

**Lao People's Democratic Republic: 2002 Article IV Consultation and Second Review Under the Poverty Reduction and Growth Facility, and Request for Waiver of Performance Criteria—Staff Report; Staff Supplement; Public Information Notice and News Brief on the Executive Board Discussion; and Statement by the Executive Director for the Lao People's Democratic Republic**

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2002 Article IV consultation with the Lao People's Democratic Republic and second review under the Poverty Reduction and Growth Facility and request for waiver of performance criteria, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation and second review under the Poverty Reduction and Growth Facility and request for waiver of performance criteria, prepared by a staff team of the IMF, following discussions that ended on **May 8, 2002**, with the officials of the Lao People's Democratic Republic on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on July 12, 2002.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff supplement of **August 22, 2002** updating the information on recent developments.
- a Public Information Notice (PIN) and News Brief summarizing the **views of the Executive Board as expressed during its August 26, 2002 discussion** of the staff report that completed the review.
- a statement by the Executive Director for the Lao People's Democratic Republic.

The documents listed below have been or will be separately released.

Letter of Intent\*

Memorandum of Economic and Financial Policies, and Technical Memorandum on Program Monitoring\*  
Poverty Reduction Strategy Paper, and Joint Staff Assessment of the Poverty Reduction Strategy Paper  
Selected Issues and Statistical Appendix

\*May also be included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

LAO PEOPLE'S DEMOCRATIC REPUBLIC

**Staff Report for the 2002 Article IV Consultation and Second Review Under the  
Poverty Reduction and Growth Facility, and Request for  
Waiver of Performance Criteria**

Prepared by the Asia and Pacific Department  
(In consultation with Fiscal Affairs, Legal, Monetary and Exchange Affairs, Policy  
Development and Review, Statistics, and Treasurer's Departments)

Approved by Daniel Citrin and Shigeo Kashiwagi

July 12, 2002

Discussions for the 2002 Article IV Consultation and the second review under the Poverty Reduction and Growth Facility (PRGF) arrangement were held in Vientiane during April 24–May 8, 2002.

The staff team comprised Messrs. Winglee (head), Marciniak, Hussain, and Mendis (all APD), and Ms. Brunschwig (PDR). Messrs. Djojosebroto and Lathouly (both OED) also attended the policy discussions. The team was assisted by Mr. Sidgwick (resident representative) and coordinated closely with a parallel World Bank mission on the Financial Management Adjustment Credit.

The mission met with Deputy Prime Minister and President of the Committee for Planning and Cooperation (CPC) H.E. Thongloun Sisoulith, Bank of Lao P.D.R. Governor Chansy Phosikham, Minister of Finance Soukanh Mahalath, the Ministers of Industry and Trade, and other senior officials.

The government has agreed to publish the Letter of Intent and attachments and the PRSP Preparation Status Report and the attendant Joint Staff Assessment.

A three-year PRGF arrangement in the amount of SDR 31.7 million (60 percent of quota) was approved by the Executive Board on April 25, 2001.

Lao P.D.R. has not yet accepted obligations under Article VIII Sections 2, 3, and 4. It does not have any identified restrictions on current international payments and transfers.

This report was prepared by a staff team led by Mr. Peter Winglee.

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## GLOSSARY OF ABBREVIATIONS

|                |   |
|----------------|---|
| AFTA .....     | Association of South East Asian Nations Free Trade Agreement            |
| AsDB.....      | Asian Development Bank  |
| BCEL .....     | Banque pour le Commerce Extérieur du Laos                               |
| BOL.....       | Bank of the Lao P.D.R.  |
| CPC.....       | Committee for Planning and Cooperation                                  |
| CPI.....       | Consumer price index  |
| DAFI.....      | Development of Agro-Forestry Industry Group                             |
| EDL.....       | Electricité du Laos   |
| FAD .....      | Fiscal Affairs Department   |
| FMAC .....     | Financial Management Adjustment Credit (World Bank)                     |
| FSPL3 .....    | Financial Sector Program Loan III (AsDB)                                |
| GDP .....      | Gross Domestic Product  |
| HIPC .....     | Highly Indebted Poor Country  |
| IAS .....      | International accounting standards                                      |
| I-PRSP.....    | Interim Poverty Reduction Strategy Paper                                |
| Lao P.D.R..... | Lao People's Democratic Republic  |
| LMB.....       | Lao May Bank  |
| LTU.....       | Large Taxpayer Unit   |
| LXB.....       | Lane Xang Bank  |
| MAE.....       | Monetary and Exchange Affairs Department                                |
| MEFP .....     | Memorandum of Economic and Financial Policies                           |
| MOF.....       | Ministry of Finance   |
| Nam Papa ..... | Lao Water Supply Enterprise   |
| NDABOL.....    | Net domestic assets of the BOL  |
| NDASCB .....   | Net domestic assets of the SCBs   |
| NIR.....       | Net international reserves  |
| NPLs .....     | Nonperforming loans   |
| NPEP.....      | National Poverty Eradication Program                                    |
| NPV .....      | Net present value   |
| NT2 .....      | Nam Theun 2   |
| PEM .....      | Public expenditure management   |
| PER.....       | Public Expenditure Review   |
| Phoudoi .....  | Bolisat Phathana Khet Phoudoi (BPKP) Highland<br>Development Enterprise |
| PRGF .....     | Poverty Reduction and Growth Facility                                   |
| PRSP .....     | Poverty Reduction Strategy Paper  |
| PSIA.....      | Poverty and Social Impact Analysis                                      |
| SCBs .....     | State commercial banks  |
| SDR.....       | Special Drawing Rights  |
| SOEs .....     | State-owned enterprises   |
| SOEs .....     | Soviet Union rubles   |

## EXECUTIVE SUMMARY

- **Over the past 15 months Lao P.D.R. has made substantial progress under the PRGF-supported program.** Inflation remains relatively low at 6½ percent and the exchange rate fairly stable. Progress at reforms has stimulated investment, and real GDP growth in 2002 is estimated at 5½ percent.
- **Program implementation has been effective and the program remains broadly on track.** Expenditure restraint has limited the impact of the revenue shortfall on bank financing of the budget. In particular, tight control of central bank financing of the budget slowed liquidity growth and enabled the international reserve target to be achieved.
- **All quantitative performance criteria were met except for the net domestic assets (NDA) of the state commercial banks (SCBs).** The latter was partly due to irregular credit operations that are being corrected. Structural targets under the program were generally implemented, although with some delays, including the structural performance criterion related to SCB provisioning on post-2000 nonperforming loans. However, the medium-term plan for public expenditure management reform has been postponed until the third review.
- **On the macroeconomic side, the program for 2002–03 consolidates stabilization efforts.** Revenue efforts will need to be reinvigorated and expenditure will be constrained to achieve the deficit and bank financing limits for 2001/02. For the next fiscal year, the government will undertake further restructuring and strengthening of the tax and customs departments and make progress in identifying education and health expenditures. Regarding the monetary program, BOL liquidity creation will remain tightly controlled and strong measures will be taken to limit state bank credit growth to offset some of the slippages in the early part of 2002.
- **On the structural side, the phased banking and enterprise reforms are underway:** (i) **Banking reform** has been initiated with measures to improve performance. In addition, plans have been developed which include the effective liquidation of the weakest bank, bi-annual performance tests, bank advisors, and branch and staff rationalization. (ii) **SOE reform**, which covers the largest and most indebted enterprises, has also begun. Management contracts, joint ventures, asset sales, and price adjustments are being used to improve SOE operations. (iii) **For the private sector**, the authorities will continue implementing the successful measures to improve the environment for foreign and domestic investment.
- **The next stage of the banking and enterprise reforms will be the most challenging** and strong political commitment will be required for their full implementation.
- **Steady progress has been made in developing the PRSP** and sharpening the poverty focus of the program.

## I. INTRODUCTION

1. **At the conclusion of the first review under the PRGF (in February 2002) and the 2001 Article IV Consultation (in April 2001), Directors commended the authorities for reducing inflation**, strengthening fiscal discipline, and laying the groundwork for further structural reforms. However, they noted that fiscal imbalances remained and called for taking strong revenue measures, establishing an information base for tracking poverty-related expenditures and improving accountability at all levels of government. Directors also urged the authorities to step up the pace of structural reform. In particular, they noted the continued weakness of the banking system and stressed the need to move ahead decisively with reforms, contain credit growth, reduce nonperforming loans, upgrade banking supervision, and initiate state-owned enterprise (SOE) restructuring, especially for the largest debtors.

2. **Over the past year, the Lao authorities have made substantial progress at strengthening macroeconomic stability and initiating a broad-based reform program.** In the attached letter dated July 8, 2002, and the accompanying Memorandum of Economic and Financial Policies (MEFP), the authorities request the completion of the second review under the PRGF, and request waivers for the nonobservance of two performance criteria for March and April 2002.<sup>1</sup> The World Bank approved the Financial Management Adjustment Credit (FMAC) on June 25 that addresses reforms to state-owned commercial banks (SCBs), SOEs, and public expenditure management. The government is close to agreement with the AsDB on a new Financial Sector Program Loan (FSPL3).

## II. RECENT DEVELOPMENTS AND PERFORMANCE UNDER THE PROGRAM

### Recent developments and short-term prospects

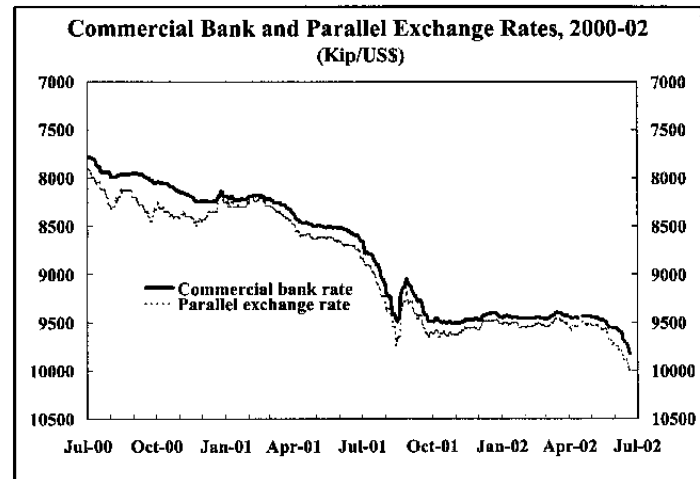
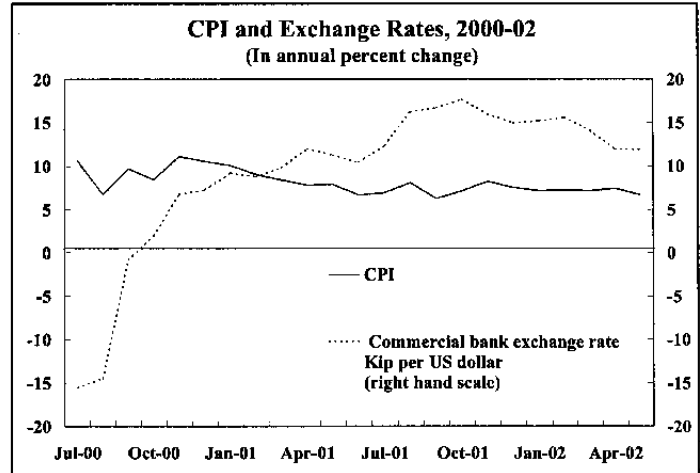
3. **Economic performance has improved considerably since late 1999.** Starting in mid 1999, the authorities tightened macroeconomic policies after inflation rose to triple digits in 1998–99. The firm implementation of these policies quickly brought down inflation and stabilized the exchange rate. Since then, economic conditions have generally been favorable. A rekindling of business confidence and continued aid inflows helped to offset the negative impact of weaker regional growth in 2001, with real GDP growth weakening only slightly to 5¼ percent. Recent anecdotal evidence suggests that the pick-up in regional activity, new small-scale construction, and foreign investment should sustain real GDP growth in 2002 at about 5½ percent (5 percent projected previously) (Table 3). In particular, ongoing reforms to

---

<sup>1</sup> With a third disbursement (SDR 4.6 million) Lao P.D.R.'s outstanding use of Fund resources will amount to SDR 34.7 million (65.7 percent of quota) at end-July 2002. Assuming full disbursement under a revised schedule for the PRGF Arrangement (Table 1), Lao P.D.R.'s outstanding use of Fund resources would amount to SDR 38.4 million (72.5 percent of quota) at end-2004 (Table 2).

the foreign investment framework, including streamlined approval procedures, have attracted relatively large investments in the second mobile phone network, manufacturing, mining, and aviation.

4. **Reflecting the success of stabilization policies, inflation remains subdued.** As explained in the previous staff report,<sup>2</sup> in 2000/01,<sup>3</sup> weak revenue without expenditure adjustment in the first year of fiscal decentralization led to excessive bank financing of the budget. In addition, ineffective provincial expenditure control gave rise to excessive commitments and an accumulation of domestic arrears. These factors contributed to a 10 percent exchange rate depreciation in June-September 2001. However, remedial actions in the 2001/02 budget, including the allocation of more revenue to the central government, and establishing budget department control over large spending commitments, stabilized the exchange rate. These actions limited the impact on inflation, which in May 2002 fell to 6½ percent. Ongoing adjustments in administered prices will keep inflation to about 6 percent at year-end. After a period of stability during September 2001–May 2002, the kip again depreciated by about 6 percent in May and June as a result of seasonal pressures, excess SCB credit, and the introduction of large denomination bank notes.<sup>4</sup>



<sup>2</sup> Lao P.D.R.: First Review under the PRGF (EBS/02/12, 02/11/02).

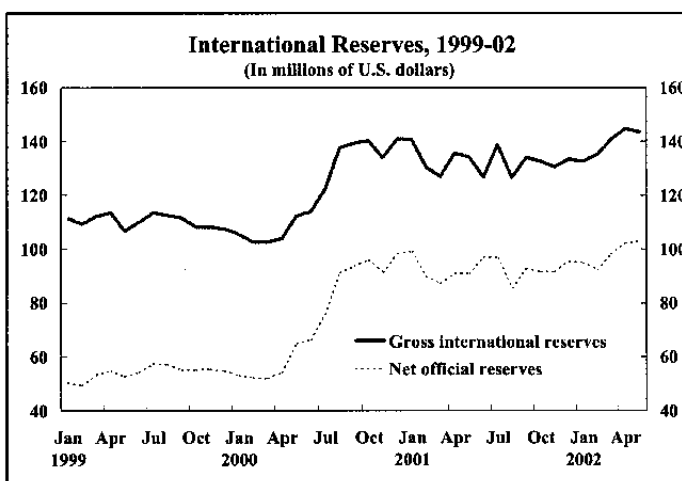
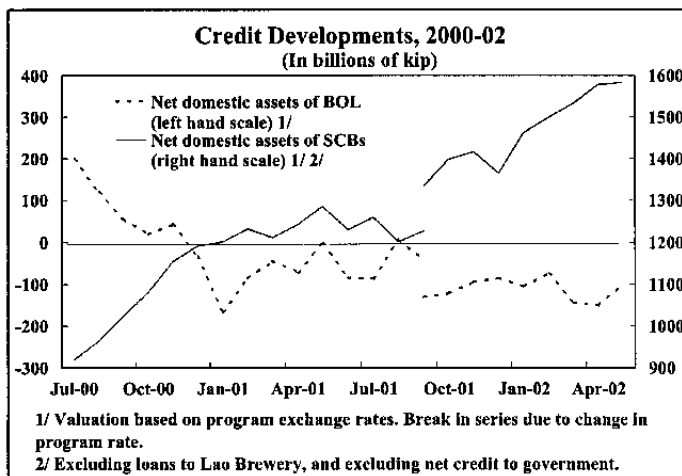
<sup>3</sup> The fiscal year runs October through September.

<sup>4</sup> Over the past year the margin between the commercial bank and parallel market exchange rates has been generally less than 2 percent. However, during periods of exchange rate instability, including May and June, this margin has sometimes exceeded 2 percent for intervals of a few days.



## Performance under the program

5. **The PRGF-supported program is broadly on track** (see Box 1 and MEFP Tables 1 and 2). All quantitative performance criteria for March 2002 were met, except for the net domestic assets (NDA) of the SCBs (NDASCB). Excessive growth in NDASCB continued in April, with a total deviation of 0.7 percent of GDP from the March ceiling. This appears to be due to the expansion of SCBs' other items (net) related to customers' defaults on letters of credit as well as some irregular lending, especially by Lao May Bank. Corrective actions were taken starting mid-May, including more intensive inspections to monitor SCB operations and BOL review of large credit decisions, which appear to have contained the problem and NDASCB stabilized in May. The ceiling on the NDA of the Bank of Lao P.D.R. (BOL) was observed by a large margin, with strong performance continuing through May, reflecting better control of budget financing. Higher foreign exchange inflows enabled net international reserves (NIR) to reach the target for March (implying gross reserves of \$141 million, 2.4 months of imports). With the lower NDA of the BOL, the build-up of NIR resulted in lower reserve money growth (19 percent, year-on-year) in March 2002.

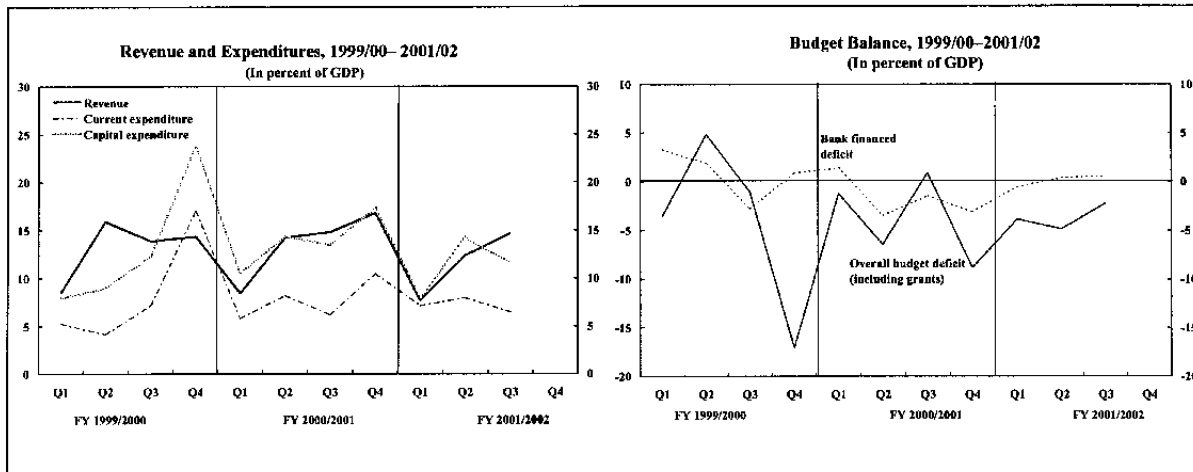


6. **Despite the fragility of the budget situation, the March target for net bank credit to the government was met.** Weak revenue for the first half year, only 37 percent of the annual program target, compared to 42 percent last year, has put the budget under pressure. This weak performance was due to: (i) the absence of the one-off effects of 2000/01, such as tax arrears clearance and tax advances; (ii) poor collections from large taxpayers both at the headquarters large taxpayer unit (LTU) and in key provinces; (iii) overly optimistic revenue

**Box 1. Lao P.D.R.: Summary of Performance Under the Program for the Second Review 1/**

| Measures   | Status  |
|--|---|
| <b>I. Quantitative targets (for March 2002)</b>  |   |
| 1. Net domestic assets of BOL.   | Met.  |
| 2. Net banking system credit to government.  | Met.  |
| 3. Net domestic assets of SCBs.  | Not met, over the ceiling by 0.4 percent of GDP. Deviation widened in April but stabilized in May.  |
| 4. Net international reserves.   | Met.  |
| 5. Public external debt.   | Met.  |
| 6. External payment arrears.   | Met.  |
| <b>II. Structural targets</b>  |   |
| 1. Cease new loans to defaulting borrowers. (Structural benchmark, March 2002).  | Met, no new lending since September 2001.   |
| 2. Implement bank supervision measures to set up full provisioning on loans approved after January 1, 2000. (Structural performance criteria, April 2002). | Met with delay. Implemented at end May, and the prior action on the restatement of 2001 accounts which has also now been implemented.   |
| 3. Formulate key elements of the individual SCB business plans. (Structural benchmark, May 2002).  | Met at end May, but work ongoing to refine the plans.   |
| 4. Complete review of internal financial controls. (Structural benchmark, May 2002).   | Met in early July.  |
| 5. Agree on action plan for public expenditure management. (Structural benchmark, April 2002).   | Not met. Work underway in improving expenditure tracking. Agreement on terms of reference for requested FAD mission a prior action, and agreement on plan postponed to November 2002. |

1/ Based on the attached MEFP Tables 1 and 2.



targets for some large provinces; and (iv) continued weak state-owned bank and enterprise performance and the recent enforcement of more realistic accounting practices for banks. Corrective measures from March have led to a pickup in revenue in April and May. Domestically financed capital spending, at 27 percent of the program target, has been compressed to limit net banking system credit to the government, while current expenditures were broadly in line with the program.<sup>5</sup>

7. **On the structural front, the Government has begun the restructuring of SCBs and SOEs.** Although problems in SCB operations emerged, as noted above, the key financial targets and benchmarks in the SCBs' preliminary business plans were elaborated with the assistance from the AsDB (structural benchmark for the PRGF for May 2002). The April 2002 structural performance criterion for banking supervision measures to implement provisioning on new lending, i.e., lending since January 1, 2000, was missed but complied with at end-May. The structural benchmark for the development of the public expenditure management reform plan has been postponed for the third review, and agreement on the terms of reference for the FAD mission is a prior action. SOE reform has begun with initiation of restructuring and tariff increases. These tariff adjustments include: electricity tariffs, which will increase by 2.3 percent per month for 36 months from May 2002; domestic airline fares, raised by 40 percent in June; and ongoing increases in water tariffs.

<sup>5</sup> The fiscal program includes 1 percent of GDP to clear arrears on capital expenditures (out of an estimated stock of 2¼ percent of GDP), but only a small amount was cleared in the first half of the fiscal year. A constraint on the rate of arrears clearance is the need for appropriate documentation since most were accumulated at the provincial level.

### III. REPORT ON THE DISCUSSIONS

#### A. Medium-Term Policy Objectives and Framework

8. **In the context of recent success at macroeconomic stabilization, the Article IV and program discussions provided an opportunity to take a medium-term perspective on reform.** This timing coincided with the government's own review of its economic reform strategy, as part of its National Poverty Eradication Programme (NPEP) that is expected to be finalized by early 2003.<sup>6</sup> This program, intended to meet the requirements of the PRSP, is the first stage in implementing the government's ambitious goal of exiting from least developed country status by 2020. The planned reforms entail restructuring the state sector to improve its efficiency, and attracting private domestic and foreign investment, as well as more effectively developing infrastructure and human resources with improved fiscal management and expenditure systems. In addition, the NPEP also addresses sectoral constraints in agriculture, education, health, and infrastructure.

9. **A key medium-term issue relating to the NPEP and the design of the reform program is the size of the state's role in the economy.** In this regard, the authorities pointed to the reforms of the early 1990s in which the bulk of the state sector was privatized, leaving state enterprises with a small share of the economy. In addition, they recognized that to meet the competitive challenges of regional integration, the role of the private sector, especially foreign investment, will need to be further increased and the poor financial performance of the state sector corrected. However, the authorities could not accept a rapid transformation, noting their limited capacity and their desire to first correct the most severe problems in the state sector themselves. Nevertheless, the government stated explicitly that from now, persistently loss-making SOEs will be privatized or liquidated and have started in this direction.

10. **The implementation of pro-growth economic policies is expected to raise real GDP growth to 6½ percent by 2004.** The authorities understand that this will depend on attracting domestic and foreign private investment. Reforms to Lao Aviation, and improved telecommunications and infrastructure are relieving major blockages to the tourism sector, and the construction of Nam Theun 2 (NT2) hydroelectric project would also add to growth starting in 2004 (Box 2). Continued strong stabilization policies are expected to reduce inflation further to 5 percent or below by 2004. Over the medium term, the government intends to keep the budget deficit (including grants) at about 4½–5 percent of GDP, with progressively increasing revenue to fund social spending and limit the use of bank financing (Table 7).

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<sup>6</sup> The delay from August 2002 envisaged in the I-PRSP is due to capacity limitations and the need to build up a participatory approach.

### **Box 2. Lao P.D.R.: Nam Theun 2 Hydroelectric Project**

**The Nam Theun 2 (NT2) hydroelectric project is a Build-Own-Operate-Transfer (BOOT) arrangement between the Government of Lao P.D.R. (GOL) and a private sector consortium, NT2 Electricity Consortium (NTEC).** Situated in central Laos, 250 km east of Vientiane, the NT2 plant is now scheduled to begin construction in 2004 and supply electricity by 2008. The project will have a capacity of 920 megawatts for export to Thailand and an additional 75 megawatts for domestic consumption.

**The total investment of US\$1.1 billion will be financed through foreign direct investment, comprising debt (70 percent) and equity (30 percent).** The NTEC consortium for this limited recourse project comprises Electricité de France (EDF) holding 35 percent, Electricity Generating Company of Thailand (EGAT) 25 percent, and Italian-Thai Development 15 percent. The GOL equity share will be 25 percent.

**The Power Purchasing Agreement (PPA) was re-initialed in July 2002 by EGAT and NTEC.** Under the PPA, EGAT would buy the 995 megawatts per year over the 25-year contract term based on a negotiated tariff schedule. Under the financial arrangements, GOL's share in revenues will be significant but back loaded. After about 10 years the GOL share would be 25 percent and would rise sharply thereafter, to 47 percent of the cumulative revenues by the end of the concession period (2033). Subsequently, the project would be transferred to the GOL, which would then retain 100 percent of revenues. During the construction period, the project is expected to add as much as one percentage point to real GDP growth per year.

**The government's exposure to financial risks would be limited to its equity stake.** The main financial risks to the project are commercial. They stem from cost overruns (contingencies allow for an extra 20 percent) and the credit and exchange risks under the PPA offset by the consortium's plan to borrow half the funds in baht. Of the GOL's \$83 million equity stake, about  $\frac{1}{2}$ - $\frac{2}{3}$  would be covered by grants from the partners for the development rights and the project preparation costs. At this stage, the only borrowing for the equity would be from the World Bank to cover the social and environmental costs.

**The World Bank has indicated that its participation in the project would depend on:** (i) implementation of a development framework; (ii) the quality of the project itself; (iii) social and environmental safeguards; and (iv) support from international donors and civil society. Under one scenario, the World Bank would provide between US\$50-100 million in partial risk guarantees and a further IDA loan of between US\$20-30 million to address the social and environmental impact. The government would provide a counter-guarantee for the partial risk guarantee, resulting in a government liability for this amount only if public policy actions prevent the operation of the project. The Bank considers that the main justification for participation in the project is to create an income stream that can be used for poverty reduction. The financial management reforms underway are an integral part of the strategy.

**Important safeguards are expected to be in place to ensure that the social and environmental impacts are addressed.** Several independent studies have highlighted the positive impact of the project including the avoidance of environmentally damaging traditional practices. Two panels have worked on these issues, a World Bank-sponsored International Advisory Group (IAG) and a GOL-appointed panel of social and environment experts. Both have broadly supported the NT2 project. However, other groups (especially NGOs) have voiced concern on its likely impact, including on the impact on the downstream communities and environment.

## B. Macroeconomic Policies for 2002–03

11. **For 2002–03, the economic outlook appears favorable with a further pickup in regional activity.** The significant rebound in foreign investment is expected to stimulate real GDP growth from 5½ percent in 2002 to 6 percent in 2003. On the expectation that the weakness in the kip in mid-2002 is short-lived, inflation is likely to fall to 6 percent by end-2002 and 5½ percent by end-2003. The current account deficit (including grants) is expected to fall slightly to about 3 percent of GDP in 2002 and 2003 due to continued strong export growth (Table 8). As a result, gross international reserves would increase to 2¾ months of imports at end 2002 and 3½ months at end 2003.

### Fiscal policy

12. **The government is committed to maintaining a prudent fiscal policy.** Expenditure adjustments will offset the bulk of the revenue shortfall in 2001/02, thus maintaining the overall deficit at 4.6 percent of GDP (including grants), with only a slight increase in bank financing to ½ percent of GDP. Despite measures such as refocusing attention on the indirect tax collections from the largest taxpayers; a revenue shortfall of 0.6 percent of GDP in relation to the program is still expected.<sup>7</sup> The staff urged the authorities to strongly implement the revenue measures, and offset the potential shortfall mainly by cuts in lower priorities financed projects. At least KN 136 billion of capital arrears (0.8 percent of GDP) should be cleared in this fiscal year to strengthen the financial position of the SCBs. The 2002/03 budget will set the revenue targets conservatively, clear the remaining arrears, and keep the overall deficit to 4½–5 percent of GDP.

13. **The staff argued that the main cause of the disappointing revenue performance remained weak central tax administration.** This and poor collections from larger taxpayers persisted despite the authorities' efforts to improve the process of fiscal decentralization. To overcome this, the government undertook to give the Tax Department additional resources and reorganize it on a functional basis to allow the bulk of the staff to focus on revenue collection, monitoring, and auditing, with some staff to specialize in improving procedures and training. Similarly, progress will continue in developing a national customs service by adding another large provincial customs point to the already included Vientiane customs office (the largest). Recognizing that weakness in administration would delay the introduction of the VAT, the authorities undertook to make up for lost ground.

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<sup>7</sup> Upward revisions to the estimate of GDP reduced the program revenue ratio by 0.2 percent of GDP. The program revenue target was 1 percentage point of GDP below the budget target.

14. **The Ministry of Finance explained that the delay in developing the medium-term expenditure management plan was due to the lack of internal agreement on expenditure management systems.** The staff expressed concern that this delay may reflect resistance to budget transparency. In addition, the delay in requesting Fund technical assistance has set back developing an overall framework, including how to combine French and Anglo treasury systems, and to improve the coordination of technical assistance from different sources. Notwithstanding this delay, progress at identifying poverty-related expenditures will continue and a pilot project to categorize expenditures in health and education by type of administrative unit (e.g., types of schools) will be launched with the 2002/03 budget.<sup>8</sup>

#### **Monetary and exchange rate policies**

15. **Following the slippages in mid-2001, control over central bank credit was strengthened.** With coordination between BOL and MOF, expenditure restraint and larger auctions of government securities have eliminated the need for central bank financing of the budget. As a result, with NDA of the BOL being well under the March target, it is expected that the September 2002 ceiling would also be observed (which implies no change in NDA over the fiscal year). Nevertheless, the BOL will continue to limit the liquidity of SCBs by continuing to withdraw its deposits at SCBs, and thus reserve money growth is expected to be 11 percent (year-on-year) by September 2002.

16. **The BOL will need to take strong actions to overcome the excessive expansion of the NDA of SCBs in the first four months of 2002.** The authorities recognized that some of this expansion is related to irregular credit activity and that this has contributed to the recent downward pressure on the exchange rate.<sup>9</sup> Recognizing the risks to both macro stability and bank restructuring, the BOL has strengthened the SCB headquarters control of the credit approval process and initiated intensive credit investigations (see paragraph 21). The credit program is based on the requirement that SCBs curtail their credit growth given that their NPLs on their post-2000 lending are over 15 percent (a condition under FMAC). SCBs are now pressing for lending repayment, but as many loans were in foreign currency, this is still having a depressing effect on the exchange rate. Broad money will grow by 20 percent in the year to September 2002, in line with recent trends in monetization.

17. **The government is committed to maintaining a flexible exchange rate policy.** As before, the exchange rate will be set to limit the spread with the parallel market to under 2 percent. In this way, the exchange rate will continue to be an indicator of the stance of macroeconomic policy, in conjunction with deviations in key variables from the program

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<sup>8</sup> Other developments in expenditure management are outlined in the accompanying Selected Issues paper.

<sup>9</sup> Reported credit growth rates are much lower than the underlying trend because of increased provisioning. Net domestic assets are not affected by this factor.

targets. In this light, the staff expressed concern that the present high depreciation reflected weakness in policy implementation, especially revenue collection and SCB credit growth. The authorities argued that these imbalances were being corrected, but the effect was lagged. With the recent depreciation of the kip, the real effective exchange rate is about 6 percent below the level of December 2000, and remains in the range of competitiveness. The staff accepts that given the high level of dollarization, improvements in competitiveness would need to be achieved by the removal of structural impediments.

### **External debt management policies**

18. **The projected financing gap for 2002–04 should amount to \$75 million, and should be covered by concessional resources.** For 2002–03, the program is fully funded by the World Bank (with the \$17 million FMAC approved in June 2002), the prospective FSPL3, (\$10 million), the PRGF, and other sector loans.

19. **Recognizing its limited debt service capacity, the government will continue a prudent approach to external debt management and generally avoid nonconcessional public debt.** Total debt service was 15½ percent of exports in 2001, although much of this relates to commercial borrowing by private hydroelectricity exporters, secured by long-term contracts. Nevertheless, public sector debt service was 7½ percent of exports (excluding hydroelectricity)<sup>10</sup> in 2001 and is expected to rise to 9¾ percent in 2003 (Table 9) because of near-term repayment of public commercial debt (see Box 3 for other debt issues). Reflecting this debt policy, a \$53 million loan to finance the Nam Mang 3 hydroelectric project is being renegotiated to increase the concessionality of the borrowing conditions and reduce the project costs, and will be reassessed as part of the third PRGF review.<sup>11</sup>

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<sup>10</sup> Nonhydroelectric exports plus receipts from the hydroelectric sector net of private debt service and profit repatriation.

<sup>11</sup> In addition, the Theun Hinboun Power Company (a limited liability company 60 percent owned by EDL, and 40 percent by foreign investors) has refinanced its commercial borrowing, and may also reduce its equity, with \$33 million to be returned to EDL. With no government guarantee, the borrowing was judged not to be subject to the public external debt ceiling. However, it was agreed that the proceeds will be fully accounted for and only used for projects with a high net return. The financial program would be fully adjusted of any funds transferred to the government before the next review.



