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Have Reforms Established Transmission Channels of Exchange Rate Policy in Myanmar?

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Abstract

While Myanmar moved to a floating exchange rate regime from a fixed exchange rate regime in April 2012, parallel market transactions of foreign exchange remained pervasive. This paper investigates the question whether the reforms have established a transmission channel of exchange rates from the formal to parallel markets. The empirical results of VAR analysis with the daily exchange rates indicate that the Central Bank has been following the parallel rate rather than guiding it, implying that a transmission channel is yet to be established.

Keywords: ***transmission channels; exchange rate policy; Myanmar; VAR***

1. Introduction

Myanmar (Burma) used to have a multiple exchange rate system. The disparity between the official exchange rate and a prevalent parallel market rate once reached 24200% in September 2007, where the official and parallel exchange rates of the Myanmar kyat vis-à-vis the US dollar were 5.6303 and 1,369, respectively. The new government, which came to office in March 2011, abolished pegging the kyat and moved to a managed float regime in April 2012. At the same time, the Central Bank of Myanmar initiated the daily price tender auction of foreign exchange with commercial banks, and announcing the cut-off rate of the auction to the public as the reference rate. The reforms, however, do not necessarily mean the end of the multiple exchange rate system.

A unified foreign exchange market is where the prices of foreign exchange in various parts of the market are

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converged. Usually, in a unified market, commercial banks hold the key position; commercial banks trade foreign exchange with exporters and importers as well as with each other and with the central bank. Arbitrage activities of commercial banks provide a transmission channel for the central bank to control market exchange rates; the central bank can influence the exchange rates of the retail market through transactions with commercial banks.

Market segmentation with separate exchange rates arises when the government regulates the uses and sources of foreign exchange (Canales-Kriljenko, 2004: 9). For example, as for the uses of foreign exchange, when the government prohibits domestic residents' portfolio investments in foreign assets, there can emerge an illicit segment of the foreign exchange market for portfolio investments. Due to the pervasive regulations in the past, the parallel foreign exchange market has developed in Myanmar. Even after the move to the managed float system, the bulk of foreign exchange transactions still take place outside the formal banking system. Accordingly, we examine if transmission channels of exchange rate from the formal to parallel markets have been established.

The remainder of the paper is structured as follows. We compare the structure of the foreign exchange market before and after the reforms. We describe the foreign exchange market segmentation before the reforms in Section 2, and we review the reforms taken by the new government in Section 3. To evaluate if transmission channels for foreign exchange policy have been established or not, we examine the relationship between the formal and parallel exchange rates by a vector autoregression (VAR) model in Section 4. We present concluding remarks in Section 5.

2. Myanmar's Foreign Exchange Market before Reforms

In this section, we describe the foreign exchange market segmentation in Myanmar before the reforms of the new government inaugurated in March 2011.[2] Myanmar's foreign exchange market was segmented in two ways: between the private and public sectors, and within the private sector.

2.1. Segmentation between the private and public sectors

As documented in World Bank (1995: 18), Hori and Wong (2008) and IMF (2012), the foreign exchange market was segmented between the private and public sectors. The official exchange rate was applied only for the transactions in the public sector. The official exchange rate was pegged at 8.50847 kyat per the special drawing right (SDR) of the International Monetary Fund (IMF) in 1977, and did not change for over 30 years until April 2012. On the other hand, the kyat has depreciated consistently in the parallel market.

In the private sector, there has been, in principle, no allocation of foreign exchange from the government at the official exchange rate, nor surrender requirement on export revenues since 1990.[3] While there was an explicit export tax, private exporters had been permitted to retain 100 percent of their export earnings (after deducting export taxes).[4] As foreign exchange regulations did not allow Myanmar residents to hold foreign banknotes, exporters had to maintain their export earnings in the form of foreign currency deposits (FCDs) at Myanmar state banks.

[2] Myat Thein (2004) offers the general description of the Myanmar economy before the recent reforms.

[3] Before 1989, foreign trade of the private sector was prohibited. In 1989, the government legalized private sector foreign trade. Initially, there was surrender requirement that private exporters had to sell 40% of their export revenue at the official exchange rate. But the government abolished this surrender requirement in 1990, and instead introduced an explicit export tax. The tax comprised an 8% of sales tax and a 2% of income tax payable in foreign currency.

[4] According to Ida (2005: 237-238), there were two exceptional cases: one is that in 2001 garment exporters were required to surrender export revenues at the government-directed exchange rate for an amount equivalent to their employment costs. The other is that prawn exporters were required to surrender a portion of their export revenues at the government-directed rate in August 2000.