

Lao People's Democratic Republic: First Review Under the Poverty Reduction and Growth Facility, and Request for Waiver of Performance Criteria—Staff Report; Staff Statement; News Brief on the Executive Board Discussion; and Statement by the Executive Director for 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 the First Review Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criteria with Lao People's Democratic Republic, the following documents have been released and are included in this package:

- the staff report for the First 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 **January 16, 2002**, with the officials of 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 February 8, 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 statement of **February 25, 2002** updating information on recent developments.
- a News Brief summarizing the **views of the Executive Board as expressed during its February 25, 2002 discussion** of the staff report that concluded the First Review Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criteria.
- a statement by the Executive Director for Lao People's Democratic Republic.

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

**First Review Under the Poverty Reduction and Growth Facility,
and Request for Waiver of Performance Criteria**

Prepared by 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

February 8, 2002

Discussions for the first review under the PRGF arrangement were held in Vientiane during September 12–25, 2001, and January 9–16, 2002.

The staff team comprised Messrs. Winglee (head), Cook, Xiao, (all APD), Ms. Brunschwig (PDR), and Mr. Song (MAE). Mr. Lathouly (OED) also attended some of the policy discussions. The team was assisted by Mr. Sidgwick (resident representative) and coordinated closely with teams from the World Bank.

The mission met with Deputy Prime Minister and President of the Committee for Planning and Cooperation (CPC), Mr. Thongloun Sisoulith, Minister of Finance Soukanh Mahalath, Acting Governor of the Bank of Lao P.D.R. Phouphet Khamphounvong, CPC Vice President, Mme. Khempheng Pholsena, and other senior officials.

The government has agreed to publish the Letter of Intent and attachments and will make a decision on the publication of the staff report by the time of the Board meeting.

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.

This report was prepared by a staff team under the direction of 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
BOL.....	Bank of the Lao P.D.R.
CPC.....	Committee for Planning and Cooperation
CPI.....	Consumer price index
FAD.....	Fiscal Affairs Department
FMAC.....	Financial Management Adjustment Credit
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
NPRP.....	National Poverty Reduction Program
NPV.....	Net present value
PEM.....	Public expenditure management
PER.....	Public Expenditure Review
Phoudoi.....	Bolisat Phathana Khet Phoudoi (BPKP) Mountainous Area Development Enterprise
PRGF.....	Poverty Reduction and Growth Facility
PRSP.....	Policy Reduction Strategy Paper
SCBs.....	State commercial banks
SDR.....	Special Drawing Rights
SOEs.....	State-owned enterprises

EXECUTIVE SUMMARY

Performance in the first year of the PRGF arrangement has been generally satisfactory. Despite the weaker regional environment, growth slowed only moderately to about 5 percent, and inflation has remained at about 7 percent for much of 2001.

Fiscal slippages through September 2001, due to weaknesses in the early implementation of the decentralization initiative, were corrected in the December quarter thus bringing the fiscal program back on track. Effective actions to improve revenue administration and expenditure management, together with offsetting monetary policy measures limited the impact on inflation.

The program strategy for the year through September 2002 envisages continued actions to strengthen macroeconomic stability while focusing structural measures on improving public sector financial management. By focusing on reforms to the budget and state banks and enterprises, the program would establish systems to more effectively use resources for poverty reduction.

For 2001/02, the program aims at GDP growth of at least 5 percent, and inflation at about 6 percent by year end. The budget deficit is projected to remain at 5 percent of GDP with additional revenue from administrative measures funding an increase in current expenditures. Given the expected program loan inflows, bank financing of the budget would be limited to 0.3 percent of GDP. Monetary operations will curb the credit growth of both the central bank and the state commercial banks (SCBs), in order to reduce inflation.

The restructuring plans for the SCBs have now been agreed (delayed from September 2001) and entail phased recapitalization, based on banks meeting performance targets. The performance targets will be included in the detailed business plans, to be prepared by May 2002, and the banks will be assisted by international advisers who would, *inter alia*, review all large credit decisions. In the meantime, the regulatory framework is being strengthened by the enforcement of full loan loss provisioning on all post 2000 loans, starting with the end-2001 accounts.

To support the environment for commercially based lending, SOEs are being moved towards cost recovery. Prices of key utilities are being adjusted, and the largest defaulters are to be restructured to promote debt recovery.

The program includes all the measures recommended by the Safeguards Assessment and technical assistance is being considered for the high level review of internal controls.

I. INTRODUCTION

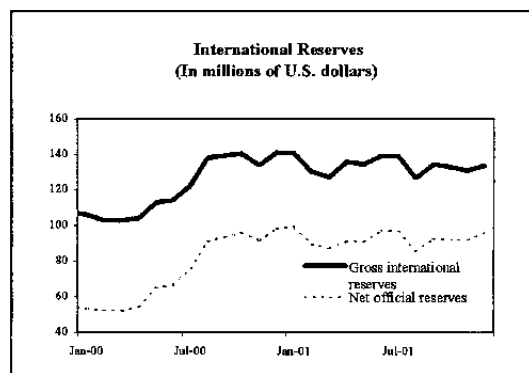
1. **In approving the Lao People's Democratic Republic's (Lao P.D.R.'s) request for a PRGF arrangement on April 25, 2001, Executive Directors commended the authorities for their success at macroeconomic stabilization.** They stressed the importance of building on this record to strengthen macroeconomic performance and put in place extensive, but appropriately sequenced reforms. Such reforms should aim at promoting efficiency and private sector activity, while spreading the benefits of development more broadly. In particular, Directors emphasized the importance of reforming the state commercial banks (SCBs) and pursuing complementary reforms in the enterprise sector, public expenditure management, and private sector development.

2. **In the attached letter dated February 11, 2002, together with the Supplementary Memorandum of Economic and Financial Policies (MEFP) (Attachments I and II), the authorities request completion of the first PRGF review, waivers for the nonobservance of three quantitative performance criteria for end-June 2001 and one structural performance criterion for end-September 2001, and modification of one structural performance criterion for end-March 2002.**¹ In support of these requests, the Supplementary MEFP reviews progress made so far under the first-year PRGF program and sets out the policies to be implemented in the fiscal year through September 2002, focusing on deepening key structural reforms. The Interim Poverty Reduction Strategy Paper (EBD/01/37) underpins Lao P.D.R.'s economic program for the PRGF and the authorities are making significant progress in preparing the full PRSP targeted for August 2002.

II. PERFORMANCE UNDER THE PROGRAM IN 2001

Economic developments

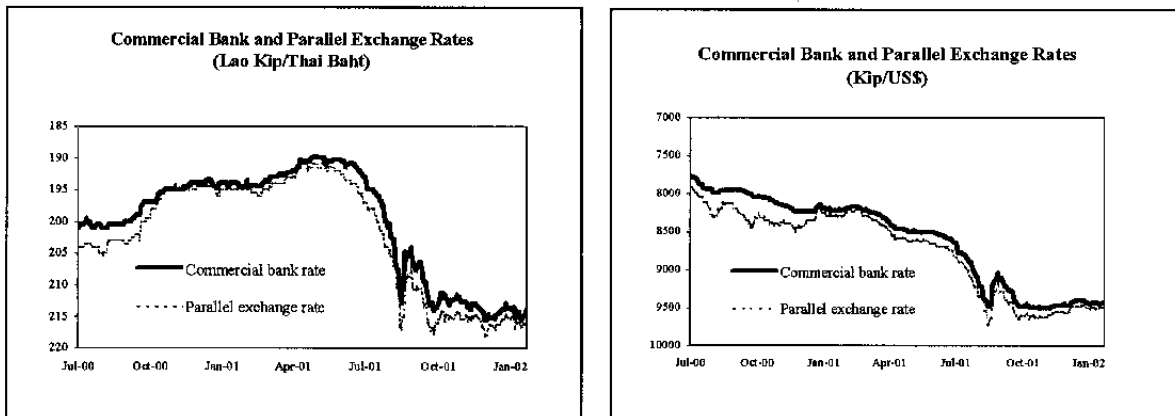
3. **Macroeconomic performance 2001 was generally satisfactory with the continuation of strong stabilization policies.** Economic activity was relatively buoyant, notwithstanding the onset of the regional slowdown. Real GDP growth for 2001 is estimated by the staff to have weakened slightly to 5.2 percent compared to the program scenario of growth remaining at



¹ With a second disbursement (SDR 4.6 million), Lao P.D.R.'s outstanding use of Fund resources will amount to SDR 32.6 million (61.5 percent of quota) as of February 28, 2002. Assuming full disbursements 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 (72.6 percent of quota) at end 2004 (Table 2).

the 2000 level of 5¾ percent (Table 3). Growth was sustained by the momentum from continued aid flows and greater business confidence from low inflation over the past two years, substantially offsetting weaker external demand. Exports were flat in 2001, partly because of a sharp drop in export prices, especially for wood products. Gross international reserves rose modestly to 2.4 months of import coverage, consistent with the increase projected in the program. However, the performance criterion for the level of reserves for June 2001 was not met because of the need to revise the series downward (by \$12 million) on account of some foreign assets (arising from Japanese grants) being identified as not fully available for balance of payment financing.

4. **As a result of effective stabilization efforts, inflation fell to 7½ percent (12-month basis) at end 2001, in line with the program target.** This positive result was aided by increased rice production and weak imported goods prices. The kip depreciated by 13 percent



against the dollar and baht in the 9 months to September 2001, but subsequently remained stable. The margin between the bank and parallel exchange rates has generally been below 2 percent, except during the periods of sharp depreciation.²

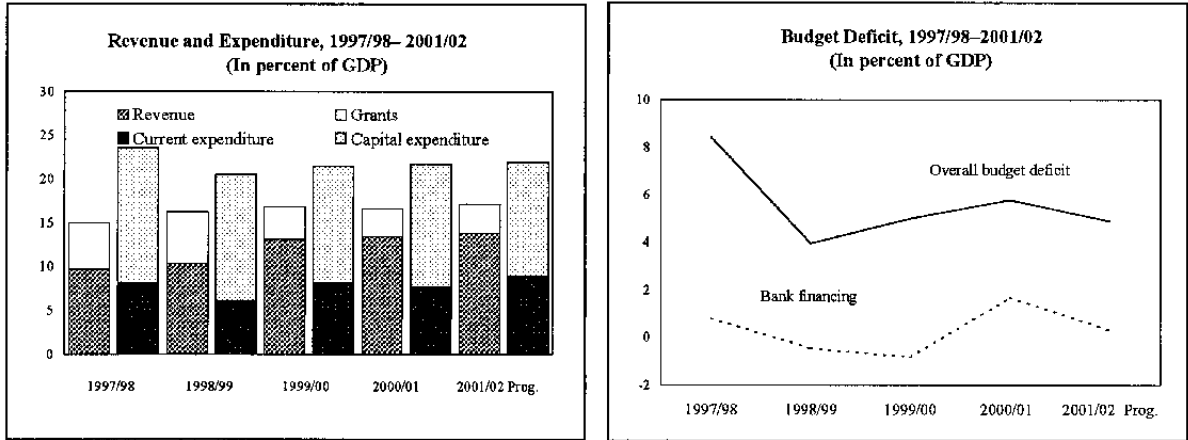
Performance under the program

5. **Although performance under the program was generally satisfactory, the completion of the review was delayed mainly because of the fiscal weakness that emerged in mid-2001.** Fiscal policy in 2000/01³ was initially restrained, but the impact of the decentralization initiative was greater than expected. This initiative was the main factor behind weak collections of profit taxes and customs revenues that reduced total revenue for the year to about 13½ percent of GDP, ½ percentage point short of the program target (Table 4). In

² Because the periods when the margin was over 2 percent were short, they do not constitute a multiple currency practice.

³ The fiscal year runs October to September.

particular, surplus provinces had less incentive to collect revenues and were also unprepared to deal with the newly assigned large taxpayers. Current expenditures were restrained to limit the impact of this revenue shortfall, mainly through lower than budgeted spending on



materials and supplies. However, provinces with surplus revenues undertook capital expenditure in excess of their budget allocations by utilizing their greater autonomy over their revenue collections rather than making transfers to the center (see Box 1 on Decentralization). As a result, although the overall deficit was in line with the program at 5 percent of GDP, the absence of transfers from surplus provinces resulted in a heavy reliance on bank financing, especially from the central bank. By June 2001, net credit to government exceeded the program target by KN 150 billion (1 percent of GDP, Table 5) and by September reached 1.7 percent of GDP for the whole fiscal year, compared to the program target of zero bank financing.

6. **The new budget contains strong corrective actions agreed as prior actions on the September mission.** During the December quarter, fiscal policy was tightened as the prior actions were implemented, including by accelerating audits of large taxpayers, scrutinizing more closely provincial government accounts, and refining expenditure controls. As a result, in the December quarter, revenue and expenditure were 15 percent and 18 percent, respectively of their annual program targets, in line with the restrained outcome of earlier years. Net bank credit to the government was sharply reduced to KN 23 billion (0.1 percent of GDP), under the PRGF benchmark.

7. **Monetary policy has been restrained as the bulk of the budget overrun was sterilized.** By substantially reducing BOL credit to banks, the increase in the net domestic assets of the BOL (NDABOL) through June 2001 was kept to only KN 46 billion (0.3 percent of GDP) above the program target, one third of the excess in bank financing of the budget. As the fiscal position deteriorated further in the September quarter, the BOL issued securities to limit the impact on the exchange rate. The underlying credit growth of SCBs has been restrained and the NDA of the SCBs was under the June 2001 program ceiling. However, large loans in August and October totaling \$24 million for the purchase of Lao Brewery

Box 1. Lao P.D.R.—The Decentralization Initiative Since 2000¹

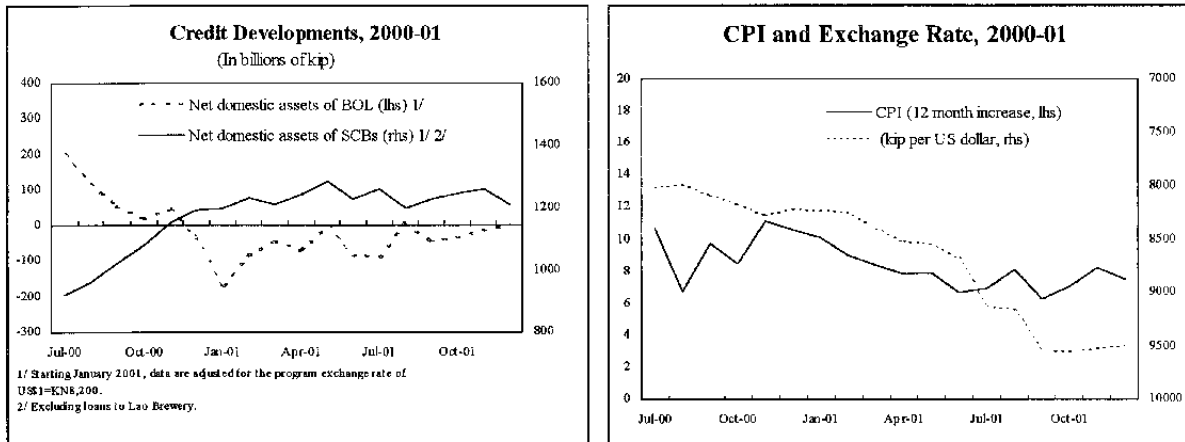
In March 2000, Instruction 01 of the Prime Minister set out the basic principles for decentralization, now a key component of the national plan for 2001/05. It is officially characterized as “making the province the strategic unit, the district the budget planning unit, and the village the implementing unit.” The decentralization initiative was aimed at making more districts self-financing, giving them greater incentives to collect revenue and better manage their expenditures, and making budget formulation more participatory. An earlier attempt at decentralization was made in 1986 as part of the “New Economic Mechanism,” but was reversed in 1991 because of sharply reduced central government revenues.

While the original intention in the 2000/01 budget was to only pilot these arrangements in a few provinces, local administrations were quick to assert more control adversely affecting total revenue. Although all levels of government are required to follow the national budget, local incentives played a major role in behavior. In particular, there were insufficient incentives for the surplus provinces to collect revenue above their expenditure level, especially when the revenue target was set ambitiously.

The main fiscal problem in 2001/01 was that transfers to the central government from the three large surplus provinces, Vientiane and two southern provinces, fell far short of their targets. This was manifested in several ways: (i) All but 50 large taxpayers were transferred to provincial tax offices, predominantly Vientiane Prefecture. Unfortunately, without a strong incentive to collect, these offices did not focus on large taxpayers and many avoided paying taxes. (ii) Surplus provinces did not report their full revenues until late in the year by which time they had spent the surpluses on their own unbudgeted capital expenditure. (iii) Southern provinces with customs points competed with each other to attract business through their posts, often by granting *ad hoc* customs exemptions since the additional business was more valuable than the additional revenue for the central government.

Measures to correct the revenue and expenditure problems were introduced in the 2001/02 budget. The expenditure measures are discussed in Box 2. The key revenue measures taken include: the designation of customs duties and turnover and excise taxes on imports as full national taxes thus excluding them from provincial revenues, and the issue of ministerial instructions to manage tax and customs administrations on a national basis. In addition, specific measures to increase revenue collections include: the acceleration of quick audits of large taxpayers by provincial tax offices and efforts to strengthen the capacity of key provincial tax offices (initially focusing on Vientiane Prefecture) to conduct such audits and introduce tax techniques pioneered at the headquarters Large Taxpayer Unit (LTU). Despite these changes, further improvements in the allocation of, and incentives for revenue collection in the decentralization scheme is needed.

¹ This note draws on a paper for the PER by François Vaillancourt Fiscal Decentralization in Lao P.D.R., Principles, Practices, and Prospects in 2001, Draft, August 2001.



shares from Thai investors temporarily pushed credit above the ceilings. In December 2001, \$6 million was repaid and the remaining \$18 million is expected to be repaid in early February 2002, after agreement to sell the shares to other foreign investors was reached at end January. Excluding this credit, the net domestic assets of the state commercial banks (NDASCB) grew by only 1.7 percent in 2001 (12 percent programmed).

8. Progress was also made in structural reforms although with a delay compared to the program. In particular:

- Individual restructuring plans for the three SCBs were agreed in December, slightly delayed from September envisaged in the structural performance criterion. The external international standard audits are in process, and the final report is expected in February 2002. The structural benchmark for September 2001 on ceasing lending to defaulting borrowers was generally met, but two of the largest 30 borrowers being monitored had small increases.⁴
- Adjustments have continued for water, electricity, and domestic aviation tariffs, to improve SOE finances. Also the largest defaulting SOE, the Phoudoi conglomerate, with extensive forestry and export/import operations, was transferred from the Ministry of Defense to the Ministry of Finance (MOF) for restructuring.
- Quantitative restrictions on imports were removed on a multilateral basis for those items currently on the AFTA inclusion list (except for a small number of items).