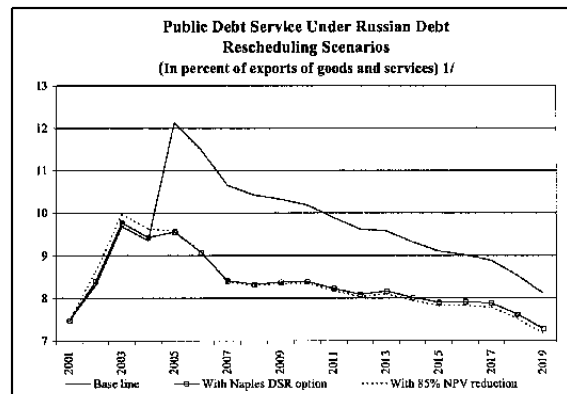
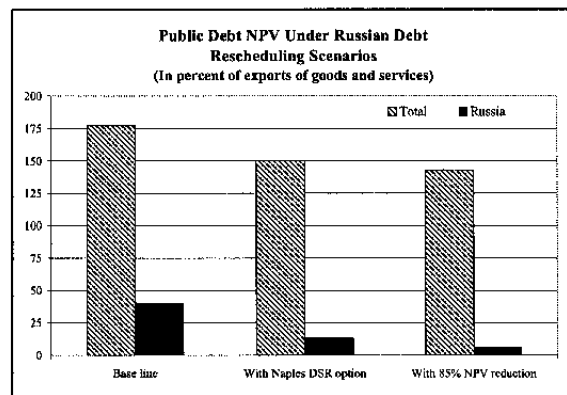
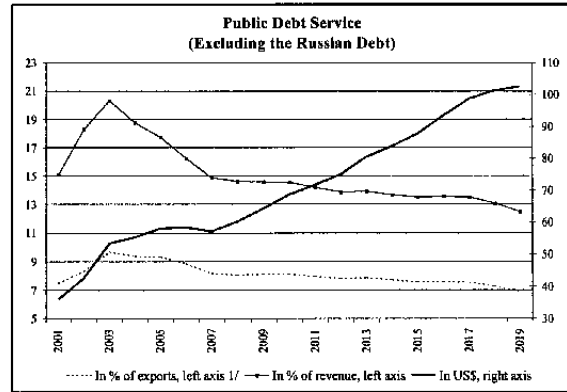
**Box 3. Lao P.D.R.: Developments and Issues in Public Sector External Debt**

Lao P.D.R. has a very high stock of external public sector debt. However, because of the highly concessional nature of the bulk of the convertible currency debt, the debt service has been manageable. Preliminary calculations of Lao P.D.R.'s stock of convertible currency external debt at end 2001 indicate that: (i) the stock of debt amounts to \$1.2 billion in nominal value or \$0.7 billion in NPV terms (137 percent of exports of goods and services, three-year average); (ii) multilateral creditors account for 83 percent of this debt; (iii) debt service, which is currently at 8¼ percent of exports of goods and services (excluding hydroelectric exports),<sup>1/</sup> would rise to 9¾ percent of exports in 2003, and fall slightly thereafter as the high repayment period passes for commercial debt. (Fuller discussion of Lao P.D.R.'s external debt, including private sector debt is contained in the accompanying Selected Issues paper.)

The debt to the Russian Federation is estimated at SUR 772 million. After applying the official exchange rate of 0.6 SUR per dollar and the 70 percent upfront discount, the stock of Russian debt amounts to \$386 million. The total debt, including the Russian debt treated in this manner would amount to \$1.6 billion, or \$0.9 billion in NPV terms (177 percent of exports).

The governments of Lao P.D.R. and the Russian Federation are currently negotiating this debt, including the precise amount and the rescheduling terms. Annex V examines three alternative scenarios: (i) the baseline with an upfront discount of 70 percent in nominal terms; (ii) a stock-of-debt operation under the debt-service-reduction (DSR) option with Naples terms; and (iii) rescheduling with an 85 percent NPV reduction at commercial interest rate. The total NPV of debt to export ratio would decline from 180 percent to 150 percent after Naples term rescheduling, and 143 percent after the 85 percent NPV reduction.

In summary, the rescheduling of the Russian debt (outside of the Paris Club) under Naples terms would reduce the NPV of debt ratio to about the HIPC initiative cut-off point. In addition, debt service to the Russian Federation would be contained at 0.3 percent of exports of goods and services (excluding hydroelectric exports),<sup>1/</sup> 2 percentage points below the baseline scenario in 2005–09 and would thus be manageable. The 85 percent NPV reduction scenario would reduce the debt further, but with a small increase in debt service until 2006.



<sup>1/</sup> Nonhydroelectric exports plus receipts from the hydroelectric sector net of private debt service and profit repatriation.

20. **The Lao and Russian governments are planning another meeting to resolve the outstanding debt issues.** These discussions will include the value of the debt, since some of these transactions may have been grants, as well as the rescheduling options. While underscoring the uncertainty on the actual debt stock, the authorities noted that the Fund staff's calculations, based on a stock of SUR 772 million, a standard conversion to U.S. dollars and upfront discount, showed that Naples terms rescheduling of the Russian debt (outside of the Paris Club) would result in a NPV of \$70 million (13½ percent of exports). Including convertible currency debt, total external debt in NPV terms would be 150 percent of exports, at the HIPC cutoff. In view of the ongoing discussions with the Russian government, the authorities have not currently applied for debt relief under the HIPC Initiative.

### C. Key Structural Policies

#### Banking reform

21. **Implementation of the bank restructuring program is continuing on three main tracks:** (i) immediate improvements in operations; (ii) phased restructuring and conditional recapitalization; and (iii) enhancement of the banking environment (see Box 4).

- **Immediate operational improvements:** Banks and the BOL are now monitoring loan quality more closely, and are implementing full provisioning for post 2000 lending in accordance with BOL regulations.<sup>12</sup> However, the results have been mixed and NPLs worsened in late 2001 and early 2002, especially for LMB. Closer monitoring of the SCBs promptly detected this and corrective measures were adopted, including modifying the plan for the worst performing bank to effectively liquidate it through merger, staff cuts, and selective branch closures.
- **Individual bank restructuring:** These restructuring and business plans (summarized in Box 4 and MEFP Appendix I) call for extensive actions to reform management and governance, streamline the branch and staff structure, upgrade the information technology to strengthen headquarters control and supervision, and use external bank advisors that could be upgraded to co-managers. Measures to clear government arrears to contractors and SOE reform should reduce NPL rates on post-2000 lending to about 15 percent by end 2002 and to about 12 percent by end 2003 for BCEL, and

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<sup>12</sup> The BOL loan classification differs from international standards mainly because it focuses on delays in payments, whereas best practices also include a forward-looking assessment of borrower risk. This latter subjective assessment is difficult to implement in Lao P.D.R. because the SCBs typically make optimistic assessments.

#### **Box 4. Lao P.D.R.: State-Owned Commercial Bank Reform**

**In support of its plan to accelerate development, the government has embarked on a program of banking and enterprise reforms.** Both these sectors have been eroded by deep-seated problems, including a culture of implementing the state plan, weak governance structures, and economic instability, especially the massive depreciation of the kip during 1997–99. The insolvency of these banks and enterprises poses a major constraint to growth, sustained poverty reduction, and the development of the private sector.

**The aim of the current phase of state-owned bank reforms is to create an environment and institutions for a market-based banking system.** As a first step, this entails the reform of the state commercial banks (SCBs) to improve their performance. Only after there have been measured improvements in performance would each of the four annual recapitalizations occur. The total amount of recapitalization is fixed on the basis of the stock of NPLs up to end 1999, matched with the phase-in of provisioning for those pre-2000 loans. Banks are aiming at positive capital by 2003, which will require, *inter alia*, NPLs on post-2000 loans of less than 15 percent.

**Immediate measures taken so far are:**

- International standard audits for the three SCBs for 2000 completed, and underway for 2001.
- Credit decisions centralized in headquarters (to remove provincial influence) and enforcement begun of individual and group exposure limits.
- Implementation of full provisioning of loans made from the start of 2000.
- Investigation and removal of fraudulent management, close monitoring and control by BOL staff, and intensive on-site inspections to prevent a further deterioration in performance.

**The restructuring plans that are nearing finalization (see MEFP, paragraphs 15-18 and Appendix I) include:**

- Merge Lanc Xang Bank (LXB), and the performing assets and deposits of Lao May Bank (LMB) to form a new bank, with government bonds making up the difference. The plans will also rationalize the bank structure and remove credit decisions from former LMB branches.
- Restructure BCEL and rationalize significantly its staffing and bank operations, and upgrade information and governance systems.
- Use foreign advisors who could be upgraded to co-managers if end-2003 targets for key financial variables and policy actions are not met.
- Implement parallel reforms in banking supervision, external audits, debt workouts, SOE restructuring, social safety nets, and in the environment for the private sector.

**A market-based banking system is necessary to attract fit and proper private investment into the financial sector.** Foreign bank branches and joint-venture banks are significant in the Lao financial system but they have not extended their operations beyond their home country clients because of the difficult credit environment and legal obstacles. After progress is made at developing the banking environment, either additional capital for one of the state banks should come from the private sector, or a consolidation of the current state bank sector would need to be complemented by a greater role for the private banks. To both provide competition and quality services, the authorities are considering whether to allow foreign banks to operate outside of Vientiane starting in 2003, with the possibility that they could take over some of the surplus SCB branches.

under 10 percent for the new (merged) bank. Recapitalization would bring their capital adequacy ratio up to at least zero by end 2003,<sup>13</sup> and the SCBs would have to raise this to 8 percent by the start of 2006, either through their own operations or attracting additional capital.

- **Improvements to the banking environment:** The program includes improvements to bank supervision, with MAE technical assistance to strengthen onsite inspections, and legal and judicial reforms. Recognizing the potential of competition to advance the restructuring process, the government is considering allowing foreign banks to operate outside of Vientiane by 2003, which the staff argued would also help businesses improve their competitiveness.

22. **The staff accepted the government's phased approach.** Even with changes in management, weakness in the enterprise sector and the credit environment will mean that a rapid turnaround to significant profitability is unlikely. Thus, it would be difficult to attract fit and proper private investment in the SCBs in the near term. Moreover, the government felt that under the current political environment, socially difficult downsizing could only be implemented by the government. The recapitalization cost, spread over four years ending 2005, is now estimated at 3½ percent of GDP, including ½ percent for the cost of closing the weakest bank.

### **Enterprise reform**

23. **The authorities are pursuing SOE reform to strengthen competitiveness and complement banking reform.** Although the state sector is now relatively small in terms of employment and production (see Box 5), it accounts for 35 percent of SCB credit and two-thirds of SCB NPLs. Supported by the FMAC, the main components of the SOE program, aimed at addressing the financial weaknesses of the largest and most indebted SOEs, are:

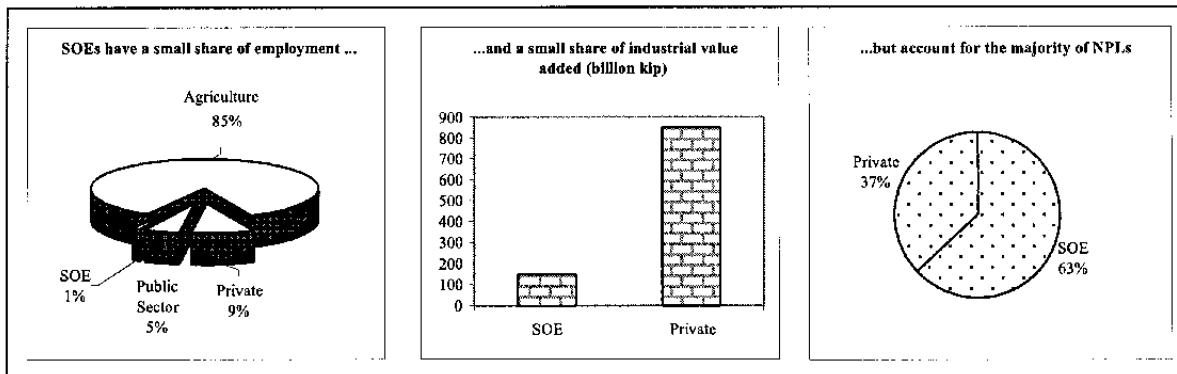
- **Tariff reforms to commercialize the large utilities.** The reforms comprise the phased adjustment of electricity, domestic airline, and water tariffs to achieve cost recovery in 2003 for the latter two, with electricity slightly later. Although the structural performance criterion in the PRGF called for cost recovery by October 2002 for electricity and domestic air tariffs, studies by the World Bank have shown that larger adjustments would be needed and are thus spread over a longer period. Although the government does not consider that privatization is appropriate at this

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<sup>13</sup> Excluding the impact of the pre-2000 open foreign currency position. The recapitalization will use kip-denominated government securities but since most NPLs were foreign currency loans, the high proportion of foreign currency deposits gives rise to a large open foreign exchange position.

### Box 5. Lao P.D.R.: Enterprise Reform

**The complementary reforms of the environment for both state and private enterprises are underway.** After the large-scale privatization of small SOEs in the early 1990s, there remain about 90 medium to large SOEs, of which the government has declared 32 strategic. Compared to other transition economies, the SOE sector in Lao P.D.R. is relatively small, with only about 1 percent of total employment and about 15 percent to industrial production. However, because the largest SOEs are capital intensive and suffer from weak financial management, this sector accounts for one-third of the SCB loans and 63 percent of the NPLs. Thus the main reforms include:



Sources: Lao authorities, UNIDO (1999), and the World Bank

#### i) Tailored plans for the largest SOEs which include:

- Ministry of Defense conglomerates Phoudoi and DAFI (starting June 2002 and March 2003, respectively) are to be restructured, including by sales of noncore assets to recover NPLs.
- Electricity (EDL), water (Nam Papa), and airline (Lao Aviation) enterprises are increasing their tariffs to enhance their debt servicing capacity (both domestic and foreign), to keep up maintenance, and to reduce cross subsidies. Private sector provision of infrastructure could also be considered. A management contract for Lao Aviation with a foreign airline was signed in early 2002 as a prelude to forming a joint venture. A joint venture is also being considered for Pharmaceutical Factory No. 3.

ii) **Smaller SOEs** also need to be reformed. However, their situation has not been reviewed for some time and the information system is being built up.

#### iii) For the private sector, actions being considered to remove impediments are:

- Streamlining the procedures for the establishment and operation of foreign investment,
- Simplifying the regulations and process for business establishment, developing the legal structure for businesses, especially for shareholding companies, and developing a forum specifically for the private sector to get the many problems they experience addressed by high levels of government,
- Improving creditor rights together with a more effective debt resolution mechanism, and
- Reducing nontariff barriers to imports, since these are a burden on larger formal private businesses but are easily circumvented by the informal sector.

time, given the weak regulatory framework and political and social concerns about rapid transformation, commercialization is the precursor to any additional reforms.<sup>14</sup>

- **Restructuring first, and then phasing in participation of the private sector:** Lao Aviation is being restructured under a management contract with Air France Consulting, and this is expected to lead to Lao Aviation forming a joint venture to obtain additional capital for upgrading its aircraft fleet. This would follow the pattern of joint ventures for Lao Brewery and Lao Tobacco. The defense ministry conglomerates, first Phoudoi, and then DAFI, which are among the largest debtors to the SCBs, will be restructured through sales of noncore assets to reduce their debts, and commercializing their main service functions. The staff stressed the importance of asset sales, with highest priority given to assets in commercial sectors is to repay their bank debt.

24. **The authorities are also implementing policies to promote the private sector.** They recognize that a predominantly private sector economy is needed to be competitive. While private investment is being introduced gradually to SOEs, it is being strongly encouraged in new projects. Additional measures for private investment, which entail simplifying the environment for domestic enterprises and strengthening the credit environment, will be supported by the AsDB in FSPL3.

#### **Trade and exchange system reform**

25. **The authorities recognize that reforms to the trade and exchange system are also key for developing the private sector.** Over the past year, import controls have been somewhat liberalized and made more consistent with international practice to improve access of businesses to inputs. Thus, although importers still prepare indicative plans, only six product groups are now subject to quantitative restrictions and two of these products are expected to be liberalized before end 2002 (see MEFP paragraph 20). In addition, liberalization under AFTA is continuing and the first meeting of the working group for Lao P.D.R.'s membership to WTO was recently convened. A reduction in barrier to Lao exports in industrial country markets would also help growth.

26. **The authorities are committed to maintaining a liberal foreign exchange regime.** The Lao authorities consider that the system is free of restrictions on current international payments and transfers, and will preserve this under the new Foreign Exchange Decree Law (expected later in 2002) and the implementing regulations. The small margin between the bank and parallel exchange rates seems to confirm the absence of significant restrictions. The

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<sup>14</sup> The FMAC, which covers one year, includes mainly restructuring. This would pave the way for the joint ventures announced by the government that would be included in subsequent PRSCs.

staff welcomed these intentions and the absence of surrender requirement. When the new legal framework is close to completion, the authorities will request an assessment of their exchange system by Fund staff on the existence of restrictions on current transactions. On the basis of this assessment the Lao authorities will consider formally accepting the obligations under Article VIII.

#### **D. Poverty and Social Impact**

27. **The reforms supported by the PRGF will have a positive social impact by reducing poverty through promoting growth and raising human capital.** The World Bank is planning a comprehensive poverty and social impact analysis (PSIA) in 2004, with component studies in 2003. In the meantime, several aspects support a positive poverty assessment. Improvements in the macroeconomic environment have stimulated business and commercializing the SCBs should result in additional credit to small and medium-size borrowers. Newly available budget expenditure data show an increasing share to education and health at the expense of administration. The negative impact on the poor and low-income households from utility tariff adjustments, especially for electricity and water, will be mitigated by lower increases for small users. A social safety net is included in the banking and enterprise reforms, and a social fund that will support community-based projects was recently approved by the World Bank.

#### **IV. PROGRAM RISKS, MONITORING, AND SAFEGUARDS**

28. **Program implementation risks remain substantial.** The next stage of the reforms, including more stringent financial management, commercially based lending, enforcement of repayments, and staff reductions in the SCBs and SOEs, will present significant political challenges. So far the positive response of private investment to the first round of stabilization and reform measures is encouraging the authorities to pursue this reform agenda. Coordinated monitoring by the World Bank, AsDB, and Fund will be important to ensure that the reform program remains on track.

29. **The authorities are requesting waivers for the nonobservance of one end-March 2002 quantitative performance criterion and one end April 2002 structural performance criterion,** and the elimination of a structural performance criterion for end October 2002. In particular:

- The waiver for the nonobservance of the performance criterion on the net domestic assets of the SCBs is requested on the basis of the BOL's implementation of measures in paragraph 16 and the stabilization of the level of NDASCB in May.
- The waiver for the nonobservance of the structural performance criterion on banking supervision for full provisioning of post 2000 lending is requested on the relatively short delay (one month) in taking action, with the restatement of the SCB's 2001 accounts as a prior action that has now been implemented.

- The removal of the structural performance criterion on adjustments to electricity and domestic airline tariffs for October 2002 is requested on the basis of similar measures included in the FMAC, and the continued price adjustments to achieve cost recovery.

30. **The proposed program includes quantitative performance criteria for September 2002 and March 2003** (MEFP Table 1). Structural conditionality under the program has been fully coordinated with the World Bank and AsDB, and is summarized in MEFP Table 3 and reviewed in Box 6.

31. **The BOL has made progress in implementing the recommendations under the Stage One safeguard assessment.** A report on internal control procedures was prepared with the assistance of a senior internal auditor of the German Bundesbank. The report found that while a number of controls were in place for domestic transactions, they were less developed for foreign exchange transactions. Thus a risk control unit will be established. The reconciliation of net international reserves was completed with no significant discrepancies found with bank statements. Work is on track for completing, by end August, the audit of the BOL's 2001 accounts by the National Audit Office (assisted by an international auditing firm), and the pro forma statement of the BOL accounts on international accounting standards. The BOL welcomed the safeguards framework as an impetus to upgrade its financial controls.

#### V. TECHNICAL ASSISTANCE, POLICY TRANSPARENCY, AND STATISTICAL ISSUES

32. **Technical assistance is key to reducing program risks.** Fund technical assistance is ongoing, or planned in the macroeconomically significant areas, especially tax and customs administration, expenditure management, statistics, and banking supervision. Both the FMAC and FSPL3 programs also have large companion capacity building elements, as do other donors. For maximum effectiveness, closer coordination is essential.

33. **The government is making progress on transparency.** Key steps include the policy discussions under the Roundtable process with donors and the investors' forum. While the budget has been made more transparent, other simple steps to make the budget, financial, and legal information more widely available would assist the public, donors, and investors.

34. **Given the deep-seated weaknesses, improving statistics is crucial for enhancing transparency and economic management.** A technical assistance mission is planned to identify the steps needed to move to the General Data Dissemination Standard (GDDS). In addition, improvements in treasury management should enable reconciliation between revenue, expenditure, and financing, and a more internationally standard presentation of the budget would assist analyses. Data on reserves and foreign currency liquidity, although adequate for Fund surveillance, would be strengthened by better data on the actual and contingent foreign exchange liabilities of the public sector.



### **Box 6. Lao P.D.R.: Structural Conditionality**

#### **Coverage of structural conditionality in the current program**

Structural conditionality for the 2002–03 program is set out in the attached MEFP dated July 8 2002, especially MEFP Table 3. Structural conditionality focuses on restructuring the SCBs and improving fiscal management. These areas are critical to achieving the program's main objectives of maintaining macroeconomic stability and developing the structural foundation for faster growth with equity. The structural performance criteria in banking are aimed directly at macroeconomic aspects of the program.

#### **Status of structural conditionality from earlier programs**

The structural conditions of the PRGF-supported program were implemented, although often with a lag of 1-2 months. An exception is the structural benchmark on the plan for expenditure management reform, which has now been postponed to the third review while interim measures are being taken. In addition, the structural performance criterion for October 2002 on utility price adjustments is being removed because it is now included in the Financial Management Adjustment Credit (FMAC).

#### **Structural areas covered by World Bank and AsDB lending and conditionality**

The World Bank FMAC, approved on June 25, 2002, has the theme of improving financial management in the SCBs, SOEs, the budget, and forestry, the latter being a large revenue source. The FMAC conditionality covers the memoranda of understanding on the banks, credit restraints, pricing and restructuring of SOEs, and expenditure management especially on the public investment program. It covers a one-year period, to be followed by PRSCs. The PRGF conditionality is closely coordinated with the FMAC and is designed to be complementary.

The AsDB is close to agreement on its Financial Sector Program Loan III (FSPL3), which also includes legal, judicial, and private sector development components. It is expected to be presented to the AsDB Board in late 2002. These components have been closely coordinated with the FMAC and PRGF. FSPL3 is structured as a cluster loan with the first year fixed and the subsequent years indicative.

#### **Other relevant structural conditions not included in the current program**

The coverage of the economic reform programs of FMAC, FSPL3, and PRGF is quite comprehensive. With the government's own initiative on trade reform, this element has been removed from the PRGF-supported program. The main issue will be to ensure effective implementation of the reform agenda rather than a more comprehensive coverage.

## VI. STAFF APPRAISAL

35. **Since early 2001, Lao P.D.R. has made considerable progress under the PRGF-supported program.** Macroeconomic stability has been strengthened and growth maintained while sustaining relatively low inflation. Broad-based structural reforms have also been initiated to improve the environment for growth and private investment. In particular, SCB restructuring is starting to arrest the deterioration in their financial position and establishing more effective control mechanisms, and SOE reform is moving ahead to improve governance and accountability for public resources.

36. **Building on the progress achieved so far, a substantial reform agenda remains to be tackled to realize the PRGF's objectives.** Sustained further progress is needed to reduce state involvement in commercial sectors to meet the competitive challenges of regional integration, achieve the targeted growth rates, and channel resources to social services, including education and health, that are essential for poverty reduction

37. **More effective implementation of structural fiscal measures is needed to consolidate macroeconomic stability.** The weak revenue performance, despite the strengthened economy, has been a major deficiency in program implementation. While recent corrective measures have been encouraging, more focus is required on collections from large taxpayers and on strengthening the operation of the central tax department and a national customs service. Notwithstanding these efforts, some cut backs in expenditure, especially low priority capital expenditures, while protecting social spending, will be needed to achieve the overall budget deficit target. Looking ahead, restoring momentum to revenue administration reforms will be crucial to the timely implementation of the VAT. The delay in expenditure management reforms is regrettable and priority should be given to improving expenditure tracking and developing more transparent expenditure management.

38. **Strong BOL surveillance is essential, especially in the near term, to restrain state bank credit and reduce inflation further.** Better control of the budget has enabled BOL credit to be contained. Now the major task ahead is to reestablish control over state bank credit, especially irregular lending, in the run-up to restructuring and recapitalization. The effectiveness of these actions should be closely monitored and the policies strengthened if necessary.

39. **Given the significant capacity and institutional constraints, the staff considers that the phased approach to bank restructuring is appropriate.** Priority should be given to improving loan quality, which will require the elimination of political influences for noncommercial lending, stronger BOL supervision with MAE technical assistance, and the full use of foreign management expertise to turn around these banks. The plan for the upfront restructuring of the insolvent Lao May Bank is encouraging. Close monitoring will be required to ensure that the restructuring plans are diligently applied. Phased targets for

performance improvement, and the possibility of upgrading the role of the advisors to co-managers, should provide incentives for effective restructuring and mitigate the implementation risks of SCB and SOE reform. The removal of restrictions on nationwide operation of foreign banks would also provide added competition and higher quality services.

40. **Subjecting the largest and most indebted SOEs to restructuring will be politically challenging.** Effective implementation of the reform programs, especially the use of foreign expertise, asset sales, and price adjustments are necessary to put the reforms on a more sustainable path and pave the way for greater private sector involvement. Significant sales of commercial operations should be conducted to reduce NPLs of SCBs.

41. **The staff welcomes the ongoing trade reforms and the continuation of the liberal foreign exchange system.** These policies are important for developing the private sector that is needed for growth. The staff strongly encourages the Lao authorities to accept the obligations under Article VIII, after the review of the exchange system.

42. **The decision to integrate the PRSP approach into the government's own poverty reduction program is a positive step in economic coordination.** To support this program, progress must be accelerated in developing systems to ensure that budget expenditures are appropriately prioritized for pro-poor programs, and the statistical base is upgraded to monitor poverty reduction and other intermediate social targets. Improvements in this information base, with external technical assistance, would pave the way for a comprehensive PSIA in 2004.

43. **Considerable progress is still needed in both policy and statistical transparency.** More emphasis should be given to improving the underlying quality of the source data, and making such data more generally available. In particular, improved data on trade, fiscal, monetary, and external debt are essential for better economic management, and their dissemination would assist the informed discussion of economic policy.

44. **Recent improvements in external debt management are welcome.** In particular, it is crucial that an effective centralized debt management policy is applied to all public sector external debt and that nonconcessional debt is avoided. The staff urges the Lao and Russian authorities to work expeditiously to reach agreement on their debt stock and rescheduling terms.

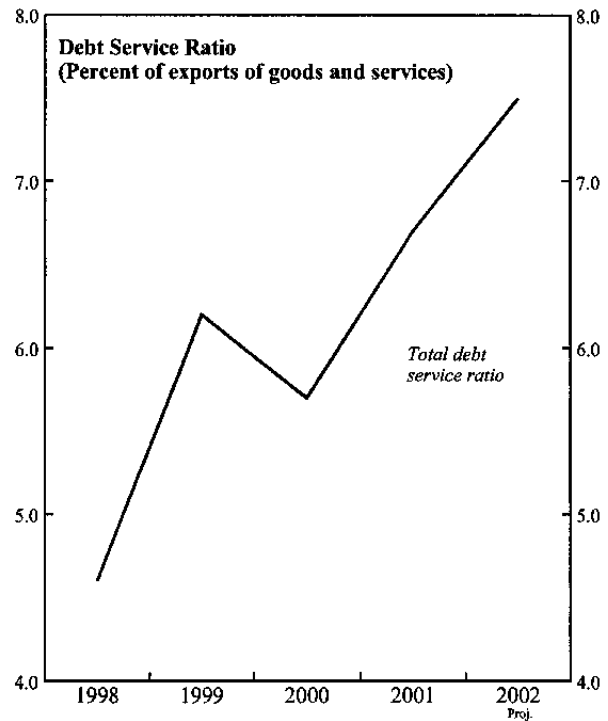
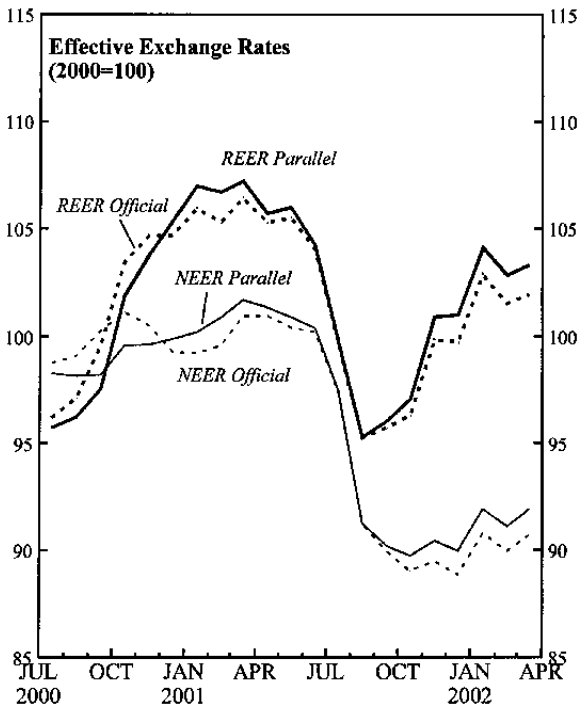
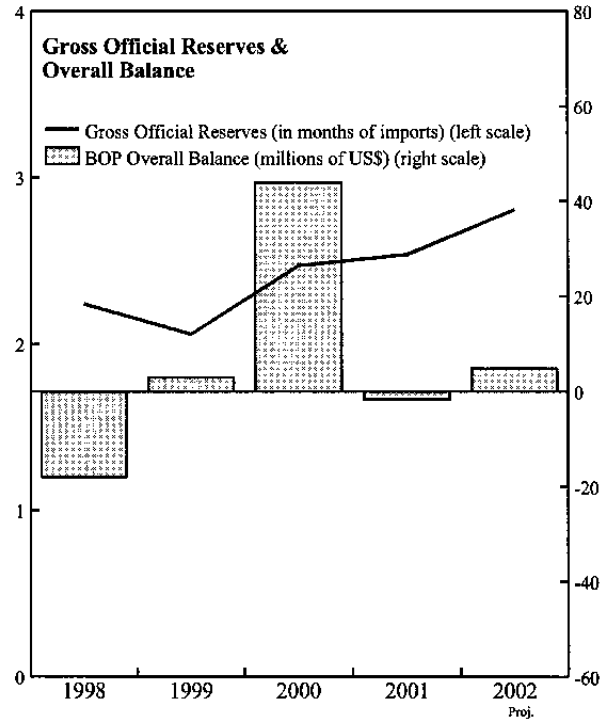
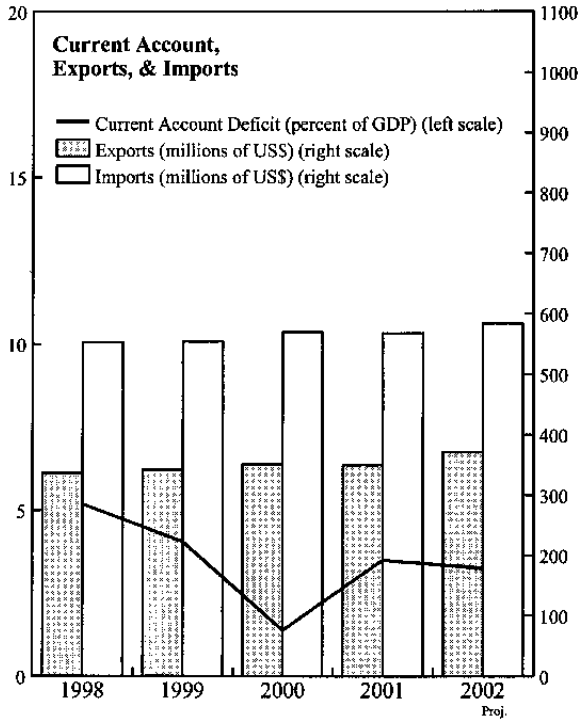
45. **The authorities have made significant progress in implementing the remedial measures in the Stage One safeguards assessment.** The staff proposes that the Executive Board complete this review based on this progress and the commitment to implement the remaining measures. Following the completion of the second external audit of the BOL, there will be an on-site safeguard assessment, which is expected to be completed by end 2002, before the third PRGF review.

46. **The staff believes that the main risks to the program stem from the vested interests in the status quo for SCBs and SOEs reforms.** Nevertheless, there appears to be sufficient ownership to persevere with the phased approach to structural reforms. In particular, the increasing recognition of the benefits of the market approach so far in Lao P.D.R., and the need to keep pace with reforms in the region in order to benefit from integration, should maintain the reform momentum.

47. **The staff recommends the completion of the second review under the PRGF arrangement on the basis of their improved economic performance and the strength of the program.** The staff supports the authorities' request for waivers for the non-observance of the NDA ceiling for SCBs, based on the corrective measures, and the provisioning by banks in view of its recent implementation.

48. The staff recommends that the next Article IV consultation be held on the standard 12-month cycle.

Figure 1. Lao P.D.R.: Selected Economic Indicators, 1998-2002



Sources: Data provided by the Lao P.D.R. authorities; and Fund staff and Information Notice System (INS) estimates.

1/ Based on their average monthly respective buying rates.

Table 1. Lao P.D.R.: Phasing of Disbursements Under the PRGF Arrangement

| Date              | Disbursement    |                  | Activity  |
|-------------------|-----------------|------------------|---|
|                   | Millions of SDR | Percent of Quota |   |
| April 23 2001     | 4.53            | 8.6              | Board approves new three-year arrangement and endorses first-year program.  |
| February 25, 2002 | 4.53            | 8.6              | Board completed first review, based on quantitative performance criteria for June 2001.                                     |
| July, 2002        | 4.53            | 8.6              | Board completes second review, based on quantitative performance criteria for March 2002, and endorses second-year program. |
| January, 2003     | 4.53            | 8.6              | Board completes third review, based on quantitative performance criteria for September 2002.                                |
| July, 2003        | 4.53            | 8.6              | Board completes fourth review, based on quantitative performance criteria for March 2003, and endorses third-year program.  |
| January, 2004     | 4.53            | 8.6              | Board completes fifth review, based on quantitative performance criteria for September 2003.                                |
| July, 2004        | 4.52            | 8.6              | Board completes sixth review, based on quantitative performance criteria for March 2004.                                    |
| Total             | 31.70           | 60.0             |   |

Source: IMF, Treasurer's Department.

