CHAPTER 1

Introduction

1.1 Principle and Rationale Backgrounds

The exchange rate is one of the critical indicators of the country because it has a powerful influence on a country's activity of foreign trade development. Therefore, it is no need to be doubtful that the changing of the exchange rate will have a permanent effect on trade balance. In the globalized world, international trade becomes more important in every economy. There are various problems that all the multinational enterprises must face. The economy can be affected by the changes in exchange rate, either positively or negatively.

When considering the changing of exchange rate, it can be divided into tow conditions: one is currency depreciation and another one is currency appreciation. Currency depreciation may have enormous impacts on the trade balance but the impact may alter, perhaps due to disparate level of the country's economic development. One of the conspicuous impacts describes that real depreciation increases the trade balance in the long run. Depreciation may improve the trade balance in to two different ways of channels.

Firstly, the quantity of export will increase. In the case of currency depreciation of the currency, the price of domestic goods is cheaper than foreign goods when comparing these two prices. Therefore, the country's export becomes more competitive. Secondly, on the other hand, the quantity of imports will decrease, because when comparing domestic and foreign price, the import for the country is more expensive as a result of currency depreciation. But, the export and import may not be reactive at the beginning period of the depreciation. Therefore, in the short run the value of export is decreased and the trade balance may deteriorate. After some period time, in the long run, it may be improved.

In Myanmar, the multiple exchange rate regimes which involved the official exchange rate that operated in public sectors and the market exchange rate that operated in private sectors trade of the country was activate for a long time. At that time, in the country there has been an enormous use of informal exchange rate by the private sector agent produced various kinds of distortions in the country in several years over decades.

To solve that problem, Myanmar government reformed the unification of that multiple exchange to benefit from more effective and productive allocation of resources. Until 2012 Myanmar adopted the fixed exchange rate system with official rate 6 Kyats per Dollar, and after 2012 the government derestricted the financial system and adopted the manage floating exchange rate system. After this the Myanmar currency depreciated over time. There is the reason why the author wants to study on the different impacts between appreciation and depreciation on the trade balance.

By geographical area, Myanmar is one of the largest countries in Southeast Asia of about 50 million people. Although the country endowed rich natural resources, it suffered from decades of weak economic performance activities and worsening socioeconomic conditions. The economy faced persistent economic problems such as low growth rate, high rate of inflation, limited international transactions, and poor investment climate. Among those weak economic policies of Myanmar, the exchange rate regime with multiple exchange-rate regimes which consist of the official exchange rate and informal market exchange rates can be seen as a key example.

The military government of Myanmar, from 1988 to 2011, regulated various administrative controls on foreign trade and foreign exchange rate system, which forced to peculiarly appear dual exchange rate regime: an official exchange rate in the public sector like SEEs and an unofficial market exchange rate in the private sector of the country. In 1977, the official exchange rate was fixed at 8.50847 kyat per special drawing right (SDR) of the International Monetary Fund (IMF) and thus had been fixed for more than 30 years (Kubo, 2012). In contrast, the parallel market rate has depreciated inveterately in the past as a result of unstable and poor macroeconomic performance.

In 2006, the market exchange rate which was conducted in public sector agents has appreciated sharply against the US dollar. In nominal terms, the exchange rate of the kyat per US dollar appreciated to 850 kyat in 2011; that is a serious difference from official rate of 5.39 at that year. So it can be seen that the informal market exchange rate is more than over 140 times when compared with the official exchange rate. According to Gelb (1988), who analyzed the impact of oil price shocks on six oil-exporting developing countries, the most severe real appreciation between 1973 and 1984 was in Nigeria; the appreciation of that country of over 11 years was 187 %. When making the comparison of that country, the results show that the official exchange rate appreciation experienced in Myanmar has been inordinately high. Most of the empirical studies on exchange rates have expressed that inappropriate and unstable exchange rates deteriorate growth in trade balance.

