

Lao People's Democratic Republic: Third Review Under the Poverty Reduction and Growth Facility, and Requests for Waiver of Performance Criterion and Extension of the Arrangement—Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Lao People's Democratic Republic

In the context of the third review under the Poverty Reduction and Growth Facility, and requests for waiver of performance criterion and extension of the Arrangement, the following documents have been released and are included in this package:

- the staff report for the third review under the Poverty Reduction and Growth Facility, and requests for waiver of performance criterion and extension of the Arrangement, prepared by a staff team of the IMF, following discussions that ended on **August 6, 2003**, with the officials of the Lao People's Democratic Republic on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on August 28, 2003.** 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 Press Release summarizing the **views of the Executive Board as expressed during its September 12, 2003 discussion** of the staff report that completed the requests and review.
- a statement by the Executive Director for the Lao People's Democratic Republic.

The document(s) listed below have been or will be separately released.

Poverty Reduction Strategy Paper Preparation Status Report
Joint Staff Assessment of the Poverty Reduction Strategy Paper
Preparation Status Report

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

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INTERNATIONAL MONETARY FUND

LAO PEOPLE'S DEMOCRATIC REPUBLIC

**Third Review under the Poverty Reduction and Growth Facility,
and Requests for Waiver of Performance Criterion and Extension of the
Arrangement**

Prepared by the Asia and Pacific Department
(In consultation with the Finance, Fiscal Affairs, Legal, Monetary and Financial Systems,
Policy Development and Review, and Statistics Departments)

Approved by Masahiko Takeda and Mark Allen

August 28, 2003

- Discussions for the third review under the Poverty Reduction and Growth Facility (PRGF) were held in Vientiane during October 23–November 6, 2002, February 25–March 5, 2003, and July 28–August 6, 2003.
- The staff team comprised, at various times, Messrs. Winglee (head), Hussain, Botman, and Nozaki (all APD), Mr. Kock (PDR), and Ms. Majaha-Jartby (MFD). Ms. Indrawati and Duriyaprapan (OED) joined some of the policy discussions. The team was assisted by Mr. Sidgwick (resident representative) and coordinated closely with various AsDB and World Bank missions.
- The mission met with Deputy Prime Minister and President of the Committee for Planning and Cooperation (CPC) H.E. Thongloun Sisoulith, Minister of Finance Chansy Phosikham, Bank of the Lao P.D.R. Governor Phoumi Thipphavone, CPC Vice President Mme. Khempheng Pholsena, and other senior officials.
- The government has agreed to publish the Letter of Intent and attachments.
- 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.
- The first review was completed on February 25, 2002 (EBS/02/23); the second review and the 2002 Article IV consultation were completed on August 26, 2002 (EBS/02/223).
- The main authors of this report were Messrs. Peter Winglee and Qaizar Hussain.

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GLOSSARY OF ABBREVIATIONS

AsDB.....	Asian Development Bank
BCEL.....	Banque pour le Commerce Extérieur du Laos
BOL.....	Bank of the Lao P.D.R.
BSRPL.....	Banking Sector Reform Program Loan (AsDB)
CPC.....	Committee for Planning and Cooperation
CPI.....	Consumer price index
EDL.....	Electricité du Laos
FAD.....	Fiscal Affairs Department
FIN.....	Finance Department
FMAC.....	Financial Management Adjustment Credit (World Bank)
GDP.....	Gross Domestic Product
HIPC.....	Highly Indebted Poor Country
IAS.....	International Accounting Standards
IBA.....	International Bank Advisors
Lao P.D.R.....	Lao People's Democratic Republic
LDB.....	Lao Development Bank
LMB.....	Lao May Bank
LTU.....	Large Taxpayer Unit
LXB.....	Lane Xang Bank
MEFP.....	Memorandum on Economic and Financial Policies
MOF.....	Ministry of Finance
MFD.....	Monetary and Financial Systems Department
NDASCB.....	Net domestic assets of the SCBs
NIR.....	Net international Reserves
NM3.....	Nam Mang 3 Hydroelectric Project
NPLs.....	Nonperforming Loans
NPEP.....	National Poverty Eradication Program
NT2.....	Nam Theun 2 Hydro-Electricity Project
PEM.....	Public expenditure management
Phoudoi.....	Bolisat Phathana Khet Phoudoi (BPKP) Highland Development Enterprise
PRGF.....	Poverty Reduction and Growth Facility
PRSP.....	Poverty Reduction Strategy Paper
SAA.....	State Audit Authority (previously National Audit Office)
SCBs.....	State commercial banks
SOEs.....	State-owned enterprises
STA.....	Statistics Department
THPC.....	Theun Hinboun Hydroelectric Power Company
VAT.....	Value-added tax

EXECUTIVE SUMMARY

Program performance

- **The third review of the Lao P.D.R.'s PRGF-supported program has been delayed since January 2003.** Although all but one performance criteria were observed for September 2002, the completion of this review was delayed by the need to take corrective measures for the misreporting of external debt and the resulting non-complying disbursement. Moreover, additional fiscal measures were necessary to offset the revenue shortfall in 2002/03 (October - September) due to a reduction in timber royalties, tax cuts, and continued weak tax administration.
- **Macroeconomic performance has been mixed.** Real GDP growth slowed moderately to 5¼ percent in 2002/03 and is expected to pick up in 2003/04. However, policy slippages in mid-2002 sparked a major slide in the exchange rate and inflation rose, peaking at 18 percent in May 2003. Tighter fiscal control has stabilized the exchange rate for close to a year, and inflation is now on a downward path towards single digits.

Program for 2002/03 and 2003/04

- **During the delay in the third review, the authorities took stock of their reform program and have strengthened policies considerably in key areas.**
- **To address the shortfall in budget revenue in 2002/03, the authorities implemented revenue and expenditure measures at end May, to steer the program back on track.** These will be reinforced by structural changes in fiscal institutions in 2003/04, especially in the treasury and revenue departments.
- **Bank credit growth remains restrained as the start of bank restructuring and stronger banking supervision have made banks more cautious and focused on improving credit quality.**
- **Although SOE price adjustments remain on schedule, other SOE reforms are lagging.** Importantly, the restructuring plans for five large SOEs are delayed because discussions on the extent of asset sales and the role of joint ventures have been protracted.
- **The safeguards assessment has been completed,** and the BOL has agreed to implement the high priority recommendations for correcting the identified vulnerabilities. In particular, the audit of the BOL's 2003 accounts will be conducted jointly with an international audit firm, and will be fully compliant with international auditing standards.

I. INTRODUCTION

1. **Since April 2001, when the Executive Board approved the Lao P.D.R.'s PRGF-supported program, the government has made progress in setting a firmer foundation for economic reform.** Progress has been made in monetary management, bank restructuring, and expenditure control, but revenue mobilization and debt management problems have continued. In particular, the third review has been delayed since January 2003 because of the need to take corrective actions for a budget revenue shortfall, and to implement the remedial measures for the misreporting of external debt. Going forward, risks remain from the weak fiscal system, limited implementation capacity, vested interests, and some policymakers' caution about the reliance on market mechanisms.

2. **At the conclusion of the 2002 Article IV consultation and the second review under the PRGF on August 26, 2002, Directors welcomed Lao P.D.R.'s robust growth and progress under the program.** However, they expressed concern at the pick-up in inflation and warned that sustained growth would require measures to ensure fiscal sustainability, especially to improve revenue performance. Most Directors considered the phased approach to bank restructuring appropriate, but emphasized the need to improve loan quality and the strict application of commercial lending criteria. They also stressed the importance of complementary state-owned enterprise (SOE) reforms, especially asset sales and price adjustments. Directors welcomed the integration of the PRSP approach into the government's own poverty reduction program, but stressed that there should be prioritization of budget expenditure for pro-poor programs.

3. **In the attached letter dated August 28, 2003, the authorities request the completion of the third review under the PRGF-supported program, a waiver for the performance criterion on external debt, and an extension of the PRGF arrangement for one year, through April 24, 2005.** The policies through March 2004 in support of this request are set out in the accompanying Memorandum of Economic and Financial Policies (MEFP).¹

II. RECENT DEVELOPMENTS AND PROGRAM PERFORMANCE

Recent developments

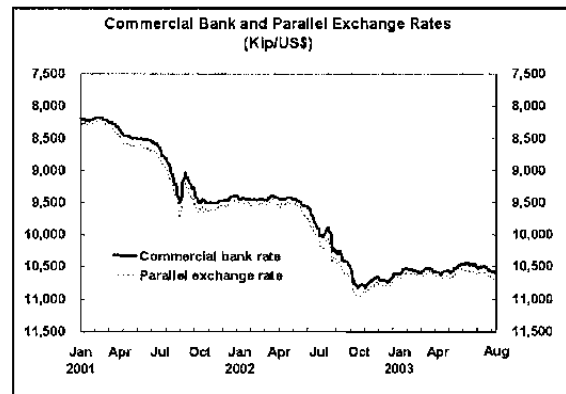
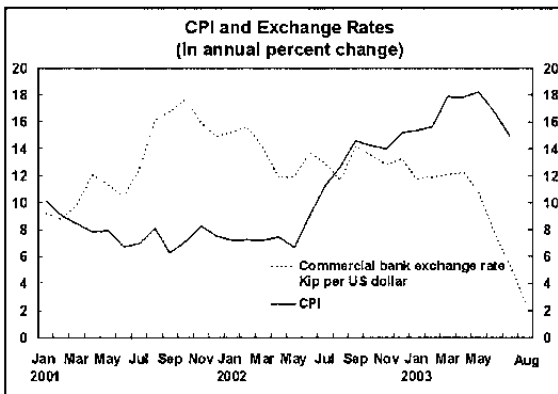
4. **Real GDP growth in 2002/03 weakened slightly to 5¼ percent, down ½ percentage point from the previous fiscal year (Table 3).**² Growth was supported by

¹ With a fourth disbursement (SDR 4.5 million), Lao P.D.R.'s outstanding use of Fund resources will amount to SDR 29.9 million (56.5 percent of quota) at end-September 2003. Assuming full disbursement under a revised schedule for the PRGF Arrangement (Table 1), Lao P.D.R.'s outstanding use of Fund resources would amount to SDR 34.1 million (64.4 percent of quota) at end-2005 (Table 2).

² Staff estimate. The authorities estimate real GDP growth to have been about 5.8 percent in each of the past three years. The Lao fiscal year runs October–September.

relatively strong increases in industrial production and agriculture, despite floods. However, slower private investment from more cautious bank lending policies, and weakness in tourism, dampened growth.

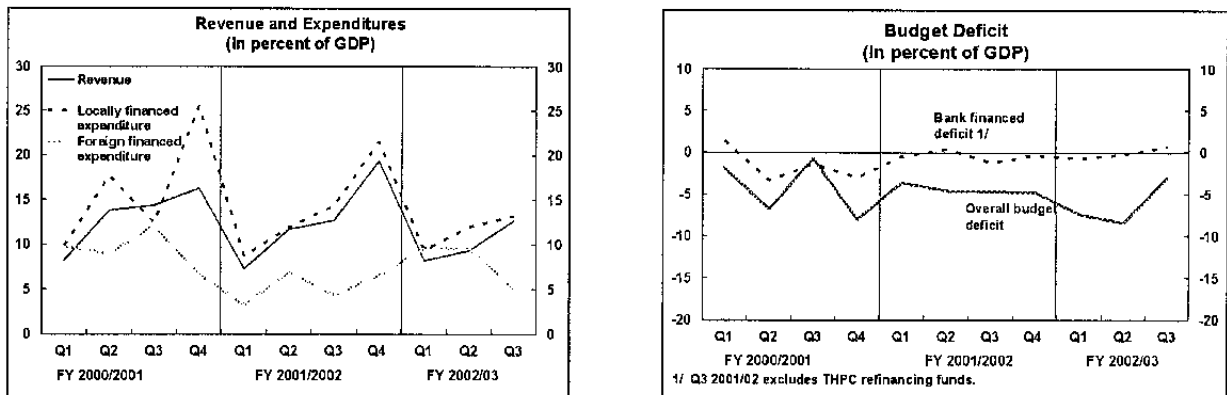
5. **After surging in mid-2002, and remaining high until May 2003, inflation has now started to decline.** The kip depreciated by 14 percent during May–September 2002, as a result of fiscal weaknesses in April–September 2002, and a surge in demand for foreign exchange to repay foreign currency bank credit.³ Reflecting this, inflation rose from about 7 percent (12-month basis) in the first part of 2002 to 15 percent in September 2002. Fiscal tightening starting October 2002 has helped to stabilize the exchange rate. However, food, utility, and petroleum price increases raised inflation further to 18 percent in May 2003. Since then, inflation has started to fall as the pass-through of the mid-2002 exchange rate slide has run its course. Inflation is expected to fall to about 10 percent by September 2003.



6. **Excessive government capital spending caused the fiscal problems in 2001/02.** The fiscal program for 2001/02 was premised on revenue at 13 percent of GDP, a cut from the optimistic projections in the budget. This was to be offset by cutbacks in expenditure from budgeted levels (based on newly introduced expenditure controls), additional foreign financing, and a small amount of domestic bank financing (excluding the one-off proceeds from a hydroelectric project refinancing). The revenue outcome was in line with the program, and cash shortages triggered the inbuilt restraint on current expenditure, which came in well under budget. However, this was not the case with domestically financed capital expenditure, which remained unchecked and exceeded budget levels. This was financed by budget arrears (about 0.7 percent of GDP), especially at the provincial level, and the high import content of the expenditures added to pressure on the exchange rate even though the bank financing ceiling was observed.

³ The margin with the parallel market remained below 2 percent, except for a few days when there were particularly large movements in the parallel market.