Table 2. Lao P.D.R.: Fund Position and Indicators of Fund Credit, 2002-12

|  | 2002<br>May 31                       | 2002  | 2003  | 2004  | 2005  | 2006  | 2007  | 2008  | 2009  | 2010  | 2011  | 2012  |
|--|--------------------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
|  | (in millions of SDRs; end of period) |       |       |       |       |       |       |       |       |       |       |       |
| Enhanced Structural Adjustment Facility (ESAF) and<br>Poverty Reduction and Growth Facility (PRGF) |                                      |       |       |       |       |       |       |       |       |       |       |       |
| Disbursements PRGF   | ...                                  | 9.1   | 9.1   | 9.1   | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   |
| Repayments   | ...                                  | 7.0   | 6.5   | 5.3   | 4.1   | 2.2   | 1.9   | 3.2   | 5.0   | 6.4   | 5.9   | 5.1   |
| ESAF/PRGF  | ...                                  | 6.5   | 6.5   | 5.3   | 4.1   | 2.2   | 1.9   | 3.2   | 5.0   | 6.4   | 5.9   | 5.1   |
| SAF  | ...                                  | 0.6   | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   |
| Total Fund credit outstanding, end of period   |                                      |       |       |       |       |       |       |       |       |       |       |       |
| ESAF/PRGF  | 31.9                                 | 31.8  | 34.5  | 38.4  | 34.3  | 32.0  | 30.1  | 26.9  | 21.9  | 15.5  | 9.6   | 4.5   |
| SAF  | 0.6                                  | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   |
|  | (in percent of quota)                |       |       |       |       |       |       |       |       |       |       |       |
| Total Fund credit outstanding, end of period   |                                      |       |       |       |       |       |       |       |       |       |       |       |
| ESAF/PRGF  | 60.4                                 | 60.1  | 65.2  | 72.5  | 64.8  | 60.6  | 56.9  | 50.9  | 41.4  | 29.3  | 18.1  | 8.5   |
| Total Fund credit outstanding, end of period   |                                      |       |       |       |       |       |       |       |       |       |       |       |
| In percent of GDP  | 2.3                                  | 2.2   | 2.3   | 2.3   | 1.9   | 1.7   | 1.5   | 1.3   | 1.0   | 0.6   | 0.4   | 0.2   |
| In percent of exports of goods and services  | 7.2                                  | 7.0   | 7.0   | 7.4   | 6.3   | 5.6   | 5.0   | 3.3   | 2.6   | 1.7   | 1.0   | 0.5   |
| Total debt service due to the Fund   |                                      |       |       |       |       |       |       |       |       |       |       |       |
| Total obligations, including interest<br>and charges (in millions of SDRs)                         | ...                                  | 7.3   | 6.7   | 5.6   | 4.4   | 2.5   | 2.2   | 3.4   | 5.2   | 6.6   | 6.1   | 5.2   |
| In percent of exports of goods and services  | ...                                  | 1.6   | 1.4   | 1.1   | 0.8   | 0.4   | 0.4   | 0.4   | 0.6   | 0.7   | 0.7   | 0.5   |
| Memorandum items:  |                                      |       |       |       |       |       |       |       |       |       |       |       |
| Exchange rate (U.S.dollars per SDR)  | 1.25                                 | 1.25  | 1.25  | 1.25  | 1.25  | 1.26  | 1.26  | 1.26  | 1.26  | 1.26  | 1.26  | 1.26  |
| Quota (in millions of SDRs)  | 52.9                                 | 52.9  | 52.9  | 52.9  | 52.9  | 52.9  | 52.9  | 52.9  | 52.9  | 52.9  | 52.9  | 52.9  |
| GDP (in millions of U.S. dollars)  | 1,782                                | 1,782 | 1,906 | 2,071 | 2,242 | 2,410 | 2,554 | 2,707 | 2,870 | 3,042 | 3,225 | 3,418 |
| Exports of goods and services (in millions of U.S. dollars)  | 567                                  | 567   | 614   | 651   | 681   | 718   | 764   | 1,016 | 1,065 | 1,118 | 1,174 | 1,232 |

Sources: Data provided by the IMF Treasurer's Department; and Fund staff estimates, and projections.

Table 3. Lao P.D.R.: Selected Economic and Financial Indicators, 1998–2002

Nominal GDP (2000): \$1,718 million  
 Population (1999): 5.1 million  
 GDP per capita (1999): \$288  
 Fund quota: SDR 52.9 million

|   | 1998  | 1999   | 2000<br>Est. | 2001<br>Est. | 2002               |        |        |
|---|-------|--------|--------------|--------------|--------------------|--------|--------|
|   |       |        |              |              | Latest 1/<br>Prog. | Rev.   | Prog.  |
| Nominal GDP (in billions of kip)                              | 4,240 | 10,329 | 13,671       | 15,599       | ...                | 17,257 | 17,638 |
| Real GDP growth (percent change) 2/                           | 4.0   | 7.3    | 5.8          | 5.2          | ...                | 5.0    | 5.5    |
| Prices (percent change)                                       |       |        |              |              |                    |        |        |
| Consumer prices<br>(12-month rate; end-of-period)             | 141.9 | 86.7   | 10.6         | 7.5          | 6.7 5/             | 6.0    | 6.0    |
| GDP deflator (annual average)                                 | 85.3  | 127.1  | 25.1         | 8.5          | ...                | 7.2    | 7.2    |
| Government budget (percent of GDP) 3/                         |       |        |              |              |                    |        |        |
| Revenue   | 9.8   | 10.6   | 13.2         | 13.6         | 5.1                | 13.9   | 13.1   |
| Grants  | 5.3   | 6.0    | 3.7          | 3.2          | 1.7                | 3.3    | 3.3    |
| Expenditure   | 23.6  | 20.5   | 21.5         | 21.3         | 9.0                | 21.9   | 21.0   |
| Current account balance (excluding grants)                    | 1.7   | 4.4    | 5.0          | 5.2          | 1.3                | 5.2    | 4.6    |
| Overall balance (including grants)                            | -8.5  | -3.9   | -4.6         | -4.5         | -2.2               | -4.6   | -4.6   |
| <i>Of which</i> : Bank financing                              | 0.8   | -0.4   | -0.8         | 1.7          | 0.0                | 0.3    | 0.5    |
| Money and credit (percent change; end-of-period) 4/           |       |        |              |              |                    |        |        |
| Broad money   | 113.3 | 78.4   | 45.7         | 23.1         | 27.3               | 19.0   | 20.2   |
| Bank credit to the economy                                    | 86.3  | 74.2   | 41.1         | 39.2         | 16.5               | 14.2   | 0.0    |
| Credit to SOEs  | 85.6  | 99.2   | 36.1         | 38.5         | 20.7               | 10.8   | -2.0   |
| Credit to the private sector                                  | 86.6  | 63.6   | 43.7         | 39.7         | 14.1               | 16.2   | 1.2    |
| Interest rates (in percent; end-of-period)                    |       |        |              |              |                    |        |        |
| On one-year deposits  | 23    | 24     | 24           | 20           | 16 5/              | ...    | ...    |
| On short-term loans   | 31-36 | 22-30  | 16-24        | 12-18        | 12-18 5/           | ...    | ...    |
| External trade  |       |        |              |              |                    |        |        |
| Trade balance (in millions of U.S. dollars)                   | -216  | -212   | -218         | -218         | ...                | -250   | -212   |
| Exports (percent change in U.S. dollar value)                 | 6.4   | 1.5    | 2.6          | -0.3         | ...                | 3.2    | 6.2    |
| Imports (percent change in U.S. dollar value)                 | -14.7 | 0.3    | 2.7          | -0.4         | ...                | 2.6    | 2.8    |
| Balance of payments (percent of GDP)                          |       |        |              |              |                    |        |        |
| Current account balance (including official transfers)        | -5.2  | -4.0   | -1.4         | -3.5         | ...                | -4.3   | -3.2   |
| Overall balance (in millions of U.S. dollars)                 | -18   | 3      | 44           | -2           | ...                | -35    | 5      |
| Gross official reserves (in millions of U.S. dollars) 4/      | 112   | 106    | 127          | 134          | 144 5/             | 140    | 144    |
| (in months of prospective goods and service imports)          | 2.2   | 2.1    | 2.5          | 2.5          | 2.5 5/             | 2.4    | 2.5    |
| Net official reserves (in millions of U.S. dollars)           | 50    | 53     | 97           | 93           | 104 5/             | 98     | 102    |
| External debt (in percent)                                    |       |        |              |              |                    |        |        |
| Ratio of public debt-to-GDP 6/                                | ...   | ...    | 67.8         | 69.2         | ...                | 72.6   | 84.8   |
| Public debt-service ratio 7/                                  | 4.6   | 6.2    | 5.7          | 6.7          | ...                | 7.5    | 7.5    |
| Exchange rate   |       |        |              |              |                    |        |        |
| Kip per U.S. dollar (end-of-period)                           |       |        |              |              |                    |        |        |
| Commercial bank rate  | 4,274 | 7,600  | 8,140        | 9,490        | 9,910 8/           | ...    | ...    |
| Parallel market rate  | 4,750 | 7,575  | 8,170        | 9,560        | 10,060 8/          | ...    | ...    |
| Real effective exchange rate (percent change, annual average) | -23.1 | 5.0    | 10.8         | 2.1          | 0.7 9/             | ...    | ...    |

Sources: Data provided by the Lao P.D.R. authorities; and Fund staff estimates, and projections.

1/ Latest data for March 2002 unless otherwise indicated.

2/ Staff estimate for 1999 real GDP growth is 5.0 percent; the lower estimate of Fund staff is due to their lower estimate of agricultural sector output, in line with observations of relevant international agencies. However, to maintain comparisons with the authorities' estimates the 7.3 percent growth rate in 1999 is used.

3/ Fiscal data are on a fiscal year basis (October–September).

4/ Money and credit data and official reserves data for 2001 and 2002 are presented on a fiscal year basis.

5/ Data for May 2002.

6/ Convertible currency debt only; assuming rescheduling of the Russian debt under Naples terms in 2002.

7/ As a ratio of exports of goods and services.

8/ Data as of June 21, 2002.

9/ Data for April 2002.



Table 4. Lao: PDR.: General Government Operations, 1999/00 - 2001/02

|   | 1999/00 | 2000/01 |        | 2001/02 |        |        | Rev. Prog. |
|---|---------|---------|--------|---------|--------|--------|------------|
|   | Est.    | Budget  | Prog.  | Est.    | Budget | Prog.  |            |
| Revenue and grants  | 2,166   | 2,614   | 2,473  | 2,476   | 3,030  | 2,850  | 2,745      |
| Revenue   | 1,691   | 2,194   | 2,053  | 2,000   | 2,481  | 2,301  | 2,196      |
| Tax   | 1,367   | 1,742   | 1,687  | 1,629   | 2,043  | 1,863  | 1,782      |
| Profit tax  | 187     | 316     | 301    | 205     | 362    | 332    | 290        |
| Income tax  | 117     | 182     | 182    | 153     | 190    | 160    | 160        |
| Turnover tax  | 290     | 379     | 359    | 318     | 452    | 427    | 427        |
| Excise tax  | 226     | 336     | 316    | 371     | 362    | 337    | 337        |
| Import duties   | 135     | 192     | 192    | 179     | 229    | 204    | 204        |
| Timber royalty receipts                                   | 273     | 115     | 115    | 182     | 165    | 165    | 132        |
| Other   | 140     | 222     | 222    | 221     | 283    | 238    | 232        |
| Nontax  | 324     | 452     | 366    | 372     | 438    | 438    | 413        |
| <i>of which</i> ; SOE dividends                           | 42      | 212     | 127    | 67      | 89     | 89     | 64         |
| Interest payments   | 79      | 40      | 40     | 76      | 42     | 42     | 42         |
| Overflight revenues                                       | 123     | 125     | 125    | 114     | 153    | 153    | 153        |
| Grants  | 475     | 420     | 420    | 476     | 549    | 549    | 549        |
| Expenditure   | 2,754   | 3,382   | 3,204  | 3,141   | 3,614  | 3,614  | 3,511      |
| Current   | 1,050   | 1,417   | 1,239  | 1,229   | 1,449  | 1,449  | 1,431      |
| Wages and salaries  | 335     | 417     | 417    | 416     | 525    | 525    | 525        |
| Materials and supplies                                    | 174     | 342     | 342    | 330     | 370    | 370    | 360        |
| Interest payments   | 103     | 175     | 175    | 134     | 145    | 145    | 145        |
| External  | 86      | 120     | 120    | 117     | 119    | 119    | 119        |
| Domestic  | 16      | 55      | 55     | 17      | 26     | 26     | 26         |
| Timber royalty financed expenditure                       | 242     | 115     | 15     | 0       | 0      | 0      | 0          |
| Other recurrent   | 196     | 368     | 290    | 350     | 409    | 409    | 401        |
| Capital and onlending                                     | 1,704   | 1,965   | 1,965  | 1,911   | 2,165  | 2,165  | 2080       |
| <i>of which</i> : domestically financed                   | 481     | 805     | 805    | 872     | 1,017  | 1,017  | 932        |
| <i>of which</i> : clearance of arrears                    | ...     | ...     | ...    | ...     | 165    | 165    | 136        |
| externally financed                                       | 1,302   | 1,200   | 1,200  | 1,200   | 1,256  | 1,256  | 1,256      |
| Current balance   | 641     | 776     | 814    | 771     | 1,033  | 853    | 765        |
| Overall balance   | -588    | -769    | -731   | -665    | -583   | -763   | -766       |
| Excluding grants  | -1,063  | -1,189  | -1,151 | -1,140  | -1,132 | -1,312 | -1,315     |
| Financing   | 588     | 769     | 731    | 665     | 583    | 763    | 766        |
| Domestic financing  | -148    | 213     | 175    | 187     | 33     | 71     | 102        |
| Bank financing 1/   | -104    | 0       | 0      | 246     | 13     | 50     | 82         |
| Nonbank financing   | -44     | 213     | 175    | -59     | 20     | 21     | 21         |
| Foreign financing (net)                                   | 736     | 556     | 556    | 478     | 550    | 692    | 664        |
| Project loans   | 827     | 780     | 780    | 724     | 826    | 826    | 826        |
| Program loans   | 96      | 0       | 0      | 0       | 0      | 143    | 114        |
| Amortization  | 187     | 224     | 224    | 247     | 276    | 276    | 276        |
| Revenue and grants  | 16.9    | 17.7    | 16.8   | 16.8    | 18.4   | 17.3   | 16.4       |
| Revenue   | 13.2    | 14.9    | 13.9   | 13.6    | 15.0   | 13.9   | 13.1       |
| Tax   | 10.6    | 11.8    | 11.4   | 11.1    | 12.4   | 11.3   | 10.7       |
| Nontax  | 2.5     | 3.1     | 2.5    | 2.5     | 2.7    | 2.7    | 2.5        |
| Grants  | 3.7     | 2.8     | 2.8    | 3.2     | 3.3    | 3.3    | 3.3        |
| Expenditure   | 21.5    | 22.9    | 21.7   | 21.3    | 21.9   | 21.9   | 21.0       |
| Current   | 8.2     | 9.6     | 8.4    | 8.4     | 8.8    | 8.8    | 8.6        |
| Capital and onlending                                     | 13.3    | 13.3    | 13.3   | 13.0    | 13.1   | 13.1   | 12.4       |
| Current balance, excluding grants                         | 5.0     | 5.3     | 5.5    | 5.2     | 6.3    | 5.2    | 4.6        |
| Overall balance   | -4.6    | -5.2    | -5.0   | -4.5    | -3.5   | -4.6   | -4.6       |
| Excluding grants  | -8.3    | -8.1    | -7.8   | -7.7    | -6.9   | -7.9   | -7.9       |
| Financing   | 4.6     | 5.2     | 5.0    | 4.5     | 3.5    | 4.6    | 4.6        |
| Domestic financing (net)                                  | -1.2    | 1.4     | 1.2    | 1.3     | 0.2    | 0.4    | 0.6        |
| Bank  | -0.8    | 0.0     | 0.0    | 1.7     | 0.1    | 0.3    | 0.5        |
| Nonbank   | -0.3    | 1.4     | 1.2    | -0.4    | 0.1    | 0.1    | 0.1        |
| Foreign financing (net)                                   | 5.7     | 3.8     | 3.8    | 3.2     | 3.3    | 4.2    | 4.0        |
| Memorandum item:  |         |         |        |         |        |        |            |
| Nominal GDP, fiscal year (in billions of kip)             | 12,836  | 14,755  | 14,755 | 14,721  | 16,510 | 16,510 | 16,731     |
| Actual/Program exchange rate (kip per US dollar, average) | 7,670   | 8,000   | 8,400  | 8,600   | 9,500  | 9,500  | 9,500      |

Sources: Data provided by the Lao P.D.R. authorities; and Fund staff estimates, and projections.

1/ Bank financing excludes the valuation adjustments on the stock of government foreign currency deposits and credit in all years, as well as reclassification of printing costs by the BOL (KN 78 billion) in 1999/00.

Table 5. Lao P.D.R.: Balance Sheet of Bank of Lao P.D.R., 2000-March 2003

|  | 2000    | 2001               |       |       |       |       |       |       |       |               |       | 2003  |
|--|---------|--------------------|-------|-------|-------|-------|-------|-------|-------|---------------|-------|-------|
|  |         | Sept.              | Dec.  | Mar.  |       | Apr.  | May   | June  | Sept. | Sept.         | Dec.  | Mar.  |
|  |         | Prog. 1/<br>Actual | Est.  | Prog. | Est.  | Est.  | Est.  | Prog. | Prog. | Rev.<br>Prog. | Prog. | Prog. |
| (in billions of kip; end of period)                        |         |                    |       |       |       |       |       |       |       |               |       |       |
| Bank of Lao P.D.R.   |         |                    |       |       |       |       |       |       |       |               |       |       |
| Net foreign assets 2/                                      | 799     | 880                | 908   | 929   | 932   | 972   | 989   | 932   | 935   | 969           | 1,064 | 1,112 |
| Foreign assets   | 1,147   | 1,273              | 1,268 | 1,321 | 1,338 | 1,375 | 1,377 | 1,300 | 1,332 | 1,370         | 1,444 | 1,524 |
| Foreign liabilities  | -347    | -393               | -361  | -392  | -405  | -403  | -388  | -368  | -398  | -401          | -380  | -413  |
| Net domestic assets 3/                                     | -33     | -130               | -85   | -100  | -143  | -150  | -102  | -102  | -134  | -134          | -152  | -185  |
| Domestic credit  | 588     | 828                | 890   | 872   | 815   | 815   | 838   | 843   | 816   | 793           | 763   | 723   |
| Net credit to government 2/                                | -347    | -76                | -96   | -67   | -116  | -143  | -141  | -115  | -76   | -125          | -130  | -135  |
| Credit to the economy                                      | 489     | 618                | 639   | 639   | 640   | 639   | 602   | 598   | 639   | 598           | 598   | 598   |
| Credit to state enterprises                                | 346     | 467                | 489   | 488   | 488   | 487   | 453   | 450   | 488   | 450           | 450   | 450   |
| Credit to private sector                                   | 143     | 151                | 151   | 151   | 152   | 151   | 148   | 148   | 151   | 148           | 148   | 148   |
| Credit to banks  | 446     | 285                | 348   | 300   | 291   | 319   | 378   | 360   | 253   | 320           | 295   | 260   |
| BOL securities   | -159    | -201               | -200  | -196  | -199  | -197  | -194  | -195  | -175  | -177          | -165  | -158  |
| Other items, net 2/  | -461    | -757               | -776  | -776  | -759  | -768  | -747  | -750  | -776  | -750          | -750  | -750  |
| of which: medium-term foreign liabilities                  | -211    | -328               | -347  | -347  | -352  | -356  | -322  | -322  | -347  | -322          | -322  | -322  |
| Reserve money 3/   | 767     | 750                | 823   | 829   | 790   | 821   | 887   | 830   | 801   | 835           | 912   | 927   |
| (in millions of U.S. dollars; end of period)               |         |                    |       |       |       |       |       |       |       |               |       |       |
| Net foreign assets 2/                                      | 97.3    | 92.7               | 95.6  | 97.8  | 98.1  | 102.3 | 104.1 | 98.1  | 98.4  | 102.0         | 112.0 | 117.0 |
| Gross international reserves 2/                            | 126.5   | 134.0              | 133.5 | 139.0 | 140.8 | 144.7 | 144.9 | 136.8 | 140.2 | 144.2         | 152.0 | 160.5 |
| Required reserves on foreign currency deposits             | 27.3    | 27.5               | 29.0  | 30.0  | 28.1  | 31.4  | 29.2  | 28.9  | 32.3  | 30.0          | 31.1  | 32.1  |
| (annual percentage change)                                 |         |                    |       |       |       |       |       |       |       |               |       |       |
| Reserve money 3/   | 59.1    | 13.0               | 33.4  | 24.9  | 18.9  | 22.2  | 20.0  | 18.9  | 6.9   | 11.4          | 10.8  | 11.8  |
| Memorandum items:  |         |                    |       |       |       |       |       |       |       |               |       |       |
| BOL financing of the budget (in billions of kip) 4/        | -73     | ...                | -21   | 9     | -40   | -67   | -66   | -39   | 0     | -49           | -5    | -10   |
| Disbursement of program loans (millions of U.S. dollar) 4/ | ...     | 0                  | 0     | 5     | 5     | 5     | 5     | 5     | 15    | 12            | 5     | 10    |
| Actual/Program exchange rate, eop (kip per U.S. dollar)    | 8,218 0 | 9,500              | 9,500 | 9500  | 9500  | 9,500 | 9,500 | 9,500 | 9500  | 9,500         | 9,500 | 9,500 |

Sources: Data provided by the Lao authorities; and Fund staff estimates, and projections.

1/ This column shows the revised program figures based on the new program exchange rate (US \$1=KN 9,500).

2/ The Japanese grant of Y 1.5 billion is excluded from the estimates of gross international reserves for Dec. 2000 and June 2001. From Sept. 2001 the proceeds in yen from the Japanese grant are recorded in other items (net) and excluded from gross foreign assets and government deposits.

3/ From January 2001 reserve money and NDA of the BOL have been reduced by KN 150 billion due to the netting of BOL deposits at banks and banks' deposits at BOL.

4/ Cumulative from the start of the fiscal year (which runs from October to September).

Table 6. Lao P.D.R.: Monetary Survey, 2000-March 2003

|  | 2000  |                    | 2001   |        | 2002   |        |        |       |        |               | 2003  |       |
|--|-------|--------------------|--------|--------|--------|--------|--------|-------|--------|---------------|-------|-------|
|  |       | Sept.              | Dec.   | Mar.   |        | Apr.   | May    | June  | Sept.  | Sept.         | Dec.  | Mar.  |
|  |       | Prog. 1/<br>Actual | Est.   | Prog.  | Est.   | Est.   | Est.   | Prog. | Prog.  | Rev.<br>Prog. | Prog. | Prog. |
| (in billions of kip; end of period)                                |       |                    |        |        |        |        |        |       |        |               |       |       |
| Monetary Survey  |       |                    |        |        |        |        |        |       |        |               |       |       |
| Net foreign assets 2/  | 1,528 | 1,443              | 1,479  | 1,606  | 1,673  | 1,761  | 1,834  | 1,779 | 1,631  | 1,760         | 1,859 | 1,917 |
| of which: SCBs   | 483   | 335                | 306    | 470    | 443    | 503    | 563    | 479   | 510    | 510           | 515   | 520   |
| Net domestic assets  | 721   | 1,156              | 1,226  | 1,252  | 1,214  | 1,180  | 1,166  | 1,252 | 1,458  | 1,364         | 1,357 | 1,392 |
| of which: SCBs (excl. net credit to gov.)                          | 1,193 | 1,501              | 1,568  | 1,460  | 1,533  | 1,578  | 1,583  | 1,533 | 1,537  | 1,537         | 1,570 | 1,610 |
| Domestic credit  | 1,439 | 2,341              | 2,437  | 2,427  | 2,308  | 2,266  | 2,216  | 2,238 | 2,611  | 2,309         | 2,340 | 2,355 |
| of which: SCBs   | 815   | 1,194              | 1,282  | 1,194  | 1,149  | 1,133  | 1,146  | 1,261 | 1,311  | 1,294         | 1,348 | 1,408 |
| Net claims on government 2/  | -420  | -141               | -117   | -112   | -134   | -166   | -157   | -140  | -91    | -59           | -28   | -13   |
| Claims on the economy  | 1,859 | 2,482              | 2,555  | 2,539  | 2,442  | 2,432  | 2,374  | 2,378 | 2,702  | 2,368         | 2,368 | 2,368 |
| of which: SCBs   | 882   | 1,253              | 1,305  | 1,233  | 1,179  | 1,175  | 1,183  | 1,280 | 1,320  | 1,237         | 1,270 | 1,310 |
| of which: in foreign currency                                      | 1,491 | 2,022              | 2,066  | 2,039  | 1,964  | 1,958  | 1,914  | 1,902 | 2,129  | 1,837         | 1,787 | 1,737 |
| Credit to state enterprises  | 606   | 982                | 1,022  | 928    | 955    | 943    | 916    | 910   | 960    | 850           | 800   | 750   |
| Credit to private sector   | 1,253 | 1,500              | 1,533  | 1,611  | 1,487  | 1,489  | 1,458  | 1,468 | 1,742  | 1,518         | 1,568 | 1,618 |
| Other items (net) 2/   | -718  | -1,185             | -1,211 | -1,175 | -1,095 | -1,087 | -1,050 | -986  | -1,152 | -946          | -983  | -963  |
| Broad money  | 2,249 | 2,599              | 2,704  | 2,859  | 2,887  | 2,941  | 3,000  | 3,031 | 3,090  | 3,124         | 3,216 | 3,309 |
| Domestic currency (cash and deposits)                              | 536   | 611                | 673    | 665    | 775    | 783    | 785    | 781   | 727    | 824           | 866   | 909   |
| Foreign currency deposits  | 1,713 | 1,988              | 2,031  | 2,194  | 2,111  | 2,158  | 2,215  | 2,250 | 2,363  | 2,300         | 2,350 | 2,400 |
| (in millions of U.S. dollars; end of period)                       |       |                    |        |        |        |        |        |       |        |               |       |       |
| Net foreign assets 2/  | 185.9 | 151.9              | 155.6  | 169.1  | 176.1  | 185.4  | 193.1  | 187.3 | 171.7  | 185.3         | 195.7 | 201.8 |
| of which: SCBs   | 58.8  | 35.3               | 32.2   | 49.5   | 46.7   | 52.9   | 59.2   | 50.5  | 53.6   | 53.6          | 58.1  | 60.7  |
| Foreign currency credit to the economy                             | 181.5 | 212.8              | 217.5  | 214.6  | 206.8  | 206.1  | 201.5  | 200.2 | 224.1  | 193.4         | 188.1 | 182.8 |
| of which: SCBs   | 80.4  | 104.1              | 107.3  | 98.2   | 94.1   | 94.0   | 95.8   | 103.2 | 106.7  | 106.7         | 106.5 | 107.0 |
| Foreign currency deposits  | 208.5 | 209.2              | 213.8  | 231.0  | 222.3  | 227.1  | 233.2  | 236.8 | 248.7  | 242.1         | 247.4 | 252.6 |
| (annual percentage change)   |       |                    |        |        |        |        |        |       |        |               |       |       |
| Broad money  | 45.7  | 23.1               | 20.3   | 24.1   | 27.5   | 27.6   | 27.3   | 30.8  | 19.0   | 20.2          | 18.9  | 14.6  |
| Net domestic asset of SCBs (increase from start of fiscal year) 3/ | ...   | 16.2               | 0.8    | 5.3    | 10.6   | 13.8   | 14.2   | 10.6  | 10.8   | 10.8          | 13.2  | 16.1  |
| Credit to the economy 3/   | 41.1  | 39.2               | 28.2   | 25.4   | 22.8   | 25.9   | 16.5   | 16.4  | 14.2   | 0.0           | -0.6  | -3.0  |
| of which: commercial banks 3/                                      | 44.1  | 43.4               | 27.4   | 28.1   | 21.5   | 24.1   | 14.0   | 12.7  | 18.0   | 1.3           | 1.5   | -1.8  |
| of which: SCBs 3/  | 58.6  | 46.9               | 28.6   | 26.6   | 21.1   | 15.5   | 14.9   | 23.2  | 16.0   | 16.0          | 13.0  | 10.9  |
| Credit to state enterprises 3/                                     | 36.1  | 38.5               | 40.3   | 22.0   | 28.1   | 27.0   | 20.7   | 18.5  | 10.8   | -2.0          | -5.9  | -21.4 |
| Credit to the private sector                                       | 43.7  | 39.7               | 22.4   | 27.4   | 19.6   | 25.1   | 14.1   | 15.2  | 16.2   | 1.2           | 2.3   | 8.8   |
| Memorandum items:  |       |                    |        |        |        |        |        |       |        |               |       |       |
| Bank financing of the budget (in billions of kip) 4/               | -46   | ...                | 23     | 29     | 7      | -25    | -16    | 1     | 50     | 82            | 31    | 46    |
| Money multiplier   | 2.9   | 3.5                | 3.3    | 3.4    | 3.7    | 3.6    | 3.4    | 3.7   | 3.9    | 3.7           | 3.5   | 3.6   |
| Actual/Program exchange rate, eop (kip per U.S. dollar)            | 8,218 | 9,500              | 9,500  | 9,500  | 9,500  | 9,500  | 9,500  | 9,500 | 9,500  | 9,500         | 9,500 | 9,500 |

Sources: Data provided by the Lao authorities; and Fund staff estimates, and projections.

1/ This column shows the revised program figures based on the new program exchange rate (US \$1=KN 9,500).

2/ From September 2001, the yen proceeds from the Japanese grant are recorded in other items (net) and excluded from gross foreign assets and government deposits.

3/ Excluding Lao Brewery.

4/ Cumulative from the start of the fiscal year (which runs from October to September).

Table 7. Lao P.D.R.: Summary Macroeconomic Framework, 1998-2004

|  | 1998  | 1999   | 2000   | 2001   | 2002        | 2003   | 2004   |
|--|---|--------|--------|--------|-------------|--------|--------|
|  |   |        |        | Est.   | Projections |        |        |
| Nominal GDP (in billions of kip)   | 4,240                                       | 10,329 | 13,671 | 15,599 | 17,638      | 19,631 | 21,953 |
| Real GDP (in billions of kip)  | 993   | 1,065  | 1,127  | 1,186  | 1,251       | 1,326  | 1,412  |
| Real GDP growth (percent change)   | 4.0   | 7.3    | 5.8    | 5.2    | 5.5         | 6.0    | 6.5    |
| Inflation (percent change, annual average)   | 90.1  | 128.4  | 23.2   | 8.5    | 7.2         | 5.0    | 5.0    |
| Merchandise exports (percent change)   | 6.4   | 1.5    | 2.6    | -0.3   | 6.2         | 8.7    | 5.4    |
| Merchandise imports (percent change)   | -14.7                                       | 0.3    | 2.7    | -0.4   | 2.8         | 8.1    | 19.3   |
| (percent change excluding NT2)   |   |        |        |        |             |        | 7.3    |
| Official gross reserves (in months of prospective goods and services imports, excluding NT2) | 2.2   | 2.1    | 2.5    | 2.5    | 2.8         | 3.4    | 3.9    |
| Budget (fiscal year basis) 1/  | (in percent of GDP; unless otherwise noted) |        |        |        |             |        |        |
| Revenue  | 9.8   | 10.6   | 13.2   | 13.6   | 13.1        | 13.7   | 14.2   |
| Grants   | 5.3   | 6.0    | 3.7    | 3.2    | 3.3         | 3.2    | 3.4    |
| Expenditure  | 23.6  | 20.5   | 21.5   | 21.3   | 21.0        | 21.8   | 22.2   |
| Current  | 8.1   | 6.1    | 8.2    | 8.4    | 8.6         | 9.0    | 9.4    |
| <i>of which</i> : Interest on bank restructuring bonds                                       | ...   | ...    | ...    | ...    | ...         | 0.1    | 0.2    |
| Capital and onlending  | 15.5  | 14.4   | 13.3   | 13.0   | 12.4        | 12.8   | 12.8   |
| Current fiscal balance before grants   | 1.7   | 4.4    | 5.0    | 5.2    | 4.6         | 4.7    | 4.8    |
| Overall fiscal balance after grants  | -8.5  | -3.9   | -4.6   | -4.5   | -4.6        | -4.9   | -4.6   |
| Augmented balance (including capital costs of SCB reform)                                    | -8.5  | -3.9   | -4.6   | -4.5   | -4.6        | -6.1   | -5.2   |
| <i>of which</i> : Capital costs of SCB reform  | ...   | ...    | ...    | ...    | ...         | 1.2    | 0.6    |
| Domestic financing   | 2.5   | -0.6   | -1.2   | 1.3    | 0.6         | 1.5    | 1.0    |
| <i>of which</i> : Bank restructuring bonds   |   |        |        |        | ...         | 1.2    | 0.6    |
| Foreign financing  | 6.0   | 4.5    | 5.7    | 3.2    | 4.0         | 4.5    | 4.1    |
| Real GDP growth (percent change) 1/  | 4.7   | 6.5    | 6.2    | 5.4    | 5.4         | 5.9    | 6.4    |
| Increase in GDP deflator (percent change) 1/   | 71.2  | 120.4  | 35.6   | 8.9    | 7.8         | 5.2    | 5.0    |
| Savings and Investment balance 2/  | (in percent of GDP)                         |        |        |        |             |        |        |
| National savings   | 11.9  | 13.9   | 12.7   | 14.3   | 15.5        | 16.5   | 22.1   |
| Private  | 10.2  | 9.4    | 7.7    | 9.1    | 11.0        | 11.8   | 17.4   |
| Government   | 1.7   | 4.5    | 5.0    | 5.2    | 4.5         | 4.7    | 4.8    |
| Investment   | 22.8  | 22.7   | 21.0   | 21.3   | 21.8        | 22.9   | 33.3   |
| Private  | 7.3   | 8.3    | 7.0    | 7.4    | 8.6         | 10.1   | 20.5   |
| o/w hydropower   | 1.4   | 1.9    | 0.1    | 0.0    | 0.0         | 0.0    | 9.6    |
| Other  | 5.9   | 6.4    | 6.9    | 7.4    | 8.6         | 10.1   | 10.9   |
| Government 3/  | 15.5  | 14.4   | 14.0   | 13.9   | 13.2        | 12.8   | 12.8   |
| Foreign savings  | 10.9  | 8.8    | 8.3    | 7.0    | 6.3         | 6.4    | 11.2   |
| Excluding hydropower   | 9.5   | 10.8   | 12.9   | 11.6   | 10.7        | 10.7   | 10.2   |

Sources: Data provided by the Lao authorities; and Fund staff estimates, and projections.