The official pegging of the Myanmar kyat to the special drawing right of the International Monetary Fund was abrogated in April 2012. Under the reformed of new government at that year, the Central Bank of Myanmar (CBM) constituted a managed floating exchange system incorporate by daily foreign exchange auctions with authorized dealer banks. At the end of March 2012, the official exchange rate was devalued from 5.56 kyat per U.S dollar to 818 kyat per dollar as a result of unification of exchange rate by CBM. Aside from that, other government policy reforms involved an extraction of the export first and import second policy and the conversion of foreign exchange certificates. In Myanmar, the pre-reform foreign exchange system had two distinctive features that exercised unfavorable effects on the economy.

The first feature was administrative controls on the foreign exchange rate and therefore the trade sector separated the foreign exchange market into the public and private sector. Different exchange rates were activated in different separated sectors, and these conditions lead to inefficient allocation of resources the economy. The other feature of the pre-reform condition was no formal institution for exporters and importers to convert currencies in the private sector. That condition led these two groups to interact in a parallel market, where exchange rates expose high volatility. It means the black market was arisen in that decade to convert currencies with depreciate exchange rate than official exchange rate.

Myanmar has had no appropriate monetary policy framework because it lacks the necessary instruments and institutions. According to the suggestion from IMF, the Central Bank of Myanmar (CBM) was created the process of an interbank money market. More essentially, the CBM prevail as a department within the Ministry of Finance and Revenue and deficiency the operational autonomy necessary to manage monetary policy in a modern market economy. The new government, Thein Sein, received advice from the IMF on the implementation of a new Central Bank Law. Three essential functions of the CBM will launch (1) an efficient payment system, (2) effectively supervise and regulate the banking system, and (3) manage the country's foreign exchange reserves.

An appropriate foreign exchange rate regime is essential for trade and investment. In Myanmar, the decades-long multiple exchange rate was finally unified in April 2012. In that year, April 2012, the exchange rate unification conducted by the Central Bank of Myanmar (CBM) operated an "auction" each morning among 17 of Myanmar's banks to determine the reference rate for the Myanmar kyat (MMK) against the US dollar. Once set, other banks and money changers are allowed to exchange the kyat within a band of increase or decrease 0.8 percent above or below the reference rate. Consistent with the rationale of a managed float, the CBM maintains that it will not intervene in the foreign exchange market to achieve any particular rate, but only when it perceives the market for the kyat has become disorderly or divorced from (unspecified) fundamentals.

The most significant economic policy adopted by the new government was the overvalued official exchange rate in effect since 1977 moved to a managed float on April, 2012. In the performance of the reform period, the IMF supported crucial technical advice in implementation of this movement, which was preceded in 2011 by giving license to seventeen private banks to open "money changer counters" for retail transactions.

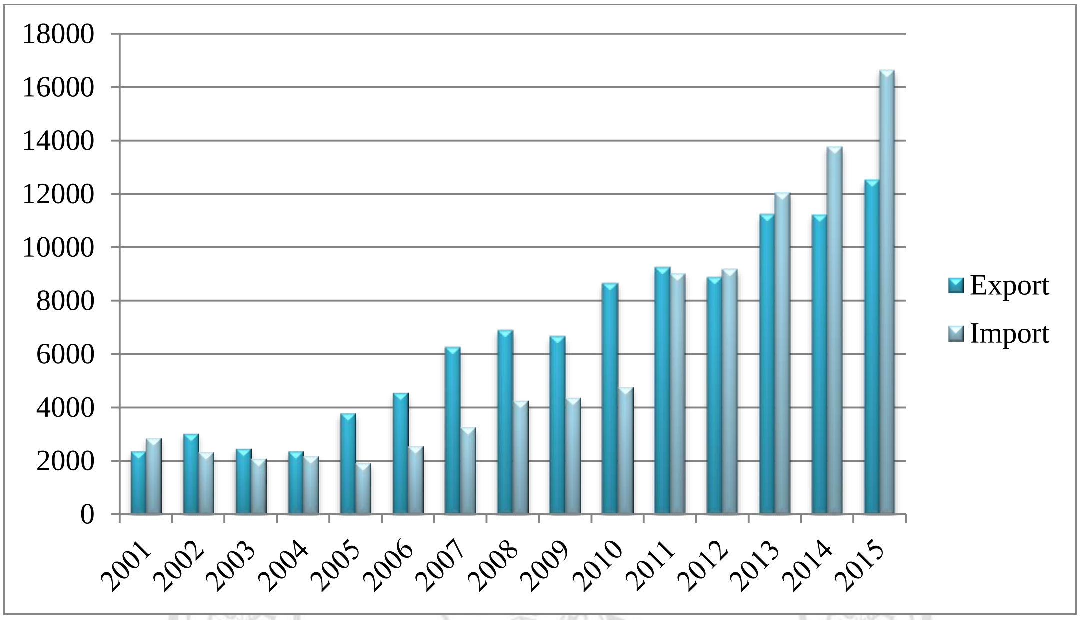
When overviewing the exchange rate history of Myanmar, it can be seen the exchange rate of Myanmar face mostly depreciated. According to the theory, the country which depreciation in exchange rate may improve the country's trade balance. The exchange rate and trade balance of Myanmar can be shown by the figure as follows.

