closed. Four joint venture proposals along the lines envisaged in the Phase 2 reforms have apparently been mooted, but only one proceeded to the point that the Central Bank of Myanmar's approval was sought. This approval was not given (Pierce 1997, p.445).⁹

The Current Structure of Burma's Banking Sector

In terms of *branch networks and access* for the great majority of the Burmese people (especially outside of Rangoon and Mandalay), Burma's banking sector continues to be dominated by state-owned institutions. All four of the state-owned banks that were the successors to the monolithic People's Bank survive. To these have been added the Myanma Investment and Commercial Bank (MICB) in 1989 and the Myanma Small Loans Enterprise (MSLE) in 1993. Both the MICB and the MSLE were carved out of the Myanma Economic Bank (MEB), the MICB to provide corporate and investment banking services and the MSLE to act as a type of state-owned 'pawn shop'.¹⁰

The four continuing state-owned banks more or less continue their established roles, though the Myanma Foreign Trade Bank now shares its foreign exchange monopoly with the MICB.¹¹ The MEB continues to be by far the largest banking operation in Burma in terms of branches, with around 300 throughout the country.¹² In 1997, according to Pierce (1997, p.443), the MEB held over 75 percent of total deposits for all banks, or around 7 times the deposits of all the (then) private banks put together. Even at the height of the MEB's dominance in 1997, however, its deposit base of 70 billion Kyat would amount, at the current market value of the Kyat, to under \$US 100 million – about the size, in short, of a small savings and loans institution in the United States.

The hitherto dominance of the state banks has been greatly eroded in recent years by the entry (the first permitted in 1992) of Burma's new private banks. There are currently 20 private domestic banks operating in Burma (full list in Appendix 1), and their growth has been nothing short of spectacular. In 1995, for example, deposits in Burma's private banks totalled 14.6 billion Kyat, or 24.8 percent of the total. By 2000 this had grown to 59.3 percent. In the meantime, according to the Economist Intelligence Unit (EIU 2001), the MEB's share of total deposits fell from 86 percent at March 1994 to less than half of this by March 1999. Of course, as always in the case of Burma, published statistics must be treated with great caution - and not just those put out by the Burmese government. On its website, for example, the Asia Wealth Bank (AWB, one claimant for the label of Burma's largest private bank) manages to cite three entirely different numbers for the amount of deposits it has on its books.

⁹ The aforementioned website of Burma's embassy in Geneva, and a number of other contemporary sources, confirm that a joint-venture bank is yet (September 2002) to emerge.

¹⁰ The MSLE has 182 branches throughout Burma. Brief details of its activities, and of those of the other state-owned banks, can be found at one of the military regime's own websites: www.goldenlandpages.com/bizmyan/bankin.htm.

¹¹ Following a brief period, noted below, when some of the private banks were permitted to deal in foreign exchange.

¹² *ibid.*

Of course, by world standards, Burma's private banks remain *exceedingly* small institutions. Five seem to dominate - the aforementioned AWB, Yoma Bank, Myanmar May Flower Bank, Kanbawza Bank and Myawaddy Bank. The AWB and Yoma Bank both claim to be the largest (with 39 and 43 branches respectively) but, at the current market exchange rate, neither exceeds \$US 200 million in assets.¹³ According to the EIU (2001, p.31), the private banks are likely to have high levels of non-performing loans on their books on account of the 'bursting' of Rangoon's property bubble of the late 1990s. More details of the performance of Burma's state-owned and private banks are given below.

The number of foreign bank representative offices in Burma - as noted above, the only form foreign bank entry can as yet take - has been subject to extraordinary volatility. As at September 2002 there are just over ten - down from 46 as little as a year ago. Representative offices are not permitted to engage in any banking business beyond liaison activities and the monitoring of loans made offshore. According to China's Xinhua news agency, the 'unavailability of banking operation licences to do international business was the main reason for the withdrawal'.¹⁴

A Functioning Banking System in Burma?

What appears to have been rapid growth in Burma's private banking sector in recent years disguises a financial system that, in fact, is barely functioning.

The evidence for this can be found by examining the data that Burma supplies to the IMF – the only recent data available since the military regime stopped publication of Burma's national accounts in 1998. Using this data, derived primarily from the IMF's *Monetary and Financial Statistics* series (as at November 2001), the following facts become apparent:

- Total deposits (demand, time, savings, foreign currency and restricted deposits) in Burma's banking system amounted to 645.0 billion Kyat. At the same time total currency in circulation outside the banks totalled 534.5 billion Kyat. This represents a cash-to-deposits ratio of 83 percent. This is an important statistic. The cash-to-deposits ratio essentially measures the extent to which banks are functioning in the creation of credit, that is, functioning in the way banks are meant to. In properly functioning banking systems this ratio should be low since in such systems 'bank money' (deposits that are the result of bank created credit) should be by far the most significant component of the money supply. In Thailand, a country with its own banking problems but one that represents a model for what at least Burma could be economically, the cash-to-deposits ratio is 8 percent. Thai banks, in other words, create credit at more than ten times the rate of their Burmese equivalents.¹⁵

¹³ Data from AWB and Yoma Bank websites. These can be found at <<http://www.e-commerce.com.mm/AWB>> and <<http://www.e-application.com.mm/yomabank>> respectively.

¹⁴ Xinhua's report is here cited from *The Irrawaddy*, vol.10, no.4, May 2002.

¹⁵ For the purposes of further comparison, the cash-to-deposits ratios for countries such as Indonesia, Korea, Singapore and Australia are 9, 4, 7 and 6 percent respectively (IMF, 2002).

Burma's banks are not fulfilling the normal role of banks in creating credit, but the country's abnormally high cash-to-deposits ratio is also indicative that; a) they are not trusted by the broad populace; and/or b) the returns on savings that they offer (as noted below, far less than inflation) are not sufficient to attract deposits. Either way, the ratio is indicative of a system that is scarcely functioning.

Of course, to some extent the issue of Burma's excess of cash reflects the broader problem that the regime funds much of its spending through the simple, but highly destructive, means of printing the Kyat in whatever volumes it requires. From 1995 to 2001, currency circulating outside banks in Burma increased by around 450 percent. In Thailand the relevant increase over this period (a period which included the Asian financial crisis) was 30 percent.

- Instead of creating credit through lending to the public, Burma's banks have instead been lending to the government. Total domestic credit outstanding in Burma in November 2001 was 1,159.8 billion Kyat. Of this, 60.1 percent was in the form of claims on the central government. A further 5.8 percent was in advances to non-financial public enterprises. The remainder then, 34.1 percent, was all that the banking system made available to the private sector. Once more, a reasonable interpretation of the facts of Burma's banking system is that it is not functioning in a way that would support the country's development.
- Using what little information is provided by some of Burma's private banks confirms the story of a banking sector that functions in large measure as a financing arm of the state. The Asia Wealth Bank, which claims to be Burma's largest bank, reports assets as at 30 April 2001 of around 160 billion Kyat. Though this particular bank is more active than most in lending to the private sector, 46 percent (73.4 billion Kyat) of its assets are in the form of government-issued treasury bonds.¹⁶
- Notwithstanding that the cash-to-deposits ratio remains low for all of the reasons above, the actual level of deposits with Burma's banks has, as noted, grown extraordinarily rapidly in recent years. In 1995, for example, the total of all deposit categories in Burma's banks was 67.7 billion Kyat – a figure that had grown to 645 billion Kyat by November 2001. This is an increase of 950 percent. Of course, some of the increase in raw Kyat terms can be explained by inflation (Burma does not publish reliable inflation numbers, but it is likely that the major part of this increase is inflation induced). However, the fact that there has been any increase in the real level of deposits at all is remarkable. With the current inflation rate in Burma approaching 50 percent according to the US State Department, depositors in Burma's banks (who receive no more than 9.5 percent interest) are actually losing money.¹⁷ That there has been any growth at all in lending by Burma's banks (maximum lending rate: 15 percent), or that they are willing to buy treasury bonds (yield: 9 percent) is also remarkable – since clearly these are also certain loss-making activities. Why the growth?

¹⁶ Asia Wealth Bank website, *op.cit.*

¹⁷ State Department estimate cited from the account of the visit of Professor Lynne Doti to Rangoon in June 2001. Professor Doti, a specialist on banking, was visiting Burma on behalf of the State Department. Her account can be found at <<http://sbe.chapman.edu/asbe.nsf/pages/burma>>.

The Shadow of Money Laundering

One answer to the question above lies in the frequently made accusation that Burma's banks don't need to make real money - they don't even need to function like normal banks - since their primary purpose is merely to launder the substantial funds that flow into Burma from the narcotics trade. Why is the issue of money laundering important? It is not just because, as outlined below, it is internationally unacceptable. This paper is concerned with examining the conditions and policies from which Burma can develop a viable and functioning financial system. Such systems, however, do not grow when their roots are in contaminated soil. It is true that money laundering does profit the criminals involved in it, but it does great damage to the country in which it takes place. Money laundering:

- Makes criminal activity profitable. In so doing, it empowers organised crime relative to legitimate enterprises.
- Damages the integrity of markets. Interest rates, exchange rates, the prices of financial assets and commodities generally become distorted and volatile. They no longer provide meaningful 'signals' regarding the efficient allocation of resources.
- By its nature, it encourages corruption. Criminal enterprises have the wherewithal to offer the kickbacks, bribes, threats and the other attributes that are their stock-in-trade.
- Discourages legitimate foreign investment. Legitimate investors fear guilt from association. Of course, they also have to confront the distortions and perversions above.
- Can contaminate the operations of legitimate financial institutions. Even if themselves legitimate, financial institutions could suffer contagion from the increased risks (legal, regulatory, credit, market volatility) from dealing in a corrupt system that allows money launderers.
- Will encourage and provide vehicles for tax evasion - eroding trust in fiscal arrangements and damaging the macro-economy.
- Siphons much-needed funds from the real economy, and greatly impairs the likelihood of economic development.¹⁸

This paper opened with the suspicions noted by FATF, but they have not been the only body to highlight the shadow that money laundering casts over Burma's financial system. The US State Department, in its 'International Narcotics Control Strategy Report' released in March 2002, noted that:

There is reason to believe that money laundering in Burma and the return of narcotics profits laundered elsewhere are significant factors in the overall Burmese economy....Burma has an under-regulated banking system and ineffective laws to control money laundering.