1/ Fiscal year ending September.

2/ Estimates for private savings and investment are highly tentative as no expenditure based national accounts have been established.

In particular, private savings reflect unrecorded imports.

3/ Comprises government investment and selected public enterprise investment.

Table 8. Lao P.D.R.: Balance of Payments, 1999-2006

|   | 1999  | 2000  | 2001   | 2002  | 2003  | 2004        | 2005   | 2006  |
|---|-------|-------|--------|-------|-------|-------------|--------|-------|
|   |       | Est.  | Est.   |       |       | Projections |        |       |
| (In millions of U.S. dollars; unless otherwise indicated)         |       |       |        |       |       |             |        |       |
| Current account   | -60   | -24   | -61    | -58   | -52   | -149        | -287   | -295  |
| (excluding official transfers)                                    | -129  | -145  | -122   | -113  | -122  | -231        | -375   | -383  |
| Merchandise trade balance   | -212  | -218  | -218   | -212  | -227  | -326        | -442   | -461  |
| Exports, f.o.b.   | 342   | 351   | 350    | 371   | 404   | 425         | 444    | 470   |
| (in percent change)   | (1.5) | (2.6) | (-0.3) | (6.2) | (8.7) | (5.4)       | (4.5)  | (5.8) |
| (in percent change excluding NT2)                                 | ...   | ...   | ...    | ...   | ...   | ...         | ...    | ...   |
| Imports, c.i.f.   | 554   | 569   | 567    | 583   | 631   | 752         | 887    | 931   |
| (in percent change)   | (0.3) | (2.7) | (-0.4) | (2.8) | (8.1) | (19.2)      | (18.0) | (5.0) |
| (in percent change excluding NT2)                                 | ...   | ...   | ...    | ...   | ...   | (7.3)       | (6.2)  | (6.2) |
| Services (net)  | 98    | 126   | 141    | 147   | 159   | 148         | 123    | 134   |
| Income (net)  | -45   | -73   | -68    | -70   | -79   | -78         | -82    | -85   |
| Of which: interest payments 1/                                    | -35   | -37   | -35    | -34   | -41   | -40         | -39    | -37   |
| Of which: public debt   | -8    | -10   | -11    | -14   | -18   | -19         | -20    | -21   |
| Of which: private debt  | -27   | -27   | -24    | -20   | -23   | -21         | -19    | -16   |
| Transfers (net)   | 99    | 142   | 83     | 78    | 94    | 108         | 115    | 117   |
| Private   | 30    | 21    | 22     | 23    | 24    | 26          | 27     | 29    |
| Official  | 70    | 121   | 61     | 55    | 70    | 82          | 88     | 88    |
| Capital account   | 63    | 68    | 60     | 63    | 63    | 176         | 308    | 317   |
| Long-term loans   | 65    | 63    | 74     | 66    | 62    | 69          | 77     | 76    |
| Disbursements   | 94    | 98    | 114    | 106   | 116   | 126         | 136    | 139   |
| Amortization  | -29   | -36   | -39    | -40   | -54   | -57         | -59    | -63   |
| Of which: public debt   | -17   | -12   | -16    | -20   | -27   | -29         | -33    | -35   |
| Foreign investment (incl. external loans)                         | 82    | 31    | 33     | 41    | 60    | 168         | 302    | 308   |
| Of which: hydropower investment 2/                                | 30    | 0     | 0      | 0     | 0     | 99          | 223    | 223   |
| Net foreign assets of commercial banks (increase -)               | -47   | 25    | 34     | -5    | -22   | -20         | -20    | -20   |
| Assets  | -45   | 19    | 11     | -5    | -22   | -20         | -20    | -20   |
| Liabilities   | -3    | 5     | 23     | 0     | 0     | 0           | 0      | 0     |
| Errors and omissions  | -37   | -51   | -82    | -40   | -36   | -41         | -51    | -47   |
| Overall balance   | 3     | 44    | -2     | 5     | 11    | 27          | 21     | 22    |
| Financing   | -3    | -44   | 2      | -5    | -11   | -27         | -21    | -22   |
| Central bank net foreign assets                                   | -3    | -44   | 2      | -25   | -46   | -47         | -21    | -22   |
| Assets (increase -)   | 6     | -33   | 6      | -26   | -46   | -46         | -16    | -20   |
| Liabilities (reduction -)   | -9    | -10   | -4     | 1     | 0     | -1          | -5     | -3    |
| Financing gap   | 0     | 0     | 0      | 20    | 35    | 20          | 0      | 0     |
| Memorandum items:   |       |       |        |       |       |             |        |       |
| Current account (in percent of GDP, excluding official transfers) | -8.8  | -8.3  | -7.0   | -6.3  | -6.4  | -11.2       | -16.7  | -15.9 |
| Current account (in percent of GDP, including official transfers) | -4.0  | -1.4  | -3.5   | -3.2  | -2.7  | -7.2        | -12.8  | -12.2 |
| (excluding official transfers and NT2)                            | -8.8  | -8.3  | -7.0   | -6.3  | -6.4  | -6.3        | -6.5   | -6.4  |
| (including official transfers and excluding NT2)                  | -4.0  | -1.4  | -3.5   | -3.2  | -2.7  | -2.3        | -2.6   | -2.7  |
| Official gross reserves (in millions of U.S. dollars)             | 106   | 127   | 134    | 159   | 205   | 252         | 268    | 287   |
| (in months of prospective goods and service imports, exc. NT2)    | 2.1   | 2.5   | 2.5    | 2.8   | 3.4   | 3.9         | 3.9    | 4.0   |
| (ratio to short-term debt by remaining maturity) 3/               | 2.5   | 1.9   | 3.3    | 2.9   | 3.6   | 4.2         | 4.3    | 4.4   |
| Debt service ratio (incl. Fund,                                   |       |       |        |       |       |             |        |       |
| in percent of goods and service exports) 1/                       | 14.1  | 15.3  | 15.5   | 14.6  | 16.9  | 15.9        | 15.2   | 14.3  |
| Public debt service ratio (incl. Fund, excl. NT2,                 |       |       |        |       |       |             |        |       |
| in percent of goods and service exports) 1/                       | 6.2   | 5.7   | 6.7    | 7.5   | 8.7   | 8.5         | 8.5    | 8.1   |

Sources: Data provided by the Lao P.D.R. authorities; and Fund staff estimates, and projections.

1/ Includes debt service to official creditors and estimates for debt service to commercial creditors, but does not include obligations to the Russian Federation which are being clarified in the context of bilateral negotiations.

2/ The large hydroelectric project Nam Theun 2 (NT2) is valued at US\$1.1bn (approximately equivalent to 60 percent of GDP) to be implemented over 2004-08, and would be financed by foreign investment.

3/ For 2001-06, excludes liabilities to banks, debt securities issued abroad, and non-bank trade credits, but includes prospective amortization on external debt

Table 9. Lao P.D.R.: Debt Stock and Debt Service, 1999-2006 1/

|   | Est.    |         |         | Projections |         |         |         |         |
|---|---------|---------|---------|-------------|---------|---------|---------|---------|
|   | 1999    | 2000    | 2001    | 2002        | 2003    | 2004    | 2005    | 2006    |
| (In millions of U.S. dollars)                 |         |         |         |             |         |         |         |         |
| Total debt stock                              | 1,538.3 | 1,447.1 | 1,458.2 | 1,735.7     | 1,773.3 | 1,884.8 | 2,087.9 | 2,289.8 |
| Public debt                                   | 1,246.5 | 1,178.9 | 1,213.5 | 1,511.4     | 1,576.3 | 1,640.3 | 1,701.2 | 1,762.3 |
| Bilateral                                     | 152.9   | 79.1    | 67.9    | 273.3       | 269.1   | 264.9   | 260.3   | 255.2   |
| <i>Of which : Russian Federation 2/</i>       | ...     | ...     | ...     | 208.9       | 208.9   | 208.9   | 207.9   | 206.8   |
| Multilateral                                  | 1,036.0 | 1,042.2 | 1,089.3 | 1,189.4     | 1,266.2 | 1,342.0 | 1,415.2 | 1,489.1 |
| <i>Of which:</i>                              |         |         |         |             |         |         |         |         |
| AsDB  | 540.4   | 541.5   | 575.0   | ...         | ...     | ...     | ...     | ...     |
| IDA   | 380.7   | 393.6   | 406.6   | ...         | ...     | ...     | ...     | ...     |
| IMF 4/  | 55.2    | 48.1    | 37.4    | 39.7        | 43.2    | 48.1    | 43.0    | 40.2    |
| Commercial                                    | 57.6    | 57.6    | 56.4    | 48.7        | 41.0    | 33.3    | 25.6    | 18.0    |
| Private debt                                  | 291.7   | 268.2   | 244.7   | 224.4       | 196.9   | 244.5   | 386.7   | 527.6   |
| Total debt service                            | 68.7    | 80.5    | 83.6    | 82.6        | 104.4   | 104.3   | 103.7   | 104.0   |
| Amortization, total                           | 33.7    | 43.3    | 48.6    | 48.8        | 62.5    | 63.4    | 64.4    | 66.4    |
| Public debt                                   | 21.8    | 19.8    | 25.0    | 28.5        | 35.1    | 36.0    | 38.1    | 38.7    |
| Bilateral                                     | 3.8     | 2.3     | 3.7     | 3.2         | 4.2     | 4.2     | 3.6     | 5.0     |
| <i>Of which : Russian Federation 2/</i>       | 0.0     | 0.0     | 0.0     | 0.0         | 0.0     | 0.0     | 0.0     | 1.0     |
| Multilateral                                  | 18.0    | 17.5    | 20.1    | 21.2        | 23.2    | 24.1    | 26.8    | 26.1    |
| <i>Of which : IMF 3/</i>                      | 4.4     | 7.6     | 9.2     | 8.9         | 8.1     | 6.6     | 5.2     | 2.8     |
| Commercial                                    | 0.0     | 0.0     | 1.3     | 4.1         | 7.7     | 7.7     | 7.7     | 7.7     |
| Private debt                                  | 11.9    | 23.5    | 23.5    | 20.3        | 27.4    | 27.3    | 26.3    | 27.7    |
| Interest payments                             | 35.0    | 37.2    | 35.1    | 33.7        | 41.9    | 40.9    | 39.2    | 37.5    |
| Public debt                                   | 8.4     | 10.3    | 11.0    | 14.2        | 18.8    | 19.9    | 20.5    | 21.1    |
| Bilateral                                     | 0.5     | 0.7     | 1.3     | 1.5         | 1.5     | 1.4     | 1.3     | 1.2     |
| <i>Of which : Russian Federation 2/</i>       | 0.0     | 0.0     | 0.0     | 0.0         | 0.5     | 0.5     | 0.5     | 0.5     |
| Multilateral                                  | 7.9     | 8.9     | 9.0     | 9.6         | 13.9    | 15.7    | 17.0    | 18.3    |
| <i>Of which : IMF 3/</i>                      | 0.3     | 0.5     | 0.7     | 0.3         | 0.3     | 0.4     | 0.4     | 0.4     |
| Commercial                                    | 0.0     | 0.8     | 0.7     | 3.1         | 3.4     | 2.8     | 2.2     | 1.6     |
| Private debt                                  | 26.6    | 26.9    | 24.1    | 19.5        | 23.1    | 21.1    | 18.7    | 16.4    |
| (In percent of GDP)                           |         |         |         |             |         |         |         |         |
| Total debt service 2/                         | 4.7     | 4.6     | 4.8     | 4.6         | 5.5     | 5.0     | 4.6     | 4.3     |
| Total debt stock 2/                           | 104.4   | 83.2    | 83.2    | 97.4        | 93.0    | 91.0    | 93.1    | 95.0    |
| excluding Russian Federation debt             | 104.4   | 83.2    | 83.2    | 85.7        | 82.1    | 80.9    | 83.8    | 86.5    |
| <i>Of which : public debt</i>                 | 84.6    | 67.8    | 69.2    | 84.8        | 82.7    | 79.2    | 75.9    | 73.1    |
| (In percent of revenues)                      |         |         |         |             |         |         |         |         |
| Central government debt service 2/            | 19.4    | 13.1    | 15.1    | 18.3        | 20.5    | 18.9    | 17.9    | 16.7    |
| (In percent of exports of goods and services) |         |         |         |             |         |         |         |         |
| Total debt service 2/                         | 14.1    | 15.3    | 15.5    | 14.6        | 17.0    | 16.0    | 15.2    | 14.5    |
| <i>Of which : public debt 2/</i>              | 6.2     | 5.7     | 6.7     | 7.5         | 8.8     | 8.6     | 8.6     | 8.3     |
| <i>Of which : public debt 2/ 4/</i>           | 6.8     | 6.4     | 7.5     | 8.3         | 9.8     | 9.4     | 9.4     | 9.1     |
| Total debt stock 2/ 5/                        | 336.5   | 293.2   | 281.7   | 319.0       | 309.4   | 308.7   | 321.9   | 335.2   |
| Public debt NPV 5/                            | ...     | ...     | 137.0   | 152.6       | 150.2   | 146.0   | 142.0   | 139.4   |
| Memorandum item:                              |         |         |         |             |         |         |         |         |
| Russian debt stock before                     |         |         |         |             |         |         |         |         |
| debt relief (in millions of SUR)              | 771.7   | 771.7   | 771.7   | ...         | ...     | ...     | ...     | ...     |

Sources: Data provided by the Lao authorities; and Fund staff estimates, and projections.

1/ Debt stock and debt service in convertible currency is calculated on the basis of existing debt, and currently identified disbursements, including prospective disbursements from the Fund, the World Bank, the AsDB, the Exim Bank of China, and debt contracted to finance NT2.

2/ Assuming rescheduling of the Russian debt under Naples terms in 2002.

3/ Including on future disbursements under the current arrangement.

4/ In percent of nonhydroelectric exports plus net receipts from the hydroelectric sector.

5/ Three-year average of exports of goods and services.

Table 10. Lao P.D.R.: Indicators of External Vulnerability, 1999–2002

|   | 1999  | 2000  | Est.<br>2001 | Latest<br>2002 |
|---|-------|-------|--------------|----------------|
| <b>Financial indicators 1/</b>  |       |       |              |                |
| Broad money (M2: annual percentage change)  | 78.4  | 45.7  | 23.1         | 27.3           |
| Foreign currency deposits to broad money (in percent)                                     | 79.5  | 76.0  | 76.8         | 76.8           |
| Credit to other (nonstate) sectors (annual percentage change)                             | 74.2  | 41.3  | 39.7         | ...            |
| Foreign currency loans to credit to the economy (in percent)                              | 83.0  | 80.0  | 81.5         | 80.6           |
| <b>External indicators</b>  |       |       |              |                |
| Exports (annual percentage change, in U.S. dollars)                                       | 1.5   | 2.6   | -0.3         | ...            |
| Imports (annual percentage change, in U.S. dollars)                                       | 0.3   | 2.7   | -0.4         | ...            |
| Current account balance (in percent of GDP, including official transfers)                 | -4.0  | -1.4  | -3.5         | ...            |
| Capital account balance (in millions of U.S. dollars) 2/                                  | 63    | 68    | 60.0         | ...            |
| <i>Of which:</i>  |       |       |              |                |
| Short-term capital (net) 3/   | -47   | 25    | 34           | ...            |
| Gross foreign direct investment (inflows)   | 82    | 31    | 33           | ...            |
| Medium- and long-term loans (net)   | 65    | 63    | 74           | ...            |
| Errors and omissions  | -37   | -51   | -82          | ...            |
| Exchange rate (per U.S. dollar, period average) 4/  | 7,012 | 7,857 | 8,875        | 9,523          |
| (annual percentage change)  | 112.6 | 12.1  | 13.1         | 7.3            |
| Exchange rate (per U.S. dollar, end-of-period) 4/   | 7,600 | 8,218 | 9,490        | 9,910          |
| (annual percentage change)  | 77.8  | 8.1   | 16.6         | 20.6           |
| Real effective exchange rate (annual average, percentage change)                          | 5.0   | 10.8  | 2.1          | 0.7            |
| <b>Reserve indicators 1/</b>  |       |       |              |                |
| Gross official reserves, including gold (in millions of U.S. dollars)                     | 106   | 140   | 134          | 144            |
| (in months of prospective imports of goods and services)                                  | 2.1   | 2.5   | 2.5          | 2.5            |
| Central bank short-term foreign liabilities (in millions of U.S. dollars)                 | 53    | 42    | 41           | 39             |
| Net official international reserves (in millions of U.S. dollars)                         | 53    | 97    | 93           | 104            |
| Gross official reserves to broad money (M2) (in percent)                                  | 52.2  | 51.0  | 49.2         | 47.3           |
| Net foreign assets of commercial banks (in millions of U.S. dollars)                      | 113   | 88    | 59           | 59             |
| <b>Debt indicators</b>  |       |       |              |                |
| Total external debt-to-GDP ratio (in percent) 5/  | 104.4 | 83.2  | 83.2         | ...            |
| Total external public debt (in millions of U.S. dollars) 5/                               | 1,247 | 1,179 | 1,214        | ...            |
| Total external public debt to exports of goods and services (in percent) 5/               | 272.7 | 238.8 | 234.4        | ...            |
| Total external public debt-to-GDP ratio (in percent) 5/                                   | ...   | 67.8  | 69.2         | ...            |
| Total external public debt service to exports of goods and services (in percent) 5/       | 6.2   | 5.7   | 6.7          | ...            |
| <i>Of which:</i> External interest payments to exports of goods and services (in percent) | 1.7   | 2.0   | 2.0          | ...            |

Sources: Data provided by the Lao P.D.R. authorities; and Fund staff estimates.

1/ Money and credit data and official reserves data for 2001 are presented on a fiscal year basis.

2/ Excludes errors and omissions.

3/ Includes net external position of banking system and portfolio investment.

4/ Official mid-rate, which comprises the previous day's average interbank buying and selling rates.

5/ Excluding debt in nonconvertible currencies; also excluding estimate of nonconvertible Russian debt under negotiation.

Table 11. Lao P.D.R.: External Financing Needs and Sources, 1999-2006

(In millions of U.S. dollars)

|   | 1999<br>Est. | 2000<br>Est. | 2001<br>Est. | 2002<br>Proj. | 2003<br>Proj. | 2004<br>Proj. | 2005<br>Proj. | 2006<br>Proj. |
|---|--------------|--------------|--------------|---------------|---------------|---------------|---------------|---------------|
| Gross financing needs                                       | 157          | 222          | 165          | 187           | 231           | 341           | 455           | 468           |
| External current account deficit (excl. official transfers) | 129          | 145          | 122          | 113           | 122           | 231           | 375           | 383           |
| Debt amortization 1/  | 29           | 36           | 39           | 40            | 54            | 57            | 59            | 63            |
| Medium- and long-term debt                                  | 29           | 36           | 39           | 40            | 54            | 57            | 59            | 63            |
| Public sector   | 17           | 12           | 16           | 20            | 27            | 29            | 33            | 35            |
| Corporate private sector                                    | 12           | 24           | 24           | 20            | 27            | 27            | 26            | 28            |
| Short-term debt 2/  | ...          | ...          | ...          | ...           | ...           | ...           | ...           | ...           |
| Gross reserve accumulation (- = increase) 3/                | 6            | -33          | 6            | -26           | -46           | -46           | -16           | -20           |
| IMF repurchase and repayments                               | 4            | 8            | 9            | 9             | 8             | 7             | 5             | 3             |
| Financial Sources   | 157          | 222          | 165          | 167           | 196           | 321           | 455           | 468           |
| Foreign direct investments                                  | 52           | 31           | 33           | 41            | 60            | 93            | 134           | 140           |
| Debt financing from private creditors                       | 30           | 0            | 0            | 0             | 0             | 75            | 169           | 169           |
| Financing from official creditors 4/                        | 164          | 219          | 175          | 161           | 186           | 208           | 224           | 227           |
| Other flows 5/  | -89          | -29          | -43          | -35           | -50           | -55           | -71           | -67           |
| Financing gap 6/  | 0            | 0            | 0            | 20            | 35            | 20            | 0             | 0             |

Sources: Data provided by the Lao P.D.R. authorities; and Fund staff estimates, and projections.

1/ Excluding the IMF.

2/ Original maturity of less than one year. Includes all short-term outflows.

3/ Includes those transactions that are undertaken for the purpose of financing a balance of payments deficit or an increase in reserves.

4/ Includes both grants and loans.

5/ Includes all other net financial flows, and errors and omissions.

6/ Includes prospective IMF disbursements.



**Lao P.D.R.—Fund Relations**  
(As of May 31, 2002)

|      |  |                      |                           |                                      |                                   |
|------|--|----------------------|---------------------------|--------------------------------------|-----------------------------------|
| I.   | <b>Membership Status:</b> Joined 7/05/61; Article XIV  |                      |                           |                                      |                                   |
| II.  | <b>General Resources Account:</b>  | <b>SDR million</b>   | <b>Percent Quota</b>      |                                      |                                   |
|      | Quota  | 52.90                | 100.0                     |                                      |                                   |
|      | Fund holdings of currency  | 52.90                | 100.0                     |                                      |                                   |
| III. | <b>SDR Department:</b>   | <b>SDR million</b>   | <b>Percent Allocation</b> |                                      |                                   |
|      | Net cumulative allocation  | 9.41                 | 100.0                     |                                      |                                   |
|      | Holdings   | 4.84                 | 51.49                     |                                      |                                   |
| IV.  | <b>Outstanding Purchases and Loans:</b>  | <b>SDR million</b>   | <b>Percent Quota</b>      |                                      |                                   |
|      | SAF arrangement  | 0.59                 | 1.11                      |                                      |                                   |
|      | ESAF arrangement   | 31.93                | 60.37                     |                                      |                                   |
| V.   | <b>Financial Arrangements:</b>   |                      |                           |                                      |                                   |
|      | <b>Type</b>  | <b>Approval Date</b> | <b>Expiration Date</b>    | <b>Amount Approved (SDR million)</b> | <b>Amount Drawn (SDR million)</b> |
|      | PRGF   | 4/25/01              | 4/24/04                   | 31.70                                | 9.06                              |
|      | ESAF   | 6/04/93              | 5/07/97                   | 35.19                                | 35.19                             |
|      | SAF  | 9/18/89              | 9/17/92                   | 20.51                                | 20.51                             |
|      | Stand-by   | 8/04/80              | 8/12/81                   | 14.00                                | 14.00                             |
| VI.  | <b>Projected Obligations to Fund</b> (SDR million; based on existing use of resources and present holdings of SDRs): |                      |                           |                                      |                                   |

|                  | <b>Forthcoming</b> |             |             |             |             |
|------------------|--------------------|-------------|-------------|-------------|-------------|
|                  | <b>2002</b>        | <b>2003</b> | <b>2004</b> | <b>2005</b> | <b>2006</b> |
| Principal        | 4.7                | 6.5         | 5.3         | 4.1         | 2.2         |
| Charges/interest | <u>0.2</u>         | <u>0.2</u>  | <u>0.2</u>  | <u>0.2</u>  | <u>0.2</u>  |
| <b>Total</b>     | 4.9                | 6.7         | 5.5         | 4.3         | 2.4         |

## VII. Implementation of HIPC Initiative

The Lao P.D.R. could be eligible for assistance under the HIPC Initiative. A loan-by-loan DSA has been undertaken with the newly available data, which together with the outcome of the negotiations on the debt to the Russian Federation, will be needed to evaluate whether to seek HIPC relief.

## VIII. Safeguards Assessments

Under the Fund's safeguards assessment policy, Bank of the Lao P.D.R. (BOL) is subject to a full safeguards assessment with respect to the PRGF arrangement, which was approved on April 25, 2001 and is scheduled to expire on April 24, 2004. An off-site safeguards assessment of the BOL was completed on December 17, 2001. The assessment concluded that high risks may exist in external audit mechanism, financial reporting framework, internal audit mechanism, system of internal controls and recommended an on-site assessment. The on-site assessment will be undertaken by end-2002, after the implementation of prior requirements by the BOL.

## IX. Exchange Rate

In September 1995, the Lao P.D.R. adopted a managed floating exchange rate system, abolishing the official rate. From October 1997, commercial banks have been encouraged to follow the parallel market closely. On June 24, 2002 the commercial bank exchange rate was kip 9,845 (buying) and kip 9,975 (selling) per U.S. dollar.

## X. Last Article IV Consultation Discussions

The last Article IV consultation discussions were held in Vientiane during October 17-November 1, 2000 and in January 2001. The staff report (EBS/01/53) was discussed by the Executive Board on April 23, 2001. The Lao P.D.R. maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions.

## XI. Technical Assistance (since 1999)

| <b>Department</b> | <b>Purpose</b>  | <b>Date</b>                |
|-------------------|---|----------------------------|
| <b>STA</b>        | - Assist in compilation of balance of payments data.                | 8/99                       |
|                   | - Review and assist in compilation of money and banking statistics. | 2/99                       |
| <b>FAD</b>        | - Missions on tax policy and administration.                        | 1/99, 2/00, 10-11/01, 3/02 |

|                    |   |   |  |
|--------------------|---|---|--|
| <b>FAD (cont.)</b> | - | Expert on tax administration.             | 9/98-12/99, 1-3/00, 5-7/00,<br>9-11/00, 1-2/01, 4-6/01 |
|                    | - | Expert on customs administration.         | 10/98-1/99, 5-6/00, 9-<br>11/00, 1-3/01, 5-6/01        |
|                    | - | Mission on public expenditure management. | 4-5/01   |
| <b>MAE</b>         | - | Expert on bank supervision                | 4-5/02   |

**XII. Resident Representative**

Mr. Eric Sidgwick assumed the post of resident representative in Vientiane on June 26, 2000.

## **Lao P.D.R.: IMF-World Bank Relations<sup>1</sup>**

### **Partnership in Lao P.D.R.'s Development Strategy**

The Government's development objectives place increased emphasis on poverty reduction. The government highlighted the progress made and its strategy going forward in the Interim-PRSP (I-PRSP) which was presented to the Bank and Fund Boards in April 2001. The full PRSP (the Lao P.D.R National Poverty Eradication Program, NPEP) is under preparation.

The IMF will continue to take the lead in assisting Lao P.D.R. to maintain macroeconomic stability within the framework of the three-year Poverty Reduction and Growth Facility (PRGF) approved in April 2001. This includes a strong stabilization program launched to address fiscal and monetary imbalances, and the structural problems that give rise to these imbalances and constrain growth and poverty reduction.

The Bank leads the policy dialogue in the state enterprise, power sector, education and health sector reforms. The Bank and Fund share the lead in the areas of public expenditure management (in which the Fund supports treasury management and budget control issues and the Bank leads in budget transparency, and budget planning and expenditure management, especially of the capital budget) and financial sector reforms (in which the Fund supports bank supervision and assesses reforms from a macroeconomic perspective, and the Bank leads in bank restructuring and NPL resolution). The Bank and the Fund jointly support the government in the preparation of the PRSP.

### **World Bank Group Strategy**

The World Bank Group's operations assist the Government in achieving its overall goals of reducing poverty through improving peoples' welfare and incomes, infrastructure development, and human resource development. Bank programs support the country's economic reform program, and the development of more efficient services across all key sectors of the economy. Key elements of the Bank strategy as outlined in the March 1999 CAS are as follows:

- Stabilize the economy (in close collaboration with the IMF);
- Deepen structural reforms in the financial sector and State-Owned Enterprises (SOEs), improving the regulatory environment for the private sector and other sectors such as agriculture and forestry, and supporting capacity building;

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<sup>1</sup> Prepared by the staff of the World Bank. Contact person: Mr. Zafar Ahmed, Senior Economist, South East Asia and Mongolia Department, East Asia and Pacific Region, phone (202) 473-4699.

- Invest in the social sectors, health and education;
- Invest in rural development and natural resource management – including support for rural and national infrastructure and hydropower development; and,
- Strengthen portfolio management.

The Bank recognizes that deep reforms in financial management are needed to achieve development objectives. This will involve structural changes in three related areas. Weaknesses in budget planning and management are compounded by problems in the SOEs. These threaten the viability of the State-Owned Commercial Banks (SCBs). The resulting NPLs at the SCBs and contingent liabilities of both the SOEs and the SCBs in turn feed back to the budget compromising fiscal stability. The Financial Management Adjustment Credit (FMAC), supported by a Financial Management Capacity Building Credit (FMCBC) is designed to break this destabilizing cycle as the first step in a longer-term process of financial management reform. Firm entrenchment of this reform process along with clear and monitorable performance benchmarks and an established track record of satisfactory performance against such benchmarks, will be necessary for the Bank to consider support for the large Nam Theun II power project which will generate significant public revenues through power export sales. The successful reform of public financial management practices underpinned by FMAC, combined with a clearly articulated strategy for poverty-focused expenditure planning stemming from the PRSP process, will be part of the foundation for continued Bank support.

As of May 31, 2002, IDA credits totaling about \$617.7 million equivalent had been approved for Lao P.D.R including adjustment support 21 percent; rural development 23 percent; transport 24 percent; energy 19 percent; telecommunications 5 percent; education and health 7 percent; and industry 2 percent.

IDA: Commitments and Disbursements to the Lao P.D.R., 1977–2002  
(In millions of U.S. dollars; as of April 30, 2002)

| Fiscal Year (to June 30) | Committed | Disbursed | Repayments |
|--------------------------|-----------|-----------|------------|
| 1977-93                  | 335.2     | 180.7     | 1.5        |
| 1994                     | 48.4      | 45.1      | 0.6        |
| 1995                     | 19.2      | 31.4      | 0.6        |
| 1996                     | 60.7      | 28.6      | 0.6        |
| 1997                     | 48.0      | 65.2      | 0.6        |
| 1998                     | 34.7      | 26.5      | 1.3        |
| 1999                     | 29.8      | 27.8      | 1.5        |
| 2000                     | 0.0       | 18.1      | 3.0        |
| 2001                     | 41.7      | 29.9      | 3.6        |
| 2002                     | 0.0       | 22.8      | 4.6        |
| Total                    | 617.7     | 476.4     | 18.0       |

Source: World Bank.

As agreed during the CAS consultations and as requested by the Government, the Bank intends to place increased emphasis on human resource development in its new credits in addition to its already broad role in basic infrastructure and productive sectors. The International Finance Corporation has also been providing support to the private sector, and further investments are being developed. The World Bank Institute continues to provide training in support of capacity building initiatives. The Bank's analytical and advisory services and economic and sector work are currently focusing on improving the analysis and monitoring of poverty, and a joint public expenditure review is being completed.

Progress is also being registered in the challenging area of environmentally sustainable natural resource management. The recent Bank logging survey mission in the NT2 project area found that logging is being more effectively controlled, the government is adopting measures needed to further village forestry reforms, and concrete steps (such as the establishment of the Nam Theun Watershed Management and Protection Authority) are being taken to promote conservation and sustainable environmental management.

### **Bank -Fund Collaboration in Specific Areas**

#### ***Financial Sector***

The Bank has worked closely with the IMF, AsDB, and BOL to craft the conditions of FMAC that complement and reinforce the elements of the PRGF that relate to financial sector strengthening. Reflecting the Bank view that SCBs must be put on a sound footing, the conditionality under FMAC includes detailed provisions on the restructuring of SCBs, NPL recovery, audit, reporting, and implementation of rural and micro finance plans. The PRGF focuses on the Bank of Lao (BOL), with improvements to bank regulation and supervision environment and macroeconomically relevant aspects of SCB restructuring.

#### ***State-Owned Enterprises***

Since the SCBs are major creditors for the SOEs, the Bank is taking the lead in policy dialogue on SOE reforms. Accordingly FMAC conditionality includes provisions for restraining the creation of new SOEs, enhancing SOE management, financial and operational monitoring, and adoption of restructuring plans for loss-making SOEs. These conditions will relieve pressures on the SCBs. They complement the Fund policies on SCB lending and serve to curb the growth of contingent liabilities that pose a threat to macroeconomic stability.

The World Bank is also taking the lead in supporting detailed tariff studies for public utilities. An understanding was recently reached with the government on electricity tariffs and a schedule of increases intended to achieve full cost recovery is being implemented. These steps will support macroeconomic stability and establish a sustainable financial basis for the operation of SOEs providing these services.

***Public Sector Management***

The World Bank is just completing a Public Expenditure, Financial Management and Procurement Review that has been conducted jointly with the IMF, the AsDB and the government. Recommendations on public sector management stemming from the Review have been integrated into FMAC and the FMCBC. In particular, FMAC conditions included the requirement that the budget be published with full sector detail (necessary to gauge progress on PRSP targets for social sector spending), that a Procurement Monitoring Office be established in the Ministry of Finance, and that improvements be introduced for the estimation of recurrent costs of investment projects in the budget. These complement several of the PRGF structural benchmarks and performance criteria including those on budget classification and reporting.

### Lao P.D.R.—Relations with the Asian Development Bank<sup>1</sup>

The Asian Development Bank's (AsDB) has extended development assistance to Lao P.D.R. since 1970. In the 1970s and 1980s, AsDB assistance was focused mainly on economic growth projects involving infrastructure development in the transport and energy sectors. Financial sector development has also been assisted by AsDB since the latter part of the 1980s. Since the early 1990s, the emphasis of AsDB assistance to Lao P.D.R. has been broadened to include rural development, social development and environment. Since the late 1990s, the AsDB has focused its activities on poverty reduction.

AsDB, together with the Government, has formulated its new Country Strategy and Program (CSP) in 2001 to guide its future operations in Lao P.D.R. for next five years in considerable consultations with stakeholders. The theme of AsDB's interventions in Lao P.D.R. will be poverty reduction by broadening community participation and opportunities. The core strategies for poverty reduction are: sustainable economic growth, inclusive social development, and good governance. The main strategic focus will be on four operational priorities including rural development and market linkages, human resource development, sustainable environmental management, and private sector development and regional integration. A third Financial Sector Program Loan, and a related capacity building credit are currently being negotiated.