⁴ One case was due to lending on account of pre-existing guarantees and has been substantially repaid. The other increase was based on a revised credit appraisal of the borrower.

9. **Modest signs of political change complementary to economic reform seem to be emerging.** Decentralization has been increasingly presented as a way of boosting grass-roots participation in fiscal decisions. Elections for the National Assembly have been brought forward from December 2002 to February, and will be contested by 50 percent more candidates than seats. Although the candidates will still need to be approved by the ruling Lao People's Revolutionary Party, some nonparty candidates are included. Also at end 2001, a committee was announced to formulate proposals to amend the 1991 Constitution to make it more responsive to Lao P.D.R.'s socio-economic development and integration into the international community.

III. POLICY DISCUSSIONS AND THE PROGRAM FOR 2001/02

10. **Discussions focused on the policy framework for faster growth and poverty reduction, and for adapting to regional integration.** During the early stage of the PRGF arrangement, priority is being placed on more efficient use of public sector resources, especially in the budget and the banking and enterprise sectors, to sustain macroeconomic stability and promote growth. Since official development assistance to Lao P.D.R. is already substantial, 25 percent of GDP,⁵ and includes a broad range of specific poverty reduction programs, the aim of the PRGF program is to develop the environment for the more effective use of these resources. In addition, regional integration, which is being brought on both by the general improvement in transport links and trade liberalization under AFTA, will provide many business opportunities as a basis for sustainable growth. Making the most of these opportunities will require complementary measures to develop the private sector.

11. **The authorities stressed that the problems and delays experienced in program implementation reflected their phased approach to economic reform.** In particular, they pointed to the broader social and political considerations underpinning decentralization, and the internal discussions to build a consensus for banking reform. Moreover, appropriate phasing of reforms was seen as important to deliver intermediate successes that could mobilize support for the next reform steps.

A. Macroeconomic Policies

12. **Macroeconomic policies for 2001/02 are aimed at securing an acceptable growth rate while continuing to maintain low inflation and a stable exchange rate.** Because of the large subsistence agricultural sector, and the substantial role of external aid relative to exports, Lao P.D.R. will not be affected by the regional slowdown to the same extent as neighboring countries. Nevertheless, the authorities are aware that macroeconomic policies need to be appropriately balanced between avoiding demand pressures on the exchange rate

⁵ Based on disbursements in State Planning Committee Foreign Aid Report 1999–2000, May 2001. The disbursements on a BOP basis were 15 percent of GDP.

and supporting poverty reduction. Under these circumstances, notwithstanding higher growth and inflation projections in their plan, the authorities agreed that it would be prudent for the financial program to be based on growth in 2001/02 of 5 percent, about the same as 2000/01, and inflation projected at 5–7 percent. International reserves are targeted to remain at 2.4 months of import coverage during the year. Given the degree of uncertainty about the external environment, the more conservative assumptions provide some protection against the program going off track.

Fiscal policy and related reforms

13. **For the 2001/02 budget, the authorities are balancing macroeconomic stability objectives with pressures for additional social spending, (MEFP Paragraphs 9–12).** Reflecting this, the program provides for a fiscal deficit of about 5 percent of GDP, the same as in 2000/01, using a modest increase in revenue to support additional current spending, including for the social sectors. Domestic financing of the budget will be limited to ½ percent of GDP, mainly as bank financing. Program loans are expected to be at least \$15 million (0.9 percent of GDP)⁶.

14. **Under the program, revenue performance will continue to depend critically on improvements in administration and increasing compliance, rather than increases in tax rates.** Revenue is projected to grow modestly, by 0.4 percent of GDP, and is based on the following already adopted budget measures: (i) revisions to the Tax Law to foster better compliance, (ii) improved administration in the four largest provincial tax offices, starting with the Vientiane Prefecture, (iii) supervision by the central MOF of provincial tax and customs departments, and (iv) making customs revenue (including turnover and excise taxes on imports) a fully national tax, to avoid competition on exemptions, and progressively developing an integrated national administrative structure for customs. The last measure also removes a significant amount of the surplus revenues from the large provinces and gives the central government a more secure revenue base, in part for transfers to the deficit provinces which have a very high incidence of poverty.

15. **While total expenditure in relation to GDP is being maintained, expenditure plans provide for a shift in the composition towards current spending.** The budget allows for an increase in current expenditures to 9 percent of GDP. This will provide for a 25 percent increase in government wages needed to recover some of the earlier large losses in real wages,

⁶ The official Lao budget has a much larger increase in revenue because of less conservative assumptions and a lower deficit, but it does not include program loans. These loans comprise \$5 million from the AsDB Environment Policy Loan, and an indicative \$10 million for the first tranche of the World Bank's Financial Management Adjustment Credit (FMAC).

additional spending for maintenance, and the repayment of current arrears.⁷ Domestically funded capital expenditures will remain at about the same nominal level as in 2000/01, given the previous overruns, and include about 1 percent of GDP to start to clear arrears on projects, one source of nonperforming loans (NPLs) for the banks.

16. Public expenditure management is being strengthened to achieve the fiscal targets while supporting effective decentralization and the development of the PRSP (Box 2). To strengthen expenditure control, Budget Department approval is now required for quarterly allocations of funds for the main current expenditures, and for individual large capital expenditures. Previously, the full annual allocation of funds was available to the spending agencies, making systematic adjustments difficult in the face of revenue shortfalls. The treasury is also continuing to rationalize provincial and line ministry bank accounts and to close unauthorized accounts.⁸ In addition, the information system is being standardized to enable the publication of the 2001/02 budget with allocations of expenditure by main function/sector in March 2002. Further improvements in expenditure control, treasury operations, and information on expenditure by program will be formulated in a medium-term action plan to be agreed with Fund staff by April 2002, and will draw on the Public Expenditure Review and the AsDB project on the accounting system.⁹

Monetary and exchange rate policy

17. Monetary policy will continue to be set to restrain inflation and maintain a relatively stable exchange rate (MEFP Paragraphs 13–15). This will require further discipline on BOL financing of the budget and more active sales of government securities, including through more attractive yields. Such actions, and an unwinding of the BOL financing to banks, will keep the increase in the net domestic assets of the BOL to zero over the year and imply a 7 percent increase in reserve money. This will significantly reduce the high excess reserves in the banking system.

18. Bank credit ceilings will continue in 2001/02 as market discipline on the SCBs is gradually developed. Under this framework, total SCB credit growth will be limited to 16 percent by September 2002, with the proviso that if their NPLs on their post 2000 lending

⁷ Wages fell from 4.8 percent of GDP in 1995/96 to 2 percent in 1998/99, and are being slowly rebuilt to reach 3.2 percent of GDP in 2001/02. Total domestic budget arrears are estimated at about 3 percent of GDP, of which about 0.7 percent are current expenditures.

⁸ For example, the newly issued requirement to pay most taxes and fees in kip will eliminate one of the justifications for the proliferation of bank accounts.

⁹ Other work by the World Bank and AsDB is aimed at improving the effectiveness of the public investment program.

Box 2. Lao P.D.R.—Public Expenditure Management

Weakness in public expenditure management has been identified as a major risk for the government's ability to sustain macroeconomic stability and achieve many of the outcomes in the I-PRSP. Effective management systems are especially important in a decentralized system to ensure appropriate accountability for all levels of government. To address these problems, a broad-based public expenditure review (PER) was conducted jointly with the government, the World Bank, AsDB, and the Fund. Under this review, a FAD public expenditure management mission identified three core areas where progress should be made in the near term, together with further medium-term measures:

- **Improve budget information systems:** Under the current classification system, information is only available for expenditure by economic type, and not by function or sector (e.g., health and education) or by program, which are needed to track spending in relation to the government's announced goals. As a first step, in the 2001/02 budget allocations by sector are being prepared based on the approved aggregates. Furthermore, the 2002/03 budget will be formulated and implemented using a redesigned budget nomenclature (and revised chart of accounts) for improved tracking of expenditure by sector at all levels. These new information requirements will be incorporated into the current AsDB project to upgrade and computerize the accounting system prior to extending the system beyond four pilot ministries and one key province.
- **Enhance control over cash management:** The practice of provinces and districts holding large amounts of domestic and foreign currencies in vaults, funding expenditures from cash revenues, and operating several bank accounts creates potential for significant irregularities in operations. From mid 2000 the government has made significant efforts to cut down on government currency holdings and in 2001/02 has taken steps to streamline provincial and line ministry bank accounts. Furthermore, a program will be designed to develop a single network of treasury accounts, aimed at restricting each administrative level of government to operating one account.
- **Reintroduce effective control over commitments:** In 2000/01, the head of the spending agency had full control of spending within the budget allocation, subject only to duplicative and ineffective inspections, and the potential for an audit by the relatively small National Audit Office. In order to better control expenditures, Budget Department review of expenditures was introduced in 2001/02 on quarterly wage and provincial level recurrent expenditures and individual investment projects to ensure that, ex ante, spending authorizations are only for budgeted programs, and that there are sufficient funds for this spending, in case of revenue shortfalls. However, a system also needs to be developed to monitor and control off budget funds, domestic arrears, and government contingent liabilities.

Next steps: Building on initial actions taken in the 2001/02 budget and work under the PER framework, the government has undertaken to develop a comprehensive medium-term program for expenditure management improvements by April 2002. This would extend the work in the above areas to set the foundations for the monitoring of the PRSP.

were to increase to above 15 percent, their total level of credit outstanding would not be permitted to increase. The outstanding level of bank credit exceeded the December benchmark by the equivalent of \$13 million because of the purchase of the Lao Brewery shares. However, the recent sale (which will yield \$18 million in addition to the \$6 million deposit paid in December) will enable credit to be brought back on track for the March 2002 test date.

19. **The flexible exchange rate system, which has worked well under the program, will continue.** The bank exchange rate will be adjusted to keep the margin with the parallel rate below 2 percent, and the pronounced depreciation of the exchange rate will, in conjunction with other program variables, continue to serve as an indicator of the need to tighten macroeconomic policies.

B. Key Structural Reforms

20. **Given the large agenda for reform and the limited implementation capacity, careful prioritization is essential.** To help maintain macroeconomic stability and improve growth prospects, structural reforms focus on improving public sector financial management. This is consistent with the approach of the World Bank's FMAC, expected to be presented to the Bank Board in May 2002.¹⁰ Central elements in this approach include bank restructuring and enterprise reform, detailed below, where financial management needs to improve substantially in order to protect the medium-term fiscal position, create a credit culture on which to base future financial development, and improve governance and accountability (MEFP Paragraphs 17–21).

Bank restructuring

21. **The authorities view bank restructuring as one of the key elements in improving financial management and economic performance.** As explained in Box 3 and earlier reports (EBS/01/53, April 9, 2001), despite recapitalization in 1994, the SCBs are again deeply insolvent. The corrective strategy comprises three tracks: (i) taking immediate steps to contain the deterioration of their financial condition; (ii) developing and implementing comprehensive restructuring plans; and (iii) strengthening banking supervision.

22. **On the first track, banks are gradually building up commercial lending practices.** Banks have set up systems for credit risk analysis, are classifying all loans, and have been instructed to fully provision for the NPLs on their post-2000 loans on the basis of BOL regulations. While implementation is still far from effective, awareness is growing of the required procedures and the implementation steps for the full provisioning on post-2000 loans will be a structural performance criterion for April 2002. At the same time, the restraints on

¹⁰ The second review under the PRGF arrangement, to take place after the FMAC approval, will present the specific division of structural conditionality between the two programs.

Box 3. Lao P.D.R.—Key Elements of State Commercial Bank Restructuring Plans

The three state commercial banks (SCBs) are technically insolvent by a large margin. At end 2000, according to reports from SCBs, 52 percent of outstanding loans were nonperforming (preliminary results from audits based on international accounting standards (IAS) point to a much higher figure). Restructuring plans have been agreed, with assistance from the AsDB and World Bank, along with immediate measures to limit the emergence of new NPLs and to enhance the implementation of basic banking practices.

Operational restructuring

- **Operations:** The two smaller banks, Lao May Bank and Lane Xang Bank will merge and rationalize their operations. Both the merged bank and Banque Pour Le Commerce Extérieur (BCEL) will rationalize the operations of branches and units.
- **Business plans:** Time bound business plans, which will be prepared by May 2002, will specify the operational and financial performance targets and will indicate the operational steps to be taken to meet the performance targets.
- **International management expertise:** The government will appoint foreign advisers for the banks, who, in addition to providing general advice, will review all credit decisions over KN 300 million for compliance with commercial lending criteria.

Credit discipline

- **Policy lending:** Though still considered necessary by the government, policy lending will be subject to commercial credit appraisal criteria and the banks will not be forced to conduct directed and other forms of non-commercial lending. The review of large loans by the foreign advisers would make such decisions more transparent.
- **Asset pricing:** The banks will price loans and deposits according to profitability and risk considerations without government influence.
- **Credit ceilings:** Credit ceilings have been imposed to limit new NPLs, and a bank will not extend any new credits if its NPL ratio for post 2000 credits exceeds 15 percent of risk assets.
- **Credit monitoring:** Full loan classification, and provisioning for all credits made after December 31, 1999 are now required and the BOL has instructed the SCBs to suspend and reverse accrued interests on NPLs. The implementation of these and other supervision measures will be monitored closely by the BOL.

Financial restructuring

- **Phased recapitalization:** The banks will be recapitalized through a four-year capital build-up program starting in the September quarter 2002 through treasury instruments. The government-funded recapitalization will be limited to their NPLs as of end 1999, which amounts to \$50 million, about 3 percent of GDP. The banks will build up their capital to eventually reach a capital adequacy ratio of 12 percent.
- **Resolution of NPLs:** The recovering of NPLs will target large defaulters and be accompanied by comprehensive restructuring programs for large SOEs such as the Defense Ministry conglomerates Phoudoi and DAFI, and Lao Aviation. The 2001/02 budget includes funds for the clearance of government arrears to contractors of about 1 percent of GDP. A high-level committee has been established to administer the payments which will be used to reduce NPLs of the banks.
- **Performance monitoring:** Successful achievement of performance targets will be the basis for continued support and recapitalization. The banks will carry out annual external audits based on international standards, which will be used to verify compliance.

Banking supervision

With technical assistance from the Fund, banking supervision will be strengthened by improving the skills of the staff of the Banking and Financial Institution Supervision Department of the BOL and conducting frequent onsite and offsite inspections. During the restructuring period, BOL will phase in compliance with prudential regulations, such as BOL 98, and will also monitor progress in relation to the performance targets.

total lending and on lending to defaulting borrowers are continuing in order to stem the banks' losses.

23. **On the second track, the individual bank restructuring plans have been agreed as a basis for the multi-year process of restructuring.** These plans, developed in conjunction with the World Bank and AsDB, are summarized in Box 3 and in the MEFP (Appendix I) and entail: (i) the phased recapitalization of the SCBs based on meeting operational and financial targets; (ii) the merger of the two smaller banks plus a rationalization of banking operations; (iii) the introduction of international management advisers with, *inter alia*, a line responsibility for reviewing all large credit decisions; and (iv) the use of strengthened debt resolution procedures, especially for the largest defaulting borrowers, and further improvements in the legal framework for credit. The more detailed business plans, including financial targets and the phasing of key restructuring measures, will be developed by May 2002 utilizing information from the soon to be completed audits. Under this framework, the first tranche of recapitalization would take place in September 2002. The total cost of bank restructuring is currently estimated at \$50 million (3 percent of GDP) spread over 4 years. The interest cost of the restructuring bonds will be included in the budget, but the timing and size is not likely to require an amendment for the 2001/02 budget.

24. **The third track is the upgrading of banking supervision, by improving the implementation of existing prudential regulations, and strengthening them as needed.** This will include an upgrading of onsite inspections and other supervision functions (for which the requested technical assistance from MAE is expected to be filled in early 2002). These improvements will allow the authorities to examine the nature of the difference in NPL ratios for end 2000, between the 52 percent reported by the banks, based on BOL Regulation 98, and the much higher figure derived from the preliminary results of the IAS audits.

Enterprise reform

25. **Enterprise reform will first focus on promoting financial discipline.** To complement the bank restructuring program and to improve budget performance, the reform efforts, which will be supported by the FMAC, will initially target five of the largest SOEs. Three of these are large defaulters. As discussed earlier, the largest defaulting borrower, the Phoudoi conglomerate, has now been transferred from the Ministry of Defense to the MOF for restructuring, with the potential for the sale of some units to recover some NPLs. In the case of the two other large defaulters, Lao Aviation and Nam Papa, tariff adjustments are continuing, although the pricing study for Lao Aviation required for the structural performance criterion has been delayed until October 2002. Electricité du Laos, the largest revenue earner, is undergoing financial restructuring and the study on cost recovery has been completed. The government will act on the agreed recommendations by April 2002. The final SOE included in the five, the pharmaceutical company, is a chronic loss maker.

26. **Private sector development is also needed to accelerate growth.** Although such measures are not included in the program, the analytical work is underway, supported by the

World Bank and the AsDB, to reduce the burden of government regulation and improve the legal environment for debt recovery. In the meantime, with the stronger policy environment, Lao Tobacco formed a joint venture with a French partner, and the government resold the 50 percent share holding it had bought in Lao Brewery in July 2001 from two Thai foreign investors to Carlsberg Hong Kong and TCC of Thailand at end-January 2002. Foreign investors have also taken interests in an additional mobile phone network and a mining venture.

C. Poverty Reduction Strategy

27. **The government has made progress in developing a comprehensive poverty reduction strategy.** The government's approach is to develop its National Poverty Reduction Program (NPRP) by August 2002 to be fully consistent with the requirements of the full PRSP, including the participatory requirements. At the same time, the government is taking steps to put in place the information and analytical basis for the PRSP, including finalizing work on poverty measurement and monitoring indicators, and elaborating specific poverty-reducing programs, including those in education, health, agriculture, the elimination of slash and burn and opium cultivation, and remote area development. The government is acutely aware of the importance of improving information on the nature of poverty and budget execution by sector/program for prioritizing these programs to make the PSRP operational and to conduct poverty and social impact analysis of key policy measures.