¹⁸ There is, of course, much written on the evils of money laundering - but approachable introductions to the topic can be found at the websites of the Financial Crimes Enforcement Network of the US Treasury <<http://www.ustreas.gov/fincen/index.html>>, and at FATF's website, <<http://www.fatf-gafi.org/>>.

In April 2002 the US Treasury outlined the following *systemic* problems in Burma's approach to money laundering:

- Burma lacks a basic set of anti-money laundering provisions.
- Money laundering is not a criminal offense for crimes other than drug trafficking in Burma.
- The Burmese Central Bank has no anti-money laundering regulations for financial institutions.
- Banks licensed by Burma are not legally required to obtain or maintain identification information about their customers.
- Banks licensed by Burma are not required to maintain transaction records of customer accounts.
- Burma does not require financial institutions to report suspicious transactions.¹⁹

Of course, *proving* money laundering is difficult. Money laundering is illegal in most jurisdictions and, since the terrorist attacks on the United States on September 11, 2001, the question of stamping out money laundering has become a high priority internationally. The penalties for states harbouring or encouraging money laundering are also likely to be severe - but as much through the loss of business than direct sanctions. The US treasury advises all US banks and financial institutions, for example, to 'give enhanced scrutiny to any transaction originating in or routed to or through Burma, or involving entities organised or domiciled, or persons maintaining accounts, in Burma'.²⁰ So, to the extent that Burma's banks are about money laundering, and the Burmese regime in profiting from and protecting the drugs trade, they are not going to be open about it. Nevertheless there are sufficient enough reports from enough disparate sources, and over enough time, to lend credibility to the idea that money laundering is rampant in Burma. Most of the private banks already mentioned in this study are implicated in various degrees in the narcotics trade (see Appendix Two). As Cho (2002, p.25) notes:

The proliferation of private banks in Burma over the last decade has...facilitated money laundering. In a country where at least half of all economic activity is officially unacknowledged, it is widely believed that illegal transactions account for a significant portion of the private banks' business'.

In response to the international pressure on it, in May 2002 Burma's government promulgated the 'Law to Control Money and Property Obtained by Illegal Means' which, on paper, meets many of the objections regarding money laundering noted by the US Treasury above. Of course, this being Burma, passing a law and enforcing it are two very different things as is, indeed, the intent of the law. Though the effect of the law is yet to be seen, Ko Cho's reminder (2002, p.25) that '[a]nti-corruption purges in the past have typically been carried out to neutralise potential threats to the ruling clique, rather than to clean up the way the country does business', must always be borne in mind. In fact the implicit 'watering-down' of the Law, and the signalling that it is not intended very seriously came in a series of press briefings issued by the government in early June. These came in the wake of what appeared to be a panic sell-off of the Kyat (for the first time breaching 1000 Kyat/\$US1) by individuals

¹⁹ United States Department of the Treasury, Financial Crimes Enforcement Network, FinCEN Advisory, 'Transactions Involving Burma (Myanmar)', April 2002, <<http://www.ustreas.gov/fincen/advis28.pdf>>.

²⁰ *ibid.*

seemingly fearful that their transactions might invite scrutiny. As again Ko Cho reported (2002, p.25), at these briefings the government;

...have taken pains to reassure Burma's leading financiers - some of them, like AWB Vice Chairman Aik Htun and MMB [Myanmar May Flower Bank] Chairman Kyaw Win, with deep involvement in the narcotics business - that they should not feel threatened by the new law.

Citing the government's mouthpiece, *The New Light of Myanmar*, Ko Cho went on to write that the business-people so briefed were assured that

'...the Law was issued with the aim of protecting the public interests [international pressure?] and not of causing public sufferings' (Ko Cho 2002, p.25).²¹

'e'-Banking?

Some of Burma's private banks have recently been making much of an 'e-banking' revolution that they claim is transforming the services they offer.²² These 'new' services (which are primarily promoted by two banks, Yoma Bank and Asia Wealth Bank), allow 'online' inter-branch, even inter-bank, remittances and other payment instruments. Both banks (and some of the others) also trumpet the arrival of credit cards. Meanwhile, the Myanmar Mayflower Bank promotes its 13-machine ATM network, an innovation still exclusive to it, albeit confined to Rangoon.

There is, of course, no 'e-banking revolution' taking place in Burma and what seems perhaps as new-found strength and efficiency in banking is nothing but a mask for its on-going weakness. The Yoma and Asia Wealth Banks exclaim that their systems allow a customer to transfer funds to another branch in 'no more than 15 seconds' via 'satellite'.²³ The latter is revealing. The reason payment instructions are sent via satellite is not because of any technological edge, but simply because Burma's land-line telecommunications are so poor, and power blackouts so frequent, that the existing system cannot be relied upon. We should also be clear about what transactions are on offer. They are, in fact, very modest. What is *not* on offer is anything like 'on-line banking' for customers. True internet banking requires encryption techniques far in excess of what the Burmese government would allow (which may even preclude access to Military Intelligence). No, what is on offer is simply a method by which banks can stay in touch with their branches and with each other. Lacking yet a rudimentary inter-bank settlement system, and even adequate internal communications infrastructure, the tale of e-banking is but a distraction.

Finally, A Word on Ownership

This paper has made the distinction, as most commentaries do, between Burma's 'state-owned' and 'private' banks. It's a not unreasonable distinction usually, but in Burma matters are never so simple. The issue here is simply that a sizeable number of

²¹ See also 'Myanmar Clarifies Money Laundering Law', *Daily Star News*, 20 June 2002, <<http://www.dailystarnews.com/200206/20/n2062005.htm#BODY6>>.

²² See, for example, the proclamations on the website for Yoma Bank, *op.cit.*

²³ Claim made on Yoma Bank website, *op.cit.*

Burma's private banks (indeed precisely half) are owned or controlled by members of the ruling military clique.²⁴ Clearly they are not 'state banks' in the traditional sense, but nor are they purely private in that they are not entirely independent of government. This adds yet another layer of complexity when considering bank reform in Burma - especially with regard to the issue of privatisation (more of which below).

IV. The Path to Reform

a) Fundamental Institutional Reforms

Reforming Burma's banking and financial system will require a host of initiatives, examined below, specific to this sector. Before these can proceed, however, greater institutional reform - often categorised under the rubric of 'good governance' - will be a necessary prerequisite. Such reform is required in the financial sector to re-establish confidence in financial instruments (at the most basic level, the currency itself) and in financial institutions.

Legal and Judicial Reform

At present Burma's financial system, and its economy more generally, is hampered by the lack of the rule of law. An obvious by-product of the lack of democracy in the country generally, for the financial sector the absence of the rule of law has its most important impact via a lack of defined property rights. Ill-defined property rights in Burma have given rise, in turn, to well-reasoned fears of arbitrary property seizure, to doubts about contract enforcement, to an inability to pledge collateral and to doubts and confusion over the fiduciary and other responsibilities of managers of financial institutions. As a result, Burma has no tradition of contract-based credit and, with it, no vibrant private sector able to access financial resources to identify and exploit economic opportunities.

The importance of well-designed property rights for economic development has been understood by economists for many years, but the issue has come to further prominence of late as a result of the research, and well-placed advocacy, of the Peruvian economist, Hernando de Soto.²⁵ De Soto and his team argue that the world's poor have accumulated essentially all the assets they need for successful capitalist development. The problem then is not a want of savings (real or financial), but an inability to convert these into liquid capital that can be used for enterprise. What creates this inability? According to de Soto it is a lack of property rights and, specifically, the documentation of these rights that would allow them to be transformed into the legal representation that, in the West, links property to the real

²⁴ These 10 'semi-private, semi-government' banks are Myanmar Citizens Bank, Myawaddy Bank, Co-operative Bank, Yadanabon Bank, Yangon City Bank, Myanmar Livestock Breeding and Fisheries Development Bank, Myanmar Industrial Development Bank, Sabin Tharyar Yay Bank, Co-operative Farmers Bank, Co-operative Promoters Bank. This list is derived from World Bank (1999). I am grateful to Eric Snider for alerting me to this extremely important issue.

²⁵ Hernando de Soto is President of the Institute for Liberty and Democracy in Lima, Peru. His approach is most comprehensively outlined in his (2000) book, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*. A summary of his argument is contained in de Soto (2001).

economy. As de Soto notes, it is not the physical attributes of property that is the key to its role in development, but property as 'pure concept' that can be used to unleash capital's 'potential energy':

Property is not the house itself but an economic concept *about* the house, embodied in a legal representation that describes not its physical qualities but rather economically and socially meaningful qualities we humans have attributed to the house (such as the ability to use it for a variety of purposes - for example, to generate funds for investment in a business without having to sell the house - by providing security to lenders in the form of liens, mortgages, easements or other covenants). In advanced nations, this formal property representation functions as the means to secure the interests of other parties and to create accountability by providing all the information, references, rules, and enforcement mechanisms required to do so (de Soto 2001).