Lao P.D.R. is a key actor in the Greater Mekong Sub-Region (GMS) program as a land-link. The AsDB will aim to explore various options to maximize the benefits to Lao P.D.R. from subregional cooperation. To enhance the development impact of projects and ensure their close monitoring, AsDB's interventions will focus primarily on the poor northern region provinces and along the GMS: East-West corridor. To help achieve the Government's goal of poverty reduction and sustainable development, a Poverty Reduction Partnership Agreement was signed between the Government and AsDB in September 2001. The Partnership Agreement includes a number of detailed monitoring indicators.

Since 1989, the AsDB has approved 36 loans (including five structural and sectoral adjustment loans) for a total of \$834.90 million, of which \$567.75 million has been disbursed to Lao P.D.R.. A total of 19 of these loans are still active. The AsDB also approved 151 technical assistance projects since 1989, for a total of \$76.5 million. Of this, \$30.8 million were from AsDB, \$33.1 million from the Japan Special Fund, and \$12.6 million from other sources.

Table 1. Lao P.D.R.: AsDB Commitments and Disbursements, 1997-2001  
(In million of US dollars)

|               | 1997  | 1998 | 1999 | 2000 | 2001 |
|---------------|-------|------|------|------|------|
| Commitments   | 103.0 | 20.0 | 57.6 | 60.5 | 65.0 |
| Disbursements | 87.0  | 66.0 | 46.8 | 51.0 | 39.8 |

Source: Data provided by the Asian Development Bank.

<sup>1</sup> Prepared by the Asian Development Bank.



### **Lao P.D.R.—Statistical Issues**

The overall coverage and quality of economic statistics in Lao P.D.R. is subject to significant shortcomings and needs to be improved, possibly through additional technical assistance, to enable the production of timely and accurate data for policy analysis and program monitoring. Economic and financial data are published in periodic reports by the Bank of the Lao P.D.R. (BOL) and by the National Statistical Center (NSC). A page for the Lao P.D.R. was introduced in the April 1996 issue of *International Financial Statistics (IFS)*.

#### **National accounts**

National accounts data are only available on an annual basis. These production-based estimates rely heavily on line ministry reports on the achievement of annual production plans and thus could have an upward bias. The CPI acts as a proxy for the majority of sectoral deflators. Fund missions have been encouraging the authorities to address these weaknesses. The Swedish government has been providing technical assistance on national accounts, including compilation of expenditure-based GDP estimates. The recently completed household expenditure survey is an important building block for this. The government is planning to request Fund technical assistance to look at specific compilation issues. A multisector statistics mission is planned for October 2002.

#### **Prices**

The NSC reports a monthly CPI with minimal lags. The latest CPI was introduced in January 2000 (rebased to December 1999) using data from the 1997/98 household expenditure survey. It comprises nine product categories covering major urban centers, including Vientiane.

#### **Government finance**

Government finance statistics are weak and there is scope to significantly improve their accuracy, coverage and transparency. The Budget Department produces monthly and quarterly revenue and expenditure summaries. Expenditure data by central government ministry and province, and by economic type are available, but not budget expenditure by function. In addition, data on bank and nonbank financing of the budget, including treasury bill operations, also need to be improved to provide consistency with the monetary accounts. Annual budget and outturn data are not produced according to GFS standards which complicate fiscal analysis. In early 2001 the authorities published annual tables for the 1999/00 outturn and the 2000/01 budget, and in March 2002 they published the 2001/02 budget by central government ministry and province and the 2000/01 outturn. Publication of the 2001/02 budget data by sector has allowed the identification of key spending categories.

Budget execution, reporting and cash management processes and system require significant upgrading. A FAD diagnostic mission has assessed shortcomings and proposed a remedial plan of actions in the context of the 2001 Public Expenditure Review (PER). Greater decentralization in 2000/01 further complicated the timely reporting of fiscal data from lower government levels, as monitoring systems are weak and skilled staff limited. This continues

to hamper the accurate reporting of such issues as timber related royalty payments to the central budget.

Owing to the lack of reliable fiscal data, no government finance data are presented in *IFS* country page or *Government Finance Statistics Yearbook*. The government is planning to request technical assistance from the Fund on the GFS framework, as a prelude to moving to a more international standard system of fiscal accounts.

### **Monetary accounts**

The BOL regularly reports its balance sheet (with a 2-week lag) and commercial bank balance sheet (with a 4-week lag) to APD for program monitoring purposes, and to STA for publication in *IFS* with a lag of between one to two months. Although the authorities have made several improvements in compiling monetary statistics in recent years, the reporting by some banks, especially new branches of foreign banks, is still weak. A new chart of accounts for the BOL and commercial banks was introduced in October 1998. In February 1999, a money and banking statistics mission provided technical assistance in compilation of monetary statistics in accordance with the Fund's methodology. The mission reviewed the new chart of accounts and found them sufficiently detailed to meet internationally accepted standards for the compilation of monetary statistics. However, it suggested ways to further improve the presentation of the chart of accounts.

### **Balance of payments**

Data on foreign reserves are reported on a weekly basis and also derived from the monetary survey, at the prevailing kip per U.S. dollar end-month exchange rate.

Balance of payments statistics need significant improvements in the frequency and coverage in the following areas: (1) customs trade data, (2) the commodity composition of external trade, (3) the recording of income, (4) actual foreign direct investment flows, (5) the use of commercial bank data on foreign transfers and other transactions, and; (6) the reconciliation of fiscal and balance of payments data on external aid (loans and grants). In addition, data quality and monitoring of external debt, especially of state enterprises, is weak. A new debt monitoring unit was established in 2001 to remedy this.

An STA mission in 1999 found that data coverage and valuation problems on traded goods arose from weaknesses in customs controls, due to staffing and computing constraints and delays in reporting from provincial customs points. A reorganization of the Customs department, including the introduction of new customs procedures, the Customs 2000 system and equipment, is being implemented (with FAD technical assistance) which started to produce more accurate data in October 2000. However, for a range of technical reasons, customs has not yet produced data on a regular basis.

In order to produce accurate balance of payments updates on a regular basis, there is an acute need to improve the coordination between the agencies involved in BOP compilation, viz., the Customs and External Financial Relations Departments of the Ministry of Finance, the Office for the Management of Foreign Investment, and the BOL.

Lao P.D.R.: Core Statistical Indicators  
(As at June 26, 2002)

|  | Exchange rates | International reserves | Reserve/base money | Central bank balance sheet | Broad money | Interest Rates | Consumer price index | Exports/imports | Current Account Balance | Overall government balance | GDP/GNP | External debt |
|--|----------------|------------------------|--------------------|----------------------------|-------------|----------------|----------------------|-----------------|-------------------------|----------------------------|---------|---------------|
| Date of latest Observation             | 6/25/02        | 05/02                  | 05/02              | 05/02                      | 05/02       | 05/02          | 05/02                | Q4/01           | Q4/01                   | 05/02                      | 2001    | Q4/01         |
| Date received                          | 6/26/02        | 6/13/02                | 6/13/02            | 6/25/02                    | 6/13/02     | 3/7/02         | 6/4/02               | 5/1/02          | 05/02                   | 6/20/02                    | 04/02   | 05/02         |
| Frequency of data                      | D              | M <sup>1/</sup>        | M                  | M                          | M           | M              | M                    | Q               | Q                       | M <sup>2/</sup>            | A       | Q             |
| Frequency of reporting                 | D              | M <sup>1/</sup>        | M                  | M                          | M           | M              | M                    | Q               | Q                       | M <sup>2/</sup>            | A       | Q             |
| Source of Data <sup>3/</sup>           | A              | A                      | A                  | A                          | A           | A              | A                    | A               | A                       | B                          | C       | A             |
| Mode of reporting <sup>4/</sup>        | E              | E                      | E                  | E                          | E           | C              | E                    | C               | C                       | C                          | C       | C             |
| Confidentiality <sup>5/</sup>          | C              | C                      | C                  | C                          | C           | C              | C                    | C               | C                       | C                          | C       | C             |
| Frequency of Publication <sup>5/</sup> | O              | O                      | O                  | O                          | O           | O              | O                    | O               | O                       | O                          | O       | O             |

<sup>1/</sup> International reserves are available on a bi-weekly basis.

<sup>2/</sup> Monthly budget revenue and expenditure reported with 3-week lag, but budget financing reported on an irregular basis.

<sup>3/</sup> Source A: Central Bank, B: Ministry of Finance, C: National Statistical Center.

<sup>4/</sup> Data are directly reported by the authorities via the resident representative's office (E –electronic , C- facsimile).

<sup>5/</sup> All data are eventually published in periodic reports by the BOL and the National Statistical Center. No explicit embargoes apply. These data (except fiscal data) have also been published in International Financial Statistics (IFS) since the April 1996 issue (C- unrestricted use, O – other irregular basis).

### **Lao P.D.R.—Rescheduling Scenarios for Lao P.D.R.’s Debt to the Russian Federation**

1. **A key issue in the assessment of the outlook for Lao P.D.R.’s external debt sustainability is the impact of the debt to the Russian Federation.** Since Lao P.D.R. has never rescheduled debt in the framework of the Paris Club, discussions with the Russian Federation have taken place bilaterally. Given the presumably large face value of the Russian debt, the outcome of these discussions will have an important bearing on Lao P.D.R.’s future debt profile. With a view to support the assessment of the likely impact, this annex presents three scenarios for debt rescheduling, assuming a rescheduling agreement outside of the Paris Club.

2. **One important element of uncertainty is the value of the outstanding stock and the terms of the loans.** These issues have been raised but not resolved during the successive rounds of discussions:

- In 1991, the Russian authorities agreed to consolidate and refinance the bulk of the debt, and to postpone agreement on the terms of this rescheduling until 2000.
- In April 2000, negotiations continued in Vientiane, in particular on the outstanding stock. No formal agreement was reached on the debt service.
- In September 2001, a Laotian delegation visited Moscow, but an agreement on the stock and terms of the rescheduling could not be reached. It was agreed then that a Russian delegation would visit Vientiane in 2002.
- In early 2002, the government of Lao P.D.R. reiterated its invitation, and the next round of discussions is expected to be held shortly in Vientiane.

**In this context, the analysis below should be understood as a preliminary assessment of debt sustainability, as it is based on provisional assumptions about both the stock and the terms of the Russian loans, which need to be verified.** In particular, it is possible that the grant component of Russian financial assistance is underestimated, and therefore the burden of external debt may be overestimated.<sup>1</sup>

3. **Preliminary indications are that the Russian debt consists of SUR 772 million and US\$0.4 million,** and results from interest-free loans contracted during 1975–1989. These loans arose mainly from the large value of Soviet net exports to Lao P.D.R. and project assistance, with valuation on the basis of COMECON pricing. The working assumptions are as follows:

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<sup>1</sup> Also, the staff did not have access to the loan documents for other creditors; therefore, this analysis is based on loan by loan information provided by the authorities.

- The bulk of the debt, SUR 735 million, was rescheduled in 1991 with zero interest. Repayment is expected to start in 2005.
- The rest of the ruble-denominated debt, SUR 37 million, dates from 1986, and was to have been paid off during the 1990s by the supply of traditional Lao exports. Because of difficulty in assigning a value to these items in SU rubles, this repayment has not taken place. The outstanding amount is considered in arrears.
- The small amount of dollar-denominated debt, US\$0.4 million, resulted from the 1991 settlement of cross debts between the Russian Federation and Lao P.D.R., and is also assumed to be in arrears.

#### **Public external debt in convertible currency DSA results**

4. Under assumptions of new borrowing under highly concessional terms and conservative growth assumptions,<sup>2</sup> the debt service in convertible currency would decline progressively back from 8.7 percent of exports in 2003 to 6.7 percent in 2019. With the projected revenue efforts, the debt service to revenue ratio for convertible currency debt would also decline from 20.3 percent in 2003 to 12.5 percent in 2019. The Nam Theun 2 (NT2) hydroelectric project is excluded (in terms of the effect on exports and fiscal revenues) because investors are still awaiting the World Bank's decision to guaranty this project. (For more details, see the Selected Issues paper)

#### **Scenarios for debt rescheduling of the Russian debt**

5. The scenarios are based on a bilateral agreement with the Russian Federation on the rescheduling of the debt as of end-2001. The entire stock of debt, including arrears and future maturities, is assumed to be rescheduled under the same terms.

#### ***Scenario A (Baseline)***

6. *Assumes an exchange rate of SUR 0.6 per dollar, which is the official U.S.S.R. Gosbank ruble exchange rate, plus an upfront discount of 70 percent in nominal terms, consistent with the Memorandum of Understanding of September 1997 on Russia's participation as a creditor in the Paris Club. The stock of arrears and the value of each future obligation for the ruble-denominated debt are reduced by 70 percent, with the current repayment profile (over 2005–25) and zero interest rate maintained.*

7. Under this scenario, the value of the Russian debt would amount to US\$386 million and the annual debt service to the Russian Federation, US\$17.5 million, would be equivalent

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<sup>2</sup> New borrowing will be limited to loans with an average grant element of 50 percent, the ratio of disbursements to GDP is projected to decline, and exports, excluding Nam Theun 2 electricity exports, will grow by 6 percent a year.

to 2 percent of exports in 2005-2015. The public debt service burden would peak in 2005, at the end of the grace period on the Russian debt, at 11 percent of exports and 23 percent of fiscal revenue (Figure 1). The end-2001 NPV of public debt, at 177 percent of export (three-year average), would be above the HIPC initiative threshold. The NPV of debt to the Russian Federation alone, at US\$209 million, would account for 40 percent of exports.

***Scenario B (Naples Terms)***

8. *Assumes a stock-of-debt operation under the debt-service-reduction (DSR) option, with Naples terms implying a 67 percent reduction in NPV terms. The arrears and future maturities are rescheduled with 33 years maturity, 3 years grace, at an interest rate of 0.2 percent.*<sup>3</sup>

9. Under this scenario, the end-2001 NPV to export ratio would decline to 150 percent of exports (three-year average) and the NPV to the Russian Federation to 14 percent of exports. The debt service to revenue ratio would be reduced to 18 percent in 2005.

***Scenario C (85 percent NPV reduction)***

10. *Assumes a rescheduling with an 85 percent NPV reduction, with 23 years maturity, 6 years grace, and a commercial interest rate.*

11. Under this scenario, the 2001 NPV would decline further to 143 percent of exports, and the NPV of the Russian debt to 6 percent of exports. The debt service would increase marginally until 2006, then be reduced further relative to Scenario B.

**Summary**

12. In sum, Scenario A (baseline) indicates that the NPV to export ratio would remain above the HIPC initiative cut-off point. Debt rescheduling under Naples terms by the Russian Federation (Scenario B) would reduce the NPV of debt below the HIPC initiative cut-off point. Moreover, it would reduce the debt service by more than 2 percentage points of exports (excluding NT2 exports), which would greatly contribute to improve debt sustainability. Finally, rescheduling with an 85 percent NPV reduction (Scenario C) would reduce the debt further, while the annual debt service would increase slightly in initial years.

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<sup>3</sup> The terms of this scenario are described in *Official Financing for Developing Countries*, World Economic and Financial Survey, 2001, p.34.

Table 1. Lao P.D.R.: Debt Sustainability Analysis and the Russian Debt, 2001-19 1/

(In million of U.S. dollars)

|   | 2001  | 2001 | 2002 | 2003   | 2004 | 2005 | 2006               | 2007 | 2008 | 2009 | 2010 | 2015  | 2019  |
|---|---|------|------|--|------|------|--------------------|------|------|------|------|-------|-------|
|   | NPV of debt                                 |      |      |  |      |      | Total debt service |      |      |      |      |       |       |
| Total, with 70% upfront discount                              | 918.1                                       | 36.0 | 42.7 | 53.4   | 55.4 | 75.6 | 75.8               | 74.7 | 77.7 | 81.8 | 86.2 | 105.4 | 120.0 |
| <i>Of which</i> Russian debt                                  | 209.0                                       | ...  | 0.0  | 0.0  | 0.0  | 17.5 | 17.5               | 17.5 | 17.5 | 17.5 | 17.5 | 17.5  | 17.5  |
| Total, with Naples terms DSR option 2/                        | 778.7                                       | 36.0 | 43.2 | 53.9   | 55.8 | 59.6 | 59.9               | 58.9 | 62.1 | 66.4 | 71.0 | 91.4  | 107.7 |
| <i>Of which</i> Russian debt                                  | 69.6  | ...  | 0.5  | 0.5  | 0.5  | 1.5  | 1.6                | 1.7  | 1.9  | 2.1  | 2.3  | 3.6   | 5.2   |
| Total, rescheduling with 85% NPV reduction                    | 740.4                                       | 36.0 | 44.3 | 55.1   | 57.0 | 59.7 | 59.9               | 58.8 | 61.9 | 66.1 | 70.6 | 90.5  | 106.0 |
| <i>Of which</i> Russian debt                                  | 31.3  | ...  | 1.6  | 1.6  | 1.6  | 1.6  | 1.6                | 1.6  | 1.7  | 1.8  | 1.9  | 2.7   | 3.5   |
|   | Ratio to three-year average export          |      |      | Ratio to current year export (goods and services, excluding NT2) |      |      |                    |      |      |      |      |       |       |
| Total, with 70% upfront discount                              | 177.3                                       | 6.7  | 7.5  | 8.7  | 8.5  | 11.1 | 10.6               | 9.8  | 9.7  | 9.6  | 9.6  | 8.8   | 7.9   |
| <i>Of which</i> Russian debt                                  | 40.4  | ...  | 0.0  | 0.0  | 0.0  | 2.6  | 2.4                | 2.3  | 2.2  | 2.1  | 1.9  | 1.5   | 1.2   |
| Total, with Naples terms DSR option 2/                        | 150.4                                       | 6.7  | 7.6  | 8.8  | 8.6  | 8.7  | 8.3                | 7.8  | 7.7  | 7.8  | 7.9  | 7.6   | 7.1   |
| <i>Of which</i> Russian debt                                  | 13.5  | ...  | 0.1  | 0.1  | 0.1  | 0.2  | 0.2                | 0.2  | 0.2  | 0.2  | 0.3  | 0.3   | 0.3   |
| Total, rescheduling with 85% NPV reduction                    | 143.0                                       | 6.7  | 7.8  | 9.0  | 8.8  | 8.8  | 8.4                | 7.7  | 7.7  | 7.8  | 7.8  | 7.5   | 7.0   |
| <i>Of which</i> Russian debt                                  | 6.1   | ...  | 0.3  | 0.3  | 0.2  | 0.2  | 0.2                | 0.2  | 0.2  | 0.2  | 0.2  | 0.2   | 0.2   |
|   | Ratio to fiscal revenue ratio (fiscal year) |      |      |  |      |      |                    |      |      |      |      |       |       |
| Total, with 70% upfront discount                              | 385.1                                       | 15.1 | 18.3 | 20.3   | 18.8 | 23.1 | 21.1               | 19.4 | 18.9 | 18.6 | 18.3 | 16.2  | 14.6  |
| <i>Of which</i> Russian debt                                  | 87.7  | ...  | 0.0  | 0.0  | 0.0  | 5.3  | 4.9                | 4.6  | 4.3  | 4.0  | 3.7  | 2.7   | 2.1   |
| Total, with Naples terms DSR option 2/                        | 326.7                                       | 15.1 | 18.5 | 20.5   | 18.9 | 18.2 | 16.7               | 15.3 | 15.1 | 15.1 | 15.0 | 14.1  | 13.1  |
| <i>Of which</i> Russian debt                                  | 29.2  | ...  | 0.2  | 0.2  | 0.2  | 0.4  | 0.4                | 0.5  | 0.5  | 0.5  | 0.5  | 0.6   | 0.6   |
| Total, rescheduling with 85% NPV reduction                    | 310.6                                       | 15.1 | 19.0 | 20.9   | 19.3 | 18.2 | 16.7               | 15.3 | 15.0 | 15.0 | 15.0 | 13.9  | 12.9  |
| <i>Of which</i> Russian debt                                  | 13.1  | ...  | 0.7  | 0.6  | 0.5  | 0.5  | 0.5                | 0.4  | 0.4  | 0.4  | 0.4  | 0.4   | 0.4   |
| Memorandum items:   | In U.S. dollar, unless specified otherwise  |      |      |  |      |      |                    |      |      |      |      |       |       |
| Exports of goods and services, excluding NT2                  | ...   | 539  | 567  | 614  | 651  | 681  | 718                | 759  | 803  | 850  | 899  | 1,199 | 1,520 |
| Three year average  | ...   | 518  | 544  | 573  | 611  | 649  | 683                | 719  | 760  | 804  | 851  | 1,133 | 1,434 |
| Exports of goods and services, excl. hydroelectric exports 3/ | ...   | 481  | 514  | 552  | 592  | 623  | 660                | 701  | 745  | 792  | 845  | 1,157 | 1,479 |
| Three year average  | ...   | 466  | 488  | 516  | 552  | 589  | 625                | 661  | 702  | 746  | 794  | 1,089 | 1,393 |
| Government revenue  | ...   | 238  | 233  | 263  | 295  | 327  | 359                | 384  | 412  | 441  | 472  | 650   | 821   |
| Debt service, excluding Russian debt                          | 709.1                                       | 36.0 | 42.7 | 53.4   | 55.4 | 58.1 | 58.3               | 57.2 | 60.2 | 64.3 | 68.7 | 87.9  | 102.5 |
| In percent of current export                                  | 137.0                                       | 6.7  | 7.5  | 8.7  | 8.5  | 8.5  | 8.1                | 7.5  | 7.5  | 7.6  | 7.6  | 7.3   | 6.7   |
| In percent of fiscal revenue                                  | 297.5                                       | 15.1 | 18.3 | 20.3   | 18.8 | 17.7 | 16.2               | 14.9 | 14.6 | 14.6 | 14.6 | 13.5  | 12.5  |
| Debt service in percent of exports of goods and services 3/   | 197.2                                       | 7.5  | 8.3  | 9.7  | 9.4  | 12.1 | 11.5               | 10.7 | 10.4 | 10.3 | 10.2 | 9.1   | 8.1   |
| After rescheduling with Naples terms 3/                       | 167.3                                       | 7.5  | 8.4  | 9.8  | 9.4  | 9.6  | 9.1                | 8.4  | 8.3  | 8.4  | 8.4  | 7.9   | 7.3   |
| After rescheduling with 85% NPV reduction 3/                  | 159.0                                       | 7.5  | 8.6  | 10.0   | 9.6  | 9.6  | 9.1                | 8.4  | 8.3  | 8.3  | 8.3  | 7.8   | 7.2   |
| Excluding the Russian debt 3/                                 | 152.3                                       | 7.5  | 8.3  | 9.7  | 9.4  | 9.3  | 8.8                | 8.2  | 8.1  | 8.1  | 8.1  | 7.6   | 6.9   |

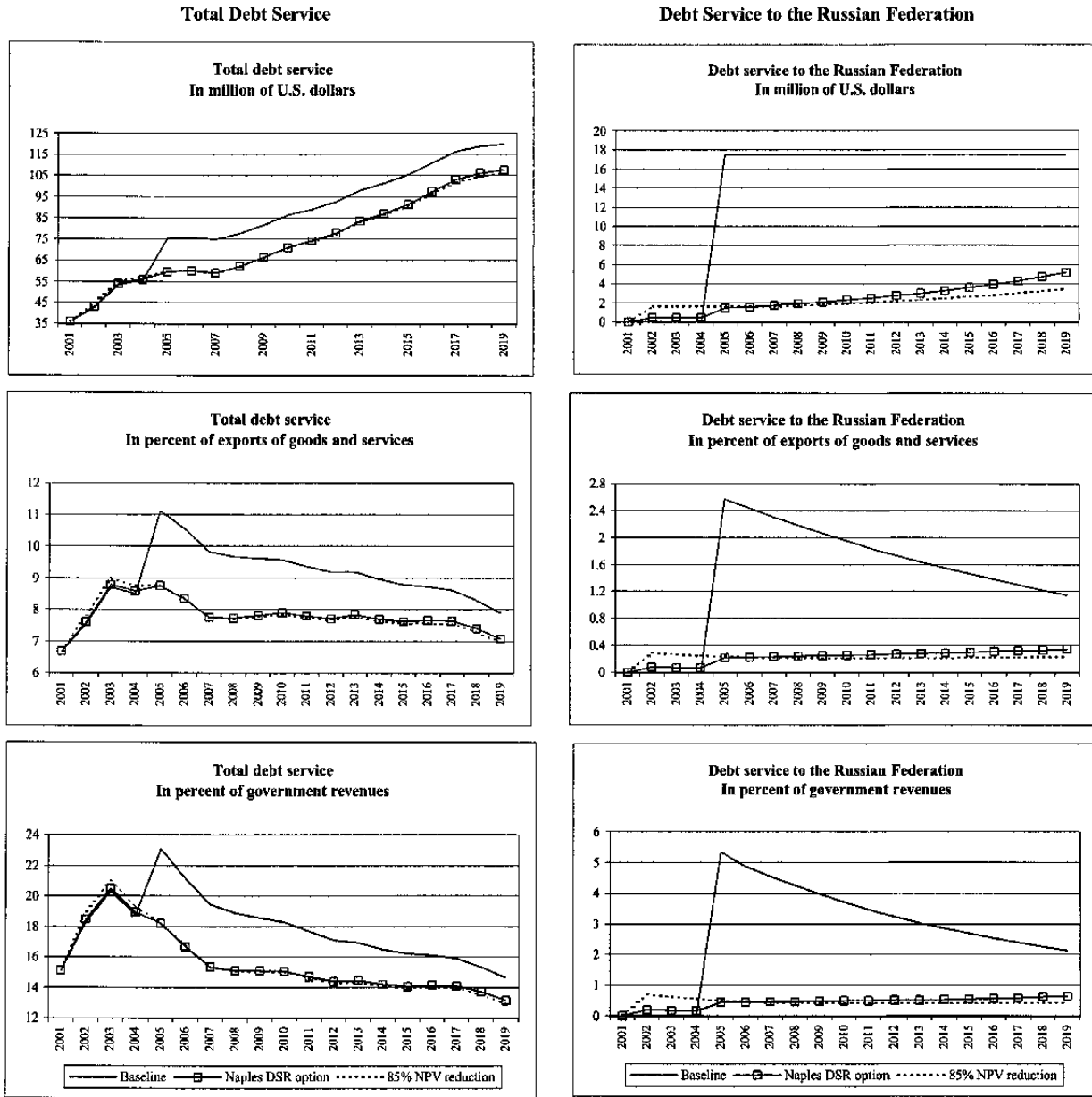
Sources: Data provided by the Lao authorities; and Fund staff estimates, and projections.

1/ Excluding private borrowing.

2/ Assuming a stock-of-debt operation.

3/ Nonhydroelectric exports plus net receipts from the hydroelectric sector.

Figure 1. Lao P.D.R.: Debt Service Under Alternative Scenarios





### Lao P.D.R.—Poverty Profile <sup>1</sup>

Despite substantial efforts over several decades aimed at promoting sustained economic growth and alleviating poverty, the Lao P.D.R. remains one of the poorest countries in the world. With 1999 GDP capita estimated at \$280, Lao P.D.R. ranked 184 among world economies, as indicated in the *2000/2001 World Development Report*. In addition, Lao P.D.R.'s key social indicators lag behind other low-income countries, as evidenced by the UNDP's *Human Development Index (HDI)*<sup>2</sup> and in Annex VII. Despite some limitations in the data available, the main dimensions of poverty in the Lao P.D.R. are as follows:

#### 1. Main Sources of Information on Poverty

- **Two expenditure and consumption surveys** in 1992/93 and 1997/98, and several studies<sup>3</sup> have shed light on the multiple dimensions of poverty in the Lao P.D.R. A new household survey (LECS III, 2002/03) is under preparation. Four main studies provide poverty analysis in the Lao P.D.R.<sup>3</sup> Social indicators are mainly derived from the National Health Survey and Reproductive Health Survey undertaken during 1999-2000.
- **A poverty line** has been calculated for each region as the sum of the regional food and nonfood poverty lines. The food poverty line is based on the calorie requirements of individual families. The calorie norm estimated for North East Thailand was used as a proxy for the Lao P.D.R. The average daily calorie requirement per person is 1,983 kcal, of which 2,009 kcal and 1,976 kcal in urban and rural areas, respectively. Nonfood requirements approximate 20 percent of the food poverty line.

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<sup>1</sup> As derived from the Public Expenditure Review (PER) report (2002).

<sup>2</sup> The *Human Development Index (HDI)* is based on the following indicators: (i) life expectancy at birth; (ii) educational attainment, as measured by the weighted average of adult literacy and school enrolment ratios; and (iii) real GDP per capita in U.S. dollars. Lao P.D.R.'s HDI ranks 131 among 162 countries. Among 12 Asian countries covered by the HDI exercise, only Bangladesh ranks lower.

<sup>3</sup> These include: the Participatory Poverty Assessment (PPA), the World Food Program (WFP) Mapping and Vulnerability Analysis, the Consensus Paper on Poverty Measurement and Analysis, and the Participatory Poverty and Evaluation Project.

<sup>4</sup> "The *Analysis of Poverty in Lao P.D.R.*," SCB, Alm StenFlo, 1999; "*Poverty in Lao P.D.R., 1992/93-1997/98*," Gaurav Datt, World Bank; "*Poverty in Lao P.D.R.*," N. Kakwani, AsDB, 2000; and "*Lao P.D.R.—Interim Poverty Reduction Strategy Paper*," EBD/01/37, April 9, 2001.

2. **Scope and Depth of Poverty**

- **Despite a continued decline, poverty is widespread, especially in rural areas.** Overall poverty incidence declined from 46 to 40 percent during 1992/98. Rural poverty rates are about twice those in urban areas; the rural poor account for 90 percent of the poor. Poverty incidence varies significantly across regions and poverty reduction has also varied across regions (see table below). The north is the poorest region, with 53 percent percent of the population below the poverty line, while poverty incidence in the southern and central regions is lowest (38 and 35 percent, respectively). Poverty incidence in the Vientiane Municipality area (14 percent) is the lowest in the country.

**Lao P.D.R.: Poverty Incidence by Region, 1992/93-1997/98**

(Percent of Poor)

| Regions           | Rural Areas |             |             | Urban Areas |             |             | Total       |             |             |
|-------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
|                   | 1992/93     | 1997/98     | Change      | 1992/93     | 1997/98     | Change      | 1992/93     | 1997/98     | Change      |
| Vientiane         | 52.9        | 11.1        | -41.8       | 26.9        | 14.9        | -12.0       | 33.6        | 13.5        | -20.1       |
| North             | 55.5        | 48.6        | -6.9        | 32.7        | 34.8        | -21.0       | 51.6        | 47.3        | -4.3        |
| Central           | 48.5        | 41.5        | -7.0        | 26.8        | 24.3        | -2.5        | 45.0        | 39.4        | -5.6        |
| South             | 51.9        | 41.6        | -10.3       | 13.3        | 22.9        | +9.6        | 45.7        | 39.8        | -5.9        |
| <b>Lao P.D.R.</b> | <b>51.8</b> | <b>42.5</b> | <b>-9.3</b> | <b>26.5</b> | <b>22.1</b> | <b>-4.4</b> | <b>46.0</b> | <b>39.1</b> | <b>-6.9</b> |

- **Income inequalities have widened between 1992/93 and 1997/98.** The Gini coefficient increased from 28.6 in 1992/93 to 35.7 percent in 1997/98. This suggests that income inequality has increased over the period, although remaining lower than in other countries of the region. This implies that during the period the poor have proportionately received less benefit from economic growth than the highest income groups.

3. **Main Dimensions of Poverty**

Poverty in the Lao P.D.R. is closely related to the following characteristics:

- **Dependency on swidden agriculture and forest products** as well as the ethnic minority status.

- **Minimal interest in education**, owing to primary concern for securing rice and other necessities.
- **Limited or nonexistent basic services** (i.e., health, potable water, electricity, roads). The poor generally live in areas where roads, electricity networks, and piped water or protected wells are scarce or remote.
- **Low life expectancy**, high infant and maternal mortality rates, and malnutrition.
- **Women are generally more affected by poverty**, due to disparities in labor burden. In addition, gender inequalities are compounded by the lack of adequate reproductive health services and access to education, paid employment, and land ownership;
- **High population growth rate** (2.6 percent annually) compared to other developing countries in the region. Among ASEAN countries, only Cambodia has a comparable rate.
- **High fertility and mortality rates**. The fertility rate of 5.4 live births per woman is significantly higher than any other ASEAN country, except Cambodia. High fertility rates have detrimental health and nutrition effects on mothers and their infants.
- **The workforce is faced with high unemployment and underemployment**, high average hours worked and low incomes for the employed population.

#### 4. **Main Findings of the Participatory Poverty Assessment (PPA)**

The 2000/01 PAA has highlighted that:

- **The primary determinant of poverty is still the degree of rice sufficiency.**
- **Secondary determinants of poverty** include: (i) livestock diseases; (ii) lack of arable land; (iii) poor health; (iv) lack of access to cash; (v) recurring natural disasters (e.g., flooding and drought); and (vi) widespread unexploded ordnance (UXO) contamination.
- **The main bottleneck preventing economic growth** is the lack of all-weather roads. The accessibility to markets during the wet season is crucial because most agricultural products are mature and ready for sale during the wet season.

#### 5. **Poverty and Social Expenditure**

Weaknesses in budget classification hampers functional compilation of government expenditure. However, efforts are underway to improve the tracking of social and poverty-related spending. Nevertheless, the government has strengthened efforts at improving social spending toward poverty alleviation. The 2001/02 budgetary allocations for education and health (10.8 and 6.1 percent of total expenditure, respectively) are significantly higher than

the 2000/01 outturn (7.9 and 4.0 percent, respectively). However, the share of labor and social welfare in total expenditure has been kept steady in the 2001/02 budget. Progress in raising health and education expenditure partly mirror the containment of defense spending at about 8 percent of total expenditure in the 2000/01 outturn and the 2001/02 budget.

## 6. Conclusion

**The government aims at exiting the Least Developed Country (LDC) status by 2020.** This agenda entails sustained growth, comprehensive institutional reform, infrastructure building and rehabilitation, as well as enhanced participation of civil society and the most vulnerable groups in decision-making. In response to the poverty challenge, the Lao P.D.R. government has formulated a comprehensive strategy spelled out in the *Interim Poverty Reduction Strategy Paper*; the strategy is under further elaboration in the upcoming National Poverty Eradication Programme (NPEP). Work underway under the NPEP should lead to costing poverty reduction actions and establishing a comprehensive monitoring framework needed to assess progress toward poverty reduction. The NPEP will be used to meet PRSP requirements; its approval by the government is expected in early 2003.

