Executive Summary

There have been few studies on capital flight and illicit financial flows to and from Myanmar, due to waning public interest in the wake of insular domestic policies and Western economic sanctions. This study finds that confinement, seclusion, and economic instability along with entrenched governance deficits have characterized the country since independence. We show that insularity and isolation have led to a declining trend in trade openness. Furthermore, we reveal that over the period 1999-2013, Myanmar experienced much larger macroeconomic instability (as measured by the variance in the rate of inflation, the current account to GDP ratio, and rates of economic growth) relative to other developing countries, including those in Asia, five ASEAN countries (Indonesia, Malaysia, the Philippines, Singapore, and Thailand), and other groupings.

Given the strong combination of macroeconomic, structural, and governance-related factors, we estimate both flight capital and illicit trade flows to and from the country. Flight capital includes a small portion of licit capital (that is not recorded due to statistical shortcomings), while illicit trade flows only include capital that is illegal in nature. Over the period 1960-2013, inflows and outflows of flight capital averaged 15.1 percent and 13.1 percent of GDP per annum in constant dollars, respectively. Illicit trade inflows and outflows amounted to an average of 14.4 percent and 6.5 percent of GDP per annum, respectively. This scale of inflows and outflows is much larger in the case of Myanmar than most other developing countries.

Flows of illicit trade capital in both directions are smaller than flight capital counterparts. Illicit trade inflows totaled US$77.7 billion over 1960-2013, while total inward capital flows amounted to US$82.8 billion. Similarly, illicit trade outflows totaled US$18.7 billion while outward flight capital totaled US$35.9 billion over this period. Average illicit trade inflows were more than four times average illicit trade outflows. Import under-invoicing, which dominated other types of trade misinvoicing, drove most inflows.

A particular feature of capital flight and illicit trade flows to and from Myanmar is that inflows are much larger than outflows. We show that this is in fact the case with other countries (such as Afghanistan, Mexico, Russia, and Thailand) where drug trafficking is a significant issue. Myanmar's place as the world's second largest producer of opium poppy places it easily within this group of countries.

We present an analysis of how economic sanctions, by creating an excess demand for certain items in domestic markets, can encourage technical smuggling as importers seek to meet the excess demand. The few importers with the license to import the goods in question reap illegal profits through import under-invoicing. The estimates of illicit trade flows provided in the paper confirm that technical smuggling through import under-invoicing is by far the largest component of inward capital flows or illicit trade inflows. We also find preliminary evidence of outward smuggling of timber and other wood products into India and China and the over-invoicing of precious stones to the latter. We cite other researchers who find perverse incentives arising from Myanmar's trade policies to explain deliberate trade misinvoicing.

Myanmar could have lost at least US$2.9 billion and as much as US$3.6 billion over the period in potential tax revenues through i) uncollected import tariff revenue due to import under-invoicing and ii) lower corporate profit tax captures due to export under-invoicing. To put it in perspective, this tax loss due to illicit flows ranged from 122-172 percent of total health expenditures and 48-73 percent of total education expenditures incurred during 1960-2013. The figures are just as startling for 2010-2013: 129 percent of health expenditures and 42 percent of education expenditures.

The paper also tests the link between illicit flows and the underground economy using estimates derived from the currency demand approach. The underground economy is a good proxy for the state of overall governance of a country. We find a strong and significant link between illicit flows and the underground economy, confirming that weak governance both drives and is driven by illicit flows. Using a currency demand approach modified to reflect the predominant role of smuggling and black markets in Myanmar's economy, we find that the underground economy averaged around 55 percent of official GDP—one of the highest in the world. The World Bank has also found the underground economy of Myanmar to be around 50 percent of official GDP.

The paper concludes with a series of policy recommendations for the Government of Myanmar. GFI urges the Government to develop a priority list of areas for technical assistance to improve the quality of its statistics. Data is a critical element of analysis and understanding the country's dynamics—for the government and for those outside the government. Anti-money laundering legislation and enforcement should be brought up to Financial Action Task Force (FATF) and IMF-defined standards. Trade misinvoicing should be curtailed with the implementation of a real-time world market pricing risk analysis system for the Customs Department.