From this, he argues, industrial countries were given

...the tools to produce surplus value over and above its physical assets. Whether anyone intended it or not, the legal property system became the staircase that took these nations from the universe of assets in their natural state to the conceptual universe of capital where assets can be viewed in their full productive potential (de Soto 2001).

Like many developing countries, Burma's lack of functioning property rights condemns its assets to the stasis of their 'natural state' rather than a more dynamic conception. Of course, for Burma matters are rather worse than in most poor countries since, under military rule, security of the person (much less property) is far from assured.

The development of Burma's financial system will require the most basic of legal/judicial reform but others (some of which are examined below) must follow - commercial laws, accounting standards, financial market laws, laws relating to shareholders' and creditors' rights, bankruptcy laws and procedures, disclosure laws...and so on. It is beyond the scope of this paper to detail the measures required to bring about legal and judicial reform in Burma. Suffice to leave it at this stage, perhaps, to comments made by the Asian Development Bank (ADB) in a recent report on liberalising Cambodia's financial sector (but equally apposite to Burma);

The development of the legal infrastructure and improved public confidence will reduce uncertainties regarding contract enforcement, which will facilitate private sector development by revitalising commercial activities and financial transactions. More important, reduced uncertainties of contract enforcement will substantially reduce the transaction and operating costs of the financial institutions and thus facilitate intermediation (Chun *et.al*, 2001, p.29).

Macroeconomic Stabilisation

A stable macro-economy requires a sound financial system but, equally, a sound financial system requires a stable macroeconomic environment. What is meant by a stable macro-economy? Whilst there may be a differences at the margins, the fundamentals are more or less clear to economists of all stripes:

- A stable currency. This has two aspects;

- a) there must be sufficient trust in the currency domestically to prevent currency or cash substitution. In order to achieve this, hyper-inflation must be avoided at all costs as must, of course, policies such as de-monetisation. Burma has traditionally indulged in both of these.
 - b) there must be a reasonable degree of stability in a currency's value vis-à-vis other currencies. Burma's exchange rate has been anything but stable and its dual nature - a grossly overvalued official exchange rate and a market value for the Kyat over one hundred times below it - has been the vehicle for corruption, chaos and mismanagement.
- The government must restrain its own spending such that it maintains, at minimum, a *sustainable* budget deficit. Excessive budget deficits are inadvisable on many fronts; they raise the possibility of excessive inflation if financed by monetary means ('printing money'), create the suspicion of default on government debt and can lead to a 'crowding out' of the private sector's access to finance.

In 1995 the World Bank wrote (p.16) that '[t]he fiscal deficit is at the heart of continued macroeconomic instability in Burma'. So it remains today. Notwithstanding numerous promises of reform, Burma continues to run a very large budget deficit which, depending on growth numbers chosen, measures at least 5 percent of GDP. More damagingly, with taxes accounting for a mere 3% of GDP and little trust amongst the public for government bonds, this is mostly financed by expedient money creation. Burma's high inflation rate is but one of the symptoms (EIU 2001).

- The country must, at a minimum, have a sustainable deficit on current account. Similarly, foreign debt levels (and their servicing) must be sustainable. As matters presently stand, Burma is in arrears on its foreign debt payments and has foreign reserves cover for a mere two months of imports.
- Policy should be 'outward orientated' - at least to the extent that, in the words of the World Bank (1998, p.32) a 'reasonable environment for international engagement' is allowed. Burma, of course, has been in self-imposed exile from the international community for over a decade. It imports little, exports (legally) even less and receives almost no foreign direct investment.
- Consistent with these other objectives, unemployment should be near enough as possible to that which would be regarded as 'voluntary'.²⁶ Precise information on unemployment in Burma is non-existent, but it is likely to be substantial.

The particular evils of currency instability *for financial institutions* is graphically highlighted by Siegelbaum (1997, p.2). Depicting a scenario familiar from his

²⁶ That is, merely consisting of what economists label as 'structural' and 'frictional' unemployment.

experiences at the coalface of banking reform in the former Soviet bloc, Sieglebaum's account could have been written with Burma's present situation in mind:

Significant rates of inflation...introduce volatility in the economy which is translated by the enterprise sector into great uncertainty. In effect, those enterprises which are the most agile in passing through to their customers the rapidly increasing costs of doing business, or the luckiest in foreign exchange and commodities speculation, become the most profitable. Unfortunately, these qualities are difficult to judge for lenders with incomplete information about potential borrowers, and they are not terribly relevant for making sensible decisions about underlying creditworthiness. The result is that banks which sought lending opportunities in the real sector were often forced to "roll the dice" with their enterprise customers.

High rates of inflation are also typically associated with negative yield curves, which, in turn, promote investment in short-term, government paper, at the expense of medium and long-term enterprise investments, desperately needed in the transition economies.²⁷ Similarly, the depreciation of the local currency, driven again by high inflation, rewards speculation in more stable currencies.

While inflation drives the real value and the quality of the typical bank's loan portfolio down, it is also operating to shrink the real value of the bank's capital base...The result is a greatly reduced capacity to absorb risk, just when risk is at a maximum.

In their landmark blueprint for Burma's economy, Kyi *et al* (1998) proposed a solution both to Burma's chronic currency instability, as well as the dangers of inappropriate policy settings, via the adoption of a currency board:

We favour the conservative Currency Board approach, of the type Burma has had in the past - a system which inflexibly links the issue of banknotes to foreign exchange reserves. In response to strong negative external shocks, recourse could be had to the IMF and the international capital market if necessary. Countries such as Argentina and Estonia have had success with this approach and their experience can be studied. Given the conditions likely to prevail in Burma for some decades to come, a supposedly independent central bank or monetary authority is, we feel, too liable to abuse by the state. Where there is no well-developed private sector which offers alternative employment, government officials cannot be expected to resist a government determined to print money to make the accounts balance (Khin Maung Kyi, *et al*, 1998).²⁸

As Kyi *et al* acknowledge, a currency board arrangement brings with it certain costs in the constraints it imposes on policy but, as they also declare, this is a deliberate choice in order to impose policy discipline. This author is in broad agreement with their approach, and has argued elsewhere (Turnell 1999) that a currency board might be the vehicle through which to achieve the desirable macroeconomic environment outlined above. It must be noted, however, that currency board arrangements bring

²⁷ Such over-investment in government paper is, of course, precisely what is observed (above) in the balance sheets of Burma's banks.

²⁸ Contrary to the myth-making, Argentina's subsequent macroeconomic instability was not caused by its (now defunct) currency board (like) system, but the usual suspects of excessive (mostly regional) government spending, debt accumulation, institutional failure and corruption. As such, Argentina's arrangements, like those of many other countries that have successfully employed currency boards, remain relevant for policy-makers in Burma.

extra costs when considering the financial sector. For example, because they cannot simply 'print money' without an increase in backing foreign reserves, currency boards cannot provide 'lender of last resort' facilities or deposit insurance schemes often offered (implicitly or explicitly) by central banks. Of course, even this might not be the problem it appears. In his review of 'what works and what doesn't' in financial sector reform, Siegelbaum (1997, pp.5-6) argues that '[c]urrency board arrangements are generally helpful in a crisis', precisely because they limit the government's ability to 'bail out distressed institutions'. Siegelbaum shares with many authors the view that deposit insurance schemes are too expensive for most developing countries and, more importantly, do greater damage through the creation of increased 'moral hazard'. Better perhaps, simply to insure that banks operate prudently - an issue to which this paper now turns.

b) Reforming Regulation

Traditionally, bank regulators in many developing countries have used financial regulation chiefly as a means to pursue specific development objectives. They have concentrated on regulations affecting credit allocation, while paying little attention to prudential aspects of monitoring. This has undermined the efficiency and stability of financial systems, leaving them vulnerable to economic shocks. Following the wave of financial crises that hit developing countries in the 1980s, there has been a shift in regulatory policy. Today, the goal of modern financial regulation is largely prudential regulation to promote an efficient, safe, and stable financial system (World Bank 2001, p.79).

In 1988 the Basel Committee on Banking Supervision, a committee coordinated via the Bank for International Settlements (BIS), published what became known as the Basel Capital Accord. Designed to be the international standard for the supervision of banks in industrial countries, the Accord quickly set the accepted benchmark for all banks and financial systems.²⁹

At the heart of the Basel Capital Accord is the idea that capital (the net worth of a bank and, accordingly, wealth belonging to its owners) acts as a 'buffer' against excessive risk taking and the losses that might result from it. In the words of the World Bank (2002, p.80), '[o]ne way of ensuring that owners retain prudent risk-taking incentives is to require them to have a significant amount of their own money at risk'. Of course, should the worst occur, the existence of capital can also allow a bank to continue to operate until problems are resolved, and provides a degree of assurance that it will honour obligations to depositors and other creditors.

The Basel Capital Accord established that banks should meet a capital-to-risk-weighted-assets ratio of 8 percent - a ratio calculated by dividing a bank's capital base

²⁹ The Basel Capital Accord was originally designed for 'internationally active banks' in the G-10 countries. For a critical assessment of the use of the Basel framework in emerging market economies, see Rojas-Suarez (2002). At present a new Basel accord, so-called "Basel 2", is being negotiated. It is likely to involve a greater use of banks' internal systems and credit rating agencies, with a smaller role for objective rules. A number of commentators, including de Krivoy (2000) and Rojas-Suarez above, have questioned its usefulness for developing countries. This author shares their reservations, and agrees that a rules-based approach, with the original Basel framework at its core, remains the best option.

by its risk-weighted exposures. The Accord required that one half of this ratio (ie, 4% of capital) must take the form of 'Tier 1' capital (so-called core capital, consisting of those capital elements that are the most permanent and unrestricted commitment of funds by the owners). Risk weighting of assets was specified, according to various categories, to reflect (largely) the relative risk of the counter-party involved. The higher the risk, the higher the risk-weight, and the more capital required to be set aside.