## Lao P.D.R.: Social and Demographic Indicators

|   | Latest single year |         |         | Same region/income group |            |
|---|--------------------|---------|---------|--------------------------|------------|
|   | 1970-75            | 1980-85 | 1993-99 | East Asia & Pacific      | Low-income |
| <b>POPULATION</b>                             |                    |         |         |                          |            |
| Total population, mid-year (millions)         | 3.0                | 3.6     | 5.1     | 1,836.6                  | 2,417.1    |
| Growth rate (% annual average for period)     | 2.2                | 2.3     | 2.6     | 1.2                      | 1.9        |
| Urban population (% of population)            | 11.4               | 15.6    | 22.9    | 34.5                     | 31.4       |
| Total fertility rate (births per woman)       | 6.5                | 6.7     | 5.4     | 2.1                      | 3.7        |
| <b>POVERTY</b>                                |                    |         |         |                          |            |
| <i>(% of population)</i>                      |                    |         |         |                          |            |
| National headcount index                      | ..                 | ..      | 46.1    | ..                       | ..         |
| Urban headcount index                         | ..                 | ..      | 24.0    | ..                       | ..         |
| Rural headcount index                         | ..                 | ..      | 53.0    | ..                       | ..         |
| <b>INCOME</b>                                 |                    |         |         |                          |            |
| GNI per capita (US\$)                         | ..                 | ..      | 290     | 1,010                    | 420        |
| Consumer price index (1995=100)               | ..                 | ..      | 619     | 136                      | 138        |
| Food price index (1995=100)                   | ..                 | ..      | ..      | ..                       | ..         |
| <b>INCOME/CONSUMPTION DISTRIBUTION</b>        |                    |         |         |                          |            |
| Gini index                                    | ..                 | ..      | 37.0    | ..                       | ..         |
| Lowest quintile (% of income or consumption)  | ..                 | ..      | 7.6     | ..                       | ..         |
| Highest quintile (% of income or consumption) | ..                 | ..      | 45.0    | ..                       | ..         |
| <b>SOCIAL INDICATORS</b>                      |                    |         |         |                          |            |
| <b>Public expenditure</b>                     |                    |         |         |                          |            |
| Health (% of GDP)                             | ..                 | ..      | 1.2     | 1.7                      | 1.2        |
| Education (% of GNI)                          | ..                 | 0.4     | 2.1     | 2.9                      | 3.3        |
| Social security and welfare (% of GDP)        | ..                 | ..      | ..      | ..                       | ..         |
| <b>Net primary school enrollment rate</b>     |                    |         |         |                          |            |
| <i>(% of age group)</i>                       |                    |         |         |                          |            |
| Total   | ..                 | ..      | 72      | 100                      | ..         |
| Male  | ..                 | ..      | 76      | 100                      | ..         |
| Female  | ..                 | ..      | 69      | 100                      | ..         |
| <b>Access to an improved water source</b>     |                    |         |         |                          |            |
| <i>(% of population)</i>                      |                    |         |         |                          |            |
| Total   | ..                 | ..      | 90      | 75                       | 76         |
| Urban   | ..                 | ..      | 59      | 93                       | 88         |
| Rural   | ..                 | ..      | 100     | 66                       | 70         |
| <b>Immunization rate</b>                      |                    |         |         |                          |            |
| <i>(% under 12 months)</i>                    |                    |         |         |                          |            |
| Measles                                       | ..                 | 6       | 71      | 83                       | 64         |
| DPT   | ..                 | 4       | 56      | 82                       | 70         |
| <b>Child malnutrition (% under 5 years)</b>   |                    |         |         |                          |            |
| Total   | ..                 | ..      | 40      | 12                       | ..         |
| <b>Life expectancy at birth</b>               |                    |         |         |                          |            |
| <i>(years)</i>                                |                    |         |         |                          |            |
| Total   | 42                 | 47      | 54      | 69                       | 59         |
| Male  | 41                 | 46      | 53      | 67                       | 58         |
| Female  | 44                 | 49      | 56      | 71                       | 60         |
| <b>Mortality</b>                              |                    |         |         |                          |            |
| Infant (per 1,000 live births)                | 139                | 115     | 93      | 35                       | 77         |
| Under 5 (per 1,000 live births)               | 218                | 200     | 143     | 44                       | 116        |
| Adult (15-59)                                 | ..                 | ..      | ..      | ..                       | ..         |
| Male (per 1,000 population)                   | 610                | 531     | 376     | 184                      | 288        |
| Female (per 1,000 population)                 | 510                | 439     | 317     | 141                      | 258        |
| Maternal (per 100,000 live births)            | ..                 | ..      | 650     | ..                       | ..         |
| Births attended by skilled health staff (%)   | ..                 | ..      | 60      | ..                       | ..         |

Source: 2001 World Development Indicators CD-ROM, World Bank.

**Lao People's Democratic Republic**  
*Peace Independence Democracy Unity Prosperity*

Vientiane, July 8, 2002

Dear Mr. Köhler,

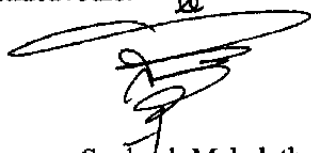
On April 25, 2001, the Executive Board of the International Monetary Fund (IMF) approved a three-year arrangement for the Lao People's Democratic Republic (Lao P.D.R.) under the Poverty Reduction and Growth Facility (PRGF). The purpose of this letter is to inform you on the progress achieved in implementing the economic program to date, and to request the third disbursement following the completion of the second review under the arrangement and the approval of the second annual program.

The attached Memorandum on Economic and Financial Policies (MEFP) supplements the MEFP of February 7, 2002, and sets out the government's objectives and policies to be implemented in the year through March 2003 to build on the progress achieved, and help increase economic growth and further reduce poverty. On the basis of the satisfactory performance under the PRGF-supported program in 2001 and in the first quarter of 2002, we request the completion of the second review under the arrangement, waivers for the nonobservance of one quantitative performance criteria for end-March and one structural performance criterion for end-April.

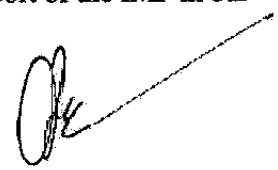
The government believes that the policies and measures set forth in the MEFP are adequate to achieve the objectives of the reform program supported by the PRGF arrangement, but will take further measures if deemed necessary. During the remaining period of the arrangement, the Lao P.D.R. will continue to consult with the Managing Director on the adoption of measures that may be appropriate, at the initiative of the government or whenever the Managing Director requests such a consultation. The government will continue to provide the IMF with such information as it requires to assess the Lao P.D.R.'s progress in implementing the economic and financial policies under the program.

The government agrees to make these understandings public and authorizes the IMF to publish this letter, the attached memorandum, the PRSP Preparation Status Report, and the related Joint Staff Assessment, including through the IMF's external website. A decision on the publication of the staff report will be made by the time of the Executive Board meeting.

We can assure you that the government of the Lao P.D.R. is determined to fully implement the program, and we hope we can count on the continued support of the IMF in our endeavours.

  
Soukanh Mahalath  
Minister of Finance  
Ministry of Finance

Sincerely yours,

  
Chansy Phosikham  
Governor  
Bank of the Lao P.D.R.

Attachment

**Memorandum on Economic and Financial Policies  
of the Government of the Lao People's Democratic Republic**

**July 8, 2002**

**I. INTRODUCTION**

1. The reform program of the Government of the Lao People's Democratic Republic aims at sustaining economic growth and reducing poverty. Our reform effort is being supported by a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF). This memorandum reviews the implementation of the PRGF-supported program to mid-2002, lays out the economic and financial policies for the remainder of the second-year program through March 2003, and updates the macroeconomic framework for 2002-2004.

**II. PERFORMANCE UNDER THE PROGRAM**

2. Economic developments in 2001 and the first quarter of 2002 have generally been favorable. The Fund staff estimates that real GDP growth weakened only to 5.2 percent in 2001, reflecting renewed business confidence and continued aid flows, generally offsetting weaker regional conditions. Preliminary evidence suggests buoyant economic activity in the first quarter of 2002, with stronger external demand, a pick up in construction activity, and renewed domestic and foreign investment. Inflation on a year-on-year basis has been contained at 6.7 percent, largely owing to the timely implementation of stabilization policies that addressed the inflationary impact of fiscal slippages in 2000/01. Since September 2001, the exchange rate has remained broadly stable against the U.S. dollar. The ongoing reforms of the investment framework, including the streamlining of the approval procedures for foreign investment, have attracted new investment, especially in telecommunications, manufacturing, mining, and aviation.

3. While net credit to the government was under the March 2002 ceiling, revenue performance remains weak and the budget situation fragile. Revenue (excluding grants) for the first half of 2001/02<sup>1</sup> was only 37 percent of the annual program target, compared to 42 percent last year, largely owing to weaker than expected profit and turnover taxes, timber and hydro-power royalties, and dividends. Current expenditures are broadly in line with seasonal patterns, and the end-March 2002 bank financing ceiling was met by containing domestically financed capital spending to only 27 percent of the program target.

4. Monetary developments through end-March 2002 were generally consistent with the program. The ceiling on the net domestic assets (NDA) of the Bank of the Lao P.D.R. (BOL) was observed, reflecting improved control on budget financing and the sharp reduction in the

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<sup>1</sup> The fiscal year runs October-September.

BOL credit to banks. After being restrained in 2001, the net domestic assets of state-owned commercial bank (SCB) grew substantially- in late 2001 and early 2002, because of an expansion in other items net related to irregular lending, while formal credit grew moderately. As a result, the ceiling on NDA of SCBs for March was not met. Stronger export growth and restrained monetary policy enabled gross international reserves to reach 2½ months of imports of goods and services (\$ 141 million), enabling the target for net international reserves to be met.

5. On the structural front, the Government is starting to reform the SCBs. Based on the signed Memoranda of Understandings on Restructuring (MoURs), key financial targets and benchmarks for the SCB's business plans have been elaborated. The structural performance criterion for the banking supervision measures to implement provisioning on new lending was complied with on May 27 after a delay, and the required restating of the SCB's 2001 accounts will be achieved as a prior action for the second review.

6. The program is broadly on track and all quantitative performance criteria for March 2002 were met, except for the NDA of the SCBs (Table 1). The structural conditionality was generally achieved (Table 2) except for the structural performance criterion on bank provisioning (which was implemented with a delay) and the structural benchmark for the development of the public expenditure management reform plan, which has been postponed for the third review (see paragraph 12).

### **III. MACROECONOMIC FRAMEWORK AND POLICIES**

7. The Government aims at achieving its target of graduating from least developed country status by 2020 through broad-based reform policies. Under the PRGF-supported program, we will continue to pursue sound macroeconomic policies and give highest priority to strengthening financial management of the public sector, liquidating or privatizing poorly performing SOEs, while promoting private sector development and regional integration. In particular, we will continue to improve the policy environment to increase private foreign and domestic investment, raise productivity in agriculture, and develop further the infrastructure and transport links, especially with neighboring countries. These factors and the Nam Theun 2 (NT2) hydroelectric project are expected to contribute to achieving a real GDP growth rate of 6½ percent in 2004, while keeping inflation at or below 5 percent.

8. The external current account deficit (including official transfers and excluding NT2) is projected to be contained to 2¼ percent of GDP by 2004, and would be covered through prospective bilateral and multilateral support. As a result, we expect to achieve a gross international reserve target of 3½ months of imports of goods and services by 2004.

9. Within this framework, the macroeconomic outlook for 2002 is expected to reflect a pickup in regional activity and investment. Accordingly, real GDP growth in 2002 is projected to increase slightly to about 5½ percent. CPI inflation is expected to decline to 6 percent by end-2002. The current account deficit (including official transfers) is expected



to be about 3¼ percent of GDP, due to stronger net exports. Gross official international reserves are expected to reach 2¾ months of imports of goods and services.

### **Fiscal policy**

10. The Government will ensure that the projected 2001/02 budget deficit of 4¾ percent of GDP (IMF definition, including grants) is not exceeded. To this end, we will take further corrective actions aimed at strengthening revenue collection during the second half of the fiscal year. Accordingly, the Government will: (i) improve revenue collection for indirect taxes, especially by focusing on turnover taxes from large taxpayers in the Large Taxpayers Unit (LTU) and the Vientiane Municipal Office; and (ii) step up efforts to improve the effectiveness of royalty collection, especially from forestry, hydroelectricity, and overflight fees. Notwithstanding these measures, revenue in 2001/02 is likely to fall short of the program target by about 0.6 percent of GDP, owing to lower than programmed profit taxes, timber royalties, and dividends.<sup>2</sup> Despite this revenue shortfall, we believe that there will be sufficient revenue to safeguard current spending on social sectors and maintenance, while reducing materials and supplies and other recurrent expenditures by 0.1 percent of GDP. However, the revenue shortfalls will also have to be offset through reductions in domestically-financed capital expenditure by about 0.5 percent of GDP, compared to the program target.

11. For the 2002/03 budget, revenue projections will be set on the basis of the most likely outcome of revenue collections. In the past, systematic shortfalls in revenue have resulted in budgetary overruns with unfunded spending leading to arrears and nonperforming loans in the banks. In addition, we will make revenue administration more efficient and better structured around large taxpayers. In particular, we will: (i) reinforce the central tax department; (ii) reorganize the tax and customs departments on a functional basis; and (iii) integrate an additional large provincial customs office into the national administration. Notwithstanding these efforts, we recognize the need to raise additional revenue from tax policy adjustments and to substantially curtail ad hoc exemptions and rate reductions to maintain future budget outcomes on a sustainable path. Preparations for the introduction of a VAT have begun and will be accelerated in 2002/03, including through continued improvements in administrative systems.

12. The Government is committed to public expenditure management reform. We have requested technical assistance from the IMF to help elaborate a more a detailed reform agenda and implementation timetable, including for strengthening the treasury and budget management systems, linking them to accounting, and building capacity. In addition, we will begin to implement a pilot program to compile education and health expenditures by classifying administrative units covering a significant number of districts, which will be

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<sup>2</sup> The revenue to GDP ratio is also lower than the program by 0.2 percent because of the recent revisions to nominal GDP.

extended in subsequent budgets. Both the detailed reform agenda and the extension of the expenditure classification are structural benchmarks for November 2002.

### **Monetary and exchange rate policy**

13. Monetary policy will continue to be supportive of the Government's objective of reducing inflation. We will achieve that goal through strict control over the net domestic assets of the BOL (NDABOL). Accordingly, BOL financing of the budget over the current fiscal year will continue to be avoided and BOL credit to banks will be reduced further so that overall NDA of the BOL at end September 2002 will be at the same level as at end September 2001. As a result of the anticipated improvement in the external environment, the target for net official international reserves (NIR) has been revised upward for September 2002 to \$102 million, corresponding to gross official international reserves of 2½ months of imports, and implying an 11 percent increase in reserve money. Under the policies since end-March 2002, to limit the growth of NPLs, the SCBs are now required to cease increasing their credit and other risk taking activities, given that their NPLs on post 2000 credit are over 15 percent. We will strengthen compliance with this measure, especially by extending BOL control over these risk operations. Accordingly, the NDA of SCBs will stay steady at KN 1,537 billion through September 2002.

14. The Government will continue to pursue a flexible exchange rate policy. Accordingly, the banks' exchange rate will be determined on a daily basis to limit the spread with the parallel market rate to under 2 percent. Macroeconomic policies will be adjusted to offset any sustained weakness in the kip, especially with respect to the currencies of neighboring countries.

## **IV. KEY STRUCTURAL REFORMS**

### **Banking reform**

15. The Government has initiated the reform of the SCBs, with support from the World Bank's proposed FMAC, and the AsDB's proposed Financial Sector Program Loan III (FSPL3). The initial phase is to stem the losses of the SCBs, and we will continue to monitor the loan classification and provisioning on the post-2000 loans and require that they be reflected in the SCBs' financial statements. In addition, we will strictly implement the requirement to stop the growth of risk portfolios while their NPL ratios on their post-2000 loans are over 15 percent. It is expected that the clearance of government budget arrears, and the target of NPL resolution of KN 100 billion by March 2003, should substantially reduce the NPL ratios to about 15 percent at least for BCEL and the New Bank.

16. The preparation of the individual SCBs' draft Restructuring and Business Plans (RBPs), including performance targets has been completed. These targets include ceilings on NPLs on loans approved after the start of 2000, recoveries of NPLs, foreign exchange exposures, and capital adequacy ratios (CARs), which, together with qualitative benchmarks,

(shown in Appendix I) will serve as a basis for broad-based restructuring operations over the next four years. In addition, agreement on the FSPL3 will trigger the financing for the external bank advisors, which are to be in place by end 2002. The advisors will provide advice on internal bank practices and review all proposed large credit decisions. Satisfactory performance in achieving the operational targets at end 2003, and beyond, will be an important factor in assessing whether or not to strengthen the management role of these advisors.

17. As a result of the recent problems in Lao May Bank, the cost of bank restructuring, originally estimated at \$50 million for the cost of addressing the pre-2000 NPLs, has increased by \$14 million. To address the problems in Lao May Bank, the worst performing state bank, as a prior action, the Government is developing a plan for upfront restructuring (see Appendix I). This plan basically comprises the centralization of credit decisions at headquarters and limits on new risk activities, including credit and contingent liabilities. We are conscious of the threat of asset stripping in all three SCBs during this phase of bank restructuring and will take strong steps to prevent this, including frequent onsite inspections to check on the quality of the assets, the implementation of which would be a structural performance criterion for November 2002. Should the SCBs' balance sheet and performance deteriorate further in the coming months, the pace of bank restructuring would be increased.

18. Strengthening banking supervision capacity is crucial for developing a sound banking system. The phased implementation of banking supervision will continue, now with the assistance of an advisor from MAE, including through compliance with BOL regulations on loan classifications, provisioning on new loans, loan concentration, and foreign exchange exposure. To promote competition and improve banking services, the Government is considering permitting foreign banks to operate outside Vientiane in 2003. Under this plan the minimum capital requirement for such banks would be gradually raised to \$10 million.

### **Enterprise reform**

19. The restructuring and strengthening of the SCBs is being closely coordinated with the reform of key large SOEs, under the umbrella of the World Bank's FMAC. The SOE component provides for: (i) restructuring of the largest SOE debtors to support the recovery of NPLs by banks (Pharmaceutical Factory No.3; Phoudoi and DAFI conglomerates, including sales of noncore assets; and Lao Aviation, under a management contract with Air France); (ii) enhancing oversight and accountability of SOEs; and (iii) strengthening the finances of key utilities through further tariff increases which have now begun and will continue to achieve cost recovery in 2003 for Nam Papa and Lao Aviation, and slightly later for EDL.

### **Trade and exchange system reform**

20. We are committed to reforming the trade system to assist in the development of the economy. Since October 11, 2001, import and export procedures have been further

simplified. Within indicative annual import plans proposed by importers at the start of the year, all goods can be freely imported by making declarations at the customs point, except for six product groups subject to quantitative restrictions (fuel, vehicles, cement, steel bars, sugar, and fertilizer), and those restricted for health and security reasons. Looking ahead, we will remove sugar and fertilizer from the list of controlled goods by end 2002. In addition to the requirements related to our accession to the World Trade Organization (WTO), we will continue to liberalize our trade regime through our commitments under the ASEAN Free Trade Agreement (AFTA).

21. The new Foreign Exchange Decree Law is expected to be passed shortly by the National Assembly. We recognize the advantages to the private sector of an efficient foreign exchange system, and are aiming to have the Decree Law and the implementing regulations maintain our exchange system free of restrictions on current international payments and transfers. To pave the way for accepting the obligations under Article VIII, we will request technical assistance from the IMF to review our exchange system.

#### **External debt management**

22. In view of the Lao P.D.R.'s limited debt-servicing capacity, we will maintain a prudent debt management policy. Accordingly, the contracting or guaranteeing of external public sector debt on nonconcessional terms will be sharply limited. Consistent with this policy, we are in the process of negotiating improved concessionality of the borrowing from Exim Bank of China for E.D.L.'s Nam Mang 3 hydroelectric project, and attempting to reduce the project costs and improve environmental and social safeguards. Given that this process is not expected to be completed until after end September 2002, we will examine the consistency of the outcome with the debt policy in the third review of the PRGF arrangement. In addition, we will continue to strengthen the debt management capability of the Ministry of Finance to monitor more closely the contracting or guaranteeing of all public sector external debt. In a renewed attempt to resolve our outstanding debt with the Russian Federation, we have invited a Russian delegation to visit Vientiane in the near future.

#### **Safeguards assessment**

23. In addition to reconciling net official international reserves we have begun to address the weaknesses in internal audit and controls systems of the BOL identified in the Stage One Safeguards Assessment Report prepared by the IMF's Treasurers Department (TRE). In April, a high-level review was undertaken as required, based on a report by an expert from the German Bundesbank. The report, which assessed existing controls and recommended specific improvements over the next few months, was forwarded to TRE in June. In the meantime, with the assistance of an international accounting firm, the National Audit Office has begun the audit of the BOL's 2001 accounts in accordance with international auditing standards and will prepare pro-forma statements in accordance with international accounting standards. The results will be available by end-August (structural benchmark) and published by end-September.

### **Poverty reduction strategy**

24. Preparations of the PRSP are advancing, as described in the PRSP Preparation Status Report. To foster the participatory process, the Government held a workshop on the PRSP process in April 2002, which included government officials from line ministries and members of mass organizations. The outcome of these discussions will help in the preparation of the Government's National Poverty Eradication Plan (NPEP), which will be fully consistent with the requirements of the PRSP. However, significant technical and resource constraints prevent us from completing the PRSP by end August 2002 and we are now aiming to finalize our NPEP by early 2003.

### **Transparency and statistics**

25. The Government will reinforce policies aimed at widening transparency by stepping up efforts to upgrade the quality of economic and social statistics and broadening their dissemination. In line with past commitments, we intend to consent to the publication and the posting of all IMF Board documents pertaining to the second PRGF review and the PRSP Preparation Status Report on the IMF's website. A key priority is to compile budget data in accordance with GFS standards and to release comprehensive budget data in a timely manner and an informative format, including for lower levels of government. The Government will review prospects for participating in the IMF's General Data Dissemination System (GDDS) as a means of enhancing statistical development, based on the recommendations of the IMF's Statistics Department multtopic mission scheduled for October 2002.

## **V. PROGRAM MONITORING**

26. The Government will achieve the quantitative performance criteria and benchmarks for the period to March 2003 as shown in Table 1. Prior actions for the second PRGF review, and structural performance criteria and benchmarks for the same period are described in Table 3. In view of the inclusion of SOE tariff adjustments in the FMAC, the corresponding performance criterion in the PRGF arrangement for October 2002 will be removed. The third review under the PRGF arrangement is expected to be completed by January 2003. It will focus primarily on: (i) the 2001/02 budget implementation and the 2002/03 budget outlook and the implementation of appropriate revenue measures; (ii) the implementation of key measures consistent with the overall plan to improve public expenditure management; (iii) progress in reducing the stock of budget arrears and the avoidance of new arrears, (iv) progress in implementing SCB and SOE reforms, including the issue of foreign banks operating outside Vientiane in 2003, and (v) the nonconcessional external borrowing for the Nam Mang 3 project.

**Attachments**

- Table 1. Quantitative Performance Criteria and Benchmarks, 2001-03
- Table 2. Structural Policy Actions For the Second Review of the PRGF-Supported Program
- Table 3. Key Structural Policy Actions Under the Second-Year PRGF-Supported Program
- Appendix I. Key Elements of the Bank Restructuring and Business Plans
- Appendix II. Technical Memorandum on Program Monitoring

Table 1. Lao P.D.R.: Quantitative Performance Criteria and Benchmarks, September 2001 - March 2003

|  | 2000              | 2001           |           | 2002          |           |           |          |            |                |                     | 2003       |               |
|--|-------------------|----------------|-----------|---------------|-----------|-----------|----------|------------|----------------|---------------------|------------|---------------|
|  | Stock at end-Dec. | Sept. Prog. 2/ | Dec. Est. | Mar. 1/ Prog. | Mar. Est. | Apr. Est. | May Est. | June Prog. | Sept. 1/ Prog. | Sept. 1/ Rev. Prog. | Dec. Prog. | Mar. 1/ Prog. |
| (In billions of kip)   |                   |                |           |               |           |           |          |            |                |                     |            |               |
| 1. Net domestic assets of the Bank of Lao P.D.R. (BOL) 3/ 4/                                 | -33               | -130           | -85       | -100          | -143      | -150      | -102     | -102       | -134           | -134                | -152       | -185          |
| 2. Net credit to the government from the banking system 4/                                   | -420              | -141           | -117      | -112          | -134      | -166      | -157     | -140       | -91            | -59                 | -28        | -13           |
| 3. Net domestic assets of the state commercial banks (excluding net claims on government) 5/ | 1,188             | 1,501          | 1,568     | 1,460         | 1,533     | 1,578     | 1,583    | 1,533      | 1,537          | 1,537               | 1,570      | 1,610         |
| 4. Net official international reserves 4/ 6/   | 57                | 65             | 67        | 68            | 70        | 71        | 75       | 69         | 66             | 72                  | 81         | 85            |
| 5. Publicly contracted or guaranteed nonconcessional external debt 7/                        |                   |                |           |               |           |           |          |            |                |                     |            |               |
| - up to one-year maturity  |                   | 0              | 0         | 0             | 0         | 0         | 0        | 0          | 0              | 0                   | 0          | 0             |
| - maturity of more than 1 year 7/  |                   | 0              | 0         | 0             | 0         | 0         | 0        | 0          | 0              | 0                   | 0          | 0             |
| of which: 1-5 years' maturity  |                   | 0              | 0         | 0             | 0         | 0         | 0        | 0          | 0              | 0                   | 0          | 0             |
| 6. External payments arrears 8/  | 0                 | 0              | 0         | 0             | 0         | 0         | 0        | 0          | 0              | 0                   | 0          | 0             |
| Memorandum item:   |                   |                |           |               |           |           |          |            |                |                     |            |               |
| Nonproject budget support (cumulative flows from start of fiscal year)                       | 11.5              | 0.0            | 0.0       | 5.0           | 5.0       | 5.0       | 5.0      | 5.0        | 15.0           | 12.0                | 5.0        | 10.0          |
| External debt service payments (cumulative from start of fiscal year)                        | ...               | 0.0            | 5.4       | 14.1          | 13.4      | ...       | ...      | 21.7       | 29.4           | 32.5                | 4.5        | 15.9          |
| Program exchange rate (kip per dollar)   | 8,218             | 9,500          | 9,500     | 9,500         | 9,500     | 9,500     | 9,500    | 9,500      | 9,500          | 9,500               | 9,500      | 9,500         |
| Foreign currency component of required reserves  | 27                | 28             | 29        | 30            | 28        | 31        | 29       | 29         | 32             | 30                  | 31         | 32            |

Sources: Data provided by the Lao P.D.R.. The full definition of terms is contained in the technical memorandum of program monitoring.

1/ Performance criteria.

2/ This column shows the revised program figures based on the new program exchange rate (US \$1=KN 9,500).

3/ Net domestic assets of the BOL are defined as reserve money minus net foreign assets (NFA) of the BOL adjusted for the valuation changes arising from the difference between the program and actual exchange rates.

The 2001 levels have been reduced from the end of December 2000 level to take account of the netting of KN 150 billion of banks reserves with BOL credit to banks.

4/ For purposes of verifying compliance with the program, the ceiling for net domestic assets of the BOL, net bank credit to the government will be adjusted upward (downward), while the floor on net official international reserves will be adjusted downward (upward) by any shortfall (excess) in external nonproject budget support, and any excess (shortfall) in debt service payments.

5/ Comprising Banque du Commerce Extérieur Lao, Lao May Bank and Lane Xang Bank. Net domestic assets of the SOCBs are defined as total deposits of these banks, less net foreign assets, net claims at the BOL, and net claims on government, all calculated at the program exchange rate.

6/ Net official reserves are calculated as net international reserves on a BOP basis less foreign currency component of required reserves. The Japanese grant is not included in the definition of net official reserves except in all of the original program targets. This resulted in a downward revision of the March and June estimates by \$12 million compared to the series originally envisaged under the program.

7/ Ceiling applies to debts contracted or guaranteed by the government, public enterprises, or the BOL on nonconcessional terms. Ceilings are flows from the start of the program, September 2001. Excludes normal import-related credit, any borrowing associated with debt rescheduling, and the loan from Exim Bank of China for the telecommunications enterprise (ETL), for a maximum amount equivalent to US\$38 million (with a 15 year repayment schedule, 2 year grace period and an interest rate of 2 percent) expected to be contracted in 2002, with a grant element of 34.4 percent. This performance criterion applies to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274 (00/85), August 24, 2000).

8/ Continuous performance criterion.

Table 2. Lao P.D.R.: Structural Policy Actions  
For the Second Review of the PRGF-Supported Program

| Policy Action  | Conditionality                               | Status   |
|--|--|--|
| Strictly implement BOL Regulation 98, including on loan classification (Article 2.0–2.4) and cease making new loans to defaulting borrowers (Article 6.0); to be monitored by quarterly reporting of the 30 largest borrowers from SCBs.                         | Structural benchmark, March 2002             | Met. No increase from September 2001 to March 2002.  |
| Implement banking supervision measures to ensure that SCBs: cease accrual of interest on all nonperforming loans, set up full provisions on nonperforming loans approved after 1/1/2000, and reflect these in their income statement and balance sheet for 2001. | Structural performance criterion, April 2002 | Met with delay at end-May. Restatement of 2001 accounts is a prior action for the second review.                     |
| Formulate key elements of the individual SCB business plans, especially qualitative and quantitative targets, and timetable for actions consistent with MoURs.   | Structural benchmark, May 2002               | Met at end-May, but work ongoing to refine the plans.  |
| Complete a high-level review of the internal financial controls of the BOL as recommended in the audit by the National Audit Office.   | Structural benchmark, May 2002               | Met at end-June  |
| Agree on an action plan for improving public expenditure management, including controls on commitments, management of bank accounts, expanding budget nomenclature and improving the quality of fiscal data.   | Structural benchmark, April 2002             | Not met. Work underway in improving expenditure tracking. Agreement on plan postponed to November 2002, see Table 3. |



Table 3. Lao P.D.R.: Key Structural Policy Actions Under the Second-Year PRGF-Supported Program

| Policy Action  | Conditionality                                  |
|--|---|
| <b><i>Banking sector</i></b>   |   |
| Restate end-2001 accounts of SCBs to reflect full provisioning of new loans in accordance with BOL Regulation 98.  | Prior action, second review                     |
| Agree on a plan to subject the weakest state commercial bank to upfront restructuring.   | Prior action, second review                     |
| Implement two rounds of quarterly targeted inspection of the three SCBs including their 5 largest branches to verify asset quality, and implementation of instructions to limit the increase in lending and the issue of off-balance sheet commitments.  | Structural performance criterion, November 2002 |
| Maintain, in accordance with BOL 98, accurate loan classification on all loans, and full provisioning on all new and rescheduled loans from the start of 2000, and compliance with other key BOL bank supervision directives.  | Subject of third review                         |
| Complete the 2001 audit of the BOL by the National Audit Office, with the assistance of an international auditing firm, and in accordance with international auditing standards and prepare pro-forma 2001 financial statements in accordance with international accounting standards.   | Structural benchmark, August 2002               |
| <b><i>Public sector</i></b>  |   |
| Identify key issues in public expenditure management and agree on the detailed terms of reference for the requested Fund technical assistance mission.   | Prior action, second review                     |
| Strengthen central tax and customs departments, organize them on a functional basis, and transfer an additional large provincial customs point to the national customs service.  | Structural benchmark, November 2002             |
| Continue improvements in revenue administration, including the national coordination of collections, and the preparation of the VAT.   | Subject of third review                         |
| Agree on a medium-term plan for expenditure management, including controls on commitments, management of bank accounts, expanding budget nomenclature and improving the quality of fiscal data, and implement a system to identify expenditure by type of administrative unit for the education and health sectors for an important proportion of these sectors in the 2002/03 budget. | Structural benchmark, November 2002             |

### **Lao P.D.R.: Key Elements of the Bank Restructuring and Business Plans**

The banking sector is mainly comprised of the SCBs which are deeply insolvent. In the recent past, the SCBs have experienced rising NPLs and foreign exchange exposures accompanied by falling profitability and capital asset ratios. Onsite inspections on SCB's classification and provisioning revealed NPLs on new lending (since January 1, 2000) at end 2001 of 20-25 percent for Banque pour le Commerce Extérieur du Laos (BCEL) and Lang Xang Bank (LXB), and 70 percent for Lao May Bank (LMB), compared to the notional limit of 15 percent. Preliminary investigation suggests that this weak performance reflects: inadequate credit analysis and monitoring, inappropriate rollovers of pre-2000 loans, and continued lags in the payment of government arrears to contractors.

In order to address these problems Memoranda of Understanding for Restructuring (MOURs) were signed by the three SCBs and the Bank of Lao PDR in late March 2002.

To operationalize these MOURs, the draft restructuring and business plans (RBPs) have recently been prepared with technical assistance from the AsDB which outline medium term plans for improving performance. The main elements are as follows:

- Given LMB's deep-seated problems, the Government will consolidate the LXB and LMB into a New Bank. This will be achieved by "cherry picking" the assets and liabilities of LXB and consolidating the known assets and liabilities of LMB. The New Bank would "cherry pick" the fixed assets; and hire/rehire new management and staff on a selective basis, with the social safety net applying to the staff of the old banking entities. The staff and branches of the New Bank would be rationalized to broadly in line with the best practice organizational model.
- The restructuring plans for BCEL and the New Bank involve a 7-point program covering separate but interrelated plans (sub plans): Operational Plan; Organizational Plan; Branch Rationalization Plan; Human Resource Plan; Fixed Asset Plan (Asset Rationalization); Technology Plan (IT/MIS); and Financial and Capital Build-up Plan. The plans consist of three phases: Phase I: October 1, 2002-June 30, 2003; Phase II: July 1, 2003-December 31, 2003; and Phase III: January 1, 2004-December 31, 2006.