28. **The main social impact of the program so far stems from the sustained reduction in inflation.** Lower inflation and the more stable exchange rate have contributed to higher growth and poverty reduction by giving businesses, especially smaller ones, more predictable costs, and greater confidence in economic management. Moreover, relative price stability has benefited the delivery of social services, since such government workers had suffered from past reductions in real wages and frequent shortages of funds, especially in remote areas.

D. External Sector Issues

29. **The extension of the removal of quantitative restrictions for items currently liberalized under the ASEAN Free Trade Agreement to a multilateral basis has been a useful start to liberalizing and simplifying the trade system.** However, it will need to be followed up by the further extension of multilateral liberalization and a more level playing field for all potential businesses. Additional measures will be included in subsequent arrangements, especially in the context of private sector development.

30. **The government is strengthening the management of external debt.** The new debt monitoring system has become operational and debt transactions from 1999 are being checked against the loan documents. Information on the old stock of debt contracted by SOEs is still being reviewed, but new debt is being closely monitored. Negotiations on the debt to the Russian Federation are ongoing. After the 2001 round in Moscow, the Russian delegation has been invited to Vientiane for the next round in 2002. These data improvements and the

outcome of debt negotiations would enable an updated assessment under the HIPC Initiative to be made.¹¹

31. **The government is committed to prudent debt policy.** In view of the continued financing requirement for investments in infrastructure identified in the I-PRSP, the government will limit new borrowing to that with a grant element of at least 35 percent.^{12,13} Given the concessional nature of the bulk of Lao P.D.R.'s debt, and assuming agreement on the Russian debt on appropriate terms, the debt-service burden should remain moderate over the medium term. With continued implementation of reform policies, Lao P.D.R. should have no difficulty continuing to service its obligations to the Fund.

IV. STATISTICAL ISSUES AND POLICY TRANSPARENCY

32. **To strengthen the statistical base, priority is being given to improving the statistics necessary to monitor key economic developments, especially on external debt, external trade, and government finances.** Work is also needed to improve the estimates of GDP where long-term technical assistance continues to be provided by Sweden. Statistics for poverty monitoring and the compilation of social indicators are being upgraded with the assistance of the World Bank and AsDB, as part of the foundations of the PRSP.

33. **General policy transparency needs to be improved.** The scope of legal instruments and the range of economic statistics, including monetary, budget, and real sector data, being published domestically are increasing.¹⁴ However, still more needs to be done. For example, although the budget for 2000/01 was ultimately published in the Official Gazette in considerable detail, its dissemination needs to be broadened.

V. PROGRAM RISKS, PROGRAM MONITORING, AND SAFEGUARDS

34. **Limited technical capacity and still entrenched vested interests are the main risks to program implementation.** To reduce these risks, the authorities, in close

¹¹ The NPV of debt before application of traditional debt relief mechanisms is currently estimated at about \$1.3 billion, or 250 percent of exports, including the SUR 782 million debt to Russia converted at the exchange rate of SUR 0.6 per U.S. dollar proposed by Russia.

¹² As explained in Table 5, one loan of \$38 million is being exempted from the debt ceiling, with a grant element of 34.4 percent.

¹³ The \$40 million financing gap in 2002 could be largely filled by \$17 million from three disbursements under the PRGF and \$20 million from the FMAC.

¹⁴ Although laws have been published, the implementation of these laws is effective only by the issuance of regulations and circulars, which until recently, were not widely published.

collaboration with the international financial institutions and bilaterals, have been building both the analytical base for the design of the reform policies, and a broader understanding of their need. Technical assistance is continuing to address capacity constraints, and is being provided by the Fund in the areas of banking supervision, tax and customs administration, and statistics. Nevertheless, a political level commitment to support improvements in governance and accountability will also be crucial to overcoming the vested interests in the *status quo*.

35. The authorities are requesting waivers of the nonobservance of three end-June quantitative performance criteria and one structural performance criterion, and the modification of one end-March 2002 performance criterion. In particular:

- The waivers are requested for the performance criteria on net bank credit to government and the net domestic assets of the BOL, on the basis of improved fiscal performance, meeting the December 2001 benchmark, and the new measures and prior actions to improve revenue collection and expenditure control (paragraphs 6, 14, and 16).
- The waiver for the nonobservance of the end-June 2001 performance criterion on NIR is based on the technical nature of the reclassification of a component of reserves and because the flows were in line with the program (paragraph 3).
- The waiver for the nonobservance of the September 2001 structural performance criterion on the SCB plans is requested on the basis of these plans only having been delayed by three months (paragraph 21–24).
- The modification of the structural performance criterion on price adjustments is being requested in terms of a delay in the completion date, from March 2002 to October 2002. This is due to the delay in preparing the Lao Aviation study and is considered justified on the basis of intermediate price adjustments being made (paragraph 25).

36. The proposed program includes quantitative performance criteria for March 2002 and September 2002. Structural conditionality under the program, summarized in Table 8 and reviewed in Box 4, is in line with staff guidelines.

37. The overall findings of the Stage One safeguards assessment of the BOL, which was completed in December 2001, indicated that significant vulnerabilities exist in all five areas of the safeguards framework. Staff recommended that certain corrective measures be taken immediately by the authorities, to be followed by a Stage Two (onsite) assessment after the measures were implemented. The immediate measures relate to the areas of the external audit mechanism, financial reporting, and the system of internal controls. Specifically, the authorities are committed to (i) use of International Standards on Auditing in the external audit starting with the 2001 accounts conducted by the National Audit Office, with the assistance of an international auditing firm, to be completed by July 2002; (ii) publish the 2001 audited financial statements by August 2002; (iii) compile the 2001 accounts using International Accounting Standards on a pro forma basis by July 2002; (iv) prepare a

Box 4. Lao P.D.R.—Structural Conditionality

Coverage of structural conditionality in the current program

Structural conditionality for the 2001 program is set out in the MEFP dated March 26, 2001, attached to the Staff Report for the Request for an Arrangement under the PRGF (EBS/01/53) and summarized in Attachment III, Table 7 and updated in Tables 6 and 7 of Attachment II of this report. The structural conditionality focuses on strengthening the financial position of the SCBs, reducing the drain on public resources from SOEs, 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 more rapid growth with equity. The structural performance criteria in banking and SOE areas are aimed directly at macroeconomic aspects of the program. Only the prior action on the publication of the budget is not macro-critical, but is needed to start the process of fiscal transparency.

Status of structural conditionality from earlier programs

Not applicable, as this is the first PRGF arrangement after a gap of four years.

Structural areas covered by World Bank lending and conditionality

The World Bank is preparing a Financial Management Adjustment Credit (FMAC) which is expected to be presented to their Board in late May 2002. It has a unified 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 on the banks, pricing and restructuring of SOEs, and expenditure management especially on the public investment program. The financial sector component of the FMAC will, in turn, be closely coordinated with the potential AsDB financial sector operation. While the PRGF incorporates conditionality in some of the FMAC areas, especially SOEs, the second review of the PRGF will show the coordination of structural conditionality. Looking ahead, PRGF program will continue to use the analytical base developed under FMAC and complement the Bank's conditionality in some macro-critical areas.

Other relevant structural conditions not included in current program

The World Bank and AsDB will cover private sector development in future programs. Such reforms are needed to ensure that regional integration under AFTA results in broad based growth that supports poverty reduction. The porous nature of the trade system has allowed many small traders to flourish. However, larger private businesses without connections to influential people or state enterprises remain severely hampered by bureaucratic problems and regulations in both the trade and business environment. The World Bank and AsDB are currently preparing analytical work to identify some of the crucial impediments as the basis for including appropriate reforms in future operations.

reconciliation of the audited reserves in the BOL's balance sheet to NIR reported to the Fund under the PRGF arrangement by March 2002; and (v) complete a high-level review of the BOL's internal control systems by May 2002 as a structural benchmark, for which technical assistance is being requested from a European central bank.

VI. STAFF APPRAISAL

38. Under the first-year PRGF-supported program, significant progress was made in strengthening macroeconomic stabilization and laying the groundwork for further structural reforms. Generally restrained policies have helped to further reduce inflation, while economic activity has remained relatively robust. Although fiscal slippages emerged during the year stemming from decentralization, they were corrected in time to preserve the hard-won stability. At the same time, with stability, the government has also started to build up the mechanisms to improve financial management and make more effective use of public resources for poverty reduction.

39. **Fiscal policy for 2001/02 has been set to maintain macroeconomic stability.** The track record already set in the December quarter gives assurances that continued improvements in revenue performance and expenditure control are achievable, and that bank financing of the budget would be limited. In particular, making customs duties a national tax and better tax administration procedures should improve revenue performance, and the balance of revenue among the levels of government. At the same time, strengthening expenditure management will aid budget discipline, reduce arrears, and improve accountability for the different levels of government. However, substantial further progress will be needed over the medium term, and should be addressed in the government's medium term action plan for expenditure management improvements.

40. **Monetary policy is appropriately aimed at maintaining low inflation.** With more flexible interest rates, additional sales of government securities would help to curtail the need for central bank financing of the deficit. This should be complemented by continued restraints on lending by the SCBs, especially while their restructuring is only beginning. The flexible exchange rate policy has worked well and should continue.

41. **Progress at banking reform will need to be accelerated.** With agreement on the framework for bank restructuring, attention should now be focused on implementing specific measures and identifying the operational improvements and financial targets to measure performance. The temporary use of foreign management expertise will assist in meeting these targets, especially in credit risk management, ensuring the independence and transparency of lending decisions. Also, the merging of the two small banks will improve their viability as long as appropriate rationalization steps are taken. It is understood that this restructuring will take some years and thus recapitalization will need to be phased.

42. **Strong SOE reform should complement banking reform.** The highest priority is to restructure the large debtors. The restructuring of largest debtor, the former military

conglomerate Phoudoi, will be important for the success of loan recovery efforts, demonstrating sanctions for nonperforming debtors. Price adjustments will need to continue so as to achieve cost recovery for key utilities.

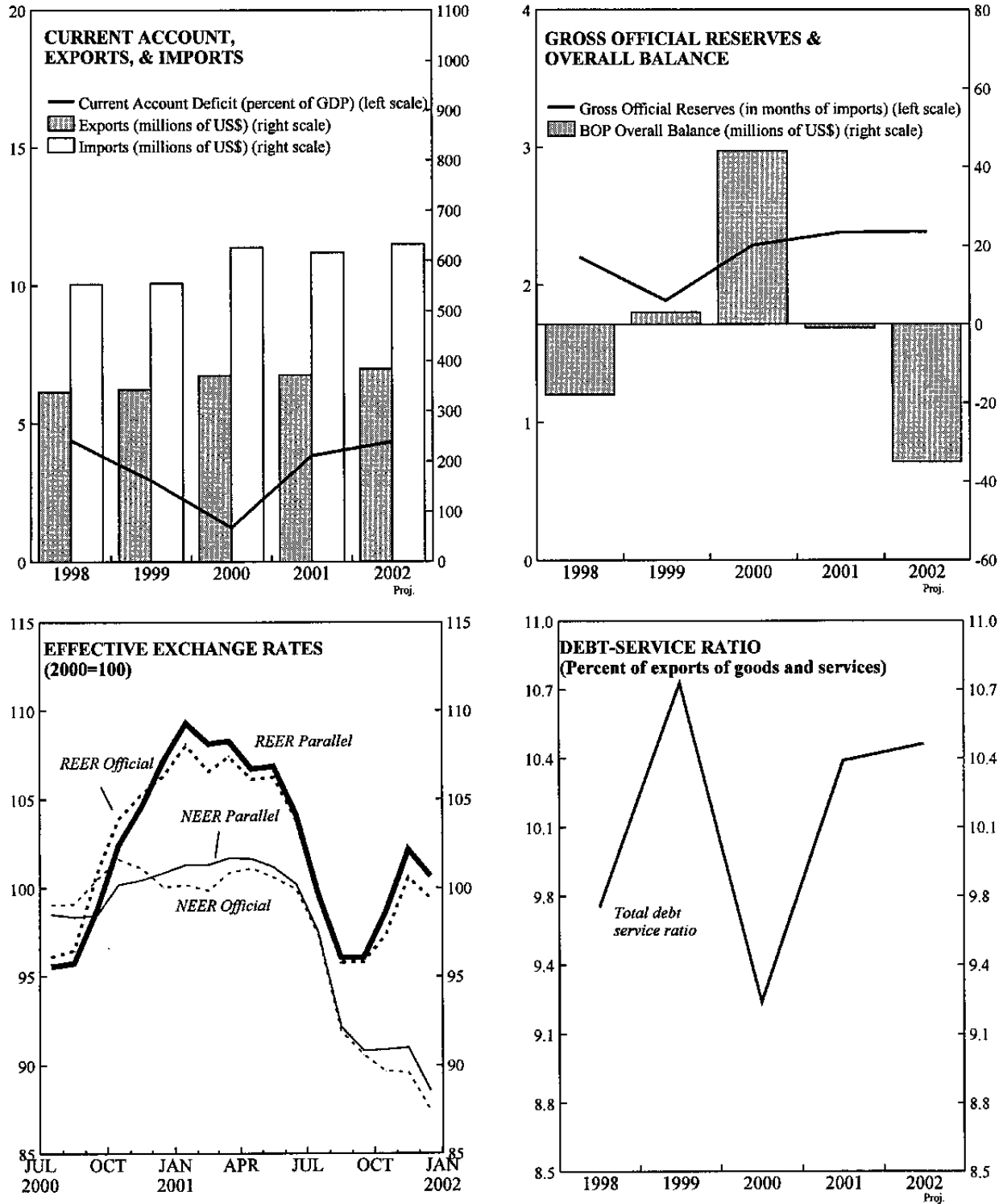
43. **On the basis of the Stage One safeguards assessment, the authorities have committed to implement a broad range of corrective measures.** However, the onsite assessment is not expected to be completed by the time of the first PRGF review, as required by the safeguards policy, to allow time for the authorities to implement these immediate corrective measures prior to conducting the onsite assessment. The staff proposes that the Executive Board complete the review based on the authorities' commitment to implement these measures. The staff expects the safeguards assessment to be completed by end 2002.

44. **Recent basic steps to strengthen transparency are welcomed, but considerable further measures are needed.** Such actions providing more information on economic performance and policy actions would boost donor and investor confidence and increase the scope for informed participation. Similarly, a further upgrading of Lao P.D.R.'s statistical base is important and the authorities should give highest priority to the areas of external trade, external debt, and government finance statistics.

45. **The staff believes that the main risks to the program are in the pace of reform, especially when affecting vested interests.** Going forward, the positive results from macroeconomic stabilization have produced a consensus for commercializing state banks and SOEs. It is noteworthy that there is a willingness to tackle the very largest debtors including the military enterprises. However, reforms will need to be sequenced to ensure that the consensus is built up to press ahead with the task of meeting the challenge of regional integration.

46. **The staff recommends completion of the first review under the PRGF arrangement on the strength of the authorities' program through September 2002 and completion of the agreed prior actions.** The staff also supports the authorities' request for waivers of the nonobservance of three performance criteria for end June and the structural performance criterion for end September, and for the associated modification of one performance criterion for end-March 2002. These breaches were due to policy problems that have been corrected and the time taken for consensus building while the underlying policy commitment remains intact.

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 PDR: 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 completes first review, based on quantitative performance criteria for June 2001.
June, 2002	4.53	8.6	Board completes second review, based on quantitative performance criteria for March 2002, and endorses second-year program.
November, 2002	4.53	8.6	Board completes third review, based on quantitative performance criteria for September 2002.
May, 2003	4.53	8.6	Board completes fourth review, based on quantitative performance criteria for March 2003, and endorses third-year program.
November, 2003	4.53	8.6	Board completes fifth review, based on quantitative performance criteria for September 2003.
May, 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, 2001–11 1/

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
		Projections									
(In millions of SDRs)											
Enhanced Structural Adjustment Facility (ESAF) and Poverty Reduction and Growth Facility (PRGF)											
Disbursements PRGF	4.5	13.7	9.1	4.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repayments	7.3	7.0	6.5	5.3	4.1	2.2	2.4	4.1	5.9	6.4	5.9
ESAF/PRGF	7.3	6.5	6.5	5.3	4.1	2.2	2.4	4.1	5.9	6.4	5.9
SAF	0.0	0.6	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											
Total	29.7	36.4	39.1	38.4	34.3	32.1	29.7	25.6	19.6	13.3	7.3
ESAF/PRGF	29.2	36.4	39.1	38.4	34.3	32.1	29.7	25.6	19.6	13.3	7.3
SAF	0.6	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											
Total	56.2	68.8	73.9	72.6	64.8	60.6	56.1	48.3	37.1	25.0	13.8
ESAF/PRGF	55.1	68.8	73.9	72.6	64.8	60.6	56.1	48.3	37.1	25.0	13.8
SAF	1.1	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											
In percent of GDP	2.2	2.6	2.7	2.4	2.0	1.8	1.6	1.3	0.9	0.6	0.3
In percent of exports of goods and nonfactor services	6.8	7.9	7.9	7.3	6.1	5.7	6.1	4.4	3.2	2.0	1.1
Total debt service due to the Fund											
Total obligations, including interest and charges (in millions of SDRs)	7.9	7.3	6.8	5.6	4.4	2.5	2.7	4.4	6.2	6.6	6.1
In percent of exports of goods and nonfactor services	1.8	1.6	1.4	1.1	0.8	0.4	0.6	0.8	1.0	1.0	0.9
Memorandum items:											
Exchange rate (U.S. dollars per SDR)	1.27	1.26	1.26	1.27	1.27	1.27	1.27	1.27	1.27	1.27	1.27
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
GDP (in millions of U.S. dollars)	1,723	1,743	1,859	2,020	2,187	2,239	2,396	2,563	2,743	2,935	3,140
Exports of goods and services	561	579	626	669	711	715	624	747	786	828	875

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

1/ Data may not add up due to rounding.