Adherence to the Basel Accord came to be accompanied, in most well-managed systems of bank supervision, with a host of other measures designed to ensure that individual banks set aside sufficient capital according to the risk of their business. These included measures of asset quality, bank liquidity, profitability, exposure concentration (to individuals or sectors), adequacy of provisioning policies and assessments of the quality of bank management and systems. In 1997 these, and more, were incorporated into another seminal document issued by the Basel Committee, the *Core Principles for Effective Banking Supervision*.

The Basel Core Principles provide an ideal, if basic, blueprint for the regulation of banks and other financial institutions. The most important principles include:

- A pre-condition for effective supervision is that supervisors enjoy operational independence from government and adequate resources to conduct their activities. An appropriate legal framework for supervision is a corollary of this, including granting supervisors sufficient enforcement powers as well as protection from vexatious counter-claims from 'the supervised'.
- Supervisors should be satisfied as to the nature and structure of any institution wanting to call itself a 'bank'. This should include minimum capital and other financial criteria, as well as 'fit and proper persons' tests for directors and senior management.
- Supervisors must set criteria in place to restrict lending to 'connected' parties (individuals or corporate).
- Supervisors should ensure that banks have adequate systems in place such that they are not vehicles for criminal activity. This should include rigorous 'know your customer' rules and anti-money laundering ordinances.
- Supervisors should receive adequate statistical and other information from banks. They should also have in place a 'means of independent evaluation of supervisory information either through on-site examination or use of external auditors'.
- Supervisors should ensure that banks publicly disclose regular financial statements and other necessary information. This should be consistent with generally accepted accounting principles as representing a 'true and fair view of the financial condition of the bank' (BIS 1997, pp.4-7).

Additional Measures in Developing Countries

As noted, the Basel Core Principles are meant to apply whatever the level of development of a national financial system. Other issues, prominent in many developing and transition economies, require probable minimum additions to this

canon. Two of the most important of these are measures to ensure adequate liquidity, and the vexed issue of so-called 'connected lending'.

Liquidity

One of the most conspicuous features of a bank's balance sheet is that there is generally a maturity mismatch between its assets and liabilities. Put simply, banks borrow short and lend long and in order to reassure its depositors, a bank needs to have adequate liquidity.

Before Basel, liquidity requirements were a feature of most supervisory regimes around the world. Such requirements typically included minimum holdings of cash, government securities or funds on deposit at the central bank. They remain in many, but financial innovation and market deepening has lessened the importance of basic liquidity measures in the largest and most sophisticated financial markets. This is not true of most developing or transition economies. As de Krivoy (2000, p.120) notes, managing liquidity is often the 'primary proof of solvency' in such economies that are usually simultaneously lacking the 'legal and accounting infrastructures' that could otherwise be relied upon. The World Bank (2002, p.84) takes a similar position on the on-going importance of liquidity. It suggests that minimum liquidity requirements provide a necessary 'buffer' in regimes in which other supervisory mechanisms may be slow to emerge. It also cautions that even the basic Basel framework can be too complex to the circumstances of many developing and transition economies and, in such contexts, 'simpler rules like liquidity requirements can offer advantages' (World Bank 2002, p.84).

Connected Lending

Connected lending is a particularly acute problem in many developing countries. Capital is often both scarce *and* highly concentrated and, as a result, banks are typically owned by a narrow cohort of individuals, families or business elites, all with strong links to the government. As shall be examined below, this form of connected lending is endemic in Burma. Connected lending leads to a number of pathologies, for which de Krivoy (2000, p.126) paints a most evocative picture:

Banks are often linked by common ownership to a variety of other commercial enterprises to which they are likely to grant loans on the basis of affiliation, whether or not the projects are financially sound, and then rescue them at the expense of the bank. Instead of relying on independent banks, the usual move for large industrial enterprises, farmers, and merchants has been to set up their own banks as a more secure way to expand their businesses, especially when credit is rationed as a result of negative real interest rate policies. In such an environment, industrial and commercial companies linked with banks enjoy the distinct advantage of having access to loans from their affiliates (de Krivoy 2000, p.126).

This paper has made much of the role of financial institutions in allocating capital in ways that it can be most efficiently employed. Clearly, connected lending practices negate this process. But the problems of connected lending are not confined to their microeconomic consequences - there are implications for systemic stability too:

Connected lending can also be the starting point for systemic risk, when closely held banks account for high shares of total deposits in a weak regulatory environment. If the banking system is highly dependent on the fate of a few banks, which in turn depend on the decisions of a very small number of people besieged by conflicts of interest, insider lending easily translates into systemic banking crises (de Krivoy 2000, p.126).

As noted above, the Basel Core Principles require that banks conduct their businesses on an 'arms-length' basis from affiliates. Of course, this is easier said than done. Drawing on the Basel framework, but adding some specific measures that recognise practical realities, de Krivoy (2000, pp.126-127) suggests five measures designed to mitigate the risks of connected lending: Firstly, the regulatory authorities should supervise banks (consistent with Basel) on a strict *consolidated basis*. Secondly, care must be taken to define affiliation (closing potential legal loopholes) and therefore clearly identify connected loans. Thirdly, disclosure - of affiliation, of lending - is critical. Such disclosure must not only be to the regulatory authorities, but to the market as well. Fourthly, the owners and managers of banks must bear the costs of bank failure. Incentives must be in place, in short, to ensure that a bank is not regarded as a 'cash-box' for its affiliates. Fifthly, internal structures must be in place (and vetted by regulators) that reward prudence.

Under ordinances created following the financial crises of 1997, the Bank of Thailand came up with the following measures - some of which could be profitably studied by future bank regulators in Burma. The Bank of Thailand:

- limits the amount a bank can lend to a related person or company to 50% of its shareholders equity, 25% of the recipient's total liabilities or 5% of the bank's Tier 1 capital - whichever of these is the lowest;
- limits lending where cross-directorships exist. This includes outright prohibition of lending to companies whose directors-in-common with the bank have equity stakes exceeding 1% of the paid up capital of each;
- limits cross-directorships (in which one entity is a bank) to three companies (Hawkins and Mihaljek 2001, p.150).

Present Bank Regulation in Burma

At first glance the regulation of banks in Burma appears rational and consistent with international norms.³⁰ The CBM applies, for example, the criteria of the Basel Capital Accord. Under Article 31 of the Financial Institutions of Myanmar Law, the CBM dictates that banks maintain a capital adequacy ratio of 10 percent (higher than Basel's benchmark of 8 percent, but not inappropriate for a country with an undeveloped financial system), whilst under Article 32 of the Law, banks are not allowed to lend in excess of 20 percent of their capital to any single individual or enterprise. The CBM also applies, in a rough and ready way, the same risk weighting categories determined under the Basel framework.

³⁰ Details of the Central Bank of Myanmar's prudential regulations can be found at the Geneva embassy website (*op.cit.*).

In addition to the basic Basel capital requirements the CBM imposes other regulations on banks - some of which are in keeping with reasonable practice for a developing country, some of which are obsolete remnants of the Stalinist era. On the positive side, the CBM imposes minimum liquidity requirements - compelling banks to maintain a liquidity ratio (liquid assets against liabilities) of 20 percent. Not content with this, however, banks are also required to hold reserves against demand deposits (10 percent) and time deposits (5 percent), the bulk of which to be maintained as deposits with the central bank (75 percent) with the remainder in cash. This latter regulation probably tips the balance in Burma's regulatory structure from reasonable prudence, to active discouragement of normal banking operations. Yet a further requirement, that banks set aside 25 percent of annual net profit up to the point in which a 'general reserve' is established equal to a bank's capital, almost certainly does so. It must be noted too that the CBM retains powers to issue 'directives' on lending to certain sectors of the economy.

Beyond these are the positively surreal laws, deriving from ancient concerns regarding usury and the domination of lending by certain ethnic groups in Burma, that restrict lending by banks in other ways.³¹ Uppermost of these is the Money Lenders Act (1945, but still in place) that not only seems to disallow compound interest, but prohibits total interest payments from exceeding the amount of principal of a loan. It is difficult to imagine a modern banking system functioning against such fundamental prohibitions.

The CBM also continues to cap interest rates in Burma. On the deposit side, minimum interest rates payable on savings and time deposits must not be less than 3 percent below the Central Bank rate, while maximum interest rates chargeable on loans must not be more than 6 percent above the Central Bank rate. These restrictions yield a current deposit rate of 9.5 percent, and a lending rate of 15 percent. The absurdity of these limits, and what they must imply for the proper functioning of the banks, is readily apparent when one reflects upon the fact that inflation in Burma has not (truly) been below 20 percent a year for a decade.³²

Joint Venture Regulations

As noted earlier, Burma's much vaunted Phase 1 reforms that allow for the establishment of foreign/Burmese joint venture banks have been a failure. Restrictions such as those above (and the foreign exchange problems noted below) are sufficient in themselves to suggest that there is not likely to be a rush any time soon to set up legitimate joint venture banks in Burma. Specific regulations pertaining to joint ventures, however, have also almost certainly played a role in the non-appearance of these institutions.