Major near-term milestones for both BCEL and the New Bank are:

- By Q4, 2002: (i) place qualified foreign advisors; (ii) initiate first recapitalization; and (iii) complete 2001 IAS audit.
- By Q1, 2003: (i) appoint Board, officers, and staff; (ii) have social safety net in place; (iii) adjust/fine tune performance grading system; and (iv) complete fixed assets inventory.
- By Q2, 2003: (i) adopt legal remedies to recover NPLs; (ii) implement performance grading system; (iii) begin implementing the social safety net; and (iv) revise and agree

on the RBPs for 2003-05, including revised qualitative and quantitative indicators for 2003 based on 2002 audits and a revised performance grading system for performance evaluation; (v) adopt/implement governance policies and procedures; (vi) start implementation of information technology (IT) program, including IT/MIS needs analysis; (vii) implement communications program for NPL resolution; (viii) complete 2002 IAS audits; (ix) prepare financial statements as per IAS 30; and (x) sign lease agreements for fixed assets.

- By Q4, 2003: (i) substantial implementation of the above sub plans; (ii) firmly establish IT program; and (iii) revise and update the branch rationalization plans.

The banks will be subject to half-yearly performance monitoring. In the first year, this would comprise quantitative benchmarks for flow NPLs and foreign exchange exposure (indicative values are in the attached tables which will be refined later in 2002) and the implementation of operational measures.

Appendix Table I.1: BCEL Projected Quantitative Performance Indicators

(In percent; unless otherwise indicated)

|                                      | 2002        | 2003 | 2004 |
|--------------------------------------|-------------|------|------|
| <b>Capital adequacy</b>              |             |      |      |
| Capital Adequacy Ratio               |             |      |      |
| Before extraordinary items           | -0.1        | 1.1  | 3.7  |
| After extraordinary items            | -8.5        | -8.5 | -5.7 |
| <b>Asset quality</b>                 |             |      |      |
| Old stock NPLs                       | 96.3        | 96.3 | 96.3 |
| New Flow NPLs                        | 15.0        | 11.8 | 10.8 |
| <b>Recovery of NPLs (KN billion)</b> |             |      |      |
| Old Stock NPLs                       | 0           | 0    | 0    |
| New Flows (Up to Dec 31, 2001)       | 56.5        | 10.2 | 0    |
| <b>Earnings</b>                      |             |      |      |
| Return on average assets             |             |      |      |
| Before extraordinary items           | 0.2         | 0.9  | 1.7  |
| After extraordinary items            | -6.8        | -4.8 | -2.5 |
| <b>Sensitivity</b>                   |             |      |      |
| Forex exposure (US\$ million)        | 70.0        | 68.0 | 65.0 |
| Proportion of FX lending in total    | No increase | 85.7 | 83.8 |

N.B. Extraordinary items refer to phased provisions on Old Stock NPLs and foreign exchange losses on the "stock foreign exchange exposure."

Appendix Table I.2: New Bank Projected Quantitative Performance Indicators

(In percent; unless otherwise indicated)

|                                      | 2002        | 2003 | 2004 |
|--------------------------------------|-------------|------|------|
| <b>Capital adequacy</b>              |             |      |      |
| Capital Adequacy Ratio               |             |      |      |
| Before extraordinary items           | -6.1        | 8.3  | 8.2  |
| After extraordinary items            | -8.8        | 3.7  | 3.9  |
| <b>Asset quality</b>                 |             |      |      |
| Old stock NPLs                       | 100.0       | 90.5 | 84.5 |
| New Flow NPLs                        | 9.6         | 7.8  | 7.4  |
| <b>Recovery of NPLs (KN billion)</b> |             |      |      |
| Old Stock NPLs                       |             |      |      |
| LMB                                  | 0           | 8.2  | 0    |
| LXB                                  | 0           | 2.3  | 1.5  |
| New Flows (Up to Dec 31, 2001)       |             |      |      |
| LMB                                  | 27.8        | 68.6 | 9.9  |
| LXB                                  | 15.7        | 6.8  | 0    |
| <b>Earnings</b>                      |             |      |      |
| Return on average assets             |             |      |      |
| Before extraordinary items           | 0.8         | 4.6  | 0.3  |
| After extraordinary items            | -0.1        | 3.9  | -0.3 |
| <b>Sensitivity</b>                   |             |      |      |
| Forex exposure (US\$ million)        | 16          | 16   | 14   |
| Proportion of FX lending in total    | No increase | 45.6 | 42.9 |

N.B. Extraordinary items refer to phased provisions on Old Stock NPLs and foreign exchange losses on the "stock foreign exchange exposure."

**GOVERNMENT OF THE LAO PEOPLE'S DEMOCRATIC REPUBLIC**

**MEMORANDUM ON ECONOMIC AND FINANCIAL POLICIES**

**TECHNICAL MEMORANDUM ON PROGRAM MONITORING**

1. This **Technical Memorandum on Program Monitoring (TMPM)** defines the concepts used to determine observance of the quantitative and structural performance criteria and benchmarks specified in the **Memorandum on Economic and Financial Policies for 2002 (MEFP)** of the Government of the Lao People's Democratic Republic (Lao P.D.R.) under the **Poverty Reduction and Growth Facility (PRGF)** arrangement (Sections I and II), and details the requirements for program monitoring and reporting (Section III).

**I. QUANTITATIVE PERFORMANCE TARGETS<sup>1</sup>**

**A. Definitions<sup>2</sup>**

**Item 1: Net domestic assets of the Bank of Lao (NDABOL)**

2. Defined as **reserve money (RM)** minus **net foreign assets of the BOL (NFABOL)**.
- **Reserve money** is defined as the sum of notes and coins issued by the BOL, excluding BOL holdings of currency, and deposits of commercial banks and the domestic nongovernmental sectors at the BOL. Reserve money excludes all BOL securities.
  - **Net foreign assets of the BOL (NFABOL)** are defined as the **gross foreign assets of the BOL (GFABOL)** less **gross official foreign liabilities of the BOL (GOFLBOL)**. GFABOL include holdings of SDRs by the BOL, the Lao P.D.R.'s reserve position in the Fund, all foreign exchange holdings and foreign assets of the monetary authorities, including official holdings of monetary gold. Foreign exchange holdings of the monetary authorities include claims of the BOL and the Ministry of Finance (MOF) on nonresidents in the form of bank deposits and all foreign government securities, regardless of maturity. Foreign exchange assets of commercial banks held as collateral against BOL credits are not included as gross foreign assets of the BOL. From September 2001 the yen proceeds from the Japanese commodity grants are excluded from gross foreign assets of the BOL and included in other items

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<sup>1</sup> For items 1 to 6 in Table 1.

<sup>2</sup> Variables with foreign currency components are to be valued according to Section I.C.

(net). GOFLBOL comprise foreign liabilities of the BOL with original maturity up to, and including, one year, and the use of Fund resources.

**Item 2: Net credit to government from the banking system (NCG)**

3. Defined as claims on the general government by the banking system less **deposits of the general government with the banking system**. Claims include bank loans and advances to the general government, as well as bank holdings of all government bonds and treasury bills, regardless of maturity, but exclude **government lending funds** as defined below.

- **Deposits of the general government with the banking system** exclude the yen proceeds from the disbursements of the Japanese commodity grants from September 2001.
- **Government lending funds (GLF)** of the BOL are defined as the sum of the kip value of long-term foreign liabilities of the BOL (i.e., with original maturities exceeding one year, except liabilities to the IMF) denominated in foreign currencies.

**Item 3: Net domestic assets of the state commercial banks (NDASCB)**

4. These state commercial banks include Banque pour le Commerce Extérieur Lao (BCEL), Lane Xang Bank (LXB), and Lao May Bank (LMB).<sup>3</sup> NDASCB is defined as the sum of deposit liabilities less net foreign assets, net credit to government, and net claims on the BOL.

**Item 4: Net official international reserves (NIRBOL)**

5. NIRBOL is defined as “freely available” GFABOL minus GOFLBOL minus the foreign currency component of banks’ required reserves at the BOL. Freely available reserves are defined in the IMF’s *Data Template on International Reserves and Foreign Currency Liquidity: Operational Guidelines* and comprise of liquid or marketable foreign exchange assets readily available to the BOL (and exclude illiquid foreign assets especially those in nonconvertible currencies). Starting December 2000, the yen proceeds from the disbursements of the Japanese commodity grants are not included in NIRBOL.

**Item 5: Publicly contracted or guaranteed nonconcessional external debt**

6. Ceilings on external debt are calculated as commitments from the start of the program year (end September 2001). They exclude concessional credits, use of Fund resources,

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<sup>3</sup> All references in Appendix II to Lane Xang Bank and Lao May Bank also apply to the “New Bank” after the merger.

normal trade-related credits, and any borrowing associated with debt rescheduling. During the program period, neither the government, the BOL, nor any other agency acting on behalf of the government will contract or guarantee short-term external loans.

- This performance criterion applies not only to debt as defined below, but also to commitments contracted or guaranteed for which value has not been received. For the purpose of this memorandum, the term “debt”, as specified in point No.9 of the *Guidelines on Performance Criteria with Respect to Foreign Debt* (Decision No. 12274-(00/85), August 24, 2000) will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debt can take a number of forms, the primary ones being as follows:

(i) loans, i.e., advances of money to obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans, and buyers’ credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements);

(ii) suppliers’ credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and

(iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of this memorandum, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair, or maintenance of the property.

Under the definition of debt set out above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt.

- **Short-term external debt** includes all short-term external debt obligations having an original maturity of up to one year, but excludes short-term trade credits.



- **The public sector** is defined to include the Government of the Lao P.D.R., the Bank of the Lao P.D.R., state-owned enterprises, or any other agency acting on behalf of the government.
- **Nonconcessional external debt** is defined as debt having a grant element of less than 35 percent. **The grant element** of a debt is determined by comparing the net present value (NPV) of the financing costs and principal repayments with the nominal value of the debt. The NPV of financing costs and principal repayments will be calculated with a discount rate based on the OECD CIRRs (as of February 15, 2002) for the currency of a debt, plus a margin. For debts with a repayment period of less than 15 years, the discount rate will be equal to the CIRR rate of the previous six months plus a margin of ¼ percent. For debts with maturities of 15 years or more, the discount rate will be equal to the average of the CIRRs for the previous ten years plus a margin that varies according to the maturity of the debt. The margins are 1 percent for debts of 15 to 19 years; 1.15 percent for debts of 20 to 29; and 1¼ percent for debts of 30 years or more.

#### **Item 6: External payments arrears**

7. Defined as the stock of external arrears on debt contracted or guaranteed by the government or the BOL, except on debt subject to rescheduling or debt forgiveness. For purposes of the program, external payments will be considered as arrears if they are not paid within 30 days of the date they are due. During the period of the program, neither the government nor the BOL will accumulate new external payments arrears. Overdue debt and debt-service obligations arising in respect of commercial obligations incurred directly, or guaranteed by, the government or the BOL, that are in dispute, will not be considered as external payment arrears for the purposes of program monitoring. As of December 31, 2001, there were no external payments arrears.

#### **B. Test Dates**

8. Quarterly quantitative targets have been established for items 1 to 5. The quantitative target on item 6 will be applicable on a continuous basis.

9. Quantitative targets for the test dates of end-September 2002 and end-March 2003 are performance criteria, and the disbursement associated with observance of end-September performance criteria will also be contingent on the completion of the third review.

#### **C. Program Monitoring Exchange Rates**

10. In assessing observance of the program targets, the level of foreign currency assets and liabilities, excluding those denominated in SDRs, will be first converted into U.S. dollars at the test date midpoint market exchange rate. Only assets and liabilities identified as being

in foreign currencies in the September 2001 balance sheets of the BOL and commercial banks would be subject to valuation adjustments.

11. For performance criteria and targets specified in kip, the U.S. dollar value of foreign currency assets and liabilities will be converted into kip at the midpoint program exchange rate of KN 9,500 = US\$1. SDR assets and liabilities will be valued at a fixed midpoint program exchange rate of SDR1 = US\$1.289. Non-U.S. dollar and non-SDR foreign assets and liabilities will be converted first into U.S. dollars using midpoint market exchange rates prevailing at end-period.

#### **D. Program Adjusters**

12. **The program (i) floor for NIRBOL** will be increased (decreased); and **(ii) ceilings for NDABOL and NCG** will be decreased (increased), by the amount of the excess (shortfall) in external nonproject budgetary support from the programmed amounts specified in Table 1 of the MEFP and the shortfall (excess) of external debt-service payments from programmed amounts.

13. **The program ceilings for NCG (and NDASCB)** will be adjusted upwards (downwards) for the issue of government securities for bank recapitalization in accordance with the agreed bank restructuring program.

14. To the extent that EDL transfers funds to the government from the Theun-Hinboun Power Company refinancing, the following adjuster would apply. The program ceiling for NCG (and NDABOL) would be revised down and the floor for NIRBOL revised up, for the amount of transfers from EDL on account of the refinancing.

## **II. STRUCTURAL PERFORMANCE CRITERIA AND BENCHMARKS**

15. In the structural benchmark on the public sector, the central tax and customs departments on a functional basis could comprise divisions on revenue, accounting, audit, collection enforcement, taxpayer services, legislative affairs and appeals, information technology, and general administration.<sup>4</sup>

16. In the structural benchmark on the public sector, the type of administrative units in the education sector could be categorized as pre-school, kindergarten, primary, lower secondary, upper secondary, vocational and technical, pre-service teacher training, university, general administration. The type of administrative units in the health sector could

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<sup>4</sup> Refer to Chapter I, *Revenue Enhancement and VAT Implementation—Issues and Priorities*, Fiscal Affairs Department, IMF, April 2002.

be categorized as health centers, referral hospitals, regional and national hospitals, and general administration.

### III. PROGRAM MONITORING AND REPORTING REQUIREMENTS

17. Data required to monitor performance under the program, including those related to performance criteria and benchmarks, will be provided to the IMF's Resident Representative and are listed in the table below.

| Item   | Periodicity   |
|--|---|
| <b>Monetary data</b> (to be provided by BOL)   |   |
| A report on loans, deposits, reserves at the BOL, and excess reserves of BCEL, LXB, and LMB; and the outstanding stock of BOL and Treasury securities, and the gross official reserve assets and liabilities of the BOL.   | Weekly within one week of the end of each week.         |
| The balance sheet of the BOL.  | Monthly within two weeks of the end of each month.      |
| The breakdown of NIRBOL in U.S. dollars (including the currency composition of foreign exchange holdings), GOFLBOL, and GLF.   |   |
| The monetary survey, the consolidated balance sheet of the commercial banks, and the individual balance sheets of the three SCBs. Each of the three SCBs will also report all off-balance sheet obligations.   | Monthly within four weeks of the end of each month.     |
| Amount of bills offered by BOL in the central bank bills auction, amount sold to each bank, and the average yield in percent per month.  |   |
| <b>Fiscal data</b> (to be provided by MOF)   |   |
| The consolidated accounts of the general government, including detailed data on tax and nontax revenues, current and capital expenditures, and net lending, reconciled with financing data. Financing components should be separated into foreign sources (grants, program and project loans), domestic sources (bank and nonbank), and receipts from asset sales. | Quarterly within four weeks of the end of each quarter. |
| <b>External sector data</b> (to be provided by MOF)  |   |
| Commitments (with information on the terms), disbursements, stocks and debt service payments (principal and interest separately) on external debt contracted or guaranteed by the government, state-owned enterprises, or the BOL, in U.S. dollars, by creditor.   | Quarterly within four weeks of the end of each quarter. |
| Stock of external payments arrears.  |   |
| Total export and total import values in U.S. dollars, along with available commodity breakdown.  |   |
| <b>Other data</b> (to be provided by NSC)  |   |
| Overall consumer price index and a detailed breakdown by major categories of goods and services included in the consumer basket.   | Monthly within two weeks of the end of each month.      |

INTERNATIONAL MONETARY FUND

LAO PEOPLE'S DEMOCRATIC REPUBLIC

**Staff Report for the 2002 Article IV Consultation and Second Review Under the  
Poverty Reduction and Growth Facility, and Request for  
Waiver of Performance Criteria**

**Supplementary Information**

Prepared by the Asia and Pacific, Legal, and Policy Development and Review Departments

Approved by Daniel Citrin and Shigeo Kashiwagi

August 22, 2002

1. This supplement provides information on the implementation of prior actions and economic developments and policy measures since the release of the staff report (EBS/02/129, July 15, 2002).<sup>1</sup> Attached to this paper is a revised proposed Board Decision for the completion of the second review under the PRGF that reflects the change in the timing of World Bank endorsement of the PRSP Preparation Status Report, as well as the revised background section of the Public Information Notice. The thrust of the staff appraisal is unchanged.

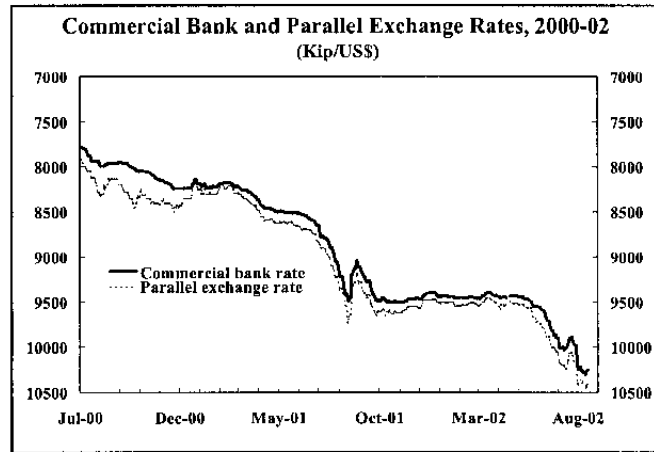
2. **All of the prior actions for the second review of the PRGF program have now been implemented**, with agreement on the terms of reference for the technical assistance mission on public expenditure management, the final prior action, having been reached on August 6. This took longer than expected because of the authorities' need to consult internally about the systemic weaknesses, especially in treasury operations, and to receive assurances from Fund staff that there would be sufficient discussions before the mission's recommendations would be included in the conditionality for the PRGF arrangement.

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<sup>1</sup> A staff team comprising Messrs. Winglee and Hussain (both APD) and assisted by Mr. Sidgwick (Resident Representative), held supplementary discussion in Vientiane during August 5-9, 2002.

3. **Recent economic data underscore the fragility of macroeconomic stabilization.**

- **Inflation rose to 11 percent (year on year) in July 2002,** compared to about 7 percent in April and May. This jump was due mainly to the depreciation of the kip in May-July and increases in food prices. Corrective fiscal and monetary policy measures—some already implemented—are expected to bring inflation down to the program’s revised, somewhat higher target of 8 percent by end-2002 (Table 1).



- **The exchange rate appears to have stabilized in August as a result of corrective measures,** following a cumulative depreciation from end-April to mid-August of 9 percent, which brought the total depreciation to 12 percent over the past year.

4. **The main factor underlying the recent weakness in the kip appears to be the excessive increase in net bank credit to the government,** which exceeded its June benchmark by about 0.4 percent of GDP, after adjustment for the \$33 million deposit by the government in the BOL of the proceeds from the electricity company’s (EDL) refinancing operation (see below). Although revenue performance in the June quarter improved to cumulatively two-thirds of the program revenue target, it was not sufficient to offset the seasonal pick-up in spending. Other data show some recent strengthening in both the monetary and fiscal situation. The net domestic assets of the state commercial banks (SCBs) declined in June, to just over its program ceiling, thus reversing most of the breach recorded at end-March. Foreign exchange reserves at end-June were slightly above the program target. In addition, preliminary data for July show an improvement in the budget balance, bringing net credit to the government closer to the program ceiling.

5. **In late June the government instructed the EDL to transfer to the treasury the \$33 million it received from the refinancing operation** of the Theun Hinboun Power Company (THPC) in which EDL has a 60 percent shareholding. As foreshadowed in the Staff Report (Page 15, footnote 11), the international reserves target was adjusted upward and the net bank credit to the government ceiling adjusted downward for this amount. Similarly, bank financing of the budget is reduced by 1.8 percent of GDP but this is excluded from performance assessments. These funds are intended to be mainly used by EDL for new hydroelectric power projects, and the transfer to the government is a transparent means to account for these funds given the gap between the time of receipt and utilization. These funds will not be used until after September 2002, when appropriate projects would be identified, mainly in the hydroelectric sector, and consistent with the medium-

term investment plan discussed with the ADB and the World Bank. The financial program in 2002/03 will be adjusted for such drawdowns in the context of the third PRGF review.

6. **Fiscal and monetary policies are being strengthened further to ensure that the financial program targets are achieved.** In particular, the Ministry of Finance has stepped up its revenue effort, to ensure that the revenue target in the program (13.1 percent of GDP) for 2001/02 is attained. In particular, it is focusing on large taxpayers, including through deploying systems to better track large taxpayers, reducing tax negotiations, and by publishing the names of about 150 delinquent taxpayers. With these revenue measures and additional restraint on spending, increased sales of treasury bills, and the program loan disbursement, the program target for bank financing of the budget is achievable. Monetary policy is being strengthened by raising the required reserves ratio to offset the reduction at the start of 2002, and also by significantly reducing BOL deposits in SCBs.

7. **Regarding the near-term structural measures,** the technical aspects of the audit of the BOL have now been completed by the National Audit Office with the assistance of an international audit firm, and the full audit should be finalized soon, in compliance with the end-August benchmark.

**Table 1. Lao P.D.R.: Selected Economic and Financial Indicators, 1998–2002**

Nominal GDP (2000): \$1,718 million  
 Population (1999): 5.1 million  
 GDP per capita (1999): \$288  
 Fund quota: SDR 52.9 million

|   | 1998  | 1999   | 2000<br>Est. | 2001<br>Est. | 2002               |        |            |
|---|-------|--------|--------------|--------------|--------------------|--------|------------|
|   |       |        |              |              | Latest 1/<br>Prog. | Prog.  | Rev. Prog. |
| Nominal GDP (in billions of kip)                              | 4,240 | 10,329 | 13,671       | 15,599       | ...                | 17,257 | 17,638     |
| Real GDP growth (percent change) 2/                           | 4.0   | 7.3    | 5.8          | 5.2          | ...                | 5.0    | 5.5        |
| Prices (percent change)                                       |       |        |              |              |                    |        |            |
| Consumer prices   |       |        |              |              |                    |        |            |
| (12-month rate; end-of-period)                                | 141.9 | 86.7   | 10.6         | 7.5          | 11.2 5/            | 6.0    | 8.0        |
| GDP deflator (annual average)                                 | 85.3  | 127.1  | 25.1         | 8.5          | ...                | 7.2    | 7.2        |
| Government budget (percent of GDP) 3/                         |       |        |              |              |                    |        |            |
| Revenue   | 9.8   | 10.6   | 13.2         | 13.6         | 8.4 5/             | 13.9   | 13.1       |
| Grants  | 5.3   | 6.0    | 3.7          | 3.2          | 2.0 5/             | 3.3    | 3.3        |
| Expenditure   | 23.6  | 20.5   | 21.5         | 21.3         | 13.8 5/            | 21.9   | 21.0       |
| Current account balance (excluding grants)                    | 1.7   | 4.4    | 5.0          | 5.2          | 2.7 5/             | 5.2    | 4.6        |
| Overall balance (including grants)                            | -8.5  | -3.9   | -4.6         | -4.5         | -3.4 5/            | -4.6   | -4.6       |
| Of which: Bank financing                                      | 0.8   | -0.4   | -0.8         | 1.7          | -1.5 5/            | 0.3    | -1.4       |
| Money and credit (percent change; end-of-period) 4/           |       |        |              |              |                    |        |            |
| Broad money   | 113.3 | 78.4   | 45.7         | 23.1         | 26.4 5/            | 19.0   | 20.2       |
| Bank credit to the economy                                    | 86.3  | 74.2   | 41.1         | 39.2         | 9.2 5/             | 14.2   | 0.0        |
| Credit to SOEs  | 85.6  | 99.2   | 36.1         | 38.5         | 16.7 5/            | 10.8   | -2.0       |
| Credit to the private sector                                  | 86.6  | 63.6   | 43.7         | 39.7         | 4.7 5/             | 16.2   | 1.2        |
| Interest rates (in percent; end-of-period)                    |       |        |              |              |                    |        |            |
| On one-year deposits  | 23    | 24     | 24           | 20           | 16 5/              | ...    | ...        |
| On short-term loans   | 31-36 | 22-30  | 16-24        | 12-18        | 12-18 5/           | ...    | ...        |
| External trade  |       |        |              |              |                    |        |            |
| Trade balance (in millions of U.S. dollars)                   | -216  | -212   | -218         | -218         | ...                | -250   | -212       |
| Exports (percent change in U.S. dollar value)                 | 6.4   | 1.5    | 2.6          | -0.3         | ...                | 3.2    | 6.2        |
| Imports (percent change in U.S. dollar value)                 | -14.7 | 0.3    | 2.7          | -0.4         | ...                | 2.6    | 2.8        |
| Balance of payments (percent of GDP)                          |       |        |              |              |                    |        |            |
| Current account balance (including official transfers)        | -5.2  | -4.0   | -1.4         | -3.5         | ...                | -4.3   | -3.2       |
| Overall balance (in millions of U.S. dollars)                 | -18   | 3      | 44           | -2           | ...                | -35    | 5          |
| Gross official reserves (in millions of U.S. dollars) 4/      | 112   | 106    | 127          | 134          | 178 6/             | 140    | 177        |
| (in months of prospective goods and service imports)          | 2.2   | 2.1    | 2.5          | 2.5          | 3.1 6/             | 2.4    | 3.0        |
| Net official reserves (in millions of U.S. dollars)           | 50    | 53     | 97           | 93           | 98 6/              | 98     | 105        |
| External debt (in percent)                                    |       |        |              |              |                    |        |            |
| Ratio of public debt-to-GDP 7/                                | ...   | ...    | 67.8         | 69.2         | ...                | 72.6   | 84.8       |
| Public debt-service ratio 8/                                  | 4.6   | 6.2    | 5.7          | 6.7          | ...                | 7.5    | 7.5        |
| Exchange rate   |       |        |              |              |                    |        |            |
| Kip per U.S. dollar (end-of-period)                           |       |        |              |              |                    |        |            |
| Commercial bank rate  | 4,274 | 7,600  | 8,140        | 9,490        | 10,310 9/          | ...    | ...        |
| Parallel market rate  | 4,750 | 7,575  | 8,170        | 9,560        | 10,460 9/          | ...    | ...        |
| Real effective exchange rate (percent change, annual average) | -23.1 | 5.0    | 10.8         | 2.1          | 0.7 10/            | ...    | ...        |

Sources: Data provided by the Lao P.D.R. authorities; and Fund staff estimates and projections.

1/ Latest data for March 2002 unless otherwise indicated.

2/ Staff estimate for 1999 real GDP growth is 5.0 percent; the lower estimate of Fund staff is due to their lower estimate of agricultural sector output, in line with observations of relevant international agencies. However, to maintain comparisons with the authorities' estimates the 7.3 percent growth rate in 1999 is used.

3/ Fiscal data are on a fiscal year basis (October–September).

4/ Money and credit data and official reserves data for 2001 and 2002 are presented on a fiscal year basis.

5/ Data for June 2002.

6/ Data for July, 2002; includes transfer of \$33 million from the electric company (EDL) to the government from the Theun-Hinboun Power Company (THPC) refinancing.

7/ Convertible currency debt only; assuming rescheduling of the Russian debt under Naples terms in 2002.

8/ As a ratio of exports of goods and services.

9/ Data as of August 19, 2002.

10/ Data for April 2002.

**Table 2. Lao P.D.R.: Balance Sheet of Bank of Lao P.D.R., 2001-2003**

| August 22, 2002  | 2001   |       |       | 2002  |       |               |       |       |            |               | 2003  |               |       |               |
|--|--|-------|-------|-------|-------|---------------|-------|-------|------------|---------------|-------|---------------|-------|---------------|
|  | Dec.   | Mar.  |       | May   | June  |               | July  | Sept. |            | Dec.          |       | Mar.          |       |               |
|  | Est.   | Prog. | Est.  | Est.  | Prog. | Adj. Prog. 1/ | Est.  | Est.  | Rev. Prog. | Adj. Prog. 1/ | Prog. | Adj. Prog. 1/ | Prog. | Adj. Prog. 1/ |
|  | (in billions of kip; end of period)          |       |       |       |       |               |       |       |            |               |       |               |       |               |
| <b>Bank of Lao P.D.R.</b>                                  |  |       |       |       |       |               |       |       |            |               |       |               |       |               |
| Net foreign assets   | 908  | 929   | 932   | 986   | 932   | 1,245         | 1,274 | 1,316 | 969        | 1,282         | 1,064 | 1,377         | 1,112 | 1,424         |
| Foreign assets   | 1,269  | 1,321 | 1,338 | 1,373 | 1,300 | 1,612         | 1,658 | 1,692 | 1,370      | 1,682         | 1,444 | 1,756         | 1,524 | 1,837         |
| Foreign liabilities  | -361   | -392  | -405  | -388  | -368  | -368          | -384  | -377  | -401       | -401          | -380  | -380          | -413  | -413          |
| Net domestic assets  | -85  | -100  | -143  | -99   | -102  | -415          | -382  | -351  | -134       | -447          | -152  | -465          | -185  | -498          |
| Domestic credit  | 891  | 872   | 815   | 838   | 843   | 531           | 573   | 582   | 764        | 452           | 674   | 362           | 607   | 294           |
| Net credit to government                                   | -96  | -67   | -116  | -141  | -115  | -428          | -390  | -387  | -125       | -438          | -130  | -443          | -135  | -448          |
| Credit to the economy                                      | 640  | 639   | 640   | 602   | 598   | 598           | 599   | 592   | 598        | 598           | 598   | 598           | 598   | 598           |
| Credit to state enterprises                                | 489  | 488   | 488   | 453   | 450   | 450           | 454   | 450   | 450        | 450           | 450   | 450           | 450   | 450           |
| Credit to private sector                                   | 151  | 151   | 152   | 148   | 148   | 148           | 145   | 142   | 148        | 148           | 148   | 148           | 148   | 148           |
| Credit to banks  | 348  | 300   | 291   | 378   | 360   | 360           | 364   | 377   | 291        | 291           | 206   | 206           | 144   | 144           |
| BoL securities   | -200   | -196  | -199  | -194  | -195  | -195          | -190  | -186  | -148       | -148          | -77   | -77           | -42   | -42           |
| Other items, net   | -777   | -776  | -759  | -743  | -750  | -750          | -764  | -747  | -750       | -750          | -750  | -750          | -750  | -750          |
| of which: medium-term foreign liabilities                  | -347   | -347  | -352  | -322  | -322  | -322          | -325  | -324  | -322       | -322          | -322  | -322          | -322  | -322          |
| Reserve money  | 823  | 829   | 790   | 887   | 830   | 830           | 892   | 965   | 835        | 835           | 912   | 912           | 927   | 927           |
|  | (in millions of U.S. dollars; end of period) |       |       |       |       |               |       |       |            |               |       |               |       |               |
| Net foreign assets   | 95.6   | 97.8  | 98.1  | 103.7 | 98.1  | 131.0         | 134.1 | 138.5 | 102.0      | 134.9         | 112.0 | 144.9         | 117.0 | 149.9         |
| Gross international reserves                               | 133.5  | 139.0 | 140.8 | 144.5 | 136.8 | 169.7         | 174.5 | 178.1 | 144.2      | 177.1         | 152.0 | 184.9         | 160.5 | 193.4         |
| Required reserves on foreign currency deposits             | 29.0   | 30.0  | 28.1  | 29.2  | 28.9  | 28.9          | 29.8  | 37.8  | 30.0       | 30.0          | 31.1  | 31.1          | 32.1  | 32.1          |
|  | (annual percentage change)                   |       |       |       |       |               |       |       |            |               |       |               |       |               |
| Reserve money  | 33.4   | 24.9  | 18.9  | 20.0  | 18.9  | 18.9          | 25.5  | 33.3  | 11.4       | 11.4          | 10.8  | 10.8          | 11.8  | 11.8          |
| <b>Memorandum items:</b>                                   |  |       |       |       |       |               |       |       |            |               |       |               |       |               |
| BoL financing of the budget (in billions of kip) 2/        | -21  | 9     | -40   | -66   | -39   | -352          | -315  | -312  | -49        | -362          | -5    | -5            | -10   | -10           |
| Disbursement of program loans (millions of U.S. dollar) 2/ | 0  | 5     | 5     | 5     | 5     | 5             | 5     | 5     | 12         | 12            | 5     | 5             | 10    | 10            |
| Actual/Program exchange rate, cop (kip per U.S. dollar)    | 9,500  | 9500  | 9500  | 9,500 | 9,500 | 9,500         | 9,500 | 9,500 | 9,500      | 9,500         | 9,500 | 9,500         | 9,500 | 9,500         |

Sources: Data provided by the Lao authorities; and Fund staff estimates and projections.

1/ Adjusted for the transfer of \$33 million from the electric company (EDL) to the government from the Theun-Hinboun Power Company (THPC) refinancing. The adjustment for December 2002 and March 2003 would also reflect drawdowns to be further specified in the third review.

2/ Cumulative from the start of the fiscal year (which runs from October to September).