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

Nominal GDP (1999): \$1,469 million
 Population (1999): 5.1 million
 GDP per capita (1999): \$288
 Fund quota: SDR 52.9 million

	1998	1999	2000 Est.	2001		2002 Prog.
				Prog.	Est.	
Nominal GDP (in billions of kip)	4,240	10,304	13,495	15,534	15,334	17,257
Real GDP growth (percent change) 1/ Prices (percent change)	4.0	7.3	5.8	5.7	5.2	5.0
Consumer prices						
(12-month rate; end-of-period)	141.9	86.7	10.6	8.0	7.5	6.0
(monthly percent change; end-of-period) 2/	4.9	-1.1	-0.9	...	...	...
GDP deflator (annual average)	85.2	126.5	23.8	9.0	8.0	7.2
Government budget (percent of GDP) 3/						
Revenue	9.8	10.6	13.2	13.9	13.5	13.9
Grants	5.3	6.0	3.7	2.8	3.2	3.3
Expenditure	23.6	20.6	21.4	21.7	21.7	21.9
Current account balance (excluding grants)	1.7	4.4	5.0	5.5	5.8	5.2
Overall balance (including grants)	-8.5	-4.0	-4.6	-5.0	-5.0	-4.6
<i>Of which</i> : Bank financing	0.8	-0.4	-0.8	0.0	1.7	0.3
Money and credit (percent change; end-of-period) 4/						
Broad money	113.3	78.4	45.7	22.6	10.2	19.0
Bank credit to the economy	86.3	74.2	41.1	24.2	23.9	18.0
Credit to SOEs	85.6	99.2	36.1	15.6	21.1	10.8
Credit to the private sector	86.6	63.6	43.7	29.2	25.5	16.2
Interest rates (in percent; end-of-period)						
On one-year deposits	23	24	24	...	20	...
On short-term loans	31-36	22-30	16-24	...	12-18	...
External trade						
Trade balance (in millions of U.S. dollars)	-216	-212	-256	-231	-245	-249
Exports (percent change in U.S. dollar value)	6.4	1.5	8.3	7.4	0.3	3.2
Imports (percent change in U.S. dollar value)	-14.7	0.3	12.9	10.6	-1.6	2.6
Balance of payments (percent of GDP)						
Current account balance (including official transfers)	-4.4	-2.9	-1.2	-3.1	-3.8	-4.3
Overall balance (in millions of U.S. dollars)	-18	3	44	-8	-4	-33
Gross official reserves (in millions of U.S. dollars)	112	106	127	152	133	146
(in months of prospective goods and service imports)	2.2	1.9	2.5	2.5	2.4	2.4
Net official reserves (in millions of U.S. dollars)	50	53	97	107	96	100
External debt (in percent)						
Ratio of debt-to-GDP 5/	84.5	80.0	70.1	61.8	70.1	72.6
Debt-service ratio 6/	9.7	10.7	9.3	9.7	10.4	10.4
Exchange rate						
Kip per U.S. dollar (end-of-period)						
Commercial bank rate	4,274	7,600	8,140	...	9,490	...
Parallel market rate	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 Fund staff estimates and projections.

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/ Moving average of latest three monthly observations.

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

4/ Money and credit program for 2001 and 2002 presented on fiscal year basis.

5/ Excludes debt in nonconvertible currencies; includes debt to the Fund (SAF and ESAF).

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

Table 4. General Government Operations, 1999/2000–2001/02

	1999/00		2000/01		2001/02	
	Est.	Budget	Prog.	Est.	Budget	Prog.
(In billions of kip)						
Revenue and grants	2,166	2,614	2,473	2,455	3,030	2,850
Revenue	1,691	2,194	2,053	1,979	2,481	2,301
Tax	1,367	1,742	1,687	1,592	2,043	1,863
Profit tax	187	316	301	204	362	332
Income tax	117	182	182	152	190	160
Turnover tax	290	379	359	315	452	427
Excise tax	226	336	316	371	362	337
Import duties	135	192	192	161	229	204
Timber royalty receipts	273	115	115	120	165	165
Other	140	222	222	268	283	238
Nontax	324	452	366	388	438	438
<i>Of which</i> : SOE dividends	42	212	127	67	89	89
Interest payments	79	40	40	100	42	42
Overflight revenues	123	125	125	114	153	153
Grants	475	420	420	476	549	549
Expenditure	2,754	3,382	3,204	3,187	3,614	3,614
Current	1,050	1,417	1,239	1,135	1,449	1,449
Wages and salaries	335	417	417	417	525	525
Materials and supplies	174	342	342	308	370	370
Interest payments	103	175	175	133	145	145
Timber royalty financed expenditure	242	115	15	0	0	0
Other recurrent	196	368	290	278	409	409
Capital and onlending	1,704	1,965	1,965	2,052	2,165	2,165
<i>Of which</i> : domestically financed	481	805	805	989	1,017	1,017
Externally financed	1,302	1,200	1,200	1,200	1,256	1,256
Current balance	641	776	814	844	1,033	853
Overall balance	-588	-769	-731	-732	-583	-763
Excluding grants	-1,063	-1,189	-1,151	-1,208	-1,132	-1,312
Financing	588	769	731	732	583	763
Domestic financing	-148	213	175	255	33	71
Bank financing 1/	-104	0	0	246	13	50
Nonbank financing	-44	213	175	9	20	21
Foreign financing (net)	736	556	556	478	550	692
Project loans	827	780	780	724	826	969
Program loans	96	0	0	0	0	143
Amortization	187	224	224	247	276	276
(In percent of GDP)						
Revenue and grants	16.9	17.7	16.8	16.7	18.4	17.3
Revenue	13.2	14.9	13.9	13.5	15.0	13.9
Tax	10.6	11.8	11.4	10.8	12.4	11.3
Nontax	2.5	3.1	2.5	2.6	2.7	2.7
Grants	3.7	2.8	2.8	3.2	3.3	3.3
Expenditure	21.4	22.9	21.7	21.7	21.9	21.9
Current	8.2	9.6	8.4	7.7	8.8	8.8
Capital and onlending	13.3	13.3	13.3	14.0	13.1	13.1
Current balance, excluding grants	5.0	5.3	5.5	5.8	6.3	5.2
Overall balance	-4.6	-5.2	-5.0	-5.0	-3.5	-4.6
Excluding grants	-8.3	-8.1	-7.8	-8.2	-6.9	-7.9
Financing	4.6	5.2	5.0	5.0	3.5	4.6
Domestic financing (net)	-1.2	1.4	1.2	1.7	0.2	0.4
Bank	-0.8	0.0	0.0	1.7	0.1	0.3
Nonbank	-0.3	1.4	1.2	0.1	0.1	0.1
Foreign financing (net)	5.7	3.8	3.8	3.3	3.3	4.2
Memorandum item:						
Nominal GDP, fiscal year (in billions of kip)	12,848	14,755	14,755	14,671	16,614	16,614
Exchange rate (kip per U.S. dollar, average)	7,670	8,000	8,400	8,600	9,500	9,500

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

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.: Quantitative Performance Criteria and Benchmarks, March 2001–September 2002

	2000		2001									2002		
	Stock at end-Dec	March		June 1/		Sept			Dec			Mar 1/ Prog.	June Prog.	Sept 1/ Prog.
		Prog.	Est.	Prog.	Est.	Prog.	Est.	Rev. prog. new base 2/	Prog.	Rev. prog.	Est.			
(In billions of kip)														
1. Net domestic assets of the Bank of Lao P.D.R. (BOL) 3/ 4/	-33	-143	-44	-130	-84	-100	-43	-130	-194	-96	-85	-100	-149	-134
2. Net credit to the government from the banking system 4/	-420	-403	-291	-386	-236	-368	-122	-141	-491	-116	-118	-112	-126	-91
3. Net domestic assets of the state commercial banks (excluding net claims on government) 5/	1,188	1,227	1,212	1,265	1,227	1,302	1,325	1,501	1,340	1,415	1,536	1,460	1,502	1,537
(In millions of U.S. dollars)														
4. Net official international reserves 4/ 6/	57	68	46	67	55	63	65	65	74	59	67	68	68	66
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
<i>Of which: 1–5 years' maturity</i>		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	0
Memorandum item:														
Nonproject budget support (cumulative flows from start of year)	11.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	15.0	0.0	0.0	5.0	15.0	15.0
External debt service payments (cumulative from start of year)	...	6.9	8.5	13.2	14.1	...	22.7	22.7	...	28.6	28.6	8.7	14.6	24.0
Program exchange rate (kip per dollar)	8,218	8,200	8,200	8,200	8,200	8,200	8,200	9,500	8,200	9,500	9,500	9,500	9,500	9,500
Foreign currency component of required reserves	27	29	28	30	28	32	28	28	33	29	29	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 (\$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 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. 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. Excludes normal import-related credit, any borrowing associated with debt rescheduling, and the loan from Exim Bank of China, for a maximum amount equivalent to \$38 million (with a 15 year repayment schedule, two-year grace period and 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 6. Lao P.D.R.: Monetary Survey, 2000–2002

	2000	2001									2002		
		June		Sept			Dec			Mar	June	Sept	
		Prog.	Est.	Prog.	Est.	Rev. prog. new base 1/	Prog.	Rev. prog.	Est.	Prog.	Prog.	Prog.	
(In billions of kip; end of period)													
Monetary Survey													
Net foreign assets 2/	1,528	1,379	1,426	1,361	1,242	1,443	1,465	1,550	1,428	1,606	1,651	1,631	
<i>Of which</i> : SCBs	483	529	412	551	289	335	574	464	283	470	479	510	
Net domestic assets	721	1,096	892	1,227	1,084	1,156	1,235	1,181	1,246	1,252	1,336	1,458	
<i>Of which</i> : SCBs (excluding net credit to government)	1,193	1,265	1,227	1,302	1,325	1,501	1,340	1,415	1,536	1,460	1,502	1,537	
Domestic credit	1,439	1,646	1,807	1,744	2,083	2,341	1,702	2,327	2,450	2,427	2,498	2,611	
<i>Of which</i> : SCBs	815	907	920	950	1,066	1,194	988	1,124	1,297	1,194	1,261	1,311	
Net claims on government 2/	-420	-386	-236	-368	-122	-141	-491	-116	-118	-112	-126	-91	
Claims on the economy	1,859	2,032	2,043	2,112	2,205	2,482	2,192	2,443	2,567	2,539	2,624	2,702	
<i>Of which</i> : SCBs	882	959	997	996	1,118	1,253	1,034	1,183	1,318	1,233	1,280	1,320	
<i>Of which</i> : in foreign currency	1,491	1,526	1,612	1,542	1,745	2,022	1,557	1,960	2,075	2,039	2,079	2,129	
Credit to state enterprises	606	701	768	725	857	982	748	892	1,028	928	948	960	
Credit to private sector	1,253	1,331	1,275	1,387	1,348	1,500	1,444	1,551	1,539	1,611	1,676	1,742	
Other items (net) 2/	-718	-550	-915	-517	-999	-1,185	-466	-1,146	-1,203	-1,175	-1,162	-1,152	
Broad money	2,249	2,476	2,318	2,588	2,327	2,599	2,701	2,731	2,675	2,859	2,987	3,090	
Domestic currency (cash and deposits)	536	594	624	621	611	611	647	631	681	665	698	727	
Foreign currency deposits	1,713	1,882	1,694	1,968	1,716	1,988	2,054	2,100	1,993	2,194	2,289	2,363	
(In millions of U.S. dollars; end of period)													
Net foreign assets 2/	185.9	168.2	173.9	166.0	151.5	151.9	178.7	163.1	150.4	169.1	173.7	171.7	
<i>Of which</i> : SCBs	58.8	64.5	50.2	67.2	35.3	35.3	70.0	48.9	29.8	49.5	50.5	53.6	
Foreign currency credit to the economy	181.5	186.1	196.5	188.0	212.8	212.8	189.9	206.3	218.4	214.6	218.8	224.1	
<i>Of which</i> : SCBs	80.4	87.7	90.1	91.1	104.1	104.1	94.6	95.0	108.3	98.2	103.2	106.7	
Foreign currency deposits	208.5	229.5	206.6	239.9	209.2	209.2	250.5	221.1	209.8	231.0	240.9	248.7	
(Annual percentage change)													
Broad money	45.7	20.9	13.2	22.6	10.2	23.1	20.0	21.4	18.9	24.1	23.8	19.0	
Net domestic asset of SCBs (increase from start of program) 3/	...	6.0	2.8	9.1	2.8	16.2	12.3	2.1	-1.6	5.3	8.3	10.8	
Credit to the economy 3/	41.1	29.3	30.0	24.2	23.9	39.2	17.8	31.4	28.9	25.4	23.1	14.2	
<i>Of which</i> : commercial banks 3/	44.1	31.8	34.1	27.5	28.9	43.4	18.0	33.2	28.3	28.1	25.7	18.0	
<i>Of which</i> : SCBs 3/	58.6	39.3	44.8	28.5	31.4	46.9	17.3	34.2	30.0	26.6	23.2	16.0	
Credit to state enterprises 3/	36.1	21.1	32.7	15.6	21.1	38.5	16.5	47.1	41.4	22.0	17.7	10.8	
Credit to the private sector	43.7	34.1	28.5	29.2	25.5	39.7	18.5	23.8	22.9	27.4	26.4	16.2	
Memorandum items:													
Bank financing of the budget (in billions of kip) 4/	-46	-18	131	0	246	...	-123	25	23	29	15	50	
Money multiplier	2.9	3.7	3.3	3.8	3.3	3.5	3.9	3.7	3.3	3.4	3.8	3.9	
Exchange rate, eop (kip per U.S. dollar)	8,218	8,200	8,200	8,200	8,200	9,500	8,200	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 (\$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.: Balance Sheet of Bank of Lao P.D.R., 2000–2002

	2000	2001							2002			
		June		Sept			Dec		Mar	June	Sept	
		Prog.	Est.	Prog.	Est.	Rev. prog. new base 1/	Prog.	Rev. prog.	Est.	Prog.	Prog.	
(In billions of kip; end of period)												
Bank of Lao P.D.R.												
Net foreign assets 2/	799	794	782	775	757	880	880	836	908	929	942	935
Foreign assets	1,147	1,148	1,138	1,117	1,099	1,273	1,246	1,254	1,268	1,321	1,361	1,332
Foreign liabilities	-347	-355	-356	-342	-343	-393	-366	-418	-361	-392	-419	-398
Net domestic assets 3/	-33	-130	-84	-100	-43	-130	-194	-96	-85	-100	-149	-134
Domestic credit	588	485	649	506	731	828	386	847	890	872	810	816
Net credit to government 2/	-347	-327	-144	-315	-65	-76	-438	-51	-96	-67	-101	-76
Credit to the economy	489	537	523	556	534	618	574	618	639	639	639	639
Credit to state enterprises	346	394	385	412	403	467	431	467	489	488	488	488
Credit to private sector	143	143	138	143	130	151	143	151	151	151	151	151
Credit to banks	446	276	270	266	262	285	250	280	348	300	272	253
BOL securities	-159	-98	-144	-71	-201	-201	-26	-188	-200	-196	-183	-175
Other items, net 2/	-461	-517	-589	-536	-573	-757	-554	-755	-776	-776	-776	-776
Of which : medium-term foreign liabilities	-211	-267	-264	-286	-283	-328	-304	-328	-347	-347	-347	-347
Reserve money 3/	767	663	698	675	714	750	686	740	823	829	793	801
(In millions of U.S. dollars; end of period)												
Net foreign assets 2/	97	97	95	95	92	93	107	88	96	98	99	98
Gross international reserves 2/	126.5	140.1	126.7	136.3	134.1	134.0	151.9	132.0	133.5	139.0	143.3	140.2
(in months of imports)	2.3	2.5	2.3	2.4	2.4	2.4	2.7	2.3	2.4	2.4	2.4	2.3
Required reserves on foreign currency deposits	27.3	30.3	28.3	31.6	27.5	27.5	32.9	28.7	29.0	30.0	31.3	32.3
(Annual percentage change)												
Reserve money 3/	59.1	18.1	24.3	1.7	7.6	13.0	11.2	20.0	33.4	24.9	11.6	6.9
Memorandum items:												
BOL financing of the budget (in billions of kip) 4/	-73	-58	125	-46	204	...	-123	25	-21	9	-25	0
Disbursement of program loans (millions of U.S. dollar) 4/	...	0	0	0	0	0	15	0	0	5	15	15
Exchange rate, eop (kip per U.S. dollar)	8,218	8,200	8,200	8,200	8,200	9,500	8,200	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 (\$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 8. Lao P.D.R.: Key Structural Policy Actions
Under the First-Year PRGF-Supported Program

Policy Action	Conditionality	Status
A: Structural Conditionality, September 2001		
Formulate individual SCB restructuring plans in support of banking reform, consistent with the Memorandum on Economic and Financial Policies, and prepared with assistance from the AsDB and the World Bank.	Structural performance criterion	Done. Plans received December 2001. Waiver requested on the basis of late compliance.
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	Generally met. Two out of the 30 large borrowers had a small increase in balances outstanding, and one has repaid most of this.
Issue regulations to apply removal of quantitative restrictions under AFTA to a multilateral basis.	Structural benchmark	Done.
B: Prior Actions for Completion of First PRGF Review		
Transmit audit of BOL by National Audit Office to the IMF.		Done.
Meet 2001/02 first quarter fiscal targets.		Done.
Implement nationwide network of Taxation and Customs Departments.		Done.
Complete quick audits for 100 of the largest taxpayers, starting July 1, 2001, and collect identified tax obligations, to be verified by providing a list of taxpayers audited and the total revenue collected.		Done.
Publish tables for 2001/02 budget with expenditure classified by central government ministry and province, and outturn for 2000/01.		Expected by February, 11.
Complete the sale of Lao Brewery shares bought by the Government to bring the credit program back on track.		Sale agreed at end-January.

Table 8. Lao P.D.R.: Key Structural Policy Actions
under the First-Year PRGF-Supported Program (concluded)

Policy Action	Conditionality	Status
C: Structural Benchmarks and Performance Criteria for Second PRGF Review		
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	Increase in credit to one defaulting borrower remains outstanding.
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	Required regulations and reporting systems established. On-site capacity and sanctions to be developed, with technical assistance.
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	Work underway.
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	Work underway, drawing on key recommendations from PER report.
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	Technical assistance is being requested from a European central bank.
Complete studies on electricity and airline tariffs, with technical assistance from the World Bank, and implement new tariff structures to achieve cost recovery and/or targeted subsidies.	Structural performance criterion, previously March 2002, now October 2002.	Delayed because of Lao Aviation study, but intermediate pricing action being taken.