Table 1.1 Exchange Rates and Trade Balance of Myanmar

Year	Official Exchange Rate	Market exchange rate **	Export*	Import*	Trade balance*
2001	6.39	616.07	2358.02	2849.27	-491.25
2002	6.39	921.14	3014.72	2323.84	690.88
2003	6.39	966.57	2458.39	2069.72	388.67
2004	6.39	988.57	2355.48	2173.93	181.55
2005	6.39	1060.27	3776.45	1908.13	1868.32
2006	6.39	1270.38	4539.12	2538.21	2000.91
2007	5.74	1272.17	6252.69	3246.61	3006.08
2008	5.48	1045.00	6882.19	4256.23	2625.96
2009	5.45	1063.60	6661.54	4347.62	2313.92
2010	5.54	973.40	8661.08	4759.66	3901.42
2011	5.39	980.00	9238.04	9018.97	219.07
2012	851.58	859.66	8876.91	9181.4	-304.49
2013	966.75	967	11232.8	12042.5	-809.7
2014	997.83	1003.08	11204	13759.5	-2555.5
2015	1,025.00	1036.01	12523.7	16633.2	-4109.5

Source: Central Statistical Organization (CSO) Myanmar, * World Trade Organization, * million in US, dollar, **Kyat per US dollar

Table 1.1 shows the exchange rate and trade balance from 2000 to 2014 in Myanmar. In the early time, the official exchange rate of Myanmar has been only about between 5 Kyats and 7 Kyats per dollar. After 2012, the new government of Myanmar adopted manages floating exchange rate system. Therefore the exchange rate become consistent rate compared with the market rate.