7. **In 2002/03 the revenue ratio declined sharply but better expenditure controls prevented a deficit overrun.** Although revenue was projected to remain at 13 percent of GDP, actual collections are now only expected to reach 11.5 percent of GDP. This is mainly due to timber royalties falling by 1¼ percent of GDP from their peak in 2001/02 because of stricter enforcement of the log export ban. Revenue was also depressed by slower GDP growth and the halving of the turnover tax on domestic products. In response to the revenue shortfall, petroleum taxes were raised at end-May by 17 percentage points, effectively doubling the tax rate. Meanwhile, stricter expenditure controls prevented a repeat of last year's unfunded expenditures, with some large unproductive projects being suspended.



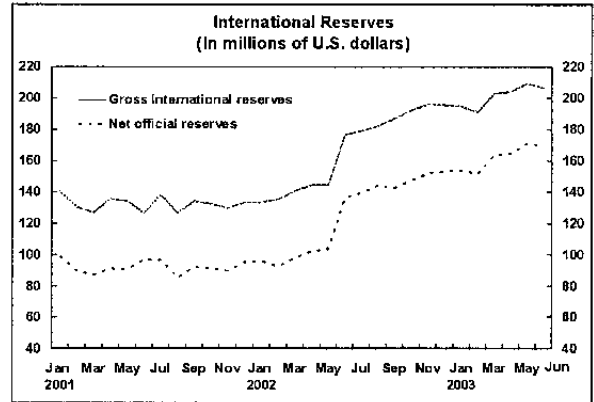
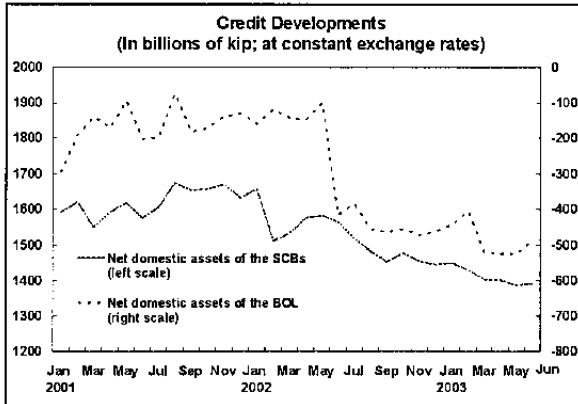
These controls appear to have limited new arrears, reduced aggregate demand, and helped to stabilize the exchange rate.⁴ Thus, by end-June 2003, net credit to the government was only slightly above the ceiling, and it is expected to fall under the ceiling by September.

8. **Credit policy has been restrained since May 2002.** After excessive credit growth through early 2002 gave rise to a further increase in nonperforming loans, the authorities took steps to restrain credit and initiate bank restructuring. This resulted in significant credit repayments in May-September 2002. Because a large proportion of this credit was in foreign currency, the rapid pace of repayments added to the demand for foreign exchange and the downward pressure on the exchange rate.⁵ Since then, net domestic assets of the state commercial banks (SCBs) have been on a slight downward trend, with tightened credit appraisals and some repayments. The credit restraint and the recall of BOL foreign currency

⁴ Although the authorities have indicated that measured arrears have declined, there is still uncertainty about this coverage. Another census/survey of arrears will be conducted for end-September 2003.

⁵ Many borrowers of foreign exchange loans from the SCBs did not have a formal source of foreign exchange. Thus repayments may have required them to obtain foreign exchange from the parallel market.

credit to banks have enabled gross international reserves to build up to 3.7 months of imports in June 2003. In November 2002, the SCBs raised short-term kip deposit interest rates by 3 percentage points to prevent a decline in real kip rates.



Performance under the program

9. **Program performance at September 2002 was mixed.** All but one of the end-September 2002 quantitative performance criteria were met (Box 1). However, the ceiling on contracting and guaranteeing external nonconcessional public debt was breached by the March 2002 loan for the Nam Mang 3 hydro-electric project (\$50 million, 2½ percent of GDP). This loan was successfully renegotiated to concessional terms in November 2002, and the related misreporting issue was considered by the Board on July 9, 2003. Also, while complying with the ceiling on bank credit to the government, significant budget arrears were accumulated.

10. **The mixed performance continued in relation to the March 2003 targets, highlighting the fiscal weakness.** Budget revenue was well below expectations during the first half of the fiscal year, and the ceilings for net bank credit to the government and the NDA of the BOL were exceeded, further delaying the review until the corrective fiscal measures at end May. On the positive side, the ceiling for NDA of SCBs and the floor for net international reserves were met by wide margins.

11. **Implementation of the structural conditionality was generally consistent with the program, although capacity and policy constraints in the fiscal area have slowed progress.** The structural benchmark on strengthening and reorganizing the tax and customs departments was broadly met although much remains to be done. Regarding public expenditure management, understandings were reached at end-November 2002 on a medium-term plan (MEFP Appendix I). Expenditure data by type of administrative unit were

Box 1. Lao P.D.R.: Summary of Performance Under the Program for the Third Review¹

Measures	Status
I. Quantitative performance criteria (for September 2002)	
1. Net domestic assets of the BOL. 2. Net banking system credit to the government. 3. Net domestic assets of SCBs. 4. Net international reserves. 5. Nonconcessional public external debt.	Met. Met. Met. Met. Not met. Waiver requested on basis of newly concessional terms.
6. External payment arrears.	Met.
II. Structural targets	
1. Complete the 2001 audit of the BOL by the National Audit Office and relevant financial statements with the assistance of an international auditing firm. (<i>Structural benchmark</i> , August 2002).	Partially met. Although international standards of auditing not achieved, the accounts were recast to international accounting standards..
2. Implement two rounds of quarterly targeted inspections of the three SCBs, including their 5 largest branches. (<i>Structural performance criterion</i> , November 2002).	Met.
3. Strengthen central tax and customs departments, organize them on a functional basis, and transfer an additional large provincial customs point to the national customs service. (<i>Structural benchmark</i> , November 2002).	Met. Completed integration of some customs divisions and established new audit and training division in tax department. Initial steps taken for more comprehensive strengthening of these departments in late 2003.
4. Agree on a medium-term plan for expenditure management and implement a system to identify expenditure by type of administrative unit for the education and health sectors. (<i>Structural benchmark</i> , November 2002).	Met. Plan agreed; data on education implemented but health data delayed. Comprehensive classifications being developed for 2003/04 budget.
5. Ensure the four international bank advisors have initiated their tasks in the SCBs. (<i>Prior action, third review</i>).	Met.
6. Agree to undertake audits of BOL's 2003 account jointly with an international audit firm. (<i>Prior action, third review</i>).	Met.
7. Revise Ministry of Finance instruction on external debt reporting and report all public sector external debt. (<i>Prior action, third review</i>).	Met.
8. Implement a package of revenue and expenditure measures to close the fiscal gap in 2002/03. (<i>Prior action, third review</i>).	Met.
9. Finalize survey of budget arrears as at end-September 2002. (<i>Prior action, third review</i>).	Met.

^{1/} Based on the attached MEFP Tables 1 and 2, and more recent information.

developed for education, but the slower pace of computerization delayed the production of data for the health sector.

12. **The structural program is on track in the banking area, but progress in state-owned enterprise reform is lagging.** The structural performance criterion for two rounds of bank supervision inspections was met as scheduled at end-November 2002, with notable improvements in the depth and quality of the inspections. Under the AsDB's Banking Sector Reform Program, four international banking advisors were placed in the SCBs. The state auditor completed its 2001 audit of the BOL on schedule in August 2002, although it was not at international standards. SOE reform has lagged significantly, especially progress towards agreement with the World Bank on restructuring programs for five large SOEs. The enterprises are seeking additional financing to revitalize their operations but the government and the Bank are looking for options that do not involve additional public resources.

III. PROGRAM FOR 2003/04

13. **The 2003/04 program is focused on strengthening macroeconomic stabilization and accelerating the related structural agenda.** This focus provides a foundation for the government's broader reform agenda, covering social, environmental, financial, and private sector development issues being developed under the National Poverty Eradication Program. The authorities explained that the slow progress resulted from the need to build consensus and coordinate these broader reforms. However, they stressed that they attach the highest priority to macroeconomic stability. For example, they noted that while fiscal decentralization had been initiated for broader development objectives, it has led to a deterioration in expenditure control and revenue performance that the government now intends to correct by recentralizing some of the tax, customs, and treasury functions.

14. **Real GDP growth is projected to pick up to about 5¾ percent in 2003/04** as a result of increased private investment and a modest recovery in tourism.⁶ Inflation should decline further, to about 8 percent by September 2004, with further utility price increases keeping inflation above that of the trading partners. Exports are expected to grow relatively strongly, especially agricultural products, garments, and tourism receipts, which will increase gross international reserves to about 3.8 months of imports by September 2004. Looking further ahead, the pick up in growth from the large Nam Thuen 2 hydro-electric project has now been put back to 2005 because of the need to find other partners, after the largest shareholder withdrew from the project to narrow the focus of its investment portfolio.

Fiscal policy

15. **In preparing the budget for 2003/04, the authorities recognize that the broader objectives need to be met within realistic financial constraints.** To achieve this, the

⁶ The authorities are projecting real GDP growth of 6.2 percent. The budget projections have factored in a lower growth rate.

government will follow through on recent tax increases, embark on fiscal reforms in 2003/04 to strengthen the fiscal institutions, improve the efficiency of spending, and keep some funds unallocated. With the identified program loans at about the same level as 2002/03, no domestic bank financing of the budget is envisaged (except for the issue of government bonds to pay down old budget arrears).⁷

16. **Revenue in 2003/04 is targeted to increase to 12.2 percent of GDP (MEFP ¶8).** Preliminary estimates envisage that this increase would come mainly from the full-year effect of the petroleum tax increases implemented in late 2002/03 (0.6 percent of GDP), and some additional increases in excises on beer and tobacco that will more than offset the further loss of timber royalties. The staff would have preferred the reversal of the turnover tax reduction enacted in 2002/03 to be included in this budget. However, the authorities were concerned that such a quick reversal would damage their creditability and also noted that it entailed only a modest direct revenue loss (0.2 percent of GDP). They would review this measure in the context of the 2004/05 budget. To improve the transfer and accounting of revenues, especially those of the central government, the customs and treasury departments will be developed into national operations. Also, the tax department is being strengthened and the central large taxpayer unit will be expanded. When fully implemented, these measures could have a substantial revenue impact because they will limit the unauthorized diversion of funds, especially at the local levels. However, because the revenue impact is hard to quantify, and implementation will depend on cooperation from the provincial governments, no revenue impact has been explicitly included in the 2003/04 budget. Separately, concerns about the state of preparation for the VAT have led the government to put back its introduction to 2006.

17. **The new Presidential Decree on Tax Incentives, being very broad and potentially costly, is a significant risk to the revenue outlook.** This decree codifies the prevailing tax exemptions on import and profit taxes for domestic and foreign investors, but also has scope to extend them by regions and sectors. The staff argued that there were more cost effective methods to promote the private sector, and that the budget could ill afford a further shrinkage of the revenue base. In response to these concerns, the authorities explained that this initiative to promote the domestic private sector, especially in remote areas and in new sectors, including health, education, electricity generation, and infrastructure, would not be allowed to undermine the fiscal position. Meanwhile, they would work with Fund staff to formulate implementing regulations to safeguard budget revenues, which the authorities believe can be done with the existing decree, but would be prepared to revise the decree, if necessary. This decree is not currently being implemented because the implementing regulations have not been issued, and the authorities agreed to continue this (as a continuous structural performance criterion) pending the formulation of appropriate regulations.

⁷ The budget estimates for project loans show high estimates of disbursements, which seem to be optimistic. Any shortfalls will be offset by reductions in externally financed capital expenditure.

18. **Domestic expenditures will shift towards current expenditures in 2003/04**, which will rise by 0.9 percent of GDP (MEFP ¶9). The rise comes mainly from the 42 percent increase in the wage bill (reflecting a new 30 percent civil service wage increase, on top of the 15 percent granted in late 2002/03). Such increases in civil service wages are needed to offset the ongoing large increases in utility tariffs and recent petroleum tax increases, and to gradually restore the real wage level to that of the mid-1990s. These wage increases are especially important for social sector workers who make up a significant share of government employment. Also both domestic and foreign debt service is likely to rise significantly due to the servicing of debt clearance bonds and Russian debt. Offsetting this will be a cut in domestically financed capital expenditure, which will fall from 4.9 percent to 4.0 percent of GDP. In addition, this category includes an unallocated amount of 0.8 percent of GDP which would be available only if budget revenues are on track. In line with a policy of stricter appraisals of investment, the budget only includes funding for existing projects and there are no allocations for new projects, while they are evaluated and prioritized this year.

19. **Recognizing the serious deficiencies in public expenditure management, the government is embarking on a range of reform measures.** In line with the plan (MEFP Appendix I) for 2003/04, these reforms will both tighten expenditure controls and improve information systems, through the development of a national treasury, the rationalization of government bank accounts, and the introduction of a classification of expenditure by administrative unit. To correct past poor fiscal management, the government will accelerate clearance of the budget arrears identified in the recent survey of arrears and the bank restructuring process, amounting to KN 600 billion (3 percent of GDP) as of September 2002. About two-thirds of this will be cleared by end 2003/04, mainly by the issuance of debt clearance bonds, which will also partly finance bank restructuring.⁸ Post-2001 arrears are being cleared by a combination of securities, cash, and tax netting, within the budget, and as noted earlier, tighter disbursement procedures have significantly reduced the likelihood of new arrears on capital expenditure.

Monetary and exchange rate policies

20. **The monetary program will continue to be based on limits on central bank credit to reduce inflation.**⁹ Net credit to the government by the BOL will decline slightly, providing scope for a further increase in gross international reserves to \$228 million (3.8 months of imports) by September 2004, while limiting reserve money growth to

⁸These bonds will be used to settle budget obligations to contractors for capital projects with NPLs at the SCBs mainly incurred before 2001.

⁹The monetary program through September 2003 is essentially the program agreed in November 2002.

15 percent in 2003/04.¹⁰ The BOL will phase the redemption of its securities so as to avoid undue increases in liquidity.