Table 9. Lao P.D.R.: Summary Macroeconomic Framework 1998–2004

	1998	1999	2000	2001	2002	2003	2004
	Projections						
Real GDP growth (percent change)	4.0	7.3	5.8	5.2	5.0	5.7	6.5
Inflation (percent change, annual average)	90.1	128.4	23.2	8.0	7.2	5.0	5.0
Merchandise exports (percent change)	6.4	1.5	8.3	0.3	3.2	8.5	6.9
Merchandise imports (percent change)	-14.7	0.3	12.9	-1.6	2.6	25.7	11.6
(percent change excluding NT2)						7.8	8.0
Official gross reserves (in months of prospective goods and services imports, excluding NT2)	2.2	1.9	2.3	2.4	2.4	2.9	3.3
Budget (fiscal year basis) 1/							
Revenue	9.8	10.4	13.2	13.5	13.9	14.1	14.7
Grants	5.3	5.9	3.7	3.2	3.3	3.1	2.9
Expenditure	23.6	20.2	21.4	21.7	21.9	22.3	22.5
Current	8.1	6.0	8.2	7.7	8.8	9.6	10.0
Capital and onlending	15.5	14.2	13.3	14.0	13.1	12.7	12.5
Current fiscal balance before grants	1.7	4.4	5.0	5.8	5.2	4.5	4.7
Overall fiscal balance after grants	-8.5	-3.9	-4.6	-5.0	-4.6	-5.1	-5.0
Domestic financing	2.5	-0.6	-1.2	1.7	0.4	0.3	0.4
Foreign financing	6.0	4.5	5.7	3.3	4.2	4.7	4.6
Real GDP growth (percent change) 1/	4.7	6.5	6.2	5.4	5.1	5.5	6.3
Increase in GDP deflator (percent change) 1/	71.2	120.4	35.6	8.4	7.8	5.2	5.0
Savings and Investment balance 2/							
National savings	12.7	14.8	12.7	14.6	15.1	15.2	16.0
Private	11.0	10.4	7.7	8.9	9.9	10.7	11.3
Government	1.7	4.4	5.0	5.8	5.1	4.5	4.7
Investment	22.8	22.5	21.0	22.1	22.5	30.9	33.3
Private	7.3	8.3	7.1	7.4	8.6	18.2	20.8
O/w hydropower	1.4	1.9	0.2	0.0	0.0	8.1	9.9
Other	5.9	6.4	6.9	7.4	8.6	10.1	10.9
Government 3/	15.5	14.2	13.9	14.7	13.9	12.7	12.5
Foreign savings	10.1	7.7	8.3	7.5	7.5	15.7	17.2
Excluding hydropower	8.7	5.8	8.1	7.5	7.5	7.4	7.1

Source: Data provided by the Lao authorities; and staff estimates

1/ Fiscal year ending September.

2/ Estimates for private savings and investment are highly tentative as no firm national accounts have been established. In particular, private savings reflect unrecorded imports.

3/ Comprises government investment and selected public enterprise investment.

Table 10: Lao P.D.R. Balance of Payments, 1998–2006

	1998	1999	2000	2001	2002	2003	2004	2005	2006
			Est.		Projections				
(In millions of U.S. dollars, unless indicated otherwise)									
Current account	-56	-43	-21	-66	-76	-222	-285	-288	-290
(excluding official transfers)	-130	-113	-143	-130	-130	-292	-355	-358	-360
Merchandise trade balance	-216	-212	-256	-245	-249	-379	-443	-450	-459
Exports, f.o.b.	337	342	370	372	383	416	444	475	501
(in percent change)	(6.4)	(1.5)	(8.3)	(0.3)	(3.2)	(8.5)	(6.9)	(6.9)	(5.4)
Imports, c.i.f.	553	554	626	616	632	795	887	925	960
(in percent change)	(-14.7)	(0.3)	(12.9)	(-1.6)	(2.6)	(25.7)	(11.6)	(4.3)	(3.7)
Services (net)	71	98	126	141	147	119	121	130	139
Factor income (net)	-34	-28	-33	-49	-51	-56	-59	-65	-68
Of which: interest payments 1/	-26	-19	-19	-20	-23	-22	-23	-22	-22
Transfers (net)	123	99	142	86	78	94	96	97	99
Private	49	30	21	22	23	24	26	27	29
Official	74	70	121	64	55	70	70	70	70
Of which: technical assistance	17	14	22	...	...	...	...	...	...
Capital account	38	46	65	65	41	229	298	324	315
Long-term loans	86	65	74	48	78	98	101	106	103
Disbursements	98	94	98	77	106	128	134	141	144
Amortization	-12	-29	-24	-29	-28	-30	-34	-35	-41
Foreign investment (including external loans)	56	79	34	40	41	210	269	279	274
Of which: hydropower investment 2/	18	27	3	0	0	150	200	200	188
Net foreign assets of commercial banks (increase)	-17	-47	25	34	-20	-22	-20	-15	-15
Errors and omissions	-86	-51	-68	-56	-58	-57	-52	-46	-47
Overall balance	-18	3	44	-1	-35	7	13	37	25
Financing	18	-3	-44	1	35	-7	-13	-37	-25
Central bank net foreign assets	18	-3	-44	1	-5	-42	-33	-37	-25
Assets (increase -)	23	6	-33	6	-12	-46	-32	-32	-22
Liabilities (reduction -)	-5	-9	-10	-5	7	3	-1	-5	-3
Financing gap	0	0	0	0	40	35	20	0	0
Memorandum items:									
Current account (in percent of GDP)									
(excluding official transfers)	-10.1	-7.7	-8.3	-7.5	-7.5	-15.7	-17.6	-16.3	-16.1
(including official transfers)	-4.4	-2.9	-1.2	-3.8	-4.3	-11.9	-14.1	-13.1	-12.9
(including official transfers and excluding NT2)	-4.4	-2.9	-1.2	-3.8	-4.3	-3.7	-3.9	-3.8	-3.8
(excluding official transfers and NT2)	-10.1	-7.7	-8.3	-7.5	-7.5	-7.4	-7.4	-7.0	-6.9
Official gross reserves (in millions of U.S. dollars)	112	106	127	135	146	191	223	255	277
(in months of prospective goods and service imports, excluding NT2)	2.2	1.9	2.3	2.4	2.4	2.9	3.3	3.6	3.7
Debt service ratio (including Fund, in percent of goods and service exports) 1/	9.7	10.7	9.3	10.4	10.4	9.7	9.4	8.8	8.8

Sources: Data provided by the Lao 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 II (NT2) is valued at \$1.0 billion (approximately equivalent to 60 percent of GDP) to be implemented over 2003–2008, and about 75 percent of this would be financed by foreign investment.

Lao P.D.R.—Fund Relations
(As of December 31, 2001)

I. **Membership Status:** Joined 7/05/61; Article XIV

II.	General Resources Account:	SDR million	Percent Quota
	Quota	52.90	100.0
	Fund holdings of currency	52.90	100.0
III.	SDR Department:	SDR million	Percent Allocation
	Net cumulative allocation	9.41	100.0
	Holdings	3.97	42.2
IV.	Outstanding Purchases and Loans:	SDR million	Percent Quota
	SAF arrangement	0.59	1.1
	ESAF arrangement	29.16	55.1

V. **Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
PRGF	4/25/01	4/24/04	31.70	4.53
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. **Projected Obligations to Fund** (SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2002	2003	2004	2005	2006
Principal	7.0	6.5	5.3	4.1	2.2
Charges/interest	<u>0.3</u>	<u>0.2</u>	<u>0.2</u>	<u>0.2</u>	<u>0.2</u>
Total	7.3	6.7	5.5	4.3	2.4

VII. Implementation of HIPC Initiative

The Lao P.D.R. is eligible for assistance under the HIPC Initiative. A loan-by-loan DSA will be undertaken as soon as the necessary debt data is available, which the authorities will need in order to evaluate whether to seek HIPC relief.

VIII. Safeguards Assessments

Under the Fund’s safeguards assessment policy, the Bank of the Lao P.D.R. is subject to a full Stage One safeguards assessment with respect to the PRGF approved on April 25, 2001, which is scheduled to expire on April 24, 2004.

A Stage One safeguards assessment of the Bank of the Lao P.D.R. was completed on 12/17/01. The assessment concluded that high risks may exist in the areas of the external audit mechanism, legal structure and independence, financial reporting framework, internal audit mechanism, and internal control systems and recommended a Stage Two (onsite) assessment.

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 January 23, 2002 the commercial bank exchange rate was kip 9,455 (buying) and kip 9,555 (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. 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)

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

- Expert on tax administration. 9/98-12/99, 1-3/00, 5-7/00, 9-11/00, 1-2/01, 4-6/01
- Expert on customs administration. 10/98-1/99, 5-6/00, 9-11/00, 1-3/01, 5-6/01
- Mission on public expenditure management. 4-5/01

XI. Resident Representative

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

Lao P.D.R.—Relations with the World Bank Group¹

With the ultimate objective of reducing poverty in Lao P.D.R., the World Bank Group's operations assist the Government in achieving its overall goals of 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. A Country Assistance Strategy (CAS) for FY2000 to FY2002, incorporating these broad objectives, was issued on March 30, 1999 and approved by the Board.

All projects are financed with IDA credits. As of January 31, 2002, credits totaling about \$617.7 million equivalent had been approved for Lao P.D.R.. The composition of this portfolio is as follows: 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. The Road Maintenance Project (\$25 million equivalent) was approved on March 27, 2001.

Since 1977, the amount of IDA credits committed and disbursed has been as follows:

IDA: Commitments and Disbursements to the Lao P.D.R., 1977–2002
(In millions of U.S. dollars; as of December 31, 2001)

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	10.9	2.2
Total	617.7	464.5	15.6

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

¹ Prepared by the World Bank, February 2002.

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 underway.

Note: The last Economic Report (Lao P.D.R.: Country Economic Memorandum, Report No. 12554-LA) was published on March 24, 1994. A report entitled the Lao P.D.R.: Public Expenditure Review was issued on February 28, 1997. The latest Lao P.D.R. Country Assistance Strategy was issued on March 30, 1999.

Lao P.D.R.—Relations with the Asian Development Bank¹

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. Furthermore, in the late 1990s, the AsDB assistance has shifted towards more social and rural development to address poverty.

AsDB, together with the Government, has formulated its new Country Strategy and Program (CSP) in 2001 to guide its future operations in Lao PDR for next five years in considerable consultations with stakeholders. The theme of AsDB's interventions in Lao PDR 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.

Lao PDR is a key actor in the Greater Mekong Sub-Region (GMS) program as land-link. The AsDB will aim to explore various options to maximize the benefits to Lao PDR 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.

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.

¹ Prepared by the Asian Development Bank.

Table 2. Lao P.D.R.: Asian Development Bank
Program/Project Loan Disbursements, 1997-2001
(In millions of U.S. dollars)

	1997	1998	1999	2000	2001 ^{1/}
Loans					
Nam Song Hydropower Development Project	1.9	-	-	-	-
Fourth Road Improvement Project	0.7	-	-	-	-
Southern Provincial Towns Water Supply Proj	1.2	-	-	-	-
Fifth Road Improvement Project	8.0	0.1	-	-	-
Rehabilitation and Upgrading Of Vientiane Water Supply Project	0.5	0.1	-	-	-
Nam Ngum-Luang Prabang Power Transmission Project	0.2	1.7	-	-	-
Theun-Hinboun Hydropower Project	35.8	0.5	-	-	-
Northern Provincial Towns Water Supply & Sanitation Project	8.1	2.8	0.1	-	-
Education Quality Improvement Project	3.1	5.2	1.8	-	-
Nam Leuk Hydropower Project	10.4	22.0	13.8	2.0	0.5
Second Financial Sector Program	-	-	-	11.3	-
Champassak Road Improvement Project	8.2	9.9	8.6	5.9	1.4
Sixth Road Improvement Project	2.4	3.7	3.9	3.1	2.1
Airports Improvements Project	2.6	4.7	2.7	1.2	0.3
Primary Health Care Project	0.9	0.9	0.8	0.7	-
Vientiane Integrated Urban Development Project	0.9	1.8	6.0	6.0	1.3
Industrial Tree Plantation Project	1.0	0.6	0.9	1.1	3.0
Postsecondary Education Rationalization Project	1.0	2.1	0.8	3.4	4.3
Xieng Khouang Road Improvement Project	-	6.0	3.6	8.2	10.1
Power Transmission & Distribution Project	-	0.6	0.7	0.7	5.6
Secondary Towns Urban Dev. Project	-	1.4	0.8	0.9	3.5
Community Managed Irrigation Sector Project	-	1.8	2.2	3.0	2.8
Greater Mekong Subregion:East West Corridor Project	-	-	-	1.6	0.7
Basic Education (Girls) Project	-	-	-	0.7	0.8
Shifting Cultivation Stabilization Pilot Project	-	-	-	0.8	0.7
Water Supply And Sanitation Sector Project	-	-	-	0.4	0.6
Primary Health Care Expansion	-	-	-	-	0.5
Decentralized Irrigation Development	-	-	-	-	0.7
Rural Access Roads	-	-	-	-	1.0
Vientiane Urban Integrated Services	-	-	-	-	-
Second Education Quality Improvement	-	-	-	-	-
Environment and Social Program	-	-	-	-	-
Total	87.0	66.0	46.8	51.0	39.8

Source: Data provided by the Asian Development Bank.

^{1/} As of 30 November 2001

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 do not accurately reflect changes in the structure of the country's production and have recently displayed some implausible movements, particularly with regard to developments in the agricultural sector. In addition, they 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 income 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.

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 consumption survey. It comprises nine product categories covering major urban centers, including Vientiane.

Government finance

Government finance statistics are very 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 is not produced to GFS standards complicating fiscal analysis. In early 2001 the authorities published annual tables for the 1999/00 outturn and 2000/01 budget and in early 2002 published the 2001/02 budget by central government ministry and province. Publication of 2001/02 provincial budget data by sector will allow the identification of key spending categories, albeit highly aggregated and is expected by March 2002.

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. 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 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 Bank of the Lao P.D.R. (BOL) regularly reports the BOL 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, there is scope for improvement and the mission suggested improvements to 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 improvements in the frequency and the coverage of, the following areas: (1) customs trade data, (2) the commodity composition of external trade, (3) the recording of factor payments, (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 to remedy this with funding from the World Bank.

An STA mission in 1999 found that data coverage and valuation problems on traded goods arose from weaknesses of 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) and started to produce more accurate data in October 2000. However, for a range of technical reasons, it has not yet produced data on a regular basis.

There is an acute need to improve the coordination and cooperation 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, in order to produce accurate balance of payments updates on a regular basis.

Lao P.D.R.: Core Statistical Indicators
(As at January 31, 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	1/31/01	1/11/02	12/01	12/01	12/01	12/01	12/01	Q2/01	Q2/01	12/01	2000	Q2/01
Date received	1/31/01	1/21/02	1/11/01	1/11/02	1/22/02	01/23/02	1/2/02	9/10/01	9/10/01	1/15/02	5/01	9/10/01
Frequency of data	D	M ^{1/}	M	M	M	M	M	Q	Q	M ^{2/}	A	Q
Frequency of reporting	D	M ^{1/}	M	M	M	M	M	Q	Q	M ^{2/}	A	Q
Source of Data ^{3/}	A	A	A	A	A	A	A	A	A	B	C	A
Mode of reporting ^{4/}	E	E	E	E	E	C	E	C	C	C	C	C
Confidentiality ^{5/}	C	C	C	C	C	C	C	C	C	C	C	C
Frequency of Publication ^{5/}	O	O	O	O	O	O	O	O	O	O	O	O

^{1/} International reserves are available on a bi-weekly basis.

^{2/} Monthly budget revenue and expenditure reported with 3-week lag, but budget financing reported on an irregular basis.

^{3/} Source A: Central Bank, B: Ministry of Finance, C: National Statistical Center.

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

^{5/} 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.: Social and Demographic Indicators

	Latest Single Year			Same Region/Income Group	
	1970-75	1980-85	1993-99	East Asia and Pacific	Low-Income
Population					
Total population, mid-year (millions)	3.0	3.6	5.1	1,837	2,417
Growth rate (percent annual average)	2.2	2.3	2.6	1.2	1.9
Urban population (percent of population)	11.4	15.6	22.9	34.5	31.4
Total fertility rate (births per woman)	6.2	6.7	5.4	2.1	3.7
Poverty (percent of population)					
National headcount index	..	..	46.1	..	..
Urban headcount index	..	..	24.0	..	..
Rural headcount index	..	..	53.0	..	..
Income					
GNI per capita (U.S. dollar)	..	..	290	1,010	420
Consumer price index (1995=100)	..	..	619	136	138
Social Indicators					
Public expenditure					
Health (percent of GDP)	..	..	1.2	1.7	1.2
Education (percent of GNI)	..	0.4	2.1	2.9	3.3
Net primary school enrollment rate (percent of age group)					
Total	..	..	72	100	..
Male	..	..	76	100	..
Female	..	..	69	100	..
Access to an improved water source (percent of population)					
Total	..	..	90	75	76
Urban	..	..	59	93	88
Rural	..	..	100	66	70
Immunization rate (percent under 12 months)					
Measles	..	6	71	83	64
DPT	..	4	56	82	70
Child malnutrition (percent under 5 years)	..	..	40	12	..
Life expectancy at birth (years)					
Total	42	47	54	69	59
Male	41	46	53	67	58
Female	44	49	56	71	60
Mortality					
Infant (per thousand live births)	139	115	93	35	77
Under 5 (per thousand live births)	218	200	143	43	116
Adult (15-59)					
Male (per 1,000 population)	610	531	376	184	288
Female (per 1,000 population)	510	439	317	141	258

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



Lao People's Democratic Republic
Peace Independence Democracy Unity Prosperity

Vientiane, February 7, 2002

Ref: 04/1301

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 first-year economic program, and to request the second disbursement following the completion of the first review under the arrangement.

The attached Memorandum on Economic and Financial Policies (MEFP) supplements the MEFP of March 26, 2001, and sets out the government's objectives and policies to be implemented in the year through September 2002 to build on the progress achieved, and help increase economic growth and further reduce poverty. On the basis of the generally satisfactory performance under the PRGF-supported program in 2001 we request the completion of the first review under the arrangement, waivers for the nonobservance of three quantitative performance criteria for end-June and one structural performance criterion for end-September, and modification of one structural performance criterion for end-March 2002.

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 intends to make these understandings public and authorizes the IMF to publish this letter and the attached memorandum, 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 endeavors.

A handwritten signature in black ink, appearing to be 'Soukanh Mahalath'.

Soukanh Mahalath
Minister of Finance
Ministry of Finance

Sincerely yours,

A handwritten signature in black ink, appearing to be 'Phouphet Khamphounvong'.