As the current laws stand (and those relevant to joint venture banks source authority from the Foreign Investment Law and the Myanmar Citizens Investment Law (1994),

³¹ Under British colonial rule control of finance and other commercial activities tended to be concentrated amongst various immigrant groups, but especially Europeans and Indians. The latter were especially dominant in small-scale lending. Following independence in 1948 Burma began a program of expulsion of these groups as part of a broader 'national' economic policy. The 1945 Act should be read in this light.

³² According to the IMF (2002), Burma's inflation rate averaged 22 percent from 1995 to 2000.

as well as the Financial Institutions Law), a joint venture bank must be capitalised at a minimum of 60 million Kyat. The joint venture can only be established between a foreign bank that has a representative office in Burma, and a domestic private bank. The foreign bank must have at least a 35 percent equity in the joint venture to be paid, in Kyat, at the official exchange rate. The official exchange rate presently stands at around 6.7 Kyat to \$US 1.³³ The domestic partner can contribute its share in domestically sourced Kyat. The extortion is not hard to see. At the time of writing the market exchange rate is around 1000 Kyat/\$US 1. Even accepting that the current exchange rate represents an overselling of the Kyat, and selecting therefore an exchange rate of around 700 Kyat/\$US 1 (a rate to which the Kyat has settled, off and on, over the last year or so), the joint venture requirements suggest that a foreign partner will over-pay relative to the domestic partner at a rate of over 100 to 1. At a minimum the foreign bank must contribute \$US 3.1 million. Yet, if the minimum amount of capital to establish a joint-venture bank is employed, the domestic partner could (theoretically?) contribute \$US1 - for a 75 percent equity share!

It's hard to imagine that given such an outcome, and if a joint-venture in normal banking business is really what is on offer, that Burma's banking sector could hope to attract foreign capital.

Exchange Controls

Burma's foreign exchange problems, and especially the dual exchange rate regime that separates the official and market exchange rates, have been very damaging to Burma's economic development. Creating opportunities for great corruption, the gulf that separates the official and market exchange rates distorts prices throughout the economy and undermines the functioning of markets. The precipitous fall of the Kyat, to a level that at the present time means that it is near worthless, makes doing business in Burma a most difficult proposition for foreign investors. In July 2001, in a characteristic effort to stem the fall of the Kyat, Burma's military regime withdrew the foreign exchange licences of all but six of the private banks.³⁴ Soon after, the private banks were forbidden altogether to deal in foreign exchange.³⁵

In addition to these very real and very large difficulties, however, are various exchange controls that inhibit still further the development of an outward-looking financial sector in Burma. Burma's military regime continues to outlaw, for example, the conversion of Kyat into foreign currency. This means that the repatriation of profits from Kyat denominated income is difficult. The creation of a parallel currency in the form of Foreign Exchange Certificates (FECs) in 1993 alleviates one aspect of this difficulty (conversion into foreign currency), but permission is still required before any repatriation can take place. Even with approval, repatriation in any one year cannot exceed profits for that year. Of course, given that the Kyat is not

³³ Burma's currency is actually fixed against the IMF's Special Drawing Rights (SDR) at a rate of 8.5085 Kyat per SDR. This yields via the cross rates the current official Kyat/\$US exchange rate of 6.7114:1.

³⁴ The remaining authorised six were Asia Wealth Bank, Myawaddy Bank, Kanbawza Bank, Myanmar Universal Bank, Innwa Bank and the Cooperative Farmers Bank (Maung Maung Oo, 2001b).

³⁵ As noted above, foreign exchange activities amongst the banks are now limited to the state-owned Myanma Foreign Trade Bank and Myanma Investment and Commercial Bank.

convertible, no formal market exists for the currency and, as a consequence, legal hedging against its volatile fluctuations is not possible.

An especially egregious restriction on foreigners in Burma comes via the Transfer of Immovable Property (Restrictions) Law, 1987. Under this law, no foreign individual or foreign owned company is permitted to acquire land in Burma, or even lease land for a term exceeding one year unless specifically authorised by the government. Of course, this would greatly inhibit the ability of foreign banks (and joint ventures) to lend since they would be unable to seek property collateral against loans.³⁶

Failure to Apply Basel's Core Principles

Notwithstanding the extraordinarily prescriptive nature of bank regulations in Burma, they do not include what are perhaps the most important elements of the *Basel Core Principles* noted above:

- As supervisor, the CBM does *not* enjoy operational independence from government.
- Whilst the CBM requires a minimum amount of capital to start up a bank, it does not (cannot, given the nature of the political-economy of Burma) have in place *objective* 'fit and proper person' requirements for bank directors or executives. This paper notes (Appendix Two) some of the allegations against the principals of Burma's existing private banks.
- Connected lending is rife in Burma's banking sector. Many of the private banks are simply the financing arms of larger corporate structures - the servicing of which, indeed, was sometimes the primary reason for their creation (see Appendix Two).
- The CBM does not, as noted, ensure that Burma's banks are free from being used for criminal activity. What might be the 'fig-leaf' of the recent anti-money laundering laws notwithstanding, it is likely that Burma's banks are heavily involved in what other jurisdictions would label as criminal activity.
- The CBM requires banks to furnish it with regular statistical information, but there are no systems in place in Burma to provide the necessary independent evaluation of this information. There is no use of external auditors in the CBM's supervisory practice.
- Basel requires a high degree of public disclosure of financial information by banks. No such reliable disclosure takes place in Burma.³⁷

The inescapable conclusion from all of the above is that reform of Burma's financial system will require the wholesale transformation of its system of bank regulation and

³⁶ Whether or not a joint venture bank could seek property collateral or not would depend upon the relative share of its capital that was contributed by the foreign and domestic partners. As the 1987 Law currently stands, a joint venture that had foreign equity in excess of 49 percent of capital would not be permitted to own land in Burma, or enter into arrangements via which ownership could be claimed. Of course, the 1987 Law also makes Burmese enterprises doubtful risks for offshore lending too – Burma's Ministry of Finance and Revenue itself notes that 'offshore loans for Myanmar projects usually require offshore guarantees' (Geneva embassy website, *op.cit.*).

³⁷

supervision. At a barest minimum, the most extreme regulations of the *ancien regime* must be swept aside and something approximating Basel best-practice placed in its stead.

A corollary of this is the restructuring of the regulator – the central bank. At this point, however, a further question is posited: Should bank regulation and supervision be left to the CBM? Or should it, as has increasingly been the case in a number of industrial countries, be placed with a separate entity entrusted solely with this task? The argument for a separate institution hinges on what is alleged to be the inherent conflict of interest between the monetary responsibilities of the central bank (which might require, for example, tightening credit to a degree detrimental to banks' interests) and its supervisory functions. Will the latter mean that a central bank will go 'too easy' regarding the former?

In advanced industrial countries this is probably an alive question. In the view of this author, however, for a country such as Burma, what is more relevant is the extent of human and other resources available to supervise banks. These are likely to be extremely rare, and heavily concentrated (albeit perhaps in a somewhat compromised form) in the CBM. Of course, the CBM *should* be radically restructured, and certainly senior management should be replaced. Burma need not venture alone in this restructuring path though – for this is one arena in which the multilateral financial institutions, as well as the central banks and regulatory authorities of a host of countries, can provide meaningful assistance. Indeed, they already do in a number of transition economies, details of which have been liberally noted throughout this paper. This support would and should be financial, creating the critical 'breathing space' that would allow for the restructuring of bad loans for example, but above all it should be in the form of training. It might also be the case that this is a logical avenue through which appropriately qualified and experienced ex-patriots can play a role - post regime change.

c) **Financial Liberalisation**

What is known in the development finance literature as 'financial repression' is a strong feature of Burma's banking system.³⁸ Financial repression arises from the fact that interest rate controls (as noted above, applied in Burma on both lending and deposits) artificially creates a shortage of funds for viable investment. This is because in high inflation environments (such as Burma's), interest rate controls create *real* interest rates that are very low, even negative. As such, the demand for these funds is likely to be high but, conversely, the supply of these funds (deposits) will tend to be low. In the absence of interest rate controls the interest rate itself would sort out this mismatch between supply and demand by rising sufficiently to 'clear' the market. With interest rate controls, however, such 'rationing' must be done via other means.

Of course, such rationing creates yet another breeding ground for corruption. It also creates a situation in which banks are only likely to lend in large amounts to keep overhead costs low. In such an environment small enterprises - the source of Burma's future prosperity - will be left out in the cold. For this same reason lending to the

³⁸ For a comprehensive discussion of the relative merits of financial liberalisation, see Fry (1997) and Singh (1997).

government becomes a relative attractive option. The latter is a not surprising outcome perhaps, since interest rate controls are often imposed precisely for the purpose of making government financing cheaper.

The solution to financial repression, and the corruption that inevitably follows in its wake, is to 'liberalise' financial markets by removing interest rate controls. In the heady environment of the transition period this can cause its own problems but, with the appropriate institutions and regulations in place (of the type advanced here), these can be, and have been elsewhere, managed effectively.³⁹

d) What to do with the Existing Banks?

Privatising the State-Owned Banks

Though there is great controversy over many aspects of financial sector reform, one area in which there is almost unanimity of opinion in the literature is on the problems associated with government ownership of banks. Government ownership of banks has typically led to an excessive politicisation of decision making, distorted resource allocation, exacerbated problems of corruption through connected lending, propped up inefficient (and otherwise insolvent) state enterprises, retarded the development of financial institutions and instruments, and enabled governments to pursue unsound macroeconomic policies by providing a 'soft' budget constraint. A recent empirical study by Barth, Caprio and Levine (2000) found that government ownership of banks was associated with;

- i) a low level of lending to the private sector;
- ii) low indexes of competition in other industrial sectors
- iii) high net interest margins
- iv) an increased probability of banking crises.