21. **SCBs will continue to be subject to overall credit limits.** Their credit will be limited to 16 percent in the year to September 2004 (slightly higher than nominal GDP growth) while total commercial bank credit is expected to grow slightly faster, at 18 percent. As SCBs gradually resume lending, it will be important that they do so cautiously and under new appraisal procedures that appropriately price risk, especially on foreign currency loans. Under this scenario, broad money is expected to grow by 19 percent in the year to September 2004, although it could be lower if banks reduce deposit interest rates, given their high level of excess reserves.

22. **The prevailing flexible exchange rate regime, and the policy of maintaining the margin with the parallel rate at less than 2 percent, are appropriate and will be maintained.** Under this approach, the exchange rate has been a visible indicator of policy slippages, signaling when corrective action is needed. The authorities have a strong preference for a stable exchange rate, since the high level of dollarization means that exchange rate changes will only result in limited adjustment in relative prices.

External debt management policies

23. **The Lao and Russian governments have made significant progress toward a mutually agreeable solution of their outstanding debt issue.** Understandings have been reached recently consistent with terms of Russia's Memorandum of Understanding as a creditor in the Paris Club (using an exchange rate of SUR 0.6 per dollar and a 70 percent upfront discount), resulting in a face value of debt of \$387 million. This will need to be followed by the end of 2003 with a specific agreement on the terms, including interest, grace period, and payment modalities (cash, goods, and/or investment).

24. **Reflecting the high level of external debt and a narrow export base, the government will refrain from contracting and guaranteeing new nonconcessional external public debt (MEFP ¶18).**¹¹ As part of the Ministry of Finance's effort to improve the monitoring of all public sector external debt, the database has been made more comprehensive by the inclusion of SOE external debts. However, in late May 2003 (before the monitoring system became effective) the state-owned Lao Airlines signed a three-year lease for a new Airbus without a government guarantee at a relatively low rental, less than

¹⁰ The definition of net international reserves for program monitoring purposes (MEFP Table 1) has been revised starting March 2003, with all foreign currency components of reserve money now excluded (previously only required reserves were excluded).

¹¹ The financing gaps in 2003 and 2004 are fully identified: in 2003 comprising \$10 million from the AsDB and \$6 million under the PRGF; and in 2004, \$10 million from the AsDB, \$10 million from the World Bank, and \$13 million under the PRGF.

for a smaller propeller aircraft leased earlier.¹² Based on the commitments from the government to not provide financial support to Lao Airlines, which the staff will monitor closely, the \$3 million (in NPV terms) debt has been allowed under the program. The net present value of Lao P.D.R.'s public external debt is high at 113 percent of exports, excluding debt to Russia. A debt sustainability analysis will be undertaken after agreement on the specific terms of the debt to Russia is reached.

Banking reform

25. **State bank restructuring is on track under the detailed program supported by the AsDB and World Bank (MEFP ¶14–16).** In particular, SCBs have implemented operational restraints, limited credit growth, and recovered 8 percent of gross credit through end-June 2003. The four international bank advisors (IBAs) started work in the main operational areas, including credit appraisals. In addition, the two small SCBs have merged and rationalization has begun. In 2003/04 the program will contain (i) half yearly financial targets and more comprehensive annual performance tests,¹³ (ii) a mechanism for upgrading the role of the BOL and the IBAs in case of poor performance by the SCBs in 2003, and (iii) the submission, by January 2004, of amendments to the Decree Law on Commercial Banks to, inter alia, permit foreign bank branches to operate on a nationwide basis (a structural benchmark). As part of the overall policy framework, the government has now decided that it would also seek strategic shareholders in one of the two remaining SCBs by 2005.

26. **Despite the encouraging implementation of banking reforms, risks remain.** In particular, it will take time for these SCBs to develop a fully commercial orientation and many difficult restructuring decisions still need to be taken. Moreover, the risk of expansion of bad credit is still present in view of the slow reform of SOEs, as highlighted by the emergence of new NPLs. The introduction of greater competition in the banking sector should add pressure for reform over the medium term, although it may be difficult to attract reputable investors in the SCBs in the near term.

¹² The Minister of Finance has stated that he did not have knowledge of this lease when he gave assurances to the staff in early June that there was no nonguaranteed SOE debt. These assurances were part of the background information for the Board's decision on July 9, 2003 to grant a waiver for the noncomplying disbursement as a result of the misreporting of external debt. To improve the monitoring of external debt, the program ceiling on nonconcessional external debt has now been made continuous.

¹³ The government's recent plan to clear old arrears to contractors who have NPLs at SCBs differs from the original bank recapitalization plan because it utilizes loan-by-loan resolution of these pre-2000 NPLs (about 75 percent of the total). Other NPLs will be addressed after this process has been worked through.

27. **The BOL will continue to strengthen bank supervision capacity.** Despite an established regulatory framework, its implementation by the BOL is still in the early stages. The implementation of on-site inspections will again be a structural performance criterion, but requiring higher standards, and these will be part of the first performance test of SCB restructuring.

State-owned enterprise reform

28. **Of the targeted structural reforms, progress has been slowest for SOEs.** Under the World Bank's FMAC, the main element of the reforms is for five large SOEs to develop and implement restructuring programs (MEFP ¶17) on which little progress has been made. Indeed, the proposals by the enterprises themselves focused only on the need for additional financial support. The government has now started to utilize international experts, with funding under the FMAC, to assist, develop, and implement the reform plans. For the Phoudoi conglomerate (the largest bad debtor), a key bottleneck is the extent of sales of noncore assets to pay down its nonperforming loans. Lao Airlines, which has foreign management advisors, is expected to reach agreement with the Bank under the FMAC program on a restructuring plan by the end of the year, which would include seeking a joint venture partner.

PRSP and links to broader reforms

29. **Formulation of the country-led National Poverty Eradication Program (NPEP) is well advanced.** The government has incorporated the NPEP process into its broader socio-economic development plan that is the basis for its general economic reforms as well as its poverty reduction and sector specific policies. Among the issues raised has been the relative size and role of the public and private sectors. After consultations with stakeholders, government ministries, mass organizations,¹⁴ private sector, and donors, a final version is expected by late 2003.

30. **The PRGF and operations of the World Bank and the AsDB are aligned to support the government's efforts at economic reforms and direct poverty reduction under the umbrella of the NPEP.** The integrated structural conditionality of the three institutions is shown in Box 2. In addition, the Bank and the AsDB are working with the government, including through Business Roundtable meetings, to identify and eliminate major impediments to private sector development, and to support direct poverty reduction programs in health, education, agriculture, rural roads, and social and environmental safeguards.

¹⁴ These mass organizations represent women, workers, and youth within the framework of the Lao People's Revolutionary Party.

Box 2: Structural Measures Supported by International Financial Institutions

IMF	World Bank	Asian Development Bank
<i>The PRGF focuses on maintaining macroeconomic stability and closely related structural reforms.</i>	<i>The FMAC is a short-term adjustment operation, covering reforms to SCBs, SOEs, and public expenditure management, which is expected to be followed by PRSCs based on the Lao Government's PRSP starting in 2004.</i>	<i>The AsDB support is aimed at poverty reduction, private sector development, and governance improvements, including through banking sector reform, and public accounting and audit reform.</i>
I. Fiscal Sector		
Revenue administration improvements, especially through centralization of the customs department, strengthening the large taxpayer units, and preparing for the VAT, supported by technical assistance.		
<ol style="list-style-type: none"> 1. Agreement on medium-term public expenditure management (PEM) plan, including treasury reform (prior to end 2002). 2. Develop budget classification by administrative unit in the 2003/04 budget (prior to end 2003). 3. Comprehensive measures for preventing and clearing budget arrears (prior to mid-2003). 4. Implementation of expenditure management improvements to support expenditure tracking, giving highest priority to the social sectors (medium term). 	<ol style="list-style-type: none"> 1. Assessment of current expenditure requirement for new projects in excess of KN 1 billion (by mid-2003). 2. Preparation of strategy for reform of Treasury Department (by mid-2003). 3. Establishment of Procurement Monitoring Office (by mid-2003). 	Technical assistance projects for the Accounting Department of MOF and State Audit Authority (2002-04).
II. Poverty		
	<ol style="list-style-type: none"> 1. Poverty Reduction Fund Project to support the government's five-year plan and Poverty Reduction Strategy (by mid-2003). 2. Time bound plan for rural and microfinance reform (by mid-2003). 	<ol style="list-style-type: none"> 1. Poverty Reduction Partnership Agreement aimed at broadening community participation (2001-06). 2. Diagnostic review and restructuring plan for Agricultural Promotion Bank (APB) (by end 2003). Market orientation and improving rural finance (by mid-2004).
III. Banking Sector		
<ol style="list-style-type: none"> 1. Two international bank advisors in each SCB group (by June 2003). 2. On site supervision and two quarterly targeted inspections (prior to end 2002). Another on site inspection (prior to late-2003). 3. Submission of amendments to Decree Law for Commercial Banks (by early 2004). 4. Move audits of the BOL and accounting practices to international standards (by mid-2004). 	<ol style="list-style-type: none"> 1. At least two banking advisors in place in SCBs (by end 2002). 2. 2001 and 2002 audit for SCBs and APB (by mid-2003). 3. NPL resolution of KN 100 billion and action taken on at least 10 accounts (by mid-2003). 	<ol style="list-style-type: none"> 1. At least one international banking advisor selected for each SCB (by end 2002). 2. BOL and MOF to sign Governance Contracts with SCBs (by end 2002). 3. New boards and management teams for SCBs (mid-2003). Finalize merger/liquidation of LMB and LXB (by end 2003). 4. Submission of amendments on Decree Law for Commercial Banks (by end 2003). 5. NPL resolution of at least KN 120 billion and recapitalization of banks starting 2003 (by end 2003). 6. Seek strategic investors for one SCB (by mid-2005).
IV. State Owned Enterprise Reform and Private Sector Development		
	<p>All measures by mid-2003:</p> <ol style="list-style-type: none"> 1. Information on financial performance of SOEs. 2. Time bound restructuring plan for Phoudoi, Nam Papa Lao, Pharmaceutical Factory No. 3, and Lao Airlines 3. Execution of MOUs for restructuring of DAFI and four other loss-making SOEs with NPLs greater than KN 1 billion. 4. Time bound action plan for tariff policies for urban water supply, telecommunications, and Lao Airlines. 5. Completion of financial restructuring of EDL to achieve cost recovery. 	For private sector development and improving credit climate, strengthening of enabling legal environment, and judicial oversight (2003-05).

Program monitoring and safeguards

31. **The program will be monitored by both quantitative and structural targets.** Quantitative performance criteria will be specified for end-September 2003 and end-March 2004. Compared to the previous financial program, indicative targets have been added for reserve money in kip (to more closely monitor domestic liquidity creation) and budget revenue (MEFP Table 1). The structural conditionality is given in MEFP Table 2, and discussed in Box 3. Because of the delay in completing the third review, the authorities have requested a one-year extension of the PRGF arrangement, through April 24, 2005. The fourth and fifth reviews have been scheduled for end-January and end-July 2004, respectively.

32. **The authorities are requesting a waiver for the nonobservance of the end September 2002 performance criterion for contracting and guaranteeing nonconcessional public debt.** This debt was contracted for the Nam Mang 3 hydroelectric project, and the waiver is requested on the basis of the loan terms being made concessional in November 2002. Waivers for the end-March 2003 performance criteria are not being sought because the lag in the implementation of the broader structural agenda does not warrant the fifth disbursement.

33. **While the core policies of the program are monitorable through reasonably accurate financial statistics, there are severe statistical weaknesses in some areas.** Weaknesses in the availability of trade, national accounts, and fiscal data constrain economic analysis, decision making, and financial accountability. Recognizing this, the government intends to adopt the Generalized Data Dissemination System (MEFP ¶21) to provide a more structured approach for improving statistics and promoting policy transparency. The government is considering to adapt the recommendations of the STA mission in 2002 that reviewed macroeconomic statistics and socio-demographic data for monitoring poverty reduction outcomes.

34. **Onsite inspection under the Fund's safeguards assessment identified significant vulnerabilities, and the BOL has agreed to implement the high priority recommendations** (Annex I and MEFP ¶22). Building on the earlier audit, the BOL has agreed that the audit of the 2002 accounts will be conducted by the State Audit Authority, with the close assistance of an international audit firm, and the audit of the 2003 accounts will be conducted jointly with an international firm. The BOL will also progressively correct the deviations from international accounting standards (IAS) identified in the 2001 and subsequent audits, starting with provisioning for its loans. Progress towards adopting IAS for the 2004 financial accounts will be discussed in the fourth PRGF review, and in light of the outcome of the 2002 audit.

IV. STAFF APPRAISAL

35. **Over the past two years, there has been welcome progress in macroeconomic stabilization and structural reforms.** The inflation pressures that emerged in mid-2002 from fiscal weaknesses and complications in monetary policy have now subsided. With the exchange rate stable for close to a year, inflation should continue to decline. At the same

Box 3. Lao P.D.R.: Structural Conditionality

Coverage of structural conditionality in the current program

Structural conditionality for the 2003/04 program is set out in the attached MEFP dated August 28, 2003, especially Table 2. Structural conditionality focuses on improving fiscal management and banking supervision. These areas are critical to achieving the program's main objectives of maintaining macroeconomic stability and developing the structural foundation for faster growth with poverty reduction.

Status of structural conditionality from earlier programs

The structural conditions for the third review of the PRGF-supported program were implemented on time, except for the benchmark on the BOL audit where the basic work was completed according to schedule, but the audit fell short of international standards. This audit arrangement was a step to build the authorities' exposure to international standard audits, and the authorities have now agreed to a joint audit for 2003.

The structural conditions for the first and second reviews were implemented, typically with a slight delay of 1–2 months, but always in advance of their respective reviews. An exception was the benchmark on the medium-term plan for public expenditure management for the second review, which was subsequently made part of the third review. The plan is now completed, and its implementation is underway.