Phouphet Khamphounvong
Acting Governor
Bank of the Lao P.D.R.

Attachment

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

February 7, 2002

I. INTRODUCTION

1. The Government of the Lao People's Democratic Republic's plan of economic reform and poverty reduction is being supported by a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF). Consistent with the goals set out in our Memorandum on Economic and Financial Policies (MEFP) dated March 26, 2001, this supplementary memorandum reviews the implementation in the first program year 2001 and sets out our policies for the fiscal year ending September 2002.

II. PERFORMANCE UNDER THE PROGRAM

2. Despite the slowdown in the regional economies during 2001, the performance of the Lao economy was satisfactory. For 2000/01, the Government estimates real GDP growth to have been as planned, at 6.4 percent.¹ However, the IMF staff estimate a lower growth rate of about 5.2 percent for the calendar year 2001, because of slower export growth and the weaker external environment. Inflation has remained subdued, in line with the program, at about 7.5 percent at end-2001 despite the depreciation of the kip.

3. While macroeconomic outcomes have generally been in line with the program, fiscal slippage emerged because of implementation problems with the decentralization initiative, administrative weaknesses, and slower growth from the downturn in the external environment. Total revenue for 2000/01 was 13.5 percent of GDP, compared to 13.9 percent of GDP under the program, with weaker performance in direct and turnover taxes and import duties. Although current expenditures were restrained in response to the revenue shortfall, this was offset by extra investment spending of provinces taking advantage of the decentralization initiative. With lower than expected assets sales and sales of government securities, domestic bank financing of the budget was KN 150 billion more than targeted in June 2001. This underperformance in bank financing continued through September 2001, widening to KN 246 billion, 1.7 percent of GDP. Since then, significant actions were taken to strengthen the fiscal position, including through quick tax audits and tighter controls on expenditures and government bank accounts.

4. Monetary policy has been successful at reducing inflation. Despite the large amount of financing for the budget, the BOL limited the excessive increase in the net domestic assets

¹ The fiscal year runs October through September. The government is considering requesting technical assistance from the Fund to improve the compilation of the GDP estimates.

of the BOL (NDABOL) to KN 46 billion as of June 2001, only one third of the fiscal slippage. In the September quarter, the BOL issued additional securities to further limit the monetary impact of the budget slippage, in advance of more sustained fiscal measures.

5. State commercial bank (SCB) credit growth was in line with the program through June 2001. Subsequently, SCB credit increased substantially, by \$24 million, on account of the loan for the Lao Brewery share purchase. These shares were resold to a foreign investor in January 2002 and the loan will be repaid shortly thereafter. Excluding this loan, the increase in credit of the SCBs, as measured by their net domestic assets, was only 1.7 percent in the year to December 2001.

6. The underlying change in net international reserves (NIR) has been consistent with the program. However, for technical reasons the base level of NIR in the program was overstated by about \$12 million due to the inclusion of funds which are not freely available; thus the June 2001 level of reserves was about \$11 million below the target. At end-December 2001 reserve coverage was 2.4 months of imports.

7. Progress has been generally steady on structural reforms:

- The main elements of the individual SCB restructuring plans were developed and approved by the government. Though there was some delay, the external audits were undertaken and the final report is expected by February.
- Key state-owned enterprises' (SOEs) prices have continued to be adjusted towards cost recovery levels, in particular for electricity (3–3½ percent per month) and airline tariffs (by 20 percent in July, 2001).
- The government has made progress in discussions with the World Bank on a comprehensive approach to improving financial management covering public expenditure, SOEs, and SCBs, the latter with technical assistance from the AsDB.
- The government has extended the removal of quantitative restrictions on items currently liberalized under AFTA to a multilateral basis, except for a few specified products.

III. MACROECONOMIC FRAMEWORK AND POLICIES OCTOBER 2001–SEPTEMBER 2002

8. We remain committed to the strategy of the PRGF-supported program, for promoting growth with equity through macroeconomic stabilization, economic reform, and integration into the regional economies. The National Assembly approved the National Socio-Economic Development Plan (NSED) for 2001/02 with a target for real growth in the range of 6-6½ percent. The Government acknowledges that Fund staff currently projects real GDP growth at about 5 percent, owing to a more fragile external environment, providing a prudent basis for the financial program. Inflation should be reduced to 6 percent by September 2002. The current account deficit is anticipated to remain manageable at 4½ percent of GDP

(including grants), as weaker export prospects are offset by reduced import demand. By creating a favorable environment for investment, and with an anticipated recovery in external demand by 2003, medium-term growth in real GDP would be at least 6 percent, inflation would be reduced to about 5 percent, and gross official reserves should reach three months of import coverage.

Fiscal policy

9. The government will improve fiscal discipline in the 2001/02 budget after the weaker-than-expected performance in 2000/01. The overall deficit in the program is targeted to remain at about 5 percent of GDP and would be financed largely through concessional external loans with only limited recourse to domestic bank financing (0.3 percent of GDP).² As outlined in the NSEDP for 2001/02 we are aiming at a significant increase in revenue collections. For the purposes of the program a conservative estimate of a ½ percent of GDP increase in revenue is projected, given the uncertainty about the economic environment and the effect of administrative measures. To make progress towards meeting the goals in our National Poverty Reduction Program (NPRP) current expenditures for social sector and human resource development will increase substantially, but cutbacks in capital expenditures will keep the ratio of total expenditure to GDP broadly constant. If revenue falls below program expectations we will take offsetting action through restraint on domestically funded capital expenditures, while protecting operations and maintenance, local counterpart funds, and key social sector spending.

10. The revenue target for 2001/02 will be mainly achieved by a further strengthening of tax administration and compliance. The key revenue measures in the 2001/02 budget include: adjusting the customs valuation exchange rate monthly to 100 percent of the bank exchange rate, and implementing the amendments to the Tax Law to improve compliance. In addition, we are committed to significant improvements in tax and customs administration through (i) strengthening the implementation of the national network of Customs and Taxation Departments and (ii) strengthening the capacity of four key provincial tax offices, initially focusing on Vientiane Prefecture, to assess and collect taxes from large taxpayers. We have also made customs duties a fully national tax to strengthen the own resource base of the central government and we are considering merging customs staff in the Vientiane Prefecture with headquarters staff, as a first step in developing a national customs administration. To further strengthen the tax base we are tentatively planning to introduce a VAT in 2003/04 and have established a VAT implementation committee and started drafting the legal framework to meet this goal.

11. Overall expenditure will be restrained to 22 percent of GDP, with increased allocations for the social sectors and operations and maintenance. Basic civil servant wages were increased by 25 percent from the start of 2002 to continue the process of compensating

² IMF definitions and GDP estimates.

for past inflation. The budget makes provision for at least 1 percent of GDP for clearing capital and 0.7 percent of GDP for current arrears. The reintroduction of effective commitment controls, for quarterly salary and provincial recurrent expenditures and case-by-case for large capital expenditures, will contribute to avoiding the accumulation of new arrears. Provincial government and line ministry bank accounts are being streamlined. To more closely monitor budget implementation under the program, the fiscal accounts will be regularly reconciled with the banking data.

12. The government will take decisive steps to improve public expenditure management. As identified in the Public Expenditure Review (PER), improvements are needed to strengthen macroeconomic stability, provide more effective cash management and treasury operations, and upgrade the information base for budget planning, execution, accountability, and transparency. By March 2002 we will develop an improved budget nomenclature and a unified chart of accounts that identifies expenditures by ministry/province and sector, for introduction in the 2002/03 budget. The 2001/02 budget, covering central government line ministries and provinces, and the outturn for 2000/01, will be published in February, and full details of the budget, covering expenditures classified by ministry/province and sector will be published in the Official Gazette by March 2002. In addition, by April 2002 we will agree with Fund staff on a comprehensive medium-term action plan for public expenditure management improvements for implementation in the remainder of the PRGF arrangement. This would include the identification of plans and timeframe to classify current and capital expenditures by program within each sector. As a prelude to move the presentation of the fiscal accounts to an internationally standard basis, the government will request technical assistance from the Fund's Statistics Department.

Monetary and exchange rate policy

13. Monetary policy will continue to be oriented towards restraining inflation while permitting prudent lending by commercial banks. With the sharp reduction in the bank financing requirement of the budget, additional sales of treasury bills (with greater flexibility in treasury bill yields), and the closer monitoring of the central government's fiscal position, the need for BOL financing of the budget will be eliminated. In addition, the BOL will continue to reduce its credit to banks so as to keep the BOL's net domestic assets broadly constant (including the proceeds from the disbursement of external concessional loans).

14. To support economic growth while limiting the additional risks to SCB portfolios, SCB credit growth in 2001/02 will be limited to 16 percent while total commercial bank credit would be permitted to grow by 18 percent (excluding the credit for the Lao Brewery share purchase, which will be fully repaid in early 2002). Although explicit ceilings will limit SCB credit growth, the more effective implementation of prudential measures will reduce the demand for credit. If the nonperforming loans (NPLs) of any of the SCBs on the post-2000 loans exceed 15 percent, the level of their total credit will be frozen.

15. The BOL will continue to manage the exchange rate flexibly, permitting the banks' exchange rate to adjust so as to maintain the margin with the parallel market rate at less than

2 percent and avoid multiple exchange rates. The government and the BOL will adjust macroeconomic policies to correct any persistent weakness in the kip especially with respect to the currencies of neighboring countries. We will also continue to improve the functioning of the interbank foreign exchange market.

IV. KEY STRUCTURAL REFORMS

16. We will continue to deepen the implementation of the structural reforms to establish a sustainable higher growth rate and to manage public resources more effectively for poverty reduction.

Banking reform

17. The MOF, BOL, and the SCBs have developed individual restructuring plans. These have been prepared in the form of Memoranda of Understanding on Restructuring and cover the main policy commitments, and are consistent with principles indicated in Appendix I of the MEFP of March 26, 2001.

18. The main elements are:

- Financial and operational restructuring will be implemented in the period 2002–05 through phased recapitalization, conditional on meeting qualitative and quantitative targets which would be specified by May 2002 as part of the banks' business plans.
- The two smaller Lao May and Lane Xang Banks (LMB-LXB) will merge and rationalize their operations to reduce operational costs and accelerate the adoption of modern banking procedures.
- To support the restructuring efforts the government accepts the role of a small number of foreign advisors in providing technical assistance in each of the two SCBs (LMB-LXB, and BCEL). In addition to providing advice on internal bank practices, they would review proposed large credit decisions. Objections by the advisor could be overridden but the process would be transparent and such credits would be subject to special monitoring. Also the form of management support would be strengthened if the new management team do not meet the performance indicators.
- Bank supervision will be strengthened for the phased implementation of bank supervision regulations, focusing first on those that affect credit quality. In this regard, the implementation of banking supervision measures for the setting up of provisions for post 2000 loans in accordance with BOL 98 from the end 2001 balance sheet will be a structural performance criteria for April 2002.

Enterprise reform

19. Enterprise policies remain aimed at protecting macroeconomic stability and supporting bank restructuring, while also laying the foundation for a more efficient sector to support faster economic growth. In conjunction with the World Bank, we will begin the restructuring process of five large SOEs, three are large defaulting borrowers, the Phoudoi conglomerate, Nam Papa (Water) and Lao Aviation, one large loss maker, Pharmaceutical Factory #3, and EDL, a main revenue earner. Drafting of the restructuring plans of an additional 5 large defaulters will start by October 2002.

20. In addition, we are strengthening the financial position of the large SOEs by adjusting prices, many of which have lagged behind inflation. Water prices were adjusted in April and November last year, by an average of about 100 percent, to provide the resources for more effective maintenance, and further adjustments will be considered in June 2002. Electricity prices were adjusted by 3–3½ percent per month through end-2001. A recent study on electricity prices is being reviewed by Government and a decision on the path of future price adjustments required to achieve cost recovery in 2002 is expected in April. In the case of Lao Aviation, prices were raised in July 2001, and will be raised again in April this year, but further adjustments will be required to enable the airline to achieve commercial viability and cost recovery. World Bank technical assistance is being considered to conduct a study on the airline's fare structure, and by March, we expect to be able to establish a revised timeline for fare adjustments to reach a cost-recovery level by October 2002.

21. To promote private sector development, we are currently streamlining administrative procedures for foreign investment, including through the single window approach. In addition, we are working with the AsDB and the World Bank to develop a more comprehensive approach in this area.

Safeguard issues

22. We acknowledge that the Stage One safeguard assessment by the Fund found that the BOL has a high risk in all five of the vulnerabilities in the assessment. To address these concerns we will fully implement the recommendations of the IMF Safeguards Report. In particular, we will:

- Request that the National Audit Office, with the assistance of an international auditing firm, audit the BOL's accounts for 2001 in accordance with international standards on auditing, to be completed by July 2002;
- Publish the BOL's audited accounts for 2001 and the audit opinion, by end-August 2002 and commit to publishing all subsequent audited accounts;
- Prepare pro forma financial statements of the BOL for 2001 in accordance with international accounting standards, and with the assistance of an international accounting firm, for completion by end-July 2002;

- Prepare a reconciliation of the audited international reserves in the 2000 and 2001 financial statements of the BOL with net international reserves as defined and reported under the PRGF-supported program by March 2002; and
- Conduct a high-level review of the internal financial controls of the BOL, as recommended in the audit of the National Audit Office, by May 2002.

Poverty reduction strategy

23. The Government of the Lao P.D.R. is planning to finalize its NPRP by August 2002. The NPRP will be fully consistent with the requirements of the PRSP and builds on the interim PRSP (I-PRSP) published in April 2001, and the Participatory Poverty Assessment published in June 2001. Importantly, the elaboration of our NPRP will be both nationally owned and participatory, involving all segments of society, including the Lao Women's Union, the Lao Youth Organization, the Trade Union Federation, and the Lao Front for Reconstruction, and, most importantly, the poor themselves.

24. We are also expeditiously putting in place the informational and analytical basis for the full PRSP, through;

- The National Statistical Center (NSC), with the assistance of the World Bank, is working towards finalizing poverty measurements based on the last household expenditure and consumption survey (LECS-II) and evaluating various poverty monitoring indicators;
- The NSC, with further support from Sweden, has started preparing a follow-up LECS (LECS-III) and drafted guidelines for a poverty reporting system (PRS) developing criteria for defining poverty at household, village and provincial levels. Both the LECS-III and the PRS will assist Government not only better analyze the sources of poverty, but also assess and monitor the impact of policies on poverty reduction outcomes;
- The Public Expenditure Review, conducted in collaboration with the AsDB, IMF, World Bank, and bilateral donors, has developed recommendations to obtain information on expenditures by sector for prioritizing them to meet the goals of the NPRP; and
- The PRSP Committee is elaborating specific poverty-reducing measures in the areas of food security, rural development, forestry, road infrastructure, and health and education, and their budgetary impact.

Other areas

25. In view of the Lao P.D.R.'s vulnerable external position, we will limit the contracting or guaranteeing of new nonconcessional external debt. In addition, we will continue to upgrade the monitoring of our external debt through the External Debt Monitoring Unit in the

Ministry of Finance. The negotiations with the Russian Federation are ongoing, and another round of negotiations is planned in 2002.

26. The government will undertake a number of prior actions ahead of the IMF Executive Board consideration of the first PRGF review, in order to keep the program on a solid footing (Table 6). Table 5 contains quantitative performance criteria for end-March and end-September 2002 and quantitative benchmarks for end-June 2002; structural policy undertakings are summarized in Table 7. The second review under the PRGF arrangement, which we are aiming to complete by June 2002, will focus on the economic program for the remainder of 2001/02, including adjustments to fiscal policy required in the mid-year budget review in March 2002, and the development of plans for reforms to the SCBs, SOEs, taxation, and public expenditure management, for the remainder of the PRGF period.

27. To help strengthen program implementation, technical assistance will continue to be sought from the IMF in bank supervision, tax policy and administration, and national accounts and government finance statistics.

Attachments

Table 1.	Summary Macroeconomic Framework 1998-2004
Table 2.	General Government Operations, 1999/00–2001/02
Table 3.	Balance Sheet of the Bank of Lao P.D.R., 2001–02
Table 4.	Monetary Survey, 2000–02
Table 5.	Quantitative Performance Criteria and Benchmarks, 2000–02
Table 6.	Prior Actions for the Completion of the First Review
Table 7.	Structural Policy Actions Under the First Annual PRGF-Supported Program
Appendix I.	Main Elements of State Commercial Bank Restructuring
Appendix II.	Technical Memorandum on Program Monitoring

Table 1. Lao P.D.R.: Summary Macroeconomic Framework 1998–2004

	1998	1999	2000	2001	2002	2003	2004
					Projections		
Real GDP growth (percent change)	4.0	7.3	5.8	5.2	5.0	5.7	6.5
Inflation (percent change, annual average)	90.1	128.4	23.2	8.0	7.2	5.0	5.0
Merchandise exports (percent change)	6.4	1.5	8.3	0.3	3.2	8.5	6.9
Merchandise imports (percent change)	-14.7	0.3	12.9	-1.6	2.6	25.7	11.6
(percent change excluding NT2)						7.8	8.0
Official gross reserves (in months of prospective goods and services imports, excluding NT2)	2.2	1.9	2.3	2.4	2.4	2.9	3.3
Budget (fiscal year basis) 1/							
Revenue	9.8	10.4	13.2	13.5	13.9	14.1	14.7
Grants	5.3	5.9	3.7	3.2	3.3	3.1	2.9
Expenditure	23.6	20.2	21.4	21.7	21.9	22.3	22.5
Current	8.1	6.0	8.2	7.7	8.8	9.6	10.0
Capital and onlending	15.5	14.2	13.3	14.0	13.1	12.7	12.5
Current fiscal balance before grants	1.7	4.4	5.0	5.8	5.2	4.5	4.7
Overall fiscal balance after grants	-8.5	-3.9	-4.6	-5.0	-4.6	-5.1	-5.0
Domestic financing	2.5	-0.6	-1.2	1.7	0.4	0.3	0.4
Foreign financing	6.0	4.5	5.7	3.3	4.2	4.7	4.6
Real GDP growth (percent change) 1/	4.7	6.5	6.2	5.4	5.1	5.5	6.3
Increase in GDP deflator (percent change) 1/	71.2	120.4	35.6	8.4	7.8	5.2	5.0
Savings and investment balance 2/							
National savings	12.7	14.8	12.7	14.6	15.1	15.2	16.0
Private	11.0	10.4	7.7	8.9	9.9	10.7	11.3
Government	1.7	4.4	5.0	5.8	5.1	4.5	4.7
Investment	22.8	22.5	21.0	22.1	22.5	30.9	33.3
Private	7.3	8.3	7.1	7.4	8.6	18.2	20.8
<i>Of which</i> : Hydropower	1.4	1.9	0.2	0.0	0.0	8.1	9.9
Other	5.9	6.4	6.9	7.4	8.6	10.1	10.9
Government 3/	15.5	14.2	13.9	14.7	13.9	12.7	12.5
Foreign savings	10.1	7.7	8.3	7.5	7.5	15.7	17.2
Excluding Hydropower	8.7	5.8	8.1	7.5	7.5	7.4	7.1

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

1/ Fiscal year ending September.