Other studies come to similar conclusions, including a recent survey by the Asian Development Bank of nine member countries caught up in the 1997 Asian 'financial crisis'. It found that government-owned banks

funnelled credit to priority sectors selected by the government, and sometimes had to lend to these sectors in accordance with lending targets, usually under a regime of administered interest rates. Attempts at "managed development" by the government spawned resource misallocation, inefficiencies and unprofitability in the sectors it effectively subsidised, and worsened operational inefficiencies in banks (Gochoco-Bautista, *et al* 2000, p.51).⁴⁰

All of this is familiar ground when examining (as per above) the performances of Burma's state-owned banks. As the EIU notes (2001, p.30), these have often been called upon not only to buy government bonds to finance the central government's expenditure, but also to fund other state-owned enterprises (SOEs). On the books of

³⁹ See, for example, the approach taken by Thailand, Turkey and Kenya in World Bank (1987), pp.117-122.

⁴⁰ Of course, in societies governed by laws, independence of institutions from government can be established by legislation. In the absence of this virtue, the World Bank is surely correct in its assessment (2002, p.87) that, 'privatisation may be the only way to ensure this [independence] effectively'.

the MEB, for example, is a large tranche of non-interest bearing bonds created in 1989 in place of accumulated SOE debts. The other state-owned banks have been forced into similar deals.

The eventual privatisation of Burma's state-owned banks must be an integral feature of its financial sector reforms. This will not be a process, however, that will be free of problems and pitfalls along the way and nor, this paper argues, should privatisation proceed with undue haste. It is an unfortunate fact that banking crises have often followed programs of privatisation and liberalisation. Whilst this does not mean that they should not proceed, a degree of caution (along the lines outlined below) will be required if the worst is to be avoided.⁴¹

Problems and Issues over Privatisation

According to Demirgüç-Kunt and Detragiache (1998 and 1999), bank privatisation and liberalisation increases the risk of a banking crisis (in the immediate 'new environment years) by around 300 to 500 percent. Whilst the magnitudes are arguable, their findings are generally consistent with the empirical record since such issues became relevant following the collapse of the Soviet bloc.

The factors behind these persistent crises are many and varied, but they can essentially be divided into two rough groupings that Hawkins and Turner (1999, p.39) label 'stock' and 'flow' problems. Stock problems are those that relate to past lending behaviour of banks, lending which was often made for purely political purposes without any expectation that it would be repaid. Siegelbaum (1997, p.3), writing of experiences in the ex-Soviet bloc, estimated that non-performing loans represented 'upwards of 50% of the portfolios of many state banks'. Flow problems extend from the behaviour of banks post-privatisation and liberalisation when, newly freed from past constraints but unskilled in the new environment, something of a 'lending binge' is often the irresistible temptation.

Solving stock problems - clearing up balance sheets and deciding what to do with problem loans - will be a necessary prerequisite for privatising state-owned banks. Asset impaired, generally overstaffed, inefficient and barely equipped with the skills required by modern banking, they otherwise hardly represent much of a catch to any would-be buyer. Of course the situation will be made more complex by the difficulties in the first instance of working out precisely what condition bank portfolios are in. There is, for instance, the strong probability (the near-certainty in the case of Burma) that past classification of delinquent loans in state-owned banks will have been less than rigorous.

⁴¹ There is an argument that banking crises can do *some* good. According to Siegelbaum (1997, p.5), banking crises;

'...reveal systemic weaknesses, teach lessons about human failings and highlight the political nature of banking regulation and intervention. In addition, they provide a critical 'reality check' for politicians who have never seen their potential for harm. At least in the early stages of the transition, crises tend to die out quickly'.

Siegelbaum also defends banking crises on the basis that many developing and transition economies have more banks than their market size can support - crises accordingly 'weed them out'. Burma also has too many banks and, as noted, most are far too small to be viable. Whether a banking crisis is the most efficient way of improving the species is, however, debatable.

Clearing up the balance sheets of state-owned banks will be necessary in order to privatise them, but it will also be necessary if they are not to be the cause of systemic instability thereafter. As the World Bank notes (2002, p.86), '[n]ew owners must start off with a viable entity'. As an example of what happens when this is not done, it offers the experience of Chile in the mid-1970s. Lacking the financial resources (and political will to do otherwise) the Chilean government privatised the (large) state-owned banking sector but left whatever problem loans existed on the books. In 1982 Chile entered into a deep economic and financial crisis, both a cause and a consequence of which was broad bank insolvency. Repairing the situation required a great many more financial resources than that which could have been used preventively at the outset of privatisation, as well as a degree of supervisory 'elasticity' in allowing banks to trade their way out.⁴²

Of course, in the case of Burma, 'stock' problems will probably not be limited to the state banks. As noted above, Burma's 'private banks' too are greatly exposed to the State and to State-owned enterprises, and their lending more generally is highly connected to the regime.

Working out what to do with problem loans has been a contentious issue in reforming countries. A consensus seems to have emerged, however, in favour of the so-called 'good bank/bad bank' approach. Under this, non-performing loans (NPLs) are separated from their originating institutions (which become 'good' banks) prior to privatisation. Meanwhile, the NPLs are transferred to a new institution - the 'bad' bank (sometimes simply a restructuring agency rather than strictly a bank) - which, funded by the state, attempts to recover some value from the delinquent debtors. Creating the 'bad bank' will clearly require fiscal commitment from the state, sometimes in large measure, and this will have to be factored in to a reforming government's fiscal program. Such costs will be lessened by what can be recovered and, on this, Siegelbaum (1997, p.3) is reasonably optimistic; 'our current thinking is that bad loans should not be dealt with prematurely, because a surprising number turn out to be collectable after all'.

Experiencing 'flow' problems will also likely be an inevitable feature of the bank reform process. Capturing the transformation nicely, Hawkins and Turner (1999, p.10) suggest banks move from being 'credit rationers to credit marketers' - the trouble being that the skills for each can hardly be more opposed. Providing credit to a burgeoning and disparate private sector can be much more profitable than merely being the passive buyer of government bonds - but it's a much more complex task too and, arguably, an activity involving considerably greater risk. Of course, on top of the changing roles for the banks themselves are changes in the broad economy that are just as great. Transition periods are not tranquil. They are usually associated with price and currency instability, civil and political disturbance, heightened expectations, supply chain and infrastructure disruption, policy changes and, of course, the reforms themselves that unsettle the pre-existing order. Banks must negotiate these changes, but so too must their customers. In the end the fate of the banks is inextricably linked to their customers, upon whose own reform (especially in the case of state-owned enterprises) all must ultimately depend.

⁴² For details of Chile's experience, see Barandiaran and Hernandez (1999).

The upshot of the above is that privatisation is neither a panacea for the inevitable problems that arise with bank reform, and nor should it be conducted prematurely. Drawing upon the experiences of nearly a decade of reform in the former Soviet Union and Eastern Europe, Siegelbaum (1997, p.3) concluded that the lesson was:

...don't be in a hurry to privatise. Once the bank's customers have been privatised, including both depositors and borrowers, and the financial state of the institution becomes somewhat more transparent and stable, then privatisation becomes easier and fairer... (emphasis in original).

Finally, this does not imply, however, that the existing management of both the state-owned and problem private banks should remain in place. As Siegelbaum (1997, p.4) observes:

The 'Old Guard has too much at stake in the *status quo* and is too well indoctrinated in the old ways of doing business to change in the fundamental ways required to succeed in such a radically different environment. This should be recognised early and implemented ruthlessly...it is important for the government to send strong signals to the bank, its management and its customers that it is committed to change, that failure will not be tolerated, and that future accommodations, whether in the form of cheap funding or loan forgiveness, cannot be expected.

e) **A Role for Foreign Banks**

A potential obstacle in the path to privatisation in Burma will be the lack of buyers of state-owned banks who possess both high integrity and sufficient financial resources. Those individuals and business groups that have prospered in today's Burma, the most likely purchasers of state assets during the transition to a more market-based economy, are not necessarily those who would pass any 'fit and proper person' test that Burma should employ - and most countries already do (consistent with Basel) - when handing out bank licences. Of course, to some extent the most obvious candidates for purchasing the state-owned banks are the existing private banks. Given some of the evidence above, however, this would be a most undesirable outcome.

The risks in this context are very real. Seeger and Patton (2000, p.31), writing of the experiences of bank privatisation in Ukraine (where so-called 'oligarchs' largely assumed control of privatised banks), note that not only are the odds stacked against honest players, but the effects of banks falling into the wrong hands are long-lasting and damaging to the economy at large:

Care must be taken in screening bidders, however, because an honest bidder may offer less money for an enterprise than a dishonest one. This is because the honest bidder has to do the hard work of restructuring the enterprise to make it profitable, while the dishonest bidder has a competitive advantage in that he can evade taxes, obtain favours from the Government, "cheat" when fulfilling investment obligations, engage in price-fixing, enforce contracts through force rather than the court system, not pay workers, and engage in profit skimming and asset stripping.

A potential solution to this problem - though one requiring greater investigation than space allows here - would be to privatise the existing state banks via 'voucher privatisation'. In essence, this involves the distribution of the share capital of

privatised enterprises amongst the general populace, 'gifted' (and therefore funded) by the government. There are, however, many problems with this method of privatisation in relation to banks - not least in that it 'may leave effective control of the bank in the hands of the existing management' (Hawkins and Turner 1999, p.82). Seeger and Patton (2000, p.11) concur with this, arguing that, for bank privatisations, 'the initial share allocation should be highly concentrated' since '[a] dispersed shareholding pattern would require legal protections [of minority shareholders] and enforcement mechanisms that take decades to develop'.