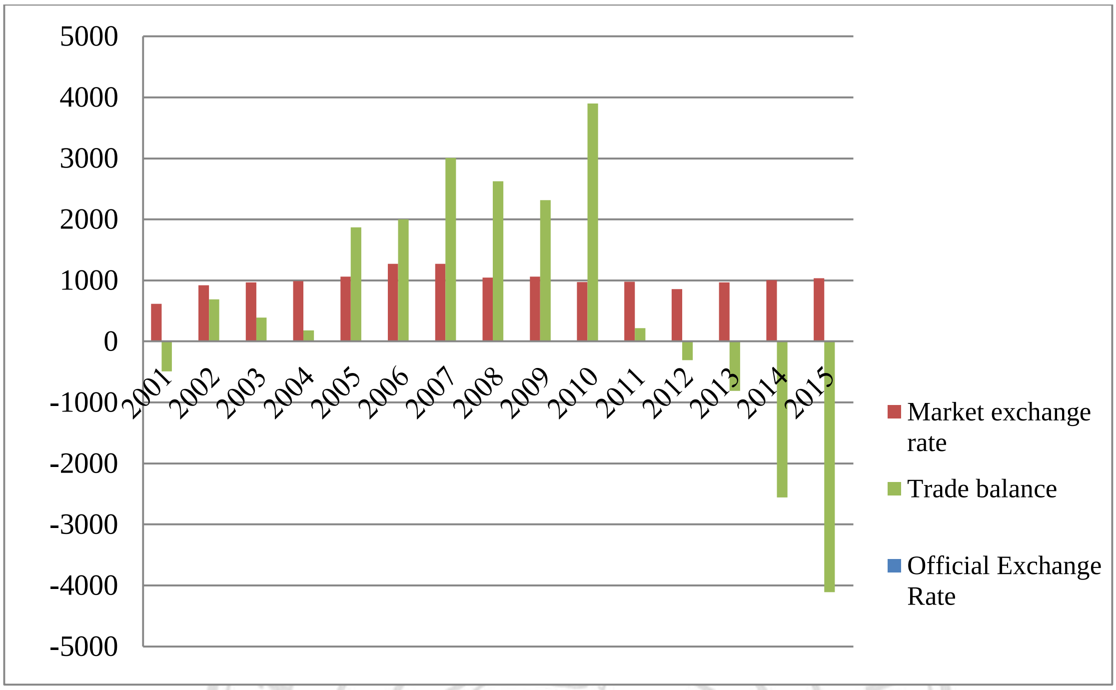


Source: Central Statistical Organization (CSO) Myanmar, * World Trade Organization, .* million in US, dollar, **Kyat per US dollar

Figure 1.1 Exports and Imports Value in US$ million, 2001 to 2015

Figure 1.1 shows the volume of export and imports from 2000-2001 to 2013-2014. Before 2012, export was higher than import, and after 2012, import was higher than export. After 2012, import was significantly greater than export when compared with previous years.

Figure 2 show the trade balance and exchange rate of Myanmar. Starting from 2012, when the exchange rate increased, the trade balance decline dramatically.



Source: Central Statistical Organization (CSO) Myanmar, * World Trade Organization, .* million in US, dollar, **Kyat per US dollar

Figure 1.2 Comparing the official and market exchange rate and Trade Balance 2001 to 2015

This research aims to study how the real exchange rate effects trade balance (how the currency appreciation and depreciation will affect the trade balance) of Myanmar. There are many studies which analyze the long run relationship and short run relationship between real exchange balance and trade balance. But there were no studies which examined the effect of currency appreciation and depreciation on the trade balance of the country by using Switching Regression Model. Therefore, this study tried to find out the effect of exchange rate on trade balance by using Switching Regression Model, and can also provide the sustainable economy of Myanmar by conducting the appropriate exchange rate regime policy.

1.2 Purpose of the Study

The objective of this study is to analyze the impact of exchange rate on trade balance in Myanmar. The main objectives of this paper is to study the different impacts between appreciation and depreciation on the trade balance before and after reform exchange rate policy in Myanmar.

1.3 Advantage of the Study

The study will investigate:

- whether the depreciation of exchange rate has a favorable impact on trade balance or not in Myanmar.
- how exchange rate effects on Myanmar trade balance and
- how the country experienced fixed and managed float exchange rates

1.4 Scope of the Study

This research paper studies the period of 1986-2015 of the annual reports of Myanmar. Most of the data used in this research are secondary data. The variables used in this research are trade balance, exports, imports, and exchange rate such as official exchange rate and market exchange rate. Based on the accessibility of data and regarding the methodology section, yearly data from 1986 to 2015 was collected. In order to increase robustness of the study, data was collected from International Monetary Fund (IMF), World Trade Organization (WTO), and Central Statistical Organization (CSO), Myanmar.

1.5 Organization of the Study

This research paper is organized into five chapters. Chapter 1 is the Introduction, which includes principle and rationale background; purpose of the study; advantage of the study; scope of the study; and organization of the study. Chapter 2 presents Theory and Literature Reviews. Chapter 3 discusses about the Methodology of the whole study. Chapter 4 deals with the Empirical results of the methodology. And the last chapter, Chapter 5, is the Conclusion.