Structural areas covered by World Bank and AsDB lending and conditionality

The World Bank's FMAC, approved in June 2002, has the theme of improving financial management in the SCBs, SOEs, the budget, and forestry, the latter being a large revenue source. The FMAC conditionality covers the initial steps of SCB restructuring, credit restraints, pricing and restructuring of SOEs, and expenditure management, especially on the public investment program. It covers an 18-month period, to be followed by PRSCs.

The AsDB's Executive Board approved the Banking Sector Reform Program (BSRP) at end November 2002 aimed at securing operational improvements in SCBs, which also include legal, judicial, and private sector development components.

These components have been closely coordinated with the FMAC and PRGF.

Other relevant structural conditions not included in the current program

The coverage of the economic reform programs of FMAC, BSRP, and PRGF is comprehensive. The main issue will be to ensure effective implementation of the reform agenda rather than a more comprehensive coverage. Nevertheless, as the government becomes more engaged in private sector development, business and trade deregulation could be added to the agenda.

time, the need to bring down inflation again and the delay in the third review have made policy makers aware of the need for structural reforms to sustain macroeconomic stability. More generally, the PRSP-based process of the NPEP is building a consensus that, while many obstacles remain, poverty reduction can only be achieved through market-based growth from the private sector.

36. **The main challenge to macroeconomic stability remains a durable improvement in fiscal performance.** After a major weakening in budget revenue, the government has now responded with a corrective plan that includes tax measures and institutional reforms to be launched in 2003/04. The authorities will have to implement these reforms decisively to raise the revenue ratio as previously planned, and will need to be prepared to counter resistance, especially from provincial governments. The envisaged fiscal reforms to increase the efficiency and accountability of public spending, through stricter project evaluation and tighter management of finances, are welcome given the major deficiencies.

37. **The staff are seriously concerned that the recent decree on tax incentives for investment could lead to significant revenue losses.** While the authorities' recent focus on private sector development is laudable, more attention should be given to regulatory and administrative reform. To protect macro stability and the program's revenue objectives, it will be critical for the authorities to delay implementing this decree, and to ensure that the implementing regulations safeguard revenue, including if necessary, by also revising the decree.

38. **Monetary policy should continue to support the reduction in inflation.** Firm control over central bank credit should reinforce the recent decline in inflation. State bank credit could resume modest growth following recent cutbacks with the implementation of stricter credit appraisals. The staff considers the continuation of the flexible exchange rate to be appropriate.

39. **The progress made so far at bank restructuring is welcome, especially the use of stricter credit appraisals.** Despite this, much remains to be done to establish commercially oriented state banks. Enhancing competition by expanding the role of reputable foreign banks and diversifying the shareholding of one of the two SCBs, after an initial period of restructuring, will be important steps to achieve this aim. At the same time, it will be critical to maintain momentum in upgrading the quality of bank supervision.

40. **Delays in SOE reform are a concern and the government needs to move ahead more decisively to complement banking reform.** The restructuring of SOEs should involve significant sales of non-core assets to pay down their NPLs. Price adjustments should continue, and operational improvements should be accelerated while imposing hard budget constraints on SOE operations, and seeking joint venture partners to provide funding for their viable operations.

41. **The BOL has moved decisively to address the vulnerabilities identified in the safeguards assessment.** The decision to have the BOL's 2003 accounts jointly audited with an international audit firm is a major contribution to correcting these vulnerabilities. The

progressive introduction of international accounting standards will also support transparency in its financial accounts.

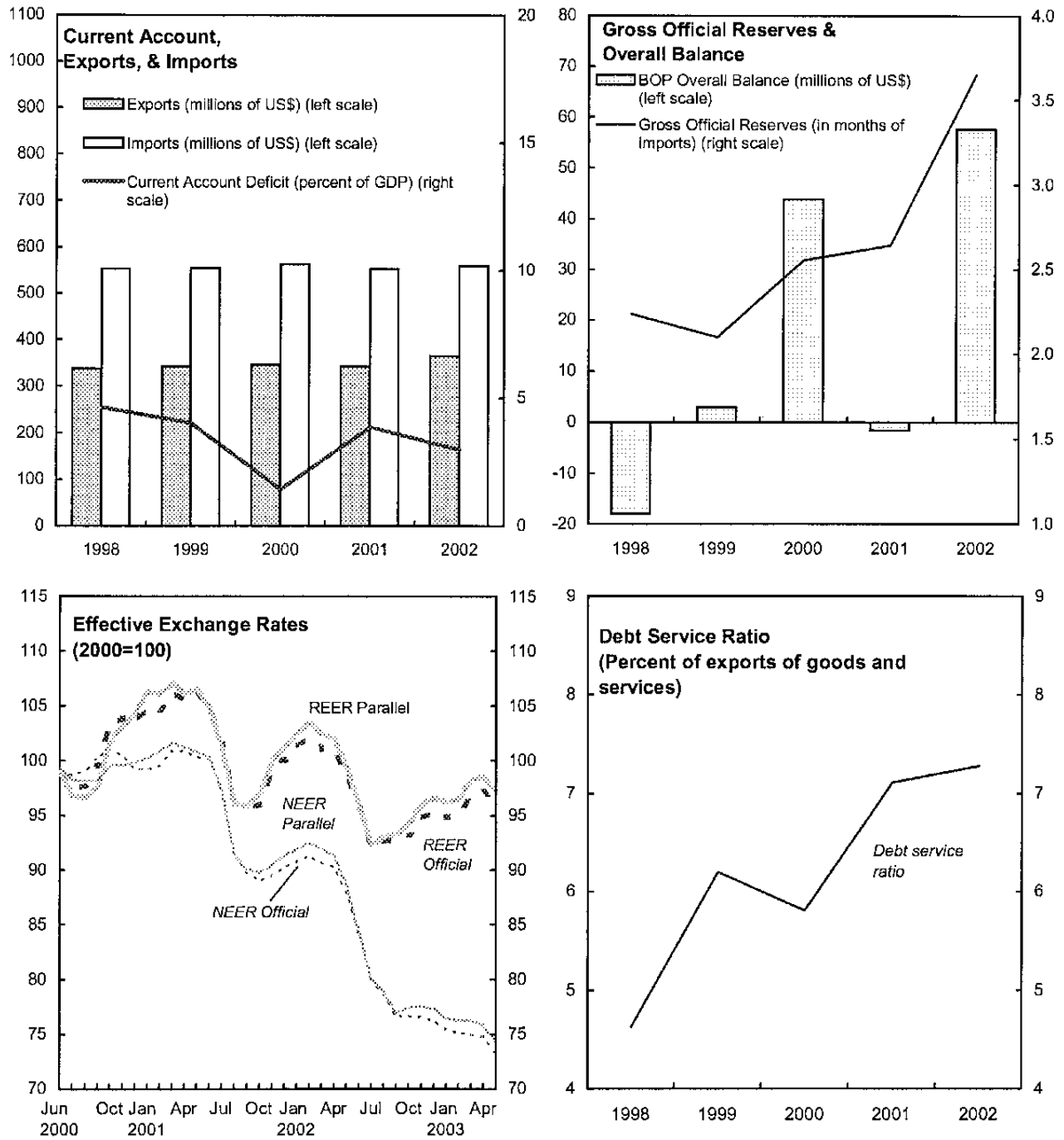
42. **The continued progress at developing Lao P.D.R.'s poverty reduction strategy is welcome.** The participatory approach has been successful in opening a debate on key economic issues especially the relative emphasis on public and private investment. In order to make more effective use of the available public resources it will be critical to implement expenditure management reforms.

43. **Given the high debt ratio and still-narrow export base, a cautious approach is needed with debt management.** Continued debt management problems indicate the need for pro-active implementation of the Ministerial Instruction on External Debt Management by the Ministry of Finance, especially regarding SOE debt. The recent agreement on aspects of the Lao P.D.R.'s outstanding debt with the Russian Federation is constructive.

44. **Significant risks remain in the program.** As has been the case, the biggest risk to the program remains the fiscal position. The recent tax and planned structural fiscal measures have the potential to reduce this risk. At the same time, while the initiative to promote the private sector is welcome, poorly controlled and expensive tax incentives could threaten the revenue base. Pressures to rebuild the state sector by utilizing more public resources would also put the program at risk, and should be resisted.

45. **The staff recommends the completion of the third review under the PRGF arrangement.** Policy implementation under the program has improved and the authorities' recent measures are indicative of their commitment to enhance program performance. The staff supports the authorities' request for a waiver for the non-observance of the external debt ceiling for end-September 2002, on the basis of the deviation being temporary.

Figure 1. Lao P.D.R.: Selected Economic Indicators, 1998-2003



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

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

Date	Disbursement		Conditions
	Millions of SDR	Percent of Quota	
April 25, 2001	4.53	8.6	Board approved new three-year arrangement and endorsed first-year program.
February 25, 2002	4.53	8.6	Board completed first review, based on quantitative performance criteria for June 2001.
August 26, 2002	4.53	8.6	Board completed second review, based on quantitative performance criteria for March 2002, and endorsed second-year program.
September, 2003	4.53	8.6	Board completes third review, based on quantitative performance criteria for September 2002 and structural performance criteria specified in the arrangement.
January, 2004	4.53	8.6	Board completes fourth review, based on quantitative performance criteria for September 2003 and structural performance criteria specified in the arrangement, and endorses third-year program.
July, 2004	4.53	8.6	Board completes fifth review, based on quantitative performance criteria for March 2004 and structural performance criteria specified in the arrangement.
January, 2005	4.52	8.6	Board completes sixth review, based on quantitative performance criteria for September 2004 and structural performance criteria specified in the arrangement.
Total	31.70	60.0	

Source: IMF, Finance Department, and staff projections.

Table 2: Lao P.D.R.: Fund Position and Indicators of Fund Credit, 2002–2012

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
	Projections										
Enhanced Structural Adjustment Facility (ESAF) and Poverty Reduction and Growth Facility (PRGF)	(In millions of SDRs)										
Disbursements PRGF	9.1	4.5	9.1	4.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repayments	7.0	6.5	5.3	4.1	2.2	1.9	3.2	5.0	6.3	5.9	5.1
ESAF/PRGF	6.5	6.5	5.3	4.1	2.2	1.9	3.2	5.0	6.3	5.9	5.1
SAF	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total Fund credit outstanding, end of period	(In percent of quota)										
ESAF/PRGF	31.9	29.9	33.7	34.1	31.9	30.0	26.8	21.8	15.5	9.6	4.5
SAF	0.0	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 quota)										
ESAF/PRGF	60.2	56.5	63.6	64.4	60.2	56.6	50.6	41.1	29.2	18.1	8.4
Total Fund credit outstanding, end of period	(In percent of GDP)										
In percent of GDP	2.3	2.1	2.2	2.0	1.8	1.5	1.3	1.0	0.6	0.4	0.2
In percent of exports of goods and nonfactor services	7.7	7.4	7.8	7.6	6.7	6.0	5.1	3.9	2.6	1.5	0.6
Total debt service due to the Fund	(In percent of exports of goods and nonfactor services)										
Total obligations, including interest and charges (in millions of SDRs)	7.3	6.7	5.5	4.3	2.4	2.2	3.4	5.2	6.5	6.0	5.2
In percent of exports of goods and nonfactor services	1.8	1.6	1.3	0.9	0.5	0.4	0.6	0.9	1.1	1.0	0.6
Memorandum items:											
Exchange rate (U.S. dollars per SDR)	1.29	1.41	1.41	1.41	1.41	1.41	1.41	1.41	1.41	1.41	1.41
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)	1,818	2,033	2,188	2,362	2,561	2,778	3,015	3,204	3,404	3,617	3,843
Exports of goods and services (in millions of U.S. dollars)	535	574	611	637	672	709	748	789	833	885	1,143

Source: Data provided by the IMF Finance Department; and Fund staff estimates and projections.

Table 3. Lao P.D.R.: Selected Economic and Financial Indicators, 2000–2004

Nominal GDP (2001): \$1,758 million

Population (2001): 5.4 million

GDP per capita (2001): \$325

Fund quota: SDR 52.9 million

	2000	2001	2002	2003		2004
				Latest 1/	Prog./Proj.	Proj.
Nominal GDP (in billions of kip)	13,671	15,705	18,390	...	21,553	24,400
Real GDP growth (percent change) 2/	5.8	5.8	5.9	...	5.3	5.8
Prices (percent change)						
Consumer prices						
(12-month rate; end-of-period)	10.6	7.5	15.2	15.0 3/	9.3	7.3
GDP deflator (annual average)	25.1	8.6	10.6	...	11.3	7.0
Government budget (percent of GDP) 4/						
Revenue	13.2	13.2	13.1	7.5	11.5	12.2
Grants	3.7	3.1	1.4	1.8	2.0	1.9
Expenditure	21.5	20.7	18.6	14.1	19.3	19.5
Current account balance (excluding grants)	5.0	5.1	5.4	2.7	4.2	3.8
Overall balance (including grants)	-4.6	-4.4	-4.1	-4.8	-5.8	-5.4
<i>of which</i> : bank financing (excluding debt clearance bonds)	-0.8	1.6	-1.3	0.1	0.2	0.0
Money and credit (percent change; end-of-period) 5/						
Broad money	45.7	10.2	26.6	21.8	17.8	18.7
Bank credit to the economy	41.1	23.9	6.6	0.6	12.8 6/	12.9
Credit to SOEs	36.1	21.1	9.2	-0.9	4.1	3.4
Credit to the private sector	43.7	25.5	4.9	1.7	11.1 6/	19.2
Interest rates (in percent; end-of-period)						
On three-month deposits	15	16	17	15 3/	...	...
On short-term loans	16–24	12–18	12–20	19–25 3/	...	...
External trade						
Trade balance (in millions of U.S. dollars)	-218	-210	-194	...	-187	-192
Exports (percentage change in U.S. dollar value)	0.8	-1.0	6.8	...	12.1	6.3
Imports (percentage change in U.S. dollar value)	1.5	-1.9	1.3	...	6.6	5.1
Balance of payments (percent of GDP)						
Current account balance (including official transfers)	-1.4	-3.9	-3.0	...	-3.4	-2.4
Overall balance (in millions of U.S. dollars)	44	-2	58	...	1	-14
Gross official reserves (in millions of U.S. dollars) 5/	127	134	187	207	203	228
(in months of prospective goods and service imports)	2.6	2.6	3.5	3.7	3.6	3.8
Net official reserves (in millions of U.S. dollars)	97	92	143	170	162	181
External debt (in percent)						
Ratio of public debt-to-GDP 7/	67.7	68.9	73.1	...	90.2	86.7
Public debt-service ratio 8/	5.8	7.1	7.3	...	10.0	9.6
Exchange rate						
Kip per U.S. dollar (end-of-period)						
Commercial bank rate	8,140	9,490	10,680	10,620 9/	...	...
Parallel market rate	8,170	9,560	10,760	10,730 9/	...	...
Real effective exchange rate (percent change, annual average)	10.8	2.1	-4.7	-0.9 10/	...	...