The most promising way to deliver to Burma a functioning financial system in the short to medium term - and bring great dynamic benefits besides - would be to open the economy to foreign banks. As noted above, foreign banks have been traditionally excluded from operating in Burma and the half-hearted efforts of the present regime to 'encourage' entry have been singularly unsuccessful. Though nationalistic objections to the operation of foreign banks would likely persist amongst certain quarters beyond a regime change, these can, and should, be met with the very solid arguments that can be mounted in the favour of foreign bank entry:

- Because of their 'outsider' status, foreign banks are less likely to engage in 'connected lending'. In the specific case of Burma, they are also unlikely to be involved with the present regime and, accordingly, be free from the taint of its activities and practices.
- Foreign banks bring with them possibly the most potent competition entrenched players are likely to face. According to a recent empirical study by Claessons, Demirgüç-Kunt and Huizinga (2001), the existence of foreign banks improve sector efficiency, being associated with lower overhead costs, lower profitability and lower interest margins for entrenched banks. They maintain, indeed, that the positive effects from foreign banks on competition is greater in developing countries than it is for more developed financial centres - the former in which high overheads and interest margins are more commonly a feature.
- Foreign banks bring with them new skills and technologies. Such of these that exist in Burma's present financial system, designed for other ideologies and other times, are not likely to be compatible with modern financial markets and practices.
- Foreign banks have established access to international capital markets - of which, indeed, they are an integral part. Such access as may be provided in this manner could be important for Burma - a country locked away from the rest of the world for four decades and likely to remain a 'doubtful quantity' in financial markets for a time even beyond the transition to a market-based democracy.
- The capital that foreign banks are able to source is likely to be cheaper than that which Burmese institutions could source on their own. This is not only because of the reasons above, but also simply because foreign banks are likely to come from countries which have higher credit ratings than Burma - and therefore face lower risk premia.⁴³

⁴³ According to a survey conducted by the Economist Intelligence Unit, and reported in *The Economist* (March 10, 2001), Burma is regarded by foreign investors as the second most risky country in which to do business. First place went to Iraq.

- The existence of foreign banks eases some of the pressure on domestic prudential regulators since it is highly likely such banks will already be subject to the Basel framework, and other relevant supervisory rules, imposed by their home regulator. A way of ensuring this would be to require that foreign banks operating in Burma be constituted as branches of the parent bank rather than as subsidiaries. Under the Basel Accord banks are supervised on a consolidated basis and, as such, branches are treated no differently than head office.⁴⁴
- In a similar vein, should it prove necessary, it is likely that foreign bank operations would obtain financial and other support from the parent institution. It should be emphasised that foreign banks have their own reputation at stake in their foreign operations - and are not likely to allow their 'brand' to be tarnished. This point, and its predecessor, are supported by the empirical record of foreign banks in transition economies. Caprio and Levine (2000), for example, found that foreign bank participation is associated with greater system-wide loan portfolio quality and greater systemic stability. Demirgüç-Kunt, Levine and Min (1998), similarly found that the entry of foreign banks reduces the probability of systemic crises.
- A reasonable concern regarding the entry of foreign banks is that Burma's financial sector could become dominated by the institutions of a *single* country. This could be a real concern in Burma which, to the extent that its economy is open under the present regime, is rather dominated by a few countries outside of the largely Western boycott.⁴⁵ Accordingly, regulations should be in place to ensure a plurality of foreign bank entrants by home country.
- Should Burma opt for a currency-board based exchange rate system, foreign banks would be a welcome source of foreign reserves.⁴⁶ In this scenario, banks from the 'anchor' currency country would be especially valuable players.

It is only through a *competitive* financial system that Burma's financial resources will be most efficiently allocated. It is through competition that financial products and instruments are appropriately priced in a market system, and it is through competition that incentives are created for financial institutions to both diversify the services they offer, and to seek markets outside their traditional milieu.

The creation of a home-grown financial system in Burma, which should follow from the liberalising processes discussed above, will take some time to emerge. In the meantime the best source of competitive pressure is likely to come from foreign institutions. Their entry should be welcomed.

⁴⁴ As Hawkins and Mihaljek (2001, p.30) note, quite a few countries in Asia and elsewhere allow foreign bank entry only on the basis that they take the structure of branches.

⁴⁵ China, and to a lesser extent Japan and Singapore, immediately come to mind.

⁴⁶ Given that their own lending is based upon maintaining a certain level of reserves, foreign banks (especially as constituted as branches) operate not unlike 'mini-currency boards' themselves.

f) A Role for Microfinance Institutions

A promising field in which Burma's financial system can be strengthened and deepened is in the provision of *microfinance*. Defined by the ADB (2000, p.2) as '...the provision of a broad range of financial services such as deposits, loans, payment services, money transfers and insurance to poor and low-income households and, their microenterprises', microfinance has become something of a 'hot topic' in the development literature. This is not only because of the promise of microfinance in reducing poverty, but also because of the empowerment it seems to offer the most marginalised groups in society. In most microfinance models, women are the chief beneficiaries and the activities financed - heavily concentrated in food production and distribution, agriculture, craft based production and trading - are dominated by women and those with little socioeconomic power.

Microfinance typically involves loans that are very small, seldom more than a few hundred US dollars. Interest rates are usually high by developed world standards, but much less than those levied by traditional money-lenders (who, in Burma, charge around 12-20 percent *per month* depending upon the borrower) and, for most viable projects, rather less than the returns they generate (EIU 2001, p.32). Microfinance institutions (MFIs) generally claim very low rates of loan default, or even of interest payment arrears. In the case of the most prominent MFI, the Grameen Bank of Bangladesh, this low rate of loan delinquency is said to be a function of 'peer group monitoring'.⁴⁷ Grameen typically lends to groups (mostly of women) rather than to individuals and, as such, group members implicitly police each other. Social pressure thus replaces physical collateral. Grameen borrowers typically return for more loans as their enterprises grow, adding a further element of repayment enforcement.

Much is claimed for the poverty reducing qualities of microfinance - so much, indeed, that the UN has rightly cautioned that a 'certain sense of proportion regarding microcredit would seem to be in order' (UN 1997, p.4). Nevertheless, there is little doubt that microfinance has enabled vast numbers of people in developing countries to enjoy higher and more stable incomes than they would otherwise have achieved in the absence of access to it. What does seem clear is that microfinance only achieves its best results when it is accompanied by other measures that enable the full expression of the latent entrepreneurial abilities amongst the world's poor. Some of these measures - the rule of law, establishing property rights and other 'fundamentals' of institution building, have been noted already and apply across many issues.

Higher and more stable incomes are driven by the production or investment uses that microfinance can be put to. It is, however, increasingly recognised that the poor desire secure savings vehicles as much as access to credit. As a consequence, this aspect of the potential for MFIs has begun to receive more attention of late. Also receiving more attention is the idea that microfinance - to the extent that it is group based - can be a vehicle for social as well as financial intermediation (Ledgerwood 1999, p.1). The weekly meetings of borrowers that prevails under the Grameen system, for

⁴⁷ Founded by the former World Bank economist, Muhammad Yunus, the Grameen family of organisations is very much the 'poster child' of microfinance. Though established in Bangladesh, it has expanded its operations to a number of countries and diversified into other activities, including the provision of telephony services to the poor. Details of Grameen, its philosophy, history and operations, can be found on its website, <www.grameen.org>.

example, provides a ready-made forum with which to disseminate information on health, legal and political rights and other broader issues. It has also been argued that the group approach can produce other spin-offs - including the 'development of self-confidence, training in financial literacy and management capabilities among members of a group' (Ledgerwood 1999, p.1). All of this may be especially relevant for Burma, a country in which many other vehicles of civil society have progressively been eliminated.

A critical issue for MFIs, and their supporters, is that of sustainability. It is still the case that a great many MFIs only function because their capital is constantly replenished by donors of some kind. Loan defaults (even at the low levels claimed), high per unit transaction costs (by their nature, unavoidable for MFIs), and what is often poor managerial structures and skills means that profits in the sector are hard to come by. According to Ledgerwood (1999, p.2), the question of sustainability is transforming the MFI sector as attention has switched from a 'poverty lending approach' (emphasising poverty and empowerment *outcomes*) to a 'financial systems approach' (emphasising MFIs role in financial system building, and in providing to finance to groups other than simply the most poor).⁴⁸ This switch, she argues, is justified by the following beliefs:

- Subsidised credit undermines development [through resource misallocation].
- Poor people can pay interest rates high enough to cover transaction costs and the consequences of the imperfect information markets in which lenders operate.
- The goal of sustainability (cost recovery and eventually profit) is the key not only to institutional permanence in lending, but also to making the lending institution more focused and efficient.
- Because loan sizes to poor people are so small, MFIs must achieve sufficient scale if they are to become sustainable.
- Measurable enterprise growth, as well as impacts on poverty, cannot be demonstrated easily or accurately: outreach and repayment rates can be proxies for impact (Ledgerwood 1999, p.3).

Notwithstanding the longer-term need for sustainability, in the immediate future (and certainly for future schemes in countries such as Burma) donor support for MFIs will continue to be both necessary and desirable. In fact, support for microfinance from multilateral institutions and international NGOs is strong. Many UN agencies, together with the multilateral financial institutions (World Bank, IMF, ADB, other regional development banks) have programs of support.⁴⁹ Sometimes this involves direct funding of MFI lending - the World Bank sponsored Consultative Group to Assist the Poorest (CGAP), for example, provides funds for MFIs according to the following eligibility criteria:

⁴⁸ For more on these approach categories, now widely used in the microfinance literature, see Gulli (1998).

