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Myanmar Faces Difficult Balance in Financial Overhaul

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Myanmar has come a long way in revamping its financial system since the military gave up formal power two and a half years ago. The country's new civilian leaders made its central bank independent last month and ushered in several other changes meant to smooth the way for more foreign investment. And over the past two weeks, the government has allowed foreign-exchange trading between local banks, according to state media, and appointed a new management team for the central bank.

But weighty questions remain as to how far the new government will go in forging a Western-style financial system. One issue is when authorities will allow foreign banks to set up in the country. It is also unclear whether the new steps will usher in an era of more stable macroeconomic management, halting the central bank's practice of buying government debt.

Eswar Prasad, a professor at Cornell University and a former senior official at the International Monetary Fund, said the latest measures would help to reassure foreign investors of the government's commitment to change. But he added that there needs to be follow-through—including improving the country's legal framework and management of public finances—if that boost to confidence is to be sustained.

"The government faces a difficult balance—liberalizing financial markets and easing restrictions on currency trading and capital flows could backfire if there is insufficient regulatory and supervisory capacity in place to police those markets," he said.

The military continues to hold huge sway in the young democracy. Many of the key functionaries, including the new head of the central bank, Kyaw Kyaw Maung, are holdovers from the old regime.

But after a series of political and financial reforms, which included freeing opposition leader Aung San Suu Kyi and introducing a new foreign investment law to boost growth, President Thein Sein and other senior leaders appear to realize that more changes are needed to turn around the country's old reputation for bungling the way it manages its economy.

Already, Myanmar has sought advice from a large number of outside experts, allowing foreigners access to what were traditionally closed-off and secretive institutions. The IMF is working with the country's authorities to develop a treasury bill market and monetary policy tools. Countries including Japan and Thailand are also providing assistance in building up Myanmar's financial infrastructure.

A law governing financial institutions—expected within months—may open the door to foreign banks, at least through joint ventures with local banks. The government hopes this will help Myanmar's domestic private banks grow and gain expertise from foreign players while protecting their market share.

The introduction of interbank bank trading of the kyat could be another important step in the next wave of reforms.

Besides providing the central bank with more influence over how the economy develops, Sean Turnell, an expert on Myanmar's economy at Macquarie University in Sydney, says the move means that investors "will finally get a real sense of what the kyat is worth."

Myanmar moved to a managed-float system in April 2012, allowing the currency to trade within a narrow band around a reference rate, set by the central bank following a daily auction with private banks. Before that, the kyat was worth more than 100 times more against the dollar compared with the black-market rate. Since the introduction of the new system, the kyat has fallen around 13.5% against the dollar, according to the IMF. The country's poor financial infrastructure means that there is strong bias for physical cash, and this could further push down the value of the kyat as currency exchange procedures improve.

The revamp at the central bank is also providing grounds for optimism. The Central Bank of Myanmar is now formally as "independent as the Bank of England or the Reserve Bank of Australia," said Mr. Turnell.

However, there is still ambiguity on some crucial details, which will be fleshed out by mid-October, including whether the bank will continue printing money to finance the government's debt, Mr. Turnell noted.

That could prove the biggest test in building a secure financial system. The text of the law that created the new central bank in July seems to preclude the central bank from buying the government's newly issued debt. But it doesn't specify a timeline for phasing out the purchases, and wouldn't rule out the central bank buying the debt indirectly.

The appointment of Columbia University-educated Khin Saw Oo and Set Aung—the government's go-to person for tricky reforms—as two of the new deputy governors could help assuage investors' concerns.

Ms. Khin Saw Oo, formerly an anti-money-laundering executive at the bank, told The Wall Street Journal in June that the institution would gradually reduce the proportion of the government's deficit that it directly finances to zero from around 40% currently.

-Myo Myo in Yangon contributed to this article