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

1/ Latest data are for June 2003 unless otherwise indicated.

2/ Staff estimate. The government estimates real GDP growth in 2002/03 to be 5.9 percent.

3/ Data for July 2003.

4/ Fiscal year basis (October–September).

5/ Money and credit data and official reserves data from 2001 onwards are presented on a fiscal year basis; Money and credit data for 2002 and 2003 are at constant exchange rates.

6/ Percent change excludes the impact of provisioning on pre-2000 NPLs of SCBs.

7/ Convertible currency debt only; Russian debt is included as of 2003, and based on preliminary agreement between the Lao and Russian government including a 70 percent discount on claims valued at SUR 0.6 per U.S. dollar.

8/ In percent of exports of goods and services, excluding NT2.

9/ Data as of August 20, 2003.

10/ As of May 2003.

Table 4. Lao P.D.R.: General Government Operations, 2000/01–2003/04

	2000/01		2001/02		2002/03		2003/04
	Est.	Budget	Prog.	Est.	Budget	Proj.	Proj.
	(In billions of kip)						
Revenue and grants	2,476	3,030	2,745	2,567	2,982	2,849	3,356
<i>Revenue</i>	2,000	2,481	2,196	2,327	2,562	2,430	2,900
Tax	1,629	2,043	1,782	1,879	2,114	2012	...
Profit tax	205	362	290	243	337	283	...
Income tax	153	190	160	126	169	169	...
Turnover tax	318	452	427	375	441	381	...
Excise tax	371	362	337	286	376	376	...
Import duties	179	229	204	240	303	304	...
Timber royalty receipts	182	165	132	362	160	160	135
Other	221	283	232	248	327	340	...
Nontax	372	438	413	449	447	417	...
SOE dividends	67	89	64	84	129	99	...
Overflight revenues	114	153	153	187	160	160	...
Other	190	196	196	177	158	158	...
<i>Grants</i>	476	549	549	240	420	419	456
Project grants	476	430	430	119	285	285	350
Non-project grants	0	119	119	122	135	134	106
Expenditure (excluding capital costs of SCB reform)	3,141	3,614	3,511	3,291	4,240	4,064	4,643
<i>Current</i>	1,229	1,449	1,431	1,376	1,658	1,550	1,983
Wages and salaries	416	525	525	555	660	610	872
Materials and supplies	330	370	360	322	370	368	400
Interest payments	134	145	145	124	158	112	188
Domestic	17	26	26	16	18	21	61
<i>of which: debt clearance bonds</i>	...	...	...	...	...	3	40
External	117	119	119	108	140	91	127
Other recurrent	350	409	401	375	470	460	523
<i>Capital and lending</i>	1,911	2,165	2,080	1,915	2,582	2,514	2,660
Domestically financed 1/	872	1,017	932	1,125	1,060	1,042	954
Externally financed	1,200	1,256	1,256	931	1,650	1,632	1,820
Onlending	-160	-108	-108	-142	-128	-160	-114
Current balance, excluding grants	771	1,033	765	951	904	879	917
Overall balance 2/	-664	-583	-766	-723	-1,258	-1,215	-1,287
Financing	664	583	766	723	1,258	1,215	1,287
<i>Domestic financing (net) 3/</i>	187	33	102	147	40	6	-50
Bank financing 4/	246	13	-231	-234	35	35	0
Nonbank financing	-59	20	333	381	5	-29	-50
<i>of which: Asset sales/THPC recapitalization</i>	...	...	313	317	5	5	0
Arrears	...	...	...	130	0	-32	-50
Discrepancy	-59	20	21	-66	0	-2	0
<i>Foreign financing (net)</i>	478	550	664	577	1,218	1,209	1,337
Project loans	724	826	826	813	1,365	1,347	1,470
Program loans	0	0	114	46	170	170	220
Amortization	247	276	276	282	317	308	353
Memorandum items:							
Stock of public debt 5/	10,104	...	...	12,624	...	14,366	15,939
external public debt	9,951	...	...	12,291	...	14,060	15,593
domestic public debt	153	...	...	333	...	306	346
Issuance of debt clearance bonds	...	...	...	...	...	114	246

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

1/ Includes KN 194 billion in unallocated domestically financed capital expenditures in 2003/04.

2/ The overall budget deficit for 2001/02 includes estimated expenditure arrears of KN 130 billion.

3/ Figures for 2001/02 include the transfer of \$33 million from EDL to the government from the Theun-Hinboun Power Company (THPC) refinancing.

4/ Bank financing excludes the valuation adjustments on the stock of government foreign currency deposits and credit in all years.

5/ Excludes Russian debt and SOE commercial debt.

Table 5. Lao P.D.R.: General Government Operations, 2000/01–2003/04

	2000/01	2001/02		2002/03		2003/04	
	Est.	Budget	Prog.	Est.	Budget	Proj.	
	(In percent of GDP)						
Revenue and grants	16.3	18.4	16.4	14.5	15.1	13.5	14.1
<i>Revenue</i>	13.2	15.0	13.1	13.1	12.9	11.5	12.2
Tax	10.7	12.4	10.7	10.6	10.7	9.6	...
Profit tax	1.4	2.2	1.7	1.4	1.7	1.3	...
Income tax	1.0	1.2	1.0	0.7	0.9	0.8	...
Turnover tax	2.1	2.7	2.6	2.1	2.2	2.0	...
Excise tax	2.4	2.2	2.0	1.6	1.9	1.7	...
Import duties	1.2	1.4	1.2	1.4	1.5	1.6	...
Timber royalty receipts	1.2	1.0	0.8	2.0	0.8	0.8	0.6
Other	1.5	1.7	1.4	1.4	1.7	1.6	...
Nontax	2.4	2.7	2.5	2.5	2.3	2.0	...
SOE dividends	0.4	0.5	0.4	0.5	0.7	0.5	...
Overflight revenues	0.8	0.9	0.9	1.1	0.8	0.8	...
Other	1.2	1.2	1.2	1.0	0.8	0.8	...
<i>Grants</i>	3.1	3.3	3.3	1.4	2.1	2.0	1.9
Project grants	3.1	2.6	2.6	0.7	1.4	1.4	1.5
Non-project grants	...	0.7	0.7	0.7	0.7	0.6	0.4
Expenditure (excluding capital costs of SCB reform)	20.7	21.9	21.0	18.6	21.4	19.3	19.5
<i>Current</i>	8.1	8.8	8.6	7.8	8.4	7.4	8.3
Wages and salaries	2.7	3.2	3.1	3.1	3.3	2.9	3.7
Materials and supplies	2.2	2.2	2.2	1.8	1.9	1.7	1.7
Interest payments	0.9	0.9	0.9	0.7	0.8	0.5	0.8
Domestic	0.1	0.2	0.2	0.1	0.1	0.1	0.3
<i>of which: debt clearance bonds</i>	...	...	...	...	...	0.0	0.2
External	0.8	0.7	0.7	0.6	0.7	0.4	0.5
Other recurrent	2.3	2.5	2.4	2.1	2.4	2.2	2.2
<i>Capital and lending</i>	12.6	13.1	12.4	10.8	13.0	11.9	11.1
Domestically financed 1/	5.7	6.2	5.6	6.3	5.4	4.9	4.0
Externally financed	7.9	7.6	7.5	5.3	8.3	7.7	7.6
Lending	-1.1	-0.7	-0.6	-0.8	-0.6	-0.8	-0.5
Current balance, excluding grants	5.1	6.3	4.6	5.4	4.6	4.2	3.8
Overall balance 2/	-4.4	-3.5	-4.6	-4.1	-6.4	-5.8	-5.4
Financing	4.4	3.5	4.6	4.1	6.4	5.8	5.4
<i>Domestic financing (net) 3/</i>	1.2	0.2	0.6	0.8	0.2	0.0	-0.2
Bank financing 4/	1.6	0.1	-1.4	-1.3	0.2	0.2	0.0
Nonbank financing	-0.4	0.1	2.0	2.1	0.0	-0.1	-0.2
<i>of which: Asset sales/THPC recapitalization</i>	0.0	0.0	1.9	1.8	0.0	0.0	0.0
Arrears	...	...	...	0.7	0.0	-0.2	-0.2
Discrepancy	-0.4	...	0.1	-0.4	0.0	0.0	0.0
<i>Foreign financing (net)</i>	3.1	3.3	4.0	3.3	6.2	5.7	5.6
Project loans	4.8	5.0	4.9	4.6	6.9	6.4	6.2
Program loans	0.0	0.0	0.7	0.3	0.9	0.8	0.9
Amortization	1.6	1.7	1.7	1.6	1.6	1.5	1.5
Memorandum items:							
Stock of public debt 5/	66.5	...	...	71.2	...	68.1	66.8
external public debt	65.5	...	...	69.4	...	66.7	65.3
domestic public debt	1.0	...	...	1.9	...	1.5	1.4
Issuance of debt clearance bonds	...	...	...	...	...	0.5	1.0
Nominal GDP, fiscal year (in billions of kip)	15,197	16,510	16,731	17,719	19,800	21,084	23,868
Actual/Program exchange rate (kip per U.S. dollar, average)	8,600	9,500	9,500	9,803	10,000	10,600	11,154

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

1/ Includes KN 194 billion in unallocated domestically financed capital expenditures in 2003/04.

2/ The overall budget deficit for 2001/02 includes estimated expenditure arrears of KN 130 billion.

3/ Figures for 2001/02 include the transfer of \$33 million from EDL to the government from the Theun-Hinboun Power Company (THPC) refinancing.

4/ Bank financing excludes the valuation adjustments on the stock of government foreign currency deposits and credit in all years.

5/ Excludes Russian debt and SOE commercial debt.

Table 6. Lao P.D.R.: The Bank of the Lao P.D.R., 2002–2004

	2002			2003						2004		
	June	Sept.		Mar.			June		Sept.	Dec.	Mar.	Sept.
	Est.	Prog.	Est.	Prog.	Est.	Est.	Prog.	Est.	Prog.	Prog.	Prog.	
	New Base											
	(In billions of kip; end of period)											
Net foreign assets	1,294	1,271	1,355	1,457	1,555	1,768	1,607	1,830	1,690	1,840	1,932	1,959
Foreign assets	1,677	1,672	1,773	1,870	1,931	2,195	2,016	2,233	2,141	2,267	2,401	2,460
Foreign liabilities	-384	-401	-418	-413	-376	-427	-409	-402	-451	-427	-469	-501
Net domestic assets	-416	-437	-463	-532	-520	-638	-545	-613	-525	-624	-644	-659
Domestic credit	572	461	537	260	417	458	483	442	496	430	410	395
Net credit to government	-390	-427	-390	-481	-382	-434	-458	-443	-445	-455	-475	-490
Credit to the economy	599	598	665	598	658	748	756	745	756	745	745	745
Credit to state enterprises	454	450	509	450	501	569	579	565	579	565	565	565
Credit to private sector	145	148	156	148	158	179	177	180	177	180	180	180
Credit to banks	363	290	262	143	140	144	185	140	185	140	140	140
BoL securities	-190	-148	-183	-42	-129	-129	-73	-62	-66	-62	-62	-62
Other items, net	-797	-750	-817	-750	-807	-967	-955	-992	-955	-992	-992	-992
Reserve money	878	835	892	927	1,035	1,129	1,062	1,218	1,165	1,216	1,288	1,300
<i>of which</i> : in kip	256	...	261	...	342	342	293	423	320	393	445	457
Required reserves	321	...	399	...	450	501	497	545	516	554	582	619
<i>of which</i> : in kip	39	...	53	...	74	74	69	82	75	99	107	108
Excess reserves: in kip	33	...	21	...	87	87	38	138	58	86	89	96
	(In millions of U.S. dollars; end of period)											
Net foreign assets	136.2	133.8	142.6	153.4	163.7	163.7	148.8	169.5	156.5	170.4	178.9	181.4
Gross international reserves	176.6	176.0	186.6	196.9	203.2	203.2	186.7	206.7	198.2	209.9	222.3	227.8
Forex component of required reserves/reserve money 1/	29.8	30.0	36.3	32.1	39.6	72.9	71.2	73.6	78.3	72.9	74.8	78.1
	(Annual percentage change)											
Reserve money 2/	23.5	11.4	19.0	11.8	30.7	30.3	10.3	26.5	19.1	11.8	14.0	15.4
<i>of which</i> : in kip	-11.4	...	6.2	...	39.4	39.4	14.5	65.1	22.5	29.9	30.1	28.1
Memorandum items:												
BoL financing of the budget (in billions of kip) 3/	-315	-351	-314	-54	7	11	-13	2	0	-10	-30	-45
Disbursement of program loans (millions of U.S. dollar) 3/	5	12	5	10	12	12	12	12	17	5	15	20
Program exchange rate, eop (kip per U.S. dollar)	9,500	9,500	9,500	9,500	9,500	10,800	10,800	10,800	10,800	10,800	10,800	10,800

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

1/ Reserve money for the program from March 2003 onwards.

2/ At constant exchange rates for the program until September 2004.