**Table 3. Lao P.D.R.: Monetary Survey, 2001-2003**

| August 22, 2002  | 2001   |        |        | 2002   |          |       |       |          |          | 2003  |          |       |          |
|--|--------|--------|--------|--------|----------|-------|-------|----------|----------|-------|----------|-------|----------|
|  | Dec.   | Mar.   |        | May    | June     |       | Sept. |          | Dec.     |       | Mar.     |       |          |
|  | Est.   | Prog.  | Est.   | Est.   | Prog.    | Adj.  | Est.  | Rev.     | Adj.     | Prog. | Adj.     | Prog. | Adj.     |
|  |        |        |        |        | Prog. 1/ |       |       | Prog. 1/ | Prog. 1/ |       | Prog. 1/ |       | Prog. 1/ |
| (in billions of kip; end of period)                                |        |        |        |        |          |       |       |          |          |       |          |       |          |
| <b>Monetary Survey</b>   |        |        |        |        |          |       |       |          |          |       |          |       |          |
| Net foreign assets   | 1,479  | 1,606  | 1,673  | 1,831  | 1,779    | 2,092 | 2,032 | 1,804    | 2,117    | 1,856 | 2,168    | 1,863 | 2,176    |
| of which: SCBs   | 306    | 470    | 443    | 563    | 479      | 479   | 473   | 510      | 510      | 515   | 515      | 520   | 520      |
| Net domestic assets  | 1,226  | 1,252  | 1,214  | 1,169  | 1,252    | 940   | 888   | 1,320    | 1,007    | 1,361 | 1,048    | 1,446 | 1,133    |
| of which: SCBs (excl. net credit to gov.)                          | 1,568  | 1,460  | 1,533  | 1,583  | 1,533    | 1,533 | 1,548 | 1,537    | 1,537    | 1,570 | 1,570    | 1,610 | 1,610    |
| Domestic credit  | 2,438  | 2,427  | 2,308  | 2,216  | 2,238    | 1,926 | 1,838 | 2,309    | 1,997    | 2,340 | 2,028    | 2,355 | 2,043    |
| of which: SCBs   | 1,282  | 1,194  | 1,149  | 1,146  | 1,261    | 1,261 | 1,024 | 1,294    | 1,294    | 1,348 | 1,348    | 1,408 | 1,408    |
| Net claims on government   | -117   | -112   | -134   | -157   | -140     | -453  | -394  | -59      | -372     | -28   | -341     | -13   | -326     |
| Claims on the economy  | 2,555  | 2,539  | 2,442  | 2,374  | 2,378    | 2,378 | 2,231 | 2,368    | 2,368    | 2,368 | 2,368    | 2,368 | 2,368    |
| of which: SCBs   | 1,305  | 1,233  | 1,179  | 1,183  | 1,280    | 1,280 | 1,047 | 1,237    | 1,237    | 1,270 | 1,270    | 1,310 | 1,310    |
| of which: in foreign currency                                      | 2,066  | 2,039  | 1,964  | 1,914  | 1,902    | 1,902 | 1,805 | 1,837    | 1,837    | 1,787 | 1,787    | 1,737 | 1,737    |
| Credit to state enterprises  | 1,022  | 928    | 955    | 916    | 910      | 910   | 897   | 850      | 850      | 800   | 800      | 750   | 750      |
| Credit to private sector   | 1,534  | 1,611  | 1,487  | 1,458  | 1,468    | 1,468 | 1,335 | 1,518    | 1,518    | 1,568 | 1,568    | 1,618 | 1,618    |
| Other items (net)  | -1,212 | -1,175 | -1,095 | -1,047 | -986     | -986  | -950  | -989     | -989     | -979  | -979     | -909  | -909     |
| Broad money  | 2,704  | 2,859  | 2,887  | 3,000  | 3,031    | 3,031 | 2,920 | 3,124    | 3,124    | 3,216 | 3,216    | 3,309 | 3,309    |
| Domestic currency (cash and deposits)                              | 673    | 665    | 775    | 785    | 781      | 781   | 766   | 824      | 824      | 866   | 866      | 909   | 909      |
| Foreign currency deposits  | 2,031  | 2,194  | 2,111  | 2,215  | 2,250    | 2,250 | 2,155 | 2,300    | 2,300    | 2,350 | 2,350    | 2,400 | 2,400    |
| (in millions of U.S. dollars; end of period)                       |        |        |        |        |          |       |       |          |          |       |          |       |          |
| Net foreign assets   | 155.7  | 169.1  | 176.1  | 192.7  | 187.3    | 220.2 | 213.9 | 189.9    | 222.8    | 195.3 | 228.2    | 196.1 | 229.0    |
| of which: SCBs   | 32.2   | 49.5   | 46.7   | 59.2   | 50.5     | 50.5  | 49.8  | 53.6     | 53.6     | 58.1  | 58.1     | 60.7  | 60.7     |
| Foreign currency credit to the economy                             | 217.5  | 214.6  | 206.8  | 201.5  | 200.2    | 200.2 | 190.0 | 193.4    | 193.4    | 188.1 | 188.1    | 182.8 | 182.8    |
| of which: SCBs   | 107.3  | 98.2   | 94.1   | 95.8   | 103.2    | 103.2 | 84.4  | 106.7    | 106.7    | 106.5 | 106.5    | 107.0 | 107.0    |
| Foreign currency deposits  | 213.8  | 231.0  | 222.3  | 233.2  | 236.8    | 236.8 | 226.8 | 242.1    | 242.1    | 247.4 | 247.4    | 252.6 | 252.6    |
| (annual percentage change)   |        |        |        |        |          |       |       |          |          |       |          |       |          |
| Broad money  | 20.3   | 24.1   | 27.5   | 27.3   | 30.8     | 30.8  | 26.0  | 20.2     | 20.2     | 18.9  | 18.9     | 14.6  | 14.6     |
| Net domestic asset of SCBs (increase from start of fiscal year) 2/ | 0.8    | 5.3    | 10.6   | 14.2   | 10.6     | 10.6  | 11.6  | 10.8     | 10.8     | 13.2  | 13.2     | 16.1  | 16.1     |
| Credit to the economy 2/   | 28.2   | 25.4   | 22.8   | 16.5   | 16.4     | 16.4  | 9.2   | 0.0      | 0.0      | -0.6  | -0.6     | -3.0  | -3.0     |
| of which: commercial banks 2/                                      | 27.4   | 28.1   | 21.5   | 14.0   | 12.7     | 12.7  | 3.3   | 1.3      | 1.3      | 1.5   | 1.5      | -1.8  | -1.8     |
| of which: SCBs 2/  | 28.6   | 26.6   | 21.1   | 14.9   | 23.2     | 23.2  | 0.7   | 16.0     | 16.0     | 13.0  | 13.0     | 10.9  | 10.9     |
| Credit to state enterprises 2/                                     | 40.3   | 22.0   | 28.1   | 20.7   | 18.5     | 18.5  | 16.7  | -2.0     | -2.0     | -5.9  | -5.9     | -21.4 | -21.4    |
|  | 22.4   | 27.4   | 19.6   | 14.1   | 15.2     | 15.2  | 4.7   | 1.2      | 1.2      | 2.3   | 2.3      | 8.8   | 8.8      |
| <b>Memorandum items:</b>   |        |        |        |        |          |       |       |          |          |       |          |       |          |
| Bank financing of the budget (in billions of kip) 3/               | 23     | 29     | 7      | -16    | 1        | -312  | -253  | 82       | -231     | 31    | 31       | 46    | 46       |
| Money multiplier   | 3.3    | 3.4    | 3.7    | 3.4    | 3.7      | 3.7   | 3.3   | 3.7      | 3.7      | 3.5   | 3.5      | 3.6   | 3.6      |
| Actual/Program exchange rate, eop (kip per U.S. dollar)            | 9,500  | 9,500  | 9,500  | 9,500  | 9,500    | 9,500 | 9,500 | 9,500    | 9,500    | 9,500 | 9,500    | 9,500 | 9,500    |

Sources: Data provided by the Lao authorities; and Fund staff estimates and projections.

1/ Adjusted for the transfer of \$33 million from the electric company (EDL) to the government from the Theun-Hinboun Power Company (THPC) refinancing. The adjustment for December 2002 and March 2003 would also reflect drawdowns to be further specified in the third review.

2/ Excluding Lao Brewery.

3/ Cumulative from the start of the fiscal year (which runs from October to September).

**Table 4. Lao P.D.R.: Quantitative Performance Criteria and Benchmarks, 2001-2003**

|   | 2001  |         | 2002  |       |       |          |       |          |          |       | 2003     |         |          |
|---|-------|---------|-------|-------|-------|----------|-------|----------|----------|-------|----------|---------|----------|
|   | Dec.  | Mar. 1/ |       | May   | June  |          |       | Sept. 1/ |          | Dec.  |          | Mar. 1/ |          |
|   | Est.  | Prog.   | Est.  | Est.  | Prog. | Adj.     | Est.  | Rev.     | Adj.     | Prog. | Adj.     | Prog.   | Adj.     |
|   |       |         |       |       |       | Prog. 2/ |       | Prog.    | Prog. 2/ |       | Prog. 2/ |         | Prog. 2/ |
| (in billions of kip)  |       |         |       |       |       |          |       |          |          |       |          |         |          |
| 1. Net domestic assets of the Bank of Lao P.D.R. (BOL) 3/ 4/                                    | -85   | -100    | -143  | -99   | -102  | -415     | -382  | -134     | -447     | -152  | -465     | -185    | -498     |
| 2. Net credit to the government from the banking system 4/                                      | -117  | -112    | -134  | -157  | -140  | -453     | -394  | -59      | -372     | -28   | -341     | -13     | -326     |
| 3. Net domestic assets of the state commercial banks<br>(excluding net claims on government) 5/ | 1,568 | 1,460   | 1,533 | 1,583 | 1,533 | 1,533    | 1,548 | 1,537    | 1,537    | 1,570 | 1570     | 1,610   | 1,610    |
| (in millions of U.S.dollars)  |       |         |       |       |       |          |       |          |          |       |          |         |          |
| 4. Net official international reserves 4/ 6/  | 67    | 68      | 70    | 74    | 69    | 102      | 104   | 72       | 105      | 81    | 114      | 85      | 118      |
| 5. Publicly contracted or guaranteed nonconcessional external debt 7/                           |       |         |       |       |       |          |       |          |          |       |          |         |          |
| - up to one-year maturity   | 0     | 0       | 0     | 0     | 0     | 0        | 0     | 0        | 0        | 0     | 0        | 0       | 0        |
| - maturity of more than 1 year 7/   | 0     | 0       | 0     | 0     | 0     | 0        | 0     | 0        | 0        | 0     | 0        | 0       | 0        |
| of which: 1-5 years' maturity   | 0     | 0       | 0     | 0     | 0     | 0        | 0     | 0        | 0        | 0     | 0        | 0       | 0        |
| 6. External payments arrears 8/   | 0     | 0       | 0     | 0     | 0     | 0        | 0     | 0        | 0        | 0     | 0        | 0       | 0        |
| Memorandum item:  |       |         |       |       |       |          |       |          |          |       |          |         |          |
| Nonproject budget support (cumulative flows from start of fiscal year)                          | 0.0   | 5.0     | 5.0   | 5.0   | 5.0   | 5.0      | 5.0   | 12.0     | 12.0     | 5.0   | 5.0      | 10.0    | 10.0     |
| External debt service payments (cumulative from start of fiscal year)                           | 5.4   | 14.1    | 13.4  | ...   | 21.7  | 21.7     | ...   | 32.5     | 32.5     | 4.5   | 4.5      | 15.9    | 15.9     |
| Program exchange rate (kip per dollar)  | 9,500 | 9,500   | 9,500 | 9,500 | 9,500 | 9,500    | 9,500 | 9,500    | 9,500    | 9,500 | 9,500    | 9,500   | 9,500    |
| Foreign currency component of required reserves   | 29    | 30      | 28    | 29    | 29    | 29       | 30    | 30       | 30       | 31    | 31       | 32      | 32       |

Sources: Data provided by the Lao P.D.R.. The full definition of terms is contained in the technical memorandum of program monitoring (EBS/02/129).

1/ Performance criteria.

2/ Adjusted for the transfer of \$33 million from the electric company (EDL) to the government from the Theun-Hiuboun Power Company (THPC) refinancing. For December 2002 and March 2003, program ceilings for net credit to government, and net domestic assets of the BOL, will be adjusted upward, and the floor for net official international reserves adjusted downward, for the amount of the utilization of the transfer from EDL.

3/ Net domestic assets of the BOL are defined as reserve money minus net foreign assets (NFA) of the BOL adjusted for the valuation changes arising from the difference between the program and actual exchange rates.

4/ For purposes of verifying compliance with the program, the ceiling for net domestic assets of the BOL, net bank credit to the government will be adjusted upward (downward), while the floor on net official international reserves will be adjusted downward (upward) by any shortfall (excess) in external nonproject budget support, and any excess (shortfall) in debt service payments.

5/ Comprising Banque du Commerce Exterieur Lao, Lao May Bank and Lane Xang Bank. Net domestic assets of the SOCBs are defined as total deposits of these banks, less net foreign assets, net claims at the BOL, and net claims on government, all calculated at the program exchange rate.

6/ Net official reserves are calculated as net international reserves on a BOP basis less foreign currency component of required reserves.

7/ Ceiling applies to debts contracted or guaranteed by the government, public enterprises, or the BOL on nonconcessional terms. Ceilings are flows from the start of the program, September 2001. Excludes normal import-related credit, any borrowing associated with debt rescheduling, and the loan from Exim Bank of China for the telecommunications enterprise (ETL), for a maximum amount equivalent to US\$ 38 million.

(with a 15 year repayment schedule, 2 year grace period and an interest rate of 2 percent) expected to be contracted in 2002, with a grant element of 34.4 percent. This performance criterion applies to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274 (00/85), August 24, 2000).

8/ Continuous performance criterion.



INTERNATIONAL MONETARY FUND

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October 4, 2002

International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

## **IMF Concludes 2002 Article IV Consultation with the Lao People's Democratic Republic**

On August 26, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Lao People's Democratic Republic.<sup>1</sup>

### **Background**

Economic performance has improved considerably since late 1999. Starting in mid 1999, the authorities tightened macroeconomic policies after inflation rose to triple digits in 1998–99. The firm implementation of these policies quickly brought down inflation and stabilized the exchange rate. Since then, economic conditions have generally been favorable. A rekindling of business confidence and continued aid inflows helped to offset the negative impact of weaker regional growth in 2001, with real GDP growth weakening only slightly to 5¼ percent. Recent evidence suggests that the pick-up in regional activity, new small-scale construction, and foreign investment should sustain real GDP growth in 2002 at about 5½ percent. In particular, ongoing reforms to the foreign investment framework, including streamlined approval procedures, have attracted relatively large investments in telecommunications, manufacturing, mining, and aviation.

Reflecting the success of stabilization policies, inflation has generally been subdued. Problems in policy implementation in 2000/01 arising from the decentralization initiative led to missed

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<sup>1</sup> Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the August 26, 2002 Executive Board discussion based on the staff report.

program targets and significant exchange rate depreciation through September 2001.<sup>2</sup> However, quick remedial actions stabilized the exchange rate and limited the impact on inflation, which in April-May 2002 fell to 7 percent. However, with renewed pressure, mainly from implementation problems, the kip depreciated significantly by about 9 percent in May-July, but has stabilized since then. As a result of this and food price increases, inflation jumped to 11 percent in July.

Fiscal policy has generally remained firm, despite the weakness of revenue. Revenue for the first half year, only 37 percent of the annual program target, compared to 42 percent last year, put the budget under pressure, but expenditure restraint limited the recourse to bank financing. Remedial measures are now being implemented, particularly refocusing attention on the largest taxpayers. Although revenue collections improved somewhat in the June quarter, they were not sufficient to offset the seasonal pick-up in expenditure. With further efforts to mobilize revenue, it is expected that net banking system credit to the government will be limited to about ½ percent of GDP and the 2001/02 budget deficit target of 4.6 percent of GDP including grants will be achieved.

For most of the past year, the modest fiscal deficit has limited the increase in the net domestic assets of the Bank of Lao P.D.R. (BOL), thus contributing to the general slow-down in inflation. However, recent fiscal weaknesses and an increase in BOL deposits at banks boosted reserve money growth to 25 percent (year-on-year) in June 2002. Higher foreign exchange inflows enabled gross international reserves to reach \$141 million, 2.4 months of imports in June. Although credit by state commercial banks increased sharply through March 2002 despite credit controls, possibly due to irregular lending, it has stabilized in recent months.

On the structural side, the phased banking and enterprise reforms are underway: (i) Banking reform has been initiated with measures to stop the deterioration in performance and reduce the level of new nonperforming loans. Restructuring plans have also been developed to improve management procedures, engage external advisors, merge the small banks, and rationalize branches. Competition will also be enhanced by expanding the role of foreign banks. (ii) SOE reform, which covers the largest and most indebted enterprises, has also begun. Management contracts, joint ventures, asset sales, and price adjustments are being used to improve SOE operations. (iii) For the private sector, the program will continue with implementing the measures to improve the environment for foreign and domestic investment. To make their inputs more accessible, the authorities have made significant progress in simplifying import controls.

### **Executive Board Assessment**

Directors welcomed Lao P.D.R.'s robust GDP growth, and the progress made under the PRGF-supported program in strengthening macroeconomic stability and initiating broad-based structural reforms to improve the environment for sustained high growth and private investment

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<sup>2</sup> The fiscal year runs October through September.

over the medium term. At the same time, however, a substantial reform agenda remains to be tackled. In particular, continued strong efforts will be needed to consolidate macroeconomic stability, put state-owned enterprises (SOEs) on a viable commercial basis and reduce the state's involvement in commercial sectors, as well as make resources available for social services that are essential for poverty reduction.

Directors noted that the recent pick-up in inflation underscores the fragility of macroeconomic stabilization. The corrective fiscal and monetary policies being implemented by the authorities are welcome, but this effort will need to be sustained and further strengthened over time to improve prospects for ensuring fiscal sustainability. In particular, Directors urged the authorities to press ahead with effective implementation of structural fiscal measures, in order to overcome the chronically weak revenue performance. More focus is required on collections from large taxpayers, and on strengthening the operation of the central tax department and developing a national customs service. A stronger tax administration will also support the timely implementation of the VAT. Directors regretted the delay in developing a public expenditure management plan, given the urgent need to significantly improve expenditure tracking and increase fiscal transparency and accountability. They recommended the authorities to make full use of the available technical assistance to address weaknesses in this area expeditiously. Continued restraint of non-priority expenditure will also be needed to protect investment and social spending.

Directors urged continued vigilance to restrain credit growth by both the central bank and the state commercial banks (SCBs). While welcoming recent efforts in this regard, they noted that further reductions in central bank credit to the government and banks will be necessary. Close monitoring to control lending by state banks in the run-up to restructuring and recapitalization will also remain important, while full credit review mechanisms are still being put in place.

Most Directors considered the phased approach to bank restructuring to be appropriate, given the significant capacity and institutional constraints that the authorities are facing. It will nevertheless be important to ensure that the reform process remains firmly on track. Priority should be given to improving loan quality and strictly applying commercial lending criteria, which will require the elimination of political interference, stronger bank supervision with Fund technical assistance, and the full use of foreign management expertise. Directors welcomed the plan for the upfront restructuring of one of the distressed banks, while urging close monitoring to ensure that the plan is fully implemented. They emphasized that the removal of restrictions on nationwide operation of foreign banks would significantly add to competition and result in higher quality services. A few Directors expressed concern about the dominant role of the SCBs in the banking sector and recommended more emphasis on privatizing them.

Directors stressed the crucial role of restructuring the largest and most indebted SOEs to promote economic efficiency and reduce the burden on the banking system. Effective implementation of the restructuring programs, especially asset sales and price adjustments, will be essential, to put the ongoing reforms on a sustainable path and pave the way for greater private sector involvement. In particular, Directors urged the sale of the commercial operations of enterprises slated for restructuring to recover nonperforming loans of the SCBs.

Directors supported ongoing trade reforms, as well as the continuation of the flexible exchange rate system, which, along with continued efforts to reduce structural impediments, will be key to preserving external competitiveness. They encouraged the Lao authorities to accept the obligations under Article VIII as soon as possible. Some Directors recommended that the implications of the high dollarization of Lao P.D.R.'s economy be kept under close review.

Directors welcomed the integration of the Poverty Reduction Strategy Paper (PRSP) approach into the government's own poverty reduction program. However, significant additional work remains to be done, including the development of systems to ensure that budget expenditures are appropriately prioritized for pro-poor programs, and upgrading the statistical base to monitor poverty reduction and other intermediate social targets.

While noting that data provision to the Fund is satisfactory for surveillance purposes, Directors saw scope for significant further progress in both policy and statistical transparency. The quality of data should be improved, and the more general dissemination of data would support the informed discussion and ownership of economic policies.

Directors welcomed recent improvements in Lao P.D.R.'s external debt management, while emphasizing the crucial importance of applying an effective centralized debt management policy to all public external debt, and avoiding nonconcessional borrowing. They supported recent efforts to resolve debt issues with Russia, and encouraged both sides to work toward an early agreement on mutually satisfactory terms.

**Public Information Notices (PINs)** are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2002 Article IV Consultation with the Lao People's Democratic Republic is also available.

Table 1. Lao P.D.R.: Selected Economic and Financial Indicators, 1998–2001  
(In percent, unless otherwise stated)

|  | 1998  | 1999   | 2000   | 2001   |
|--|-------|--------|--------|--------|
| <b>National Income and Prices</b>  |       |        |        |        |
| Nominal GDP (in billions of kip)   | 4,240 | 10,329 | 13,671 | 15,599 |
| Real GDP growth (percent change) 1/  | 4.0   | 7.3    | 5.8    | 5.2    |
| CPI (end of period)  | 141.9 | 86.7   | 10.6   | 7.5    |
| <b>Government budget (percent of GDP) 2/</b>                               |       |        |        |        |
| Revenue  | 9.8   | 10.6   | 13.2   | 13.6   |
| Grants   | 5.3   | 6.0    | 3.7    | 3.2    |
| Expenditure  | 23.6  | 20.5   | 21.5   | 21.3   |
| Overall fiscal balance (including grants)                                  | -8.5  | -3.9   | -4.6   | -4.5   |
| <i>Of which: Bank financing</i>  | 0.8   | -0.4   | -0.8   | 1.7    |
| <b>Money and credit</b>  |       |        |        |        |
| Broad money  | 113.3 | 78.4   | 45.7   | 23.1   |
| Bank credit to the economy   | 86.3  | 74.2   | 41.1   | 39.2   |
| Interest rates (on one-year deposits)                                      | 23    | 24     | 24     | 20     |
| Interest rates (on short-term loans)                                       | 31-36 | 22-30  | 16-24  | 12-18  |
| <b>External Sector</b>   |       |        |        |        |
| Exports (percent change in U.S. dollar value)                              | 6.4   | 1.5    | 2.6    | -0.3   |
| Imports (percent change in U.S. dollar value)                              | -14.7 | 0.3    | 2.7    | -0.4   |
| Current account balance (including official transfers)                     | -5.2  | -4.0   | -1.4   | -3.5   |
| Overall balance (in millions of U.S. dollars)                              | -18   | 3      | 44     | -2     |
| Gross official reserves (in millions of U.S. dollars)                      | 112   | 106    | 127    | 134    |
| (in months of prospective goods and service imports)                       | 2.2   | 2.1    | 2.5    | 2.5    |
| Total external public debt (percent of GDP) 3/                             | ...   | ...    | 67.8   | 69.2   |
| Public debt-service ratio (as a ratio of exports of goods and services) 3/ | 4.6   | 6.2    | 5.7    | 6.7    |
| <b>Exchange rate</b>   |       |        |        |        |
| Commercial bank rate (end of period)                                       | 4,274 | 7,600  | 8,140  | 9,490  |
| Parallel market rate (end of period)                                       | 4,750 | 7,575  | 8,170  | 9,560  |
| Real effective exchange rate (percent change, annual average)              | -23.1 | 5.0    | 10.8   | 2.1    |

Sources: Data provided by the Lao P.D.R. authorities; and IMF staff estimates.

1/ Staff estimate for 1999 real GDP growth is 5.0 percent; the lower estimate of Fund staff is due to their lower estimate of agricultural sector output, in line with observations of relevant international agencies. However, to maintain comparisons with the authorities' estimates the 7.3 percent growth rate in 1999 is used.

2/ Fiscal data are on a fiscal year basis (October–September).

3/ Convertible currency debt only.



FOR IMMEDIATE RELEASE

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News Brief No. 02/94  
FOR IMMEDIATE RELEASE  
September 4, 2002

International Monetary Fund  
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Washington, D. C. 20431 USA

**IMF Gives Final Approval of Second Review of Lao P.D.R. 's PRGF  
Loan**

The Executive Board of the International Monetary Fund (IMF) has given its final approval of the second review of the performance of the Lao People's Democratic Republic under the Poverty Reduction and Growth Facility (PRGF). The final decision by the IMF Executive Board was contingent on the World Bank's review of Lao P.D.R.'s Poverty Reduction Strategy Paper Preparation Status Report.

The completion of the second review releases a further SDR 4.53 million (about US\$6 million) from the IMF from the PRGF arrangement (See News Brief No. 02/90).



**Statement by Dono Iskandar Djojosebroto, Executive Director and Panom Lathouly,  
Assistant to the Executive Director for the Lao People's Democratic Republic  
August 26, 2002**

**Introduction**

During the late 1980's and early 1990s, the Government of the Lao P.D.R adopted many important policies, including the one widely known by the international community as the New Economic Mechanism (NEM), to transform the country towards a more market-oriented economy. The NEM has received important support from the international community including the Bretton Woods institutions, the Asian Development Bank, the UNDP and bilateral donors. In the first half of the 1990s, real GDP growth averaged 7-8 percent, per capita income increased significantly, and inflation remained largely in single-digits.

The Government also adopted an open door policy in 1988. This policy was supported by the adoption and the promulgation of the Foreign Investment Law in that year. Since then, foreign investment has played a critical role in the Lao economy. The main activities the foreign investors have engaged in so far, besides the hydropower, are the garment manufacturing industry, telecommunications and the wood product industry. The Government has given top priority to develop hydropower projects for export, including Nam Theun 2 that has a great potential for contributing to economic growth in the medium- and long term.

**Recent economic development and macro-economic prospects**

The latest estimate of the GDP growth rate in **2001** was 5.7 percent, which was in line with the Fund staff's estimate, due to the sluggish global economic situation. However, the economic developments in the first quarter of 2002 have generally been favorable. The salient areas of buoyant economic activity so far are: stronger external demand, a pick up in construction activity, and a renewed domestic and foreign investment.

The ongoing reforms of the foreign investment framework have attracted new foreign investment in telecommunications, manufacturing, mining and aviation. An Australian mining company, with an IFC loan of US\$30 million, is exploring gold and copper ores in the Southern part of Lao P.D.R. In addition, Millicom, a Swedish company, has invested in mobile phones.

The Bank of the Lao P.D.R (BOL) has managed to contain average inflation for the seven months of 2002 at 7.99 percent. Since September 2001, the exchange rate has remained broadly stable against the US dollar.

The macro-economic outlook for **2002** is expected to reflect a pickup in regional activity and investment. Real GDP growth is expected to increase to about 6.0 percent in

2002 and the CPI inflation is expected to decline to 6 percent by end-2002. The current account deficit (including official transfers) is expected to be about 3.15 percent of GDP, due to stronger net exports. Gross official international reserves are expected to reach 2.5 months of import coverage.

### **Fiscal policy**

While net credit to the government was under the March 2002 ceiling, revenue performance remains weak and the budget situation remains fragile. Owing largely to weaker than expected profits and turnover taxes, timber and hydropower royalties and dividends, revenue (excluding grants) for the first half of 2001/02 was five percent less compared to last year's achievement. However, current expenditures are broadly in line with seasonal patterns, and end-March 2002 bank financing ceiling was met by containing expenditures to only 27 percent of the program target.

During the second half of the fiscal year 2001/02, the Government will enhance the revenue collection by focusing on large taxpayers, especially on indirect taxes. The Government will further restrain expenditure where they can, to compensate for budget slippages in June and July. They also intend to step up the clearance of the budget arrears, especially the arrears on capital expenditures, which will be financed by government securities. In addition, in order to limit the recent BOL financing of the budget, the Government will sell the government securities in the amount of Kip15 billion in August and September to offset the amount of BOL financing of the budget in the preceding month.

For the 2002/03 budget, the government will do its best to avoid government arrears to the construction enterprises, which have led to non-performing loans in the banks. To facilitate the process, the Government will prepare realistic revenue projections on the basis of the most likely outcome of revenue collection. To increase the revenue, the Government will strengthen tax administration by (i) reinforcing the central tax department; (ii) reorganizing the tax and customs departments on a functional basis; and (iii) integrating large provincial customs offices into the national administration. In addition, the Government will adjust the tax policy and curtail ad hoc exemptions and rate reductions to raise additional revenue to maintain future budget outcomes on a sustainable path. Preparations for the introduction of a VAT have begun and will be accelerated in 2002/03, including through continued improvements in administrative systems.

On the expenditure side, the Government is committed to strengthen public expenditure management reform and has requested technical assistance from the IMF in this regard. This assistance will focus on strengthening the treasury and budget management systems, and linking them to accounting and capacity building.

### **Monetary and exchange rate policy**

Monetary developments through end-March 2002 were generally consistent with the program. The ceiling on the net domestic assets (NDA) of the BOL was observed, reflecting

improved control on budget financing and the sharp reduction in the BOL credit to banks. In addition, stronger export growth and restrained monetary policy enabled gross international reserves to reach 2.5 months of import coverage, enabling the target for net international reserves to be met. However, after being restrained in 2001, the net domestic assets of state-owned commercial banks (SCBs) grew substantially in late 2001 and early 2002, due to expansion in other net items related to irregular lending, while formal credit grew moderately. As a result, the ceiling on NDA of the SCBs for March was not met.

In the remaining period of 2002, the monetary policy will continue to be tight in order to reduce the inflation rate to the target of 6 percent by end-2002. In response to the recent rise of inflation, the BOL, in July, increased the required reserve from 6 percent to 8 percent for Kip liability deposits and from 12 percent to 15 percent for foreign currency liability deposits. This measure was aimed to signal the banks to increase their interest rates and to act as an indicator to the banks to reduce their lending and bring net domestic assets back under the program ceiling.

The exchange rate policy will remain flexible, by allowing the banks' rate to adjust so as to maintain the margin with the parallel market rate at less than 2 percent. The Government has issued higher denomination notes of Kip10,000 and Kip 20,000 in late June this year to facilitate financial transactions. As a result, the use of Kip as a medium of exchange by the general public is increasing. The resulting psychological effect has led the Kip to slightly depreciate. The authorities have taken measures and are closely monitoring this development.

### **Financial sector reform**

By end May 2002, the authorities completed the draft of Restructuring and Business Plans (RBPs), including performance targets of the SCBs. The RBPs are formulated in conjunction with the conditionality under the current PRGF and the recently approved Financial Management Adjustment Credit (FMAC) of the World Bank (WB) and the Asian Development Bank's proposed Banking Sector Reform Program Loan (BSRPL).

As a result of the recent problem of NPL in Lao May Bank, the cost of bank restructuring, originally estimated at US\$50 million for the cost of addressing the pre-2000 NPLs, has increased by US\$14 million. To address this problem, the Government is developing a plan for upfront restructuring. This plan basically comprises the centralization of credit decisions at headquarters and limitation on new risk activities, including credit and contingent liabilities. Should the SCBs balance sheet and performance deteriorate further in the coming months, the pace of bank restructuring would be increased.

Assisted by an advisor from the Fund (MAE), bank supervision is being strengthened for the phased implementation of bank supervision regulations, focusing on those that affect credit quality. To promote competition and to improve banking services, the Government is considering allowing foreign banks to operate outside Vientiane in 2003. Under this plan, the minimum capital requirement for such banks would be gradually raised to \$10 million.

## **Enterprise reform**

Under the umbrella of the World Bank's FMAC, the restructuring and the strengthening of the SCBs is being closely coordinated with the reform of key large SOEs. The SOEs reform includes (i) restructuring of the largest SOE debtors to support the recovery of NPLs by banks (Pharmaceutical Factory No. 3; Phoudoi and DAFI conglomerates); and Lao Aviation; (ii) enhancing oversight and accountability of SOEs; and (iii) strengthening the financial position of key utility companies through further tariff increases to achieve cost recovery in 2003 for Nam Papa and Lao Aviation, and slightly later for EDL.

## **Trade and exchange system reform**

The Government is committed to reform the trade system to support the development effort of the economy. Since October 11, 2001, import and export procedures have been further simplified. Within indicative annual import plans proposed by importers at the start of the year, all goods can be freely imported by making declarations at the customs point, except for six product groups subject to quantitative restrictions (fuel, vehicles, cement, steel bars, sugar, and fertilizers), and those restricted for health and security reasons. Looking ahead, the Government will remove sugar and fertilizers from the list of controlled goods by end 2002. In addition to the requirements related to the accession of the World Trade Organization (WTO), the Government will continue to liberalize their trade regime based on their commitments to the ASEAN Free Trade Agreement (AFTA).

The new Foreign Exchange Decree Law, which aims at providing a more efficient foreign exchange system, is expected to be promulgated in the near future. To pave the way for accepting the obligations under Article VIII, the Government will request technical assistance from the IMF to review the foreign exchange system under the new Foreign Exchange Decree Law.

## **External debt management**

In view of the Lao P.D.R's limited debt –servicing capacity, the Government will maintain a prudent debt management policy. The authorities will limit the contracting or guaranteeing of new nonconcessional external debt. Consistent with this policy, the authorities are in the process of renegotiating the borrowings from Exim Bank of China for EDL's Nam Mang 3 hydroelectric project, and at the same time try to reduce the project costs and improve environmental and social safeguards. Since the completion of the negotiation could not be expected until after end September 2002, the Government will examine the consistency of the outcome with the debt policy in the third review of the PRGF arrangement. In addition, the authorities will continue to upgrade the capability of the Ministry of Finance to monitor closely the external borrowings made by SOEs. In a renewed attempt to resolve our outstanding debt with the Russian Federation, the Government has invited a Russian delegation to visit Vientiane in the near future.

### **Safeguard assessment**

The weaknesses in internal audit and control systems of the BOL, as identified in the Stage One Safeguards Assessment Report, are being addressed. In April, a high level review was undertaken, based on a report by an expert from the Bundesbank. The report that recommended the necessary improvements over the next few months was forwarded to the Fund in June. In the meantime, the National Audit Office has begun the audit of the BOL's 2001 accounts in accordance with international auditing standards and will prepare pro-forma statements in accordance with international accounting standards. This process was assisted by an international accounting firm. The results will be available by end-August 2002 and will be published by end-September 2002 as scheduled.

### **Poverty reduction strategy**

Progress has been made in the preparations of PRSP as described in the PRSP Status Report. To foster the participatory process, the Government held a workshop on the PRSP in April 2002, which included government officials from line ministries and members of mass organizations. The outcome of these discussions will be used in the preparation of the Government's National Poverty Eradication Plan (NPEP), which will be fully consistent with the requirements of PRSP. However, significant technical and resource constraints prevent the authorities from completing the PRSP by end August 2002 and the authorities are aiming to finalize the NPEP by early 2003.

### **Statistics**

The Government will review the prospects for participating in the IMF's General Data Dissemination System (GDDS) as a means of enhancing statistical development, based on the recommendations of the IMF's Statistics Department.

### **Closing remarks**

The Lao authorities continue to maintain macroeconomic stability despite numerous resource constraints within the country. They remain committed to implement all necessary measures under the conditionalities of the PRGF arrangement. They are hopeful that their request for the completion of the second review under the arrangement, and waivers for the nonobservance of the NDA ceiling for SCBs and the provisioning by banks, will be supported by the Board. Finally, they hereby wish to express gratitude and appreciation once again to the Board and the Management of the Fund for the continued support to the Lao PDR in the poverty reduction process in their country.