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

In particular, private savings reflect unrecorded imports.

3/ Comprises government investment and selected public enterprise investment.

Table 2. Lao P.D.R.: General Government Operations, 1999/00–2001/02

	1999/00	2000/01		2001/02		
	Est.	Budget	Prog.	Est.	Budget	Prog.
	(In billions of kip)					
Revenue and grants	2,166	2,614	2,473	2,455	3,030	2,850
Revenue	1,691	2,194	2,053	1,979	2,481	2,301
Tax	1,367	1,742	1,687	1,592	2,043	1,863
Profit tax	187	316	301	204	362	332
Income tax	117	182	182	152	190	160
Turnover tax	290	379	359	315	452	427
Excise tax	226	336	316	371	362	337
Import duties	135	192	192	161	229	204
Timber royalty receipts	273	115	115	120	165	165
Other	140	222	222	268	283	238
Nontax	324	452	366	388	438	438
<i>Of which:</i> SOE dividends	42	212	127	67	89	89
Interest payments	79	40	40	100	42	42
Overflight revenues	123	125	125	114	153	153
Grants	475	420	420	476	549	549
Expenditure	2,754	3,382	3,204	3,187	3,614	3,614
Current	1,050	1,417	1,239	1,135	1,449	1,449
Wages and salaries	335	417	417	417	525	525
Materials and supplies	174	342	342	308	370	370
Interest payments	103	175	175	133	145	145
Timber royalty financed expenditure	242	115	15	0	0	0
Other recurrent	196	368	290	278	409	409
Capital and onlending	1,704	1,965	1,965	2,052	2,165	2,165
<i>Of which:</i> domestically financed	481	805	805	989	1,017	1,017
externally financed	1,302	1,200	1,200	1,200	1,256	1,256
Current balance	641	776	814	844	1,033	853
Overall balance	-588	-769	-731	-732	-583	-763
excluding grants	-1,063	-1,189	-1,151	-1,208	-1,132	-1,312
Financing	588	769	731	732	583	763
Domestic financing	-148	213	175	255	33	71
Bank financing 1/	-104	0	0	246	13	50
Nonbank financing	-44	213	175	9	20	21
Foreign financing (net)	736	556	556	478	550	692
Project loans	827	780	780	724	826	826
Program loans	96	0	0	0	0	143
Amortization	187	224	224	247	276	276
	(In percent of GDP)					
Revenue and grants	16.9	17.7	16.8	16.7	18.4	17.3
Revenue	13.2	14.9	13.9	13.5	15.0	13.9
Tax	10.6	11.8	11.4	10.8	12.4	11.3
Nontax	2.5	3.1	2.5	2.6	2.7	2.7
Grants	3.7	2.8	2.8	3.2	3.3	3.3
Expenditure	21.4	22.9	21.7	21.7	21.9	21.9
Current	8.2	9.6	8.4	7.7	8.8	8.8
Capital and onlending	13.3	13.3	13.3	14.0	13.1	13.1
Current balance, excluding grants	5.0	5.3	5.5	5.8	6.3	5.2
Overall balance	-4.6	-5.2	-5.0	-5.0	-3.5	-4.6
excluding grants	-8.3	-8.1	-7.8	-8.2	-6.9	-7.9
Financing	4.6	5.2	5.0	5.0	3.5	4.6
Domestic financing (net)	-1.2	1.4	1.2	1.7	0.2	0.4
Bank	-0.8	0.0	0.0	1.7	0.1	0.3
Nonbank	-0.3	1.4	1.2	0.1	0.1	0.1
Foreign financing (net)	5.7	3.8	3.8	3.3	3.3	4.2
Memorandum items:						
Nominal GDP, fiscal year (in billions of kip)	12,848	14,755	14,755	14,671	16,614	16,614
Exchange rate (kip per US dollar, average)	7,670	8,000	8,400	8,600	9,500	9,500

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

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 4. Lao P.D.R.: Monetary Survey, 2000–02

	2000	2001									2002		
		June		Sept			Dec			Mar	June	Sept	
		Prog.	Est.	Prog.	Est.	Rev. prog. new base 1/	Prog.	Rev. prog.	Est.	Prog.	Prog.	Prog.	
(In billions of kip; end of period)													
Monetary Survey													
Net foreign assets 2/	1,528	1,379	1,426	1,361	1,242	1,443	1,465	1,550	1,428	1,606	1,651	1,631	
of which: SCBs	483	529	412	551	289	335	574	464	283	470	479	510	
Net domestic assets	721	1,096	892	1,227	1,084	1,156	1,235	1,181	1,246	1,252	1,336	1,458	
Of which: SCBs (exc. net credit to gov.)	1,193	1,265	1,227	1,302	1,325	1,501	1,340	1,415	1,536	1,460	1,502	1,537	
Domestic credit	1,439	1,646	1,807	1,744	2,083	2,341	1,702	2,327	2,450	2,427	2,498	2,611	
of which: SCBs	815	907	920	950	1,066	1,194	988	1,124	1,297	1,194	1,261	1,311	
Net claims on government 2/	-420	-386	-236	-368	-122	-141	-491	-116	-118	-112	-126	-91	
Claims on the economy	1,859	2,032	2,043	2,112	2,205	2,482	2,192	2,443	2,567	2,539	2,624	2,702	
Of which: SCBs	882	959	997	996	1,118	1,253	1,034	1,183	1,318	1,233	1,280	1,320	
of which: in foreign currency	1,491	1,526	1,612	1,542	1,745	2,022	1,557	1,960	2,075	2,039	2,079	2,129	
Credit to state enterprises	606	701	768	725	857	982	748	892	1,028	928	948	960	
Credit to private sector	1,253	1,331	1,275	1,387	1,348	1,500	1,444	1,551	1,539	1,611	1,676	1,742	
Other items (net) 2/	-718	-550	-915	-517	-999	-1,185	-466	-1,146	-1,203	-1,175	-1,162	-1,152	
Broad money	2,249	2,476	2,318	2,588	2,327	2,599	2,701	2,731	2,675	2,859	2,987	3,090	
Domestic currency (cash and deposits)	536	594	624	621	611	611	647	631	681	665	698	727	
Foreign currency deposits	1,713	1,882	1,694	1,968	1,716	1,988	2,054	2,100	1,993	2,194	2,289	2,363	
(In millions of U.S. dollars; end of period)													
Net foreign assets 2/	185.9	168.2	173.9	166.0	151.5	151.9	178.7	163.1	150.4	169.1	173.7	171.7	
Of which: SCBs	58.8	64.5	50.2	67.2	35.3	35.3	70.0	48.9	29.8	49.5	50.5	53.6	
Foreign currency credit to the economy	181.5	186.1	196.5	188.0	212.8	212.8	189.9	206.3	218.4	214.6	218.8	224.1	
Of which: SCBs	80.4	87.7	90.1	91.1	104.1	104.1	94.6	95.0	108.3	98.2	103.2	106.7	
Foreign currency deposits	208.5	229.5	206.6	239.9	209.2	209.2	250.5	221.1	209.8	231.0	240.9	248.7	
(Annual percentage change)													
Broad money	45.7	20.9	13.2	22.6	10.2	23.1	20.0	21.4	18.9	24.1	23.8	19.0	
Net domestic asset of SCBs (increase from start of program) 3/	...	6.0	2.8	9.1	2.8	16.2	12.3	2.1	-1.6	5.3	8.3	10.8	
Credit to the economy 3/	41.1	29.3	30.0	24.2	23.9	39.2	17.8	31.4	28.9	25.4	23.1	14.2	
Of which: commercial banks 3/	44.1	31.8	34.1	27.5	28.9	43.4	18.0	33.2	28.3	28.1	25.7	18.0	
SCBs 3/	58.6	39.3	44.8	28.5	31.4	46.9	17.3	34.2	30.0	26.6	23.2	16.0	
Credit to state enterprises 3/	36.1	21.1	32.7	15.6	21.1	38.5	16.5	47.1	41.4	22.0	17.7	10.8	
Credit to the private sector	43.7	34.1	28.5	29.2	25.5	39.7	18.5	23.8	22.9	27.4	26.4	16.2	
Memorandum items:													
Bank financing of the budget (in billions of kip) 4/	-46	-18	131	0	246	...	-123	25	23	29	15	50	
Money multiplier	2.9	3.7	3.3	3.8	3.3	3.5	3.9	3.7	3.3	3.4	3.8	3.9	
Exchange rate, end of period (kip per U.S. dollar)	8,218	8,200	8,200	8,200	8,200	9,500	8,200	9,500	9,500	9,500	9,500	9,500	

Sources: Data provided by the Lao P.D.R. 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 3. Lao P.D.R.: Balance Sheet of Bank of Lao P.D.R., 2000-02

	2000	2001									2002		
		June		Sept			Dec			Mar	June	Sept	
		Prog.	Est.	Prog.	Est.	Rev. prog. new base 1/	Prog.	Rev. prog.	Est.	Prog.	Prog.	Prog.	
(In billions of kip; end of period)													
Bank of Lao P.D.R.													
Net foreign assets 2/	799	794	782	775	757	880	880	836	908	929	942	935	
Foreign assets	1,147	1,148	1,138	1,117	1,099	1,273	1,246	1,254	1,268	1,321	1,361	1,332	
Foreign liabilities	-347	-355	-356	-342	-343	-393	-366	-418	-361	-392	-419	-398	
Net domestic assets 3/	-33	-130	-84	-100	-43	-130	-194	-96	-85	-100	-149	-134	
Domestic credit	588	485	649	506	731	828	386	847	890	872	810	816	
Net credit to government 2/	-347	-327	-144	-315	-65	-76	-438	-51	-96	-67	-101	-76	
Credit to the economy	489	537	523	556	534	618	574	618	639	639	639	639	
Credit to state enterprises	346	394	385	412	403	467	431	467	489	488	488	488	
Credit to private sector	143	143	138	143	130	151	143	151	151	151	151	151	
Credit to banks	446	276	270	266	262	285	250	280	348	300	272	253	
BoL securities	-159	-98	-144	-71	-201	-201	-26	-188	-200	-196	-183	-175	
Other items, net 2/	-461	-517	-589	-536	-573	-757	-554	-755	-776	-776	-776	-776	
Of which : medium-term foreign liabilities	-211	-267	-264	-286	-283	-328	-304	-328	-347	-347	-347	-347	
Reserve money 3/	767	663	698	675	714	750	686	740	823	829	793	801	
(In millions of U.S. dollars; end of period)													
Net foreign assets 2/	97.3	96.8	95.4	94.5	92.3	92.7	107.3	88.0	95.6	97.8	99.2	98.4	
Gross international reserves 2/	126.5	140.1	126.7	136.3	134.1	134.0	151.9	132.0	133.5	139.0	143.3	140.2	
(in months of imports)	2.3	2.5	2.3	2.4	2.4	2.4	2.7	2.3	2.4	2.4	2.4	2.3	
Required reserves on foreign currency deposits	27.3	30.3	28.3	31.6	27.5	27.5	32.9	28.7	29.0	30.0	31.3	32.3	
(Annual percentage change)													
Reserve money 3/	59.1	18.1	24.3	1.7	7.6	13.0	11.2	20.0	33.4	24.9	11.6	6.9	
Memorandum items:													
BoL financing of the budget (in billions of kip) 4/	-73	-58	125	-46	204	...	-123	25	-21	9	-25	0	
Disbursement of program loans (millions of U.S. dollar)4/	...	0	0	0	0	0	15	0	0	5	15	15	
Exchange rate, end of period (kip per U.S. dollar)	8,218	8,200	8,200	8,200	8,200	9,500	8,200	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/ 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 5. Lao P.D.R.: Quantitative Performance Criteria and Benchmarks, March 2001–September 2002

	2000	2001									2002				
	Stock at end-Dec	March		June 1/		Sept			Dec			Mar 1/	June	Sept 1/	
		Prog.	Est.	Prog.	Est.	Prog.	Est.	Rev. prog. new base 2/	Prog.	Rev. prog.	Est.	Prog.	Prog.	Prog.	
	(In billions of kip)														
Net domestic assets of the Bank of Lao P.D.R. (BOL) 3/ 4/	-33	-143	-44	-130	-84	-100	-43	-130	-194	-96	-85	-100	-149	-134	
Net credit to the government from the banking system 4/	-420	-403	-291	-386	-236	-368	-122	-141	-491	-116	-118	-112	-126	-91	
Net domestic assets of the state commercial banks (excluding net claims on government) 5/	1,188	1,227	1,212	1,265	1,227	1,302	1,325	1,501	1,340	1,415	1,536	1,460	1,502	1,537	
	(In millions of U.S. dollars)														
Net official international reserves 4/ 6/	57	68	46	67	55	63	65	65	74	59	67	68	68	66	
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	
External payments arrears 8/	0	0	0	0	0	0	0	0	0	0	0	0	0	0	
Memorandum items:															
Nonproject budget support (cumulative flows from start of year)	11.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	15.0	0.0	0.0	5.0	15.0	15.0	
External debt service payments (cumulative from start of year)	...	6.9	8.5	13.2	14.1	...	22.7	22.7	...	28.6	28.6	8.7	14.6	24.0	
Program exchange rate (kip per dollar)	8,218	8,200	8,200	8,200	8,200	8,200	8,200	9,500	8,200	9,500	9,500	9,500	9,500	9,500	
Foreign currency component of required reserves	27	29	28	30	28	32	28	28	33	29	29	30	31	32	

Sources: Data provided by the Lao P.D.R. authorities. 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 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 6: Lao P.D.R.: Prior Actions for the Completion of the First Review of the PRGF-Supported Program

Action	Status
Banking reform	
Transmit audit of BOL by National Audit Office to the IMF.	Done.
Formulate individual SCB restructuring plans in support of banking reform, consistent with the Memorandum on Economic and Financial Policies, and prepared with assistance from the AsDB and the World Bank.	Done. Plans received end Dec 2001.
Fiscal reforms	
Meet fiscal targets as specified in the September 2001 Aide Memoire.	Done.
Implement nationwide network of Taxation and Customs Departments.	Done.
Complete quick tax audits for 100 of the largest taxpayers, starting July 1, 2001, and collect identified tax obligations, to be verified by providing a list of taxpayers audited and the total revenue collected.	Done.
Publish tables for 2001/02 budget with expenditure classified by central government ministry and province, and outturn for 2000/01.	Expected by February 11.
Complete the sale of the Lao Brewery shares bought by the government to bring the credit program back on track.	Done. Sale agreed at end January, 2002

Table 7. Lao P.D.R.: Structural Policy Actions Under the
First Annual PRGF-Supported Program

Policy Action	Conditionality
Banking reform	
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, September 2001 and 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.
Formulate key elements of the individual SCB business plans, especially qualitative and quantitative targets, and timetable for actions consistent with MoUR with assistance from the AsDB and World Bank.	Structural benchmark, May 2002.
SOE reform	
Complete studies on electricity and airline tariffs, with technical assistance from the World Bank, and implement new tariff structures to achieve cost recovery and/or targeted subsidies.	Structural performance criterion, October 2002.
Review development of a program of SOE commercialization and restructuring, in consultation with the World Bank.	Subject of second review.
Fiscal and public resource reforms	
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.
Implement tax reform measures, including: reduce exemptions, prepare for VAT, broaden the tax base, and strengthen the large taxpayer units.	Subject of first and second reviews.
Review macroeconomically significant issues of forestry sector policies, mainly an assessment of related revenues and their transfer into the budget, in consultation with the World Bank.	Subject of second review.
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.

Main Elements of State Commercial Bank Restructuring

The state commercial banks need to be restructured in order to create robust banking institutions. With the technical assistance of the Asian Development Bank and the World Bank, the government has adopted the Memoranda of Understanding for Restructuring (MoURs) that set out the main elements of the restructuring program. To ensure credit discipline and to move the banks to a more sustainable direction, comprehensive operational restructuring and financial recapitalization will be phased in during the period 2002–05. This support will be conditional on performance improvements, which will be closely monitored.

Operational restructuring

- The two smaller banks, Lao May Bank and Lane Xang Bank will merge and rationalize their operations to reduce operational costs and accelerate the adoption of modern banking procedures.
- Both the merged bank and BCEL will rationalize the operations of branches and units, and would implement rightsizing and cost cutting measures. A social safety net for affected staff will be implemented.
- The banks will take steps to set up an efficient bank information technology system.
- The key elements of the business plans will be prepared by May 2002, which will specify the qualitative (structural) and quantitative performance indicators and targets based on BOL 98, and the operational steps to be taken to meet the performance targets. Parallel monitoring will also be done on the basis of international accounting standards and there will be a review of the cause of widening divergences.
- Both the merged banks and BCEL will utilize foreign advisors whose role would include:
 - Reviewing proposed credit transactions in excess of KN 300m for compliance with commercial lending criteria. An objection by the advisor would be accompanied by a full written commentary. This objection may be overridden by the SCB management or board, but such credits would be subject to special monitoring.
 - Providing advice on internal banking practices, and information system requirements.
 - The arrangements for management support would be upgraded if the new management team did not meet the performance indicators.

- The specifics of the terms of reference of the advisors, and selection process would be developed with the AsDB and World Bank in preparation for their operations.

Credit discipline

- Though still considered necessary, policy lending will be subject to commercial credit appraisal criteria. The banks will not conduct directed and other forms of noncommercial lending.
- The banks will price loans and deposits according to profitability and risk considerations without government influence.