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

Table 7. Lao P.D.R.: Monetary Survey, 2002–2004

	2002			2003						2004		
	June	Sept.		Mar.			June		Sept.	Dec.	Mar.	Sept.
	Est.	Prog.	Est.	Prog.	Est.	Est.	Prog.	Est.	Prog.	Prog.	Prog.	
	New Base											
	(In billions of kip; end of period)											
Monetary Survey												
Net foreign assets	2,057	2,105	1,933	2,208	2,245	2,553	2,345	2,851	2,491	2,883	3,073	3,266
of which: SCBs	478	510	397	520	512	582	455	639	492	740	806	941
Net domestic assets	881	1,019	1,013	1,101	1,174	1,181	1,312	1,088	1,325	1,307	1,345	1,383
of which: SCBs (excluding net credit to government)	1,566	1,537	1,453	1,610	1,404	1,571	1,740	1,563	1,780	1,732	1,763	1,839
Domestic credit	1,933	2,007	1,975	2,009	2,130	2,354	2,436	2,184	2,555	2,401	2,512	2,561
of which: SCBs	1,119	1,294	1,075	1,408	1,121	1,241	1,361	1,132	1,421	1,341	1,382	1,483
Net claims on government	-391	-361	-375	-359	-322	-378	-421	-415	-398	-398	-408	-398
Claims on the economy	2,324	2,368	2,350	2,368	2,452	2,731	2,857	2,599	2,953	2,799	2,920	2,959
of which: SCBs	1,139	1,237	1,091	1,310	1,106	1,229	1,354	1,146	1,404	1,314	1,345	1,422
of which: in foreign currency	1,893	1,837	1,950	1,737	2,042	2,321	2,261	2,216	2,276	2,240	2,255	2,285
Credit to state enterprises	921	850	936	750	962	1,090	1,092	1,029	1,104	1,047	1,059	1,068
Credit to private sector	1,403	1,518	1,414	1,618	1,490	1,641	1,646	1,569	1,729	1,752	1,861	1,891
Other items (net)	-1,052	-988	-963	-908	-956	-1,173	-1,125	-1,096	-1,230	-1,094	-1,166	-1,178
Broad money	2,938	3,124	2,946	3,309	3,420	3,734	3,657	3,939	3,815	4,190	4,419	4,649
Domestic currency (cash and deposits)	777	824	811	909	1,124	1,124	1,007	1,198	1,088	1,375	1,480	1,489
Foreign currency deposits	2,161	2,300	2,134	2,400	2,295	2,610	2,649	2,741	2,727	2,815	2,939	3,160
	(In millions of U.S. dollars; end of period)											
Net foreign assets	216.5	221.6	202.7	232.4	236.4	236.4	217.1	264.0	230.6	267.0	284.6	302.4
of which: SCBs	50.3	53.6	41.8	60.7	53.9	53.9	42.1	59.1	45.6	68.5	74.6	87.2
Foreign currency credit to the economy	199.2	193.4	205.3	182.8	214.9	214.9	209.4	205.2	210.8	207.4	208.8	211.6
of which: SCBs	93.6	106.7	92.4	107.0	95.2	95.2	97.9	90.4	99.8	93.2	94.1	96.0
Foreign currency deposits	227.5	242.1	224.7	252.6	241.6	241.6	245.3	253.8	252.5	260.7	272.1	292.6
	(Annual percentage change)											
Broad money 1/	26.7	20.2	26.6	14.6	18.5	17.6	13.1	21.8	17.8	20.5	18.3	18.7
Net domestic asset of SCBs (increase from start of fiscal year) 1/ 2/ 3/	12.9	10.8	4.8	4.7	-3.4	-3.1	8.8	-3.6	11.9	5.5	7.4	12.0
Credit to the economy 1/ 2/	13.7	0.0	6.6	-3.0	0.4	0.7	10.6	0.6	12.8	4.6	6.9	12.9
of which: commercial banks 1/ 2/	13.5	1.3	0.8	-1.8	-0.5	0.0	0.9	-2.5	11.6	6.9	9.7	18.1
of which: SCBs 1/ 2/	9.6	16.0	-12.9	10.9	-6.2	-5.5	7.4	-9.1	16.0	5.8	9.4	16.1
Memorandum items:												
Bank financing of the budget (in billions of kip) 4/ 5/	-250	-220	-234	2	53	55	12	18	35	0	-10	0
Money multiplier	3.3	3.7	3.3	3.6	3.3	3.3	3.4	3.2	3.3	3.4	3.4	3.6
Program exchange rate, eop (kip per U.S. dollar)	9,500	9,500	9,500	9,500	9,500	10,800	10,800	10,800	10,800	10,800	10,800	10,800

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

1/ At constant exchange rates for the program until September 2004; excludes provisioning of pre-2000 NPLs of SCBs.

2/ Adjusted for the short-term borrowing for Lao Brewery.

3/ Excludes debt clearance bonds.

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

5/ Excludes bank recapitalization.

Table 8. Lao P.D.R.: Summary Macroeconomic Framework, 2000–2006

	2000	2001	2002	2003	2004	2005 1/	2006
		Est.	Est.		Projections		
Nominal GDP (in billions of kip)	13,672	15,705	18,390	21,553	24,400	27,157	30,297
Real GDP (in billions of kip)	1,127	1,192	1,263	1,330	1,407	1,491	1,584
Real GDP growth (percent change)	5.8	5.8	5.9	5.3	5.8	6.0	6.3
Inflation (percent change, annual average)	25.1	8.6	10.6	11.3	7.0	5.0	5.0
Merchandise exports (percent change)	0.8	-1.0	6.8	12.1	6.3	10.5	5.8
Merchandise imports (percent change)	1.5	-1.9	1.3	6.6	5.1	25.3	19.7
Official gross reserves (in months of prospective goods and services imports)	2.6	2.6	3.7	3.7	3.9	3.9	4.0
Budget (fiscal year basis) 2/		(In percent of GDP; unless otherwise noted)					
Revenue	13.2	13.2	13.1	11.5	12.2	12.6	13.4
Grants	3.7	3.1	1.4	2.0	1.9	2.1	2.1
Expenditure	21.5	20.7	18.6	19.3	19.5	19.4	20.1
Current	8.2	8.1	7.8	7.4	8.3	8.9	9.8
<i>of which</i> : interest on debt clearance bonds	...	...	...	0.0	0.2	0.3	0.3
Capital and onlending	13.3	12.6	10.8	11.9	11.1	10.5	10.4
Current fiscal balance before grants	5.0	5.1	5.4	4.2	3.8	3.7	3.6
Overall fiscal balance after grants 3/	-4.6	-4.4	-4.1	-5.8	-5.4	-4.8	-4.7
Domestic financing	-1.1	1.2	0.8	0.0	-0.2	0.2	0.2
Foreign financing	5.7	3.1	3.3	5.7	5.6	4.6	4.5
Real GDP growth (percent change) 2/	6.2	5.8	5.9	5.3	5.8	6.0	6.2
Increase in GDP deflator (percent change) 2/	35.6	11.9	10.1	13.0	7.0	5.0	5.0
Savings and Investment balance 4/		(In percent of GDP)					
National savings	19.4	17.0	17.3	18.6	19.6	19.3	20.2
Private	10.7	8.8	10.6	12.5	13.8	13.5	14.5
Government	8.7	8.2	6.7	6.1	5.8	5.8	5.7
Investment	20.9	20.9	20.2	22.0	22.0	26.4	32.1
Private	6.9	7.4	8.6	10.1	10.9	15.9	21.7
Hydropower	0.0	0.0	0.0	0.0	0.0	4.2	8.7
Other	6.9	7.4	8.6	10.1	10.9	11.7	13.0
Government 5/	14.0	13.5	11.6	11.9	11.1	10.5	10.4
Foreign savings (excluding official transfers)	8.1	7.5	6.3	6.3	5.3	10.2	15.1
Foreign savings (including official transfers)	1.4	3.9	3.0	3.4	2.4	7.1	11.9

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

1/ It is expected that the construction of the large NT2 hydroelectric project will begin in 2005.

2/ Fiscal year ending September.

3/ The overall budget deficit for 2001/02 includes estimated expenditure arrears of KN 130 billion.

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

5/ Comprises government investment and selected state owned enterprise investment.

Table 9. Lao P.D.R.: Balance of Payments, 1999–2006

	1999	2000	2001	2002	2003	2004	2005	2006
			Est.	Est.		Projections		
(In millions of U.S. dollars; unless otherwise indicated)								
Current account	-59	-25	-68	-54	-69	-53	-168	-304
(excluding official transfers)	-129	-141	-132	-115	-128	-116	-241	-388
Merchandise trade balance	-212	-218	-210	-194	-187	-192	-295	-416
Exports, f.o.b.	342	345	341	365	409	435	451	478
Imports, c.i.f.	554	562	552	559	596	626	746	893
Services (net)	99	132	125	124	118	130	111	86
Income (net)	-45	-75	-68	-67	-83	-80	-84	-86
of which : interest payments 1/	-35	-37	-35	-31	-44	-42	-40	-38
of which : public debt	-8	-10	-11	-11	-21	-20	-21	-22
Transfers (net)	99	136	85	83	83	89	99	112
Private	30	21	22	23	24	25	26	28
Official	70	115	63	61	59	64	73	84
Capital account	62	69	67	112	70	38	188	326
Long-term loans	65	63	74	98	73	65	72	77
Disbursements	94	98	114	137	128	123	132	139
Amortization	-29	-36	-39	-39	-55	-58	-60	-62
of which : public debt	-17	-12	-16	-19	-28	-30	-33	-34
Foreign investment (including debt financing from private creditors)	82	31	33	31	40	44	150	277
of which : hydropower investment 2/	30	0	9	1	0	0	99	223
Net foreign assets of commercial banks (increase -)	-47	25	28	15	-22	-20	-20	-20
Errors and omissions	-37	-50	-69	-32	-20	-51	-14	-8
Overall balance	3	44	-2	58	1	-14	20	22
Financing	-3	-44	2	-58	-1	14	-20	-22
Central bank net foreign assets	-3	-44	2	-58	-17	-19	-20	-22
Assets (increase -)	6	-33	6	-62	-14	-24	-20	-22
Liabilities (reduction -)	-9	-10	-4	5	-3	5	0	0
Financing gap 4/	0	0	0	0	16	33	0	0
Memorandum items:								
Current account (in percent of GDP; excluding official transfers)	-8.8	-8.1	-7.5	-6.3	-6.3	-5.3	-10.2	-15.1
Current account (in percent of GDP; including official transfers)	-4.0	-1.4	-3.9	-3.0	-3.4	-2.4	-7.1	-11.9
(excluding official transfers and NT2)	-8.8	-8.1	-7.5	-6.3	-6.3	-5.3	-5.9	-6.2
(including official transfers and excluding NT2)	-4.0	-1.4	-3.9	-3.0	-3.4	-2.4	-2.8	-2.9
Official gross reserves (in millions of U.S. dollars)	106	127	134	196	210	234	254	276
(in months of prospective goods and service imports, excl. NT2)	2.1	2.6	2.6	3.7	3.7	3.9	3.9	4.0
(ratio to short-term debt by remaining maturity) 3/	2.5	1.9	3.4	3.5	3.6	3.9	4.1	3.9
Debt service ratio (incl. Fund, in percent of goods and service exports) 1/	14.1	15.5	16.6	14.7	18.8	17.5	16.5	15.3
Public debt service ratio (incl. Fund, excl. NT2, in percent of goods and service exports) 1/	6.2	5.8	7.1	7.3	10.0	9.6	9.5	8.8
Imports of goods and services (in millions of U.S. dollars)	554	606	594	606	642	673	820	1,002

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

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

2/ The large hydroelectric project Nam Theun 2 (NT2) is valued at US\$1.1 billion (60 percent of GDP), to be implemented over 2005–09, and would be financed by foreign investment.

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

4/ The financing gap in 2003 comprises \$10 million from the AsDB and \$6 million under the PRGF; and in 2004, \$10 million from the AsDB, \$10 million from the World Bank, and \$13 million under the PRGF.

Table 10: Lao P.D.R.: Debt and Debt Service 1999–2006 1/

	1999	2000	2001	2002	2003	2004	2005	2006
	Est.	Est.	Est.	Est.		Proj.		
(In millions of U.S. dollars)								
Total debt stock (public and private)	1,538	1,447	1,458	1,613	2,090	2,126	2,233	2,435
Public debt	1,247	1,179	1,214	1,329	1,834	1,896	1,955	2,016
Bilateral official	153	79	68	64	447	443	439	435
<i>of which: Russian Federation 2/</i>	...	...	...	...	387	387	387	387
Multilateral	1,036	1,042	1,089	1,189	1,266	1,342	1,415	1,489
<i>of which:</i>								
AsDB	540	541	575	603	651	698	744	788
IDA	381	394	407	435	464	497	529	561
IMF 3/	55	48	37	43	42	48	48	45
Commercial	58	58	56	75	120	111	101	91
Private debt	292	268	245	284	257	229	278	419
Total debt service 5/	69	81	84	79	108	107	105	103
Amortization	34	43	49	48	64	65	66	65
Public debt	22	20	25	28	37	38	39	37
Bilateral official	4	2	4	4	4	4	4	4
Multilateral	18	17	20	23	24	25	25	24
<i>of which: IMF 3/</i>	4	8	9	9	9	7	6	3
Commercial	0	0	1	1	8	9	9	8
Private debt	12	24	24	20	27	27	26	28
Interest payments	35	37	35	31	44	42	40	38
Public debt	8	10	11	11	16	14	13	12
Bilateral (official debt)	0	1	1	2	1	1	1	1
Multilateral	8	9	9	9	10	9	9	9
<i>of which: IMF 3/</i>	0	1	1	0	0	0	0	0
Commercial	0	1	1	1	5	4	3	3
Private debt	27	27	24	20	23	21	19	16
(In percent of GDP)								
Total debt service 5/	4.7	4.6	4.8	4.3	5.3	4.9	4.5	4.0
Total debt stock	104.4	83.2	82.8	88.7	102.8	97.2	94.5	95.1
Excluding Russian Federation debt	104.4	83.2	82.8	88.7	83.8	79.5	78.2	80.0
Total public debt	84.6	67.7	68.9	73.1	90.2	86.7	82.8	78.7
(In percent of revenues)								
Central government debt service 5/	19.4	13.2	15.5	16.3	24.6	22.0	19.9	17.3
(In percent of exports of goods and services)								
Total debt service 5/	14.1	15.5	16.6	14.7	18.8	17.5	16.5	15.3
<i>of which: public debt 2/</i>	6.2	5.8	7.1	7.3	10.0	9.6	9.5	8.8
Total debt stock 2/ 4/	336.5	294.4	288.7	309.6	388.0	370.7	350.1	348.9
Public debt NPV 4/ 5/	...	...	122.6	117.3	113.3	105.6	96.3	85.5
Memorandum Item:								
Russian Federation debt stock before debt relief (in millions of SUR)	771.7	771.7	771.7	771.7	...	...	...	...