⁴⁹ A regional example of a large (\$US273 million) and apparently successful microfinance scheme supported by a multilateral financial institution (the World Bank) is the Kecamatan Development Program in Indonesia. Details of the program can be found at <www.worldbank.org/eapsocial/countries/indon/INDPRO~1p7.htm>.

(a) institutions must serve more than 3,000 very poor clients, of which at least 50 per cent must be women; (b) institutions must be operationally self-sufficient and on the path to financial self-sufficiency; and (c) institutions must be on the path to mobilising domestic commercial resources (UN 1997, p.7).

Perhaps the most important ways in which multilateral institutions can support microfinance, however, is via capacity and institution building. The World Bank, the ADB, the Inter-American Development Bank (IADB), and a number of other institutions are already moving in this direction. The use of training programs as a vehicle for disseminating MFI best practice is a particular focus - representative of which is the IADB's Microenterprise Development Fund, the resources of which can be applied to;

(i) meet the cost of workshops, publications, and related activities; (ii) provide technical assistance to local organisations for development of microenterprise development projects; (iii) finance activities that directly or indirectly support institutional strengthening of local organisations involved in microenterprise development; and (iv) finance applied research and information gathering and dissemination, especially best practices, that will benefit local organisations working on microenterprise development (ADB 2000, p.51).⁵⁰

The Burmese regime's self-imposed exile from the international community has meant that Burma has largely missed out on the microfinance 'revolution'. Nevertheless, a scheme established in 1996 by the Grameen organisation in Burma's Delta Zone seems (on the limited information available) to have been successful. Twenty-five thousand borrowers are claimed, all of which are women and for which a 100 percent repayment rate is recorded. The scheme is relatively small (around \$US 3 million has been disbursed) but it provides a promise for what might be achieved, should the Burmese regime reform sufficiently to both allow multilateral assistance and the development of a more rational political economy.⁵¹ Another scheme, managed by the US NGO 'PACT Myanmar' in conjunction with the United Nations Development Programme (UNDP) in Kawkapudang, is similarly constrained by Burma's political isolation and policy failures.⁵²

⁵⁰ The role for host *governments* in supporting microfinance are similar in that the most important set of policies they can adopt is those that establish the requisite institutional framework. According to Gulli (1998, pp.83-84):

Government's main role is to establish the overall conditions necessary for investment and growth of microfinance. By maintaining economic stability and competitive markets, fostering political plurality, developing the appropriate legal and regulatory framework, and promoting sensible oversight, government can help create an environment that facilitates the proliferation and strengthening of financial institutions that serve the microenterprise sector.

This framework is, of course, roughly that required for the development of financial institutions broadly. As also noted previously, it's also a framework greatly lacking in Burma under the present regime.

⁵¹ Details of this scheme can be found at the website of the Grameen Foundation of the United States - <www.gfusa.org/replications/myanmar.html>.

⁵² 'PACT' stands for 'Private Agencies Collaborating Together', and is something of an umbrella group for a number of US charities and NGOs. Details of PACT's operations in Burma can be found at <<http://www.pactworld.org/Services/myan.html>>. Thanks to Alison Vicary for providing this information on PACT and its activities.

V. Conclusion

The transformation of Burma into a fully institutionalised liberal democracy based on a market economy will be a multi-faceted process. One aspect of this must be, however, the creation of a properly functioning financial system. Financial institutions are integral to economic development. In a market economy they provide the central coordinating mechanism through which resources are allocated. At best, they do this in ways that maximise the wealth and welfare of their respective national economies.

The foundations of a proper functioning financial system are transparency, accountability and the effective transmission of market signals. Burma's existing financial system, unfortunately, possesses few of these virtues. Worse, its principal financial institutions may be little more than facades for the activity of criminals and a narco-state.

Reforming Burma's financial system, in particular the banks that make up its core, will require the privatisation of its state banks, the legitimisation of its existing private banks and the opening up of the sector to foreign competitors. Before these measures can be undertaken, however, fundamental institutional reform will be necessary. Burma must become an economy and a society ruled by law and not the whim of generals. The Burmese people must have rights to property in order to best liberate their latent skills and energy. Financial regulation must adopt practices that have been demonstrated to work elsewhere. Macroeconomic policy must leave the irrational world and enter that which reason and history teaches us can achieve all that governments are able. Burma's political economy, in short, awaits its transformation.

APPENDIX ONE

Private Domestic Banks in Burma

Asia Wealth Bank
Asian Yangon International Bank
C.B. Bank
Cooperative Bank
Cooperative Farmers Bank
Cooperative Promoters Bank
First Private Bank
Innwa Bank
Kanbawza Bank
Myanmar Citizens Bank
Myanmar Industrial Development Bank
Myanmar Livestock Breeding & Fisheries Development Bank
Myanmar May Flower Bank
Myanmar Oriental Bank
Myanmar Universal Bank
Myawaddy Bank
Sibin Tharyar Yay Bank
Tun Foundation Bank
Yangon City Bank
Yoma Bank

APPENDIX TWO

Burma's Private Banks and (Accusations of) Money Laundering

The **Asia Wealth Bank**, which vies with Yoma Bank for the title of Burma's largest, was founded by U Eike Htun, a shadowy figure who emerged in the early 1990s from Kokang, 'an area notorious for opium production' (Maung Maung Oo 2001a). Eike Htun also heads a leading trading and property business called the Olympic Group that has been very active in investing large sums in residential property and hotel developments in Rangoon. Most of these stand empty. The Asia Wealth Bank reports a return on equity of 54.56 percent for 2000-2001 – substantial profits for a bank whose funds are tied up in assets in which the returns (as noted above) are less than half the rate of inflation.⁵³ The Asia Wealth Bank does much of its business along the Chinese border, a prime transit point through which drugs from Burma go out into the world. It is particularly popular amongst ethnic Chinese business in Burma generally. Protests were staged in Thailand in May 2000 when Eike Htun was invited to attend an Asian Development Bank conference in Chiang Mai.⁵⁴

The **Mynamar May Flower Bank**, often listed as the third biggest in Burma, was founded by U Kyaw Win. Kyaw Win is accused of being a leading figure in the drugs

⁵³ Return cited from AWB website, *op.cit.*

⁵⁴ News report, *The Irrawaddy*, June 2000, vol,8, no.6.

trade in Burma. He is said to be close to SPDC Chairman Maung Aye, and he was an associate of Khun Sa, Burma's former leading 'drug lord' who 'surrendered' to Burma's military regime in 1996 (Maung Maung Oo, 2001a). In 2000 Kyaw Win sold an 80 percent stake in the bank to the United Wa State Army (UWSA). The UWSA's role in the drug trade is well known, of course and it has been described by the US State Department as the 'world's largest armed narcotics-trafficking organisation'.⁵⁵

Kanbawza Bank has grown extremely rapidly in recent years. Established by U Aung Ko Win in Shan State (in an area also noted for opium production), the bank is famed for its largesse in many areas, not least for its sponsorship of Burma's national football team.⁵⁶ According to Maung Maung Oo (2001a), Aung Ko Win is believed by business people in Burma to be 'the adopted son of [junta Vice-Chairman] General Maung Aye and that he is laundering the corrupt money of the generals through his bank'.

Myawaddy Bank is owned by Union of Myanmar Economic Holdings (UMEH). UMEH, Burma's largest firm, is to all intents and purposes Burma's army itself. Formed in February 1990, UMEH is 40% owned by the Defence Ministry's Directorate of Defence Procurement and the remaining 60% by 'defence services personnel'. The latter are mostly senior officers, including members of the State Peace and Development Council (since 1997, the more acronym-friendly name of the SLORC), current serving members of military regiments and army veterans (individuals and organisations). UMEH has its fingers in all manner of pies and enjoys great privileges (including exemption from profit taxes). UMEH runs monopoly subsidiaries in industries that range from tourism, mining, trading to textiles. As was reported in the last issue of BEW, it often gets 'first pick' of joint-venture projects and partners. Myawaddy Bank is located in the old Central Bank of Myanmar Building, a demonstration of its establishment status. According to Kyee-Mohn U Thaung, 'when Myawaddy Bank opened on January 4 1991, they declared that there would be no questioning of the depositors...'.⁵⁷

Innwa Bank. Like Myawaddy Bank, is owned by UMEH.

Myanmar Universal Bank has been implicated not only in the laundering of drugs money, but in the financing of amphetamine factories in Burma. The Bank is believed to be owned by Wei Hsueh-Gang, described by the South China Morning Post as Burma's 'premier trafficker'. Wei is from Shan State and has been indicted on drugs charges in both the United States and Thailand (Barnes 2001).

Tun Foundation Bank. Owned and founded by Thein Tun, the former 'Mr Pepsi' (so-named because he was Pepsico's business partner in Burma before that company's withdrawal from the country). Thein Tun was famously told a group of Burmese business people that they should unite to 'crush destructualists' who were undermining the work of SLORC.⁵⁸

⁵⁵ Cited from *The Irrawaddy*, February 1998, Burma: Asia's first narco-state?', vol.6, no.1.

⁵⁶ *ibid.*

⁵⁷ Kyee-Mohn U Thaung's comments are reproduced at <http://rebound88.tripod.com/gp/eco/eco.html>.

⁵⁸ For these comments, see <http://www.criminallawyers.ca/newslett/oct96/11copela.htm>.

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