Financial restructuring

- The banks will be recapitalized through a four-year capital build-up program in the period 2002-2005. Treasury instruments will be used for capital build-up which will pay market interest and will initially be non-discountable and non-marketable. The recapitalization will be limited to pre-2000 nonperforming loans (NPLs). The banks will build up their capital to eventually reach a capital adequacy ratio of 12 percent.
- The NPL resolution process will be: initiated and led by the banks, well-documented, carried out on a case-by-case basis, with full disclosures to all concerned parties, and implemented under a well-defined decision making process that strictly adheres to objective criteria.
- The 2001/02 budget includes funds for the clearance of government arrears to contractors of about 1 percent of GDP. A high-level committee, comprising the Minister of Finance, the Minister of Justice, and the Acting Governor of the BOL, has been established to administer the payments which will be used to reduce NPLs of the banks.

Performance monitoring

- Qualitative performance indicators on the implementation of the restructuring plans, as well as quantitative indicators on capital adequacy, asset quality, management efficiency, earnings, and liquidity will be established. Successful achievement of performance targets will be the basis for continued support and recapitalization.
- The final performance targets will be set and agreed upon on the basis of the diagnostic reviews and audit results.
- The banks will carry out annual external audits based on international standards.

Banking supervision

- Banking supervision will be strengthened by improving the skills of the staff of the Banking Supervision Department of the BOL and conducting frequent onsite and

offsite inspections. The government has requested technical assistance from the IMF in this regard.

- During the restructuring period, BOL will phase in compliance with prudential regulations, such as BOL 98. Full provisioning for all credits made after December 31, 1999 is currently required and provisioning on earlier loans will be phased in over four years.
- Other requirements, e.g. on the concentration of risks and foreign exchange exposure, and on the reporting of off-balance sheet exposures, will also be phased in, and the banks have suspended and reversed accrued interest on all NPLs.

GOVERNMENT OF THE LAO PEOPLE'S DEMOCRATIC REPUBLIC

SUPPLEMENTARY MEMORANDUM OF 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 of 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 TARGETS¹

A. Definitions²

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

¹ For items 1 to 6 in Table 5.

² Variables with foreign currency components are to be valued according to Section I.B.

(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). 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 debts are calculated as commitments from the start of the program year (end September 2001). They exclude concessional credits, use of Fund resources, 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. Debts 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 CIRR 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 ¾ 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 debts contracted or guaranteed by the government or the BOL, except on debts 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-March 2002 and end-September 2002 are performance criteria, and the disbursement associated with observance of end-March performance criteria will also be contingent on the completion of the second 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 6 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.

II. STRUCTURAL PERFORMANCE CRITERIA AND BENCHMARKS

14. **Defaulting borrowers** are defined as those borrowers from the banking system with loans classified by commercial banks as doubtful (grade D) and loss (grade E), as defined in BOL Regulation No. 98, 1998.

15. **Large borrowers** are defined to include, at each test date, the 20 largest borrowers from BCEL, the 5 largest borrowers from LMB, and the 5 largest borrowers from LXB.

16. **Bank supervision measures** for loan provisioning comprise the issuing of required regulations and instructions, implementing the reporting system, effective onsite inspections and the sanctions for noncompliance.

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
Monetary data (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.	
A report on the largest borrowers, in terms of credit outstanding, from the state commercial banks (5 largest for LXB and LMB, and 20 largest for BCEL) showing total amount of credit in original currency and credit risk rating.	Quarterly within four weeks of the end of each quarter.
Fiscal data (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.
External sector data (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.	
Other data (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.

**Statement by the IMF Staff Representative
February 25, 2002**

This statement provides an update on the status of one of the prior actions listed in Attachment Table 6 of the staff report (EBS/02/23, 2/11/02). It does not change the thrust of the staff appraisal.

Regarding the prior action on the publication of the budget tables, the Minister of Finance gave the approval in early February. These tables were published in several installments starting February 6, with the final installment published on February 22. While completion of the prior action thus came after the required five working days prior to the Board meeting, the staff considers it appropriate to proceed with the Board meeting as scheduled, given that publication was authorized well in advance.

NEWS  BRIEF

FOR IMMEDIATE RELEASE

News Brief No. 02/17
FOR IMMEDIATE RELEASE
February 25, 2002

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Completes First Review of Lao P.D.R.'s PRGF Program and Approves US\$5.6 Million Credit

The Executive Board of the International Monetary Fund (IMF) today completed the first review of the performance of the Lao People's Democratic Republic under a three-year Poverty Reduction and Growth Facility (PRGF¹—see Press Release No. 01/18). This enables the immediate release of a further SDR 4.53 million (about US\$5.6 million) from the arrangement, which would bring total disbursements under the IMF-supported program to SDR 9.06 million (about US\$11.3 million).

After the IMF Executive Board's discussion on Lao P.D.R., Deputy Managing Director and Acting Chairman, Eduardo Aninat, made the following statement:

"The Lao authorities have made significant progress in strengthening macroeconomic stability and laying the groundwork for further structural reforms. Corrective action to arrest the fiscal slippages that emerged in

¹ On November 22, 1999, the IMF's concessional facility for low-income countries, the Enhanced Structural Adjustment Facility, was renamed the Poverty Reduction and Growth Facility, and its purposes were redefined. It is intended that PRGF-supported programs will in time be based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners, and articulated in a Poverty Reduction Strategy Paper (PRSP). This is intended to ensure that each PRGF-supported program is consistent with a comprehensive framework for macroeconomic, structural, and social policies to foster growth and reduce poverty. PRGF loans carry an annual interest rate of 0.5 percent, and are repayable over 10 years with a 5 ½-year grace period on principal payments.

mid-2001 helped contain pressures on the exchange rate and preserve the hard-won stabilization gains.

"Fiscal policy is appropriately focused on strengthening tax administration, making customs duties a national tax, and enhancing public expenditure management. These measures should improve budget discipline and permit a reduction in domestic arrears, while making room for higher allocations to social services. Further reforms are needed, however, including the establishment of an information database to help monitor implementation of the poverty reduction strategy and measures to promote the accountability of the different levels of government.

"The temporary use of direct credit controls is appropriate during the early stages of state bank reform to maintain monetary stability and limit potential losses of these banks. Central bank financing of the budget deficit and of state-owned commercial banks should be avoided in order to prevent a resurgence of inflationary pressures.

"The authorities are advised to implement immediately the restructuring plans for the state commercial banks, especially measures to strengthen the quality of new loans. In this regard, the temporary use of foreign expertise, including for credit risk management, is essential for improving the performance of the state-owned banks.

"Regarding state enterprise reforms, the priority being given to the restructuring of the large debtors is appropriate, as this will facilitate the resolution of nonperforming bank loans. Moreover, an adjustment in tariffs will enable the key utility companies to cover their costs and move toward commercializing their operations.

"Lao P.D.R.'s weak statistical base needs to be strengthened, especially in the areas of external trade, external debt, and government finances," Mr. Aninat said.

**Statement by Dono Iskandar Djojosebroto, Executive Director and Panom Lathouly,
Assistant to the Executive Director for the Lao People's Democratic Republic
February 25, 2002**

At the outset, on behalf of the Lao authorities, we would like to thank staff for a well written report on the Lao P.D.R. The authorities would also like to express their gratitude and appreciation to the Board and the Management of the Fund for their continued financial support, technical assistance and policy advice. They broadly agree with the staff analysis and appraisal.

Introduction

Over the past decade, Lao P.D.R has made good progress in economic reforms. The Government has taken various measures to transform the country towards a more market-oriented economy under its New Economic Mechanism (NEM), which has the broad support of the international community, particularly the Bretton Woods institutions and the Asian Development Bank. 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.

While agriculture remains the dominant sector of the economy, the other areas in generating growth such as manufacturing, construction and services are becoming more dominant. Foreign investment has played an important role in the economy since the Government's open door policy in 1988. In particular, the foreign investment in hydropower generation for export, which has ranked first in terms of value has a high potential for contributing to growth in the medium- and long-term.

Recent economic development and macroeconomic prospects

Despite many economic difficulties confronted by the authorities in 2001 due to the economic slowdown in the region and the world, the authorities managed to maintain the economic stability throughout the year. The real GDP growth is estimated to be at 6.4 percent¹. The inflation rate continued to decrease and remained at about 7.5 percent at end-2001, in line with the program while the kip depreciated by about 13 percent in the nine months to September 2001, and thereafter remained stable.

In the fiscal year 2001/02, the National Assembly approved the National Socio-Economic Development Plan (NSED) with a target for real growth in the range of 6-6.5 percent². Inflation should be reduced to 6 percent by September 2002³. The current account deficit is projected to remain manageable at 4.5 percent of GDP (including grants), as weaker export prospects are offset by reduced import demand. By creating a favourable environment for investment, and with anticipated recovery in external demand by 2003,

¹ However, the IMF staff estimate a lower growth rate of about 5.2 percent for the calendar year 2001 because of slower export growth and the weaker external environment.

medium-term growth in real GDP would be at least 6 percent, inflation would be reduced to about 5 percent, and gross official reserves should reach three months of import coverage.

Fiscal policy

The total revenue for the fiscal year 2000/01 improved at the level of 13.5 percent of GDP compared to 13.2 percent for 1999/00. However, the small shortfall to the target of 13.9 percent under the program was mainly due to weaker performance in direct and turnover taxes and import duties.

The Government acted quickly to restrain the current expenditures in response to the revenue shortfall. But, the extra investment spending of the provincial authorities, due to the recent launch of decentralization, caused the domestic bank financing of the budget. Compared to the end June 2001 target, there was an excess of kip 150 billion or 1 percent of GDP, and to the end September target, an excess of kip 246 billion or 1.7 percent of GDP. Since then, the Government has taken substantial corrective measures to strengthen the fiscal position, including through quick tax audits and tighter controls on expenditures and Government bank accounts.

In 2001/02 budget, the Government will improve fiscal discipline. The overall deficit in the program is targeted to be at about 5 percent of GDP and would be financed largely through concessional external loans with limited recourse to domestic bank financing. However, given the uncertainty of the economic environment and the effect of administrative measures, the authorities have projected at 13.9 percent of GDP revenue or an increase of 0.4 percent, from the previous year. Some of the key measures to increase revenue during the fiscal year include: the full adjustment of customs valuation in accordance with the monthly bank exchange rate, the implementation of the recently amended Tax Law and the making of customs revenue a fully national tax. The technical assistance from the Fiscal Affairs Department has been extremely important in implementing these reforms.

On the expenditure side, the Government will focus more on social sectors and human resource development by increasing its current budget spending, while spending on the capital investment will be reduced. This will keep the ratio of total expenditure to GDP broadly constant. If revenue falls short of the program expectations, the Government will take offsetting measures through restraint on domestically funded capital expenditures, while keeping operations and maintenance, local counterpart funds, and key social sector spending at the budgeted level.

² The Government acknowledges that Fund staff currently projects real GDP growth at about five percent owing to a more fragile external environment, providing a prudent basis for the financial program.

³ The fiscal year runs October through September.

Some of the key measures to strengthen the public expenditure management during the fiscal year are: the Budget Department approval of quarterly allocations of funds for the main current expenditures and separately for large capital expenditures, the rationalization of provincial and line ministry bank accounts, closure of unauthorized accounts, and upgrading of the information system of the budget.

Monetary policy

In 2001, monetary policy remained relatively tight and was successful in reducing inflation. Despite the Government's withdrawal of the deposits from the Bank of the Lao P.D.R (BOL) for budgetary purposes as mentioned above, the BOL managed to limit in the net domestic assets of the BOL to Kip 46 billion as of June 2001, or one third of the fiscal slippage. In the September quarter, the BOL issued additional securities to further limit the monetary impact of the budgetary slippage.

State commercial banks' (SCBs) credit growth was in line with the program through June 2001. However, as a result of the incidence of a temporary loan for the Lao Brewery share purchase⁴, SCBs credit increased substantially by \$24 million. In any event, this amount was fully repaid on February 21, 2002. Therefore, excluding this transaction, the increase in credit of the SCBs, as measured by their net domestic assets, was only 1.7 percent by end December 2001.

In 2002, the monetary policy will continue to be tight and the exchange rate policy will remain flexible in order to further restrain the inflation rate to the target of 6 percent by end September. The BOL financing for the budget will be eliminated since the Government will use increased sales of treasury bills (with greater flexibility in treasury bill yields) to finance the domestic requirement of the budget and will monitor the central Government's fiscal position more closely. Moreover, the BOL will continue to reduce its credit to banks so as to keep the BOL's net domestic assets broadly constant.

The BOL will continue to manage the exchange rate regime flexibly, allowing the banks' exchange rate to adjust so as to maintain the margin with the parallel market rate at less than 2 percent and avoid multiple currency practice. The Government and the BOL will adjust macroeconomic policies to correct any persistent weakness in the kip. The Government will also continue to improve the functioning of the interbank foreign exchange market by strengthening the foreign exchange operation and management of the banking sector, in particular, the state-owned commercial banks.

Financial sector reform:

⁴ This temporary share purchase in July 2001 by the Government was prompted by an unexpected decision of foreign partners to sell their share in Lao Brewery in May 2001. An agreement to resell 50 percent of the total shares to Hong Kong investors was concluded in January 2002.

In 2001, the Lao authorities prepared a comprehensive plan for state commercial bank restructuring in connection with the conditionality under the current PRGF arrangement and a possibility of concessional loans from the World Bank(WB) and the Asian Development Bank (AsDB) in 2002 to develop the Lao financial sector. During this process, the authorities have consulted with the staff of the Fund, WB and AsDB.

The main elements of the banking reform are:

- Financial and operational restructuring will be implemented in the period 2002-05 through phased recapitalization, conditional on meeting qualitative and quantitative targets which would be specified by May 2002 as part of the banks' business plans.
- The two smaller Lao May and Lane Xang Banks will merge and rationalize their operations to reduce operational costs and accelerate the adoption of modern banking procedures.
- To support the restructuring efforts, the Government will use the role of a small number of foreign advisors in providing technical assistance in each of the two SCBs, the merged Bank (Lao May and Lane Xang) and the Banque Pour Le Commerce Exterieur Lao (BCEL). In addition to providing advice on internal bank practices, they will have a role to review proposed large credit decisions. The bank management may override the objections by the advisor, but the process would be transparent and such credits would be subject to special monitoring; and if the new management team do not meet the performance indicators, a form of management support would be strengthened.
- Bank supervision will be strengthened for the phased implementation of bank supervision regulations, focusing first on those that affect credit quality. The Monetary and Exchange Affairs Department (MAE) is in the process of fulfilling the Government's request for technical assistance in banking supervision.

Other structural reforms

In 2001, the authorities adjusted upward the prices of three major state-owned enterprises (SOEs) to reach a cost recovery level before end 2002. The water prices were adjusted in April 2001 by an average of about 100 percent and further adjustments will be in June 2002; the electricity prices were adjusted by 3-3.5 percent per month through end-2001 and a decision on the future price adjustments required for cost recovery price is expected in April 2002; the Lao Aviation air fares were raised in July 2001 by 20 percent, will be raised again in April 2002 and further adjustments would be made to reach the cost recovery level by October, 2002.

In conjunction with the WB, the authorities will begin the restructuring process of five large state-owned enterprises (SOEs), three are large defaulting borrowers namely: the Phoudoi conglomerate, Nam Papa (Water) and Lao Aviation; one large loss maker, that is Pharmaceutical Factory #3, and Electricite Du Laos (EDL), a main revenue earner. Drafting of the restructuring plans of an additional five large defaulters is scheduled to start by October 2002.

Safeguard assessment

Stage One safeguard assessment conducted by the Fund staff at the Headquarters was completed in December 2001. The authorities appreciate the concerns and the recommendations of the IMF Safeguards Report. In particular, the recommendations for five categories of vulnerabilities namely: the external audit mechanism, legal structure and independence, financial reporting framework, internal audit mechanism and internal control system. The authorities will fully implement as soon as possible in order to move to Stage Two assessment this year.

Poverty reduction strategy

The authorities are planning to finalize their National Poverty Reduction Program (NPRP) by August 2002. The NPRP will be fully consistent with the requirements of PRSP and builds on the interim PRSP (I-PRSP). The elaboration of NPRP will be both nationally owned and participatory, involving all segments of society, including the Lao Women's Union, the Lao Youth Organization, the Trade Union Federation, and the Lao Front for Reconstruction, and most importantly, the poor themselves.

In order to have the sources of poverty better analyzed and to help the authorities better assess and monitor the impact of policies on poverty reduction outcomes, the authorities have given a mandate to the National Statistical Center (NSC) to prepare a follow-up household expenditure and consumption survey (LECS-III) to finalize poverty measurements; and to draft guidelines for a poverty reporting system (PRS) in developing criteria for defining poverty at household, village and provincial levels. Both of these instruments (LECS-III and PRS) are in the process of being developed with the assistance of the WB and the support from Sweden.

The PRSP Committee is elaborating specific poverty-reducing measures in the areas of food security, rural development, forestry, road infrastructure, and health and education, and their budgetary impact. It is expected that the full PRSP will be finalized by August, 2002 as scheduled.

Other areas

In view of the Lao P.D.R's vulnerabilities external position, the authorities will limit the contracting or guaranteeing of new noncessional external debt. In addition, the authorities will continue to upgrade the monitoring of the external debt through the External Debt Monitoring Unit in the Ministry of Finance.

The debt negotiations with the Russian Federation are ongoing. The authorities are doing their best to reach an acceptable agreement for the repayment of the debt to the Russian Federation, taking into account the debt payment capacity of Lao P.D.R over the medium term. At least, another round of negotiations is planned for 2002. On February 5, 2002 Lao Vice Minister of Finance sent a letter to the Russian authorities restating the Lao authorities are sincerely interested in solving the debt issue in a mutually acceptable manner and would like to conduct another meeting at the earliest convenience with the Russian authorities.

Closing Remarks

Despite numerous internal constraints and economic downturn of the region and of the world in 2001, the Lao authorities managed to maintain the hard-won macroeconomic stability. The authorities recognize that there remains much to be done and much assistance will be needed to achieve a sustained economic growth over the medium term in order to support the poverty reduction strategy of the country. As such, they remain committed to implement all necessary measures under the PRGF arrangement. They are hopeful that their request for the completion of the first review under the arrangement, waivers for the nonobservance of three quantitative performance criteria for end-June and one structural performance criterion for end-September, and modification of one structural performance criterion for end-March 2002 will be supported by the Board. They, hereby, wish to express their appreciation and gratitude once again to the Board and the Management of the Fund for the continued support to the endeavors of Lao P.D.R.

Regarding the publication of the staff report, we are pleased to inform the Board that the Lao authorities have consented to the publication of the staff report dated February 11, 2002. They also have consented to the publication of staff report and the selected issues and statistical appendix thereof dated April 9, 2001.