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

1/ Debt service and the stock of debt are calculated on the basis of existing debt, and currently identified disbursements, disbursements from the Fund, the World Bank, the AsDB, and debt contracted to finance NT2.

2/ Preliminary rescheduling agreement between Russia and Lao P.D.R., based on a 70 percent discount on Russian claims valued at SUR 0.6 per US dollar.

3/ Including future disbursements under the current arrangement.

4/ Three year average of exports of goods and services.

5/ Excluding Russian debt, pending final agreement on the terms of the rescheduling.

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

(In millions of U.S. dollars)

	1999	2000	2001	2002	2003	2004	2005	2006
	Est.	Est.	Est.	Est.	Proj.	Proj.	Proj.	Proj.
Gross financing needs	157	218	174	225	207	205	326	475
External current account deficit (excl. official transfers)	129	141	132	115	128	116	241	388
Debt amortization 1/	29	36	39	39	55	58	60	62
Medium- and long-term debt	29	36	39	39	55	58	60	62
Public sector	17	12	16	19	28	30	33	34
Corporate private sector	12	24	24	20	27	27	26	28
Short-term debt 2/	...	...	...	...	...	...	...	...
Gross reserve accumulation (- = increase) 3/	6	-33	6	-62	-14	-24	-20	-22
IMF repurchase and repayments	4	8	9	9	9	7	6	3
Financial sources	157	218	174	225	191	173	326	475
Foreign direct investments	52	31	33	31	40	44	75	109
Debt financing from private creditors	30	0	0	0	0	0	75	169
Financing from official creditors 4/	164	214	177	198	187	186	205	223
Other flows 5/	-89	-27	-36	-4	-36	-58	-28	-25
Financing gap 6/	0	0	0	0	16	33	0	0

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

1/Excluding the IMF.

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

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

4/Includes both grants and loans.

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

6/ The financing gap in 2003 comprises \$10 million from the AsDB and \$6 million under the PRGF; and in 2004, \$10 million from the AsDB, \$10 million from the World Bank, and \$13 million under the PRGF.

Lao P.D.R. — Fund Relations
(As of June 30, 2003)

I.	Membership Status: Joined 7/05/61; Article XIV				
II.	General Resources Account:	SDR million	Percent Quota		
	Quota	52.90	100.00		
	Fund holdings of currency	52.90	100.00		
III.	SDR Department:	SDR million	Percent Allocation		
	Net cumulative allocation	9.41	100.00		
	Holdings	11.34	120.55		
IV.	Outstanding Purchases and Loans:	SDR million	Percent Quota		
	ESAF/PRGF arrangements	28.25	53.41		
V.	Latest Financial Arrangements:				
	Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
	PRGF	4/25/01	4/24/04	31.70	13.59
	ESAF	6/04/93	5/07/97	35.19	35.19
	SAF	9/18/89	9/17/92	20.51	20.51
VI.	Projected Obligations to Fund (SDR million; based on existing use of resources and present holdings of SDRs):				

	Forthcoming				
	2003	2004	2005	2006	2007
Principal	2.93	5.28	4.11	2.21	1.95
Charges/interest	<u>0.07</u>	<u>0.11</u>	<u>0.09</u>	<u>0.07</u>	<u>0.06</u>
Total	3.00	5.39	4.20	2.29	2.01

VII. Implementation of HIPC Initiative

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

VIII. Safeguards Assessments

Under the Fund's safeguards assessment policy, the Bank of the Lao P.D.R. (BOL) is subject to a full safeguards assessment with respect to the PRGF arrangement, which was approved on April 25, 2001. An off-site safeguards assessment of the BOL was completed on December 17, 2001. The assessment concluded that high risks may exist in the external audit mechanism, and financial reporting framework, internal audit mechanism, and system of internal controls and recommended an on-site assessment. The FIN on-site safeguards assessment mission took place in early December 2002. It noted that the BOL has taken initial steps to strengthen its safeguards framework with the creation of an internal audit department and the initiation of external audits. However, staff noted that significant vulnerabilities remain and the BOL must continue to strengthen its external audit, adopt a recognized financial reporting framework, and develop its internal audit function further.

To address the significant vulnerabilities, staff recommended that the BOL: (i) contract an audit firm with international experience and exposure to conduct joint audits with the state auditor for financial years ending December 2003 and 2004; (ii) adopt International Accounting Standards (IAS) as its financial reporting framework beginning with the financial year ending December 31, 2004; (iii) establish a formal monthly process of reconciling accounting data to program data reported to the Fund; and (iv) train internal audit staff to become proficient in conducting internal audits professionally.

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 August 20, 2003 the commercial bank exchange rate was kip 10560 (buying) and kip 10680 (selling) per U.S. dollar.

X. Last Article IV Consultation Discussions

The last Article IV consultation discussions were held in Vientiane during April 24-May 8, 2002. The staff report (EBS/02/129) was discussed by the Executive Board on August 26, 2002. 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 1998)

Department	Purpose	Date
STA	- Multisector statistics/GDDS mission.	10/02
	- 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, 3/02
	- Expert on tax administration.	9/98-12/99, 1-3/00, 5-7/00, 9-11/00, 1-2/01, 4-6/01, 3-4/03
	- Expert on customs administration.	10/98-1/99, 5-6/00, 9-11/00, 1-3/01, 5-6/01, 3-4/03, 7-8/03
	- Mission on public expenditure management.	4-5/01, 10/02
MAE	- Expert on bank supervision.	4-5/02, 7/02, 10-11/02, 1/03, 6-4/03, 7/03

XII. Resident Representative

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

Lao P.D.R.: Fund-Bank Relations Annex¹

Partnership for Development

The Government (GOL) of the Lao Peoples' Democratic Republic (PDR) aims to achieve rapid economic growth in order to improve the living conditions of its poor and graduate from its status as a least-developed country. The development strategy to achieve these goals has been articulated in the National Socioeconomic Development Plan (2001-05), the Interim Poverty Reduction Strategy Paper (I-PRSP) and the recently-prepared preliminary draft of the National Poverty Eradication Plan (NPEP), scheduled to be discussed at the National Assembly in October 2003. This strategy seeks to:

1. Maintain macroeconomic stability by increasing revenue and ensuring appropriate fiscal and monetary policy;
2. Deepen structural reforms in the following areas: public expenditure management, financial sector, state-owned enterprises (SOEs), private sector, trade, and development of the legal system;
3. Invest in the social sectors to expand access and improve social sector outcomes;
4. Invest in infrastructure such as roads, power, and water supply, and expand access to these services;
5. Invest in rural development and natural resource management—including support for agricultural, mining, forestry and hydropower development; and
6. Strengthen capacity.

The World Bank Group – International Finance Corporation (IFC), Mekong Project Development Facility (MPDF), World Bank Institute (WBI) and the World Bank (Bank) – provides technical and financial support to Lao PDR in the implementation of this strategy. The Bank itself supports analytical work in the structural reform areas cited above, in poverty diagnostics, in key sectors and in capacity building for the public sector, in addition to concessional financial assistance of around US\$30 million a year. As agreed during the recent Country Assistance Strategy (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 existing broad role in basic infrastructure and agriculture. The WBI provides training in support of capacity building initiatives. The IFC, together with its MPDF, the private sector arm of the Group, promotes private sector development through technical assistance, strengthened dialogue between public and private sectors and direct financing of private-sector projects.

¹ Prepared by the staff of the World Bank. Contact person: Mr. Alessandro Magnoli, Country Economist, Poverty Reduction and Economic Management Department, East Asia and Pacific Region, phone (202) 473-1653.

IMF-World Bank Collaboration in Specific Areas

In broad terms, the International Monetary Fund (IMF or Fund) has taken the lead in supporting the Government in strengthening the macroeconomic framework for ensuring macroeconomic stability. This support covers tax, fiscal, monetary, interest-rate and exchange rate policies, and balance of payments and related statistical issues. In addition, some aspects of three structural policy areas that have an important bearing on macroeconomic performance (e.g. financial sector, public expenditure management, trade policy) are also part and parcel of the Fund's work program. The Bank has taken the lead in supporting the Government in poverty diagnostics, analysis and advice, poverty and social impact assessments, SOE reform and restructuring, private sector development, and legal/judicial development, in addition to natural resource management and sectoral reforms. The Bank also shares responsibility with the Fund in structural areas of the financial sector, public expenditure management and trade policy as well as in supporting the Government in the development of the poverty reduction strategy. Both institutions also collaborate closely with the Asian Development Bank (AsDB) in the financial sector and in public expenditure management, and with the UN agencies in the trade policy area and poverty reduction strategy.

The Bank also plans to initiate new work on capacity enhancement in the public sector as well as in legal and judicial development. The Government has indicated that while various types of capacity-building is going on in different parts of the public sector, and the Bank projects have components that address this issue in the sectors, there is a need for greater focus, systematic effort and scaling up of capacity enhancement efforts. Two missions visited Vientiane in May and July 2003, to discuss with various agencies their assessment of what is needed and a brainstorming session was organized by the National Organization for the Study of Policy and Administration (NOSPA), with participation of several agencies and ministries in July 2003. The Government's recent governance report has emphasized its commitment to the rule of law and the need for implementing that in the country; the Bank plans to support this area, especially in the context of private sector development.

Bank and Fund Policy Dialogue

Poverty Reduction Strategy. The World Bank has been leading the work in supporting the Government's poverty diagnostics, poverty and social impact of policies, and supporting the consultations for the poverty reduction strategy. Both the Bank and the Fund have been jointly (together with UNDP) involved in the Government's process of formulating their medium-term poverty reduction strategy. In April, 2001, the GOL submitted an I-PRSP to the Boards of the World Bank and the IMF, and in August 2002, a Progress Report on the preparation of the full PRSP. More recently in May 2003, GOL circulated the first draft of the full PRSP, which in Lao PDR is the *National Poverty Eradication Program (NPEP)*. This was presented at the May 2003 mini Roundtable Meeting (RTM) of donors and NGOs for comments. Participants at the mini-RTM suggested that further consultations would be needed to develop a consensus among all development partners. Also, further substantive work would be needed for specifying the appropriate medium-term macroeconomic

framework, costing the proposed public investment and current expenditure program, prioritizing the proposed reform measures in the various areas, including a timeline, and developing targets and indicators for monitoring the implementation of the NPEP. A second draft was circulated in August 2003, in preparation of the September 2003 RTM. The final document is scheduled to be submitted to the National Assembly in October 2003, with the Bank and the Fund's Joint Staff Assessment (JSA) of the strategy expected soon thereafter.

Public Expenditure Management. In 2002, the Bank completed a Public Expenditure, Financial Management and Procurement Review, jointly with the IMF, the AsDB and the Government, and the IMF completed a FAD mission review of the treasury, budget reporting and accounting systems. These assessments provided a further basis for the Government's reform program that is being supported by the IMF's PRGF and by the Bank's financial support in the form of the Financial Management Adjustment Credit (FMAC)², and the technical assistance provided by the Financial Management Capacity Building Credit (FMCBC), the IDF grant for public financial management, and the PPIAF grant for tariff-studies. In particular, the FMAC seeks to enhance transparency, accountability and efficiency through the publication of the budget, improvements in procurement, greater balance between recurrent and capital expenditures and the development of a better chart of accounts for classifying expenditures. These actions complement several of the PRGF structural benchmarks in respect of treasury reforms, budget reporting and public accounting.

Given the current situation of public financial management, reforms are expected to continue for some time to make such management adequately transparent, accountable and efficient. The final NPEP expects to incorporate not only the public investment and current expenditure plan that would be needed to achieve the goals set out in that strategy, but also reforms in public financial management that would be needed to manage effectively the rising revenues from natural resources and general taxes. Firm entrenchment of this reform process, along with clear, monitorable performance benchmarks, and an established track record will be necessary for the World Bank and other donors to continue expanding support to Lao PDR, including possible support for future projects to export power to neighbors, like the large Nam Theun 2 (NT2) power project.

The Bank is currently completing, jointly with the Government, an examination of the likely sources of growth for Lao PDR, the institutional development that is necessary for better public financial management and the likely impact of both on poverty and human development. Work on intergovernmental fiscal relations is also planned. The Bank expects to support public financial management reforms over the medium term through a cycle of Poverty Reduction Support Credits (PRSCs), with the first one covering the first-year

² This is a two-tranche adjustment operation of US\$17 million, with the first tranche of US\$7 million disbursed in January 2003. The second-tranche release has been delayed and is now expected to be disbursed when all the actions are completed (January 2004).

program under the NPEP; self-standing technical assistance projects may also be provided in this area, if needed.

Financial Sector Reforms. The World Bank has worked closely with the IMF and the AsDB to support the Bank of the Lao PDR (BOL) in developing and implementing a multi-year banking reform program, with technical assistance provided by the AsDB. The Bank's ongoing FMAC supports restructuring of State-owned Commercial Banks (SCBs) and their move to a more commercial basis of operation, as well as the development of rural micro-finance institutions. Reflecting the Bank's view that SCBs must be put on a commercial footing, the conditionality under FMAC includes detailed provisions on the restructuring of SCBs, including non performing loans (NPL) resolution process, proper and regular reporting by SCBs, as well as international audits so as to improve transparency and accountability. In addition, it supports the development of an appropriate policy framework for rural and micro finance institutions through a consultative process. This restructuring is supported by AsDB with the provision of technical assistance in the form of international banking advisors in the SCBs, as well as a recent multi-year program loan to support ongoing restructuring. The IMF is taking the lead in strengthening banking regulation and supervision, and complementing the Bank and AsDB work on SCB restructuring, by focusing on the financial aspects of restructuring which has implications for fiscal stability.

The Bank recognizes, together with the IMF, that the restructuring of SCBs and the reform of regulation and supervision is not only important for the proper functioning of the financial sector, but also for fiscal and macro-stability in Lao PDR, as NPLs and the losses from NPLs have impacted the budget adversely and could do so in the future. The Bank's FMAC, supported by the FMCBC, and the PRGF seek to break this destabilizing cycle as a key step in the process of better management of public resources and fiscal stability, and expects this support to be needed over the medium-term; the Bank's cycle of PRSCs will provide such support together with the PRGF and the AsDB's program loans.

Trade Policy. The IMF and the Bank have both worked on trade policy issues for some time, and this was an integral part of the earlier analytical work and programs. More recently, the Bank is conducting workshops and carrying out analysis of trade issues. The WBI conducted several seminars on trade policy issues through the GDLN facility, and in April 2003, organized a face-to-face workshop on WTO accession and its potential for exports and poverty reduction, in a peer-learning mode, which was attended by more than a dozen senior Lao officials. The Bank completed the updating of earlier work on Lao PDR's trade regime and exports, and plans to lead a bigger piece of diagnostic work on trade policy and export potential during October 2003 – June 2004; this will be done jointly with the Government (led by the Ministry of Commerce) under the Integrated Framework program. Reforms in this area are also expected to be supported by the proposed PRSC.

The Bank's Key Roles in Policy Dialogue

Poverty and Social Impact Analysis. This work, supported by the Bank, is being mainstreamed into the various pieces of the Bank's analytical and advisory assistance (AAA)

and so there will be no single piece of work designated as the PSIA. Instead, all future pieces of Bank AAA work, agreed in consultation with the Government and the NPEP process, will not only diagnose the problems at hand and identify the technical solutions to the problems/constraints being analyzed, but go on to assess the ex ante poverty and social impact of those potential solutions and policies, before developing recommendations. Most of the AAA work is also being conducted in a more consultative mode using some of the processes developed for the NPEP. The ongoing Sources of Growth study, the planned Poverty Assessment and Public Expenditure Tracking work, and the planned Trade Policy Diagnostics will all be done in this mode; the IMF will provide relevant inputs for this work in the specific areas where the Fund leads (e.g. tax policy, exchange rate policy).

State-Owned Enterprises (SOEs). The SOEs have been large users of resources and certainly have been the main creditors of SCBs; they have also been the main contributors to the problem of NPLs at SCBs. Accordingly, the FMAC supports the Government's ongoing SOE reform program aimed at improving and institutionalizing the reporting and recording of annual performance of all SOEs, the restructuring of the five large SOEs (BPKP, Pharmaceutical Factory No. 3, Nam Papa Lao, Lao Airlines and Electricité du Lao), drawing up of memorandums of restructuring for another five large SOEs, and appropriate pricing policy for public utility SOEs. The latter requires the development of appropriate tariff policies for water, telecommunications and aviation to ensure cost-recovery tariffs and transparent subsidies where applicable, so that the impact of pricing on the commercial viability of those SOEs are predictable and favorable.

For this purpose, the Bank is supporting, through technical assistance, the preparation of multi-year restructuring plans for the above five SOEs, the development of the monitoring system for SOE performance and detailed tariff studies in telecommunications and aviation. The SOE reform effort not only seeks to move SOEs towards greater efficiency and more commercially viable operation, but also expects to limit future contingent liabilities of SOEs that may undermine medium-term fiscal stability.

The Bank will support the implementation of the SOE's multi-year restructuring plans, the monitoring system as well as the utilities' tariff-policies beyond the second-tranche release of FMAC; this will be done through the PRSCs, the technical assistance grants and credits, and analytical work.

Private Sector Development. The World Bank Group (World Bank, IFC, MPDF) supports the development of the private sector, both economy-wide and in sectors. This includes analytical work by the Bank and surveys by MPDF, both aimed at identifying economy-wide and sectoral constraints to private sector growth, the development of private-sector projects for funding with support from MPDF, and training of SME managers and bankers. The Bank has provided inputs to the private sector component of the NPEP and plans to hold workshops and surveys of provincial climates for private sector, with a view to developing jointly with Government and the private sector a detailed multi-year strategy for promoting the private sector. The Government plans to establish a private sector forum for conducting regular public-private sector dialogue and MPDF expects to support this effort. The World

Bank's sector programs in education, health and transport are supporting the development of a policy framework supportive of private participation.

Forestry Development. The Government is involved in a continuing process of reforming its forestry sector and improving the implementation of forestry programs and projects. The Bank is cooperating with the Government, including trying to ensure that the Government's objectives and strategy for forestry are nested within and consistent with the overall National Socio-economic Development Plan, NPEP/PRSP, Rural Development Program, and Agriculture Development Strategy. Through these, the Government is, inter alia, seeking to:

- Stabilize or increase forest cover and condition;
- Ensure protection of water resources and critical infrastructure through forest conservation; and,
- Put forest resources to work directly for the reduction of rural poverty through partnerships with local communities.

The Nam Theun 2 hydro-power Project. This project, involving the construction of a dam to export power to Thailand, constitutes an opportunity to: (i) combat widespread poverty in the Lao PDR through additional revenues gained from electricity exports; (ii) meet Thailand's energy needs; and (iii) promote sustainable development. The government has asked for World Bank support for this project through an IBRD partial risk guarantee and an IDA environmental and social project.

A World Bank decision on support to the proposed project is linked to: (i) Lao PDR establishing and implementing a viable development policy framework and national programs for poverty reduction and social and environmental protection; (ii) the technical, financial, economic and implementation aspects of the proposed project, as well as the design and implementation of safeguards policies, being sound; (iii) broad support from the international donor community and global and local civil society for Lao PDR's development framework and the proposed project; and (iv) satisfactory resolution of the shareholding, management and contracting issues resulting from the recent decision of the lead sponsor to withdraw from the project.

The Government and the remaining private sponsors have indicated their intent to seek a new lead private sector sponsor to replace the lead sponsor, Electricité de France (EDF). To this end, the Government has asked the Bank to help provide appropriate advisory assistance which the Bank is in the process of doing.

World Bank Strategy and Lending Operations

Country Assistance Strategy (CAS). The last CAS was presented to the Bank's Board in April 1999 and the next one is proposed to be presented around the middle of 2004; this timing is aimed at using the NPEP (i.e. full PRSP, to be completed in October 2003) as the basis for the next CAS.

The overarching objectives of the last CAS was poverty reduction, focusing on sustained growth to improve Lao PDR's social indicators, and graduate from the present rank of Least Developed Countries by the year 2020. The last CAS focused on supporting the stabilization of the economy, to be accomplished in close collaboration with the IMF. This consisted of a lending and non-lending (analytical and advisory assistance) program, with the former amounting to US\$111 million of new commitments during July 1, 1999 to June 30, 2003. Since 2001, there has been a jump in the non-lending program for Lao PDR, given the special emphasis given to low income countries facing especially difficult conditions.

Analytical and Advisory Activities (AAA). The current sources of growth in the Lao PDR economy will be examined in a new Country Economic Memorandum (CEM)/Sources of Growth Report, which is expected to be completed by November 2003.

The World Bank's Main Non-Lending Work
(recently completed and ongoing)

Area	Instrument
Poverty Reduction	Poverty Assessment Report (completed, 2002; new one ongoing, June 2004); Poverty-Environment Nexus Study Phase 1 (completed, 2002);
Growth Analysis	Sources of Growth - CEM (ongoing, November 2003)
Public Expenditure Management	PER, CFA, CPAR (completed, 2002); Public Expenditure Tracking in Health & Education (ongoing, June 2004); Intergovernmental Fiscal System Note (planned July 2004)
Private Sector Development & Trade Policy	Note on Private Sector Development for CAS (planned March 2004) Integrated Framework work on trade diagnostics (planned to be completed by Aug 2004)
Capacity Enhancement & Public Sector Reform	Note on Capacity Enhancement for CAS (planned Mar 2004)

Lending Operations

As of June 30, 2003, IDA credits totaling about US\$687.2 million equivalent had been approved for Lao PDR including support for adjustment operations, rural development, forestry, transport, energy, telecommunications, education, health, industry, and capacity building.

IDA: Commitments and Disbursements to the Lao PDR, 1977–2003
(In millions of U.S. dollars; as of June 30, 2003)

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	44.8	30.6	4.9
2003	24.7	41.2	6.1
Total	687.2	525.2	24.3

Source: World Bank, 2003.

In the last three years, lending operations have focused on the above mentioned CAS objectives, with an average commitment of about US\$37 million, while disbursements averaged US\$34 million. The level and composition of the lending program for the next four years will be determined in the context of the forthcoming CAS, currently scheduled for FY 2004.

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

The Asian Development Bank (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. AsDB has been active in financial sector development since the latter part of the 1980s. Since the early 1990s, the emphasis of AsDB assistance to Lao P.D.R. has been broadened to include rural development, social development and environment. Since the late 1990s, the AsDB has focused its activities on poverty reduction.

AsDB worked with the Government and other stakeholders to formulate its new Country Strategy and Program in 2001 to guide its future operations in Lao P.D.R. for the next five years. The theme of AsDB's interventions in Lao P.D.R. will be poverty reduction by broadening community participation and opportunities. The core strategies for poverty reduction are: sustainable economic growth, inclusive social development, and good governance. The main strategic focus will be on four operational priorities including rural development and market linkages, human resource development, sustainable environmental management, and financial and private sector development and regional integration. 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.

Lao P.D.R. is a key actor in the Greater Mekong Sub-Region (GMS) program as a land-link among the other member countries. The AsDB will aim to explore various options to maximize the benefits to Lao P.D.R. from sub-regional 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 East-West corridor, which links Thailand to Savannakhet and Vietnam.

Since 1989, the AsDB has approved 43 loans (including five structural and sectoral adjustment loans) for a total of \$937.8 million, of which \$612.7 million has been disbursed to Lao P.D.R. As of end-June 2003, 22 of these loans are still active. The AsDB also approved 169 technical assistance projects since 1989, for a total of \$80.4 million. Of this, \$33.0 million were from AsDB, \$34.3 million from the Japan Special Fund, and \$13.1 million from other sources.

In 2003, the AsDB will approve 2 loans with the planned commitments of \$46 million.

Table 1. Lao P.D.R.: AsDB Commitments and Disbursements, 1998-2003
(In million of US dollars)

	1998	1999	2000	2001	2002	2003 ^{1/}
Commitments	20.0	57.6	60.5	65.0	86.9	46.0
Disbursements	66.0	46.8	51.0	44.7	45.6	64.6

1/ Planned. Figures including GMS sub-regional projects.

Source: Data provided by the Asian Development Bank.

¹ Prepared by the Asian Development Bank.

Lao P.D.R.—Statistical Issues

The overall coverage, quality, and timeliness of macroeconomic statistics in Lao P.D.R. need to be significantly improved for effective monitoring of economic developments, policy formulation, and program compliance. In this regard, a multisector STA mission visited Vientiane during October 2002 in order to facilitate in the preparation of the General Data Dissemination System (GDDS) metadata. It provided key recommendations including in areas where technical assistance and training would be needed. The mission recommended greater coordination between the various agencies responsible for compiling macroeconomic statistics, including through the formation of an inter-agency working group. The authorities indicated the intention to participate in the GDDS, but have not nominated the GDDS coordinator. The authorities also need to finalize the GDDS metadata to formally endorse the strategy for the improvement of statistics.

Economic and financial data are published in periodic reports by the National Statistical Center (NSC) and the Bank of the Lao P.D.R. (BOL). Since 1996, the Lao P.D.R. has been included in the *International Financial Statistics (IFS)* publication.

National accounts

National accounts statistics consist of annual estimates of GDP by activity at current and constant 1990 prices which broadly follow the *System of National Accounts 1968 (1968 SNA)*. The lack of regular surveys to collect comprehensive data on current economic activities and the use of inadequate compilation methods raise questions about the coverage and reliability of the GDP estimates. The estimates rely heavily on data on quantity of production or quantity indicators collected by line ministries. The Swedish International Development Agency (SIDA) is providing technical assistance to the NSC to compile new series of GDP by activity and by expenditure at current and constant 2002 prices. With SIDA support, the Lao Expenditure and Consumption Survey 2002-2003 (LECS 3) is being conducted which will be finalized by end 2003. Furthermore, the October 2002 multisector STA mission recommended to the authorities to establish a system for collecting data on current economic activities based on regular surveys and to implement compilation methods in accordance with the *System of National Accounts 1993 (1993 SNA)*.

Prices

The NSC compiles a monthly CPI which is available on a timely basis. The latest CPI was introduced in January 2000 (with December 1999 as the reference period) using the results of the 1997/98 Lao Expenditure and Consumption Survey (LECS) for deriving a consumption basket. It comprises nine product categories covering major urban centers, including Vientiane. The NSC plans to revise the weights and review the sample of outlets and products on the basis of the LECS 2002. The NSC is also working on the development of a producer price index (PPI) on a quarterly basis with SIDA's assistance. The project is planned to be completed by the end of 2003.

Government finance

Government finance statistics are weak and there is scope to significantly improve their accuracy, coverage and transparency. The Budget Department produces monthly, quarterly,

and annual revenue and expenditure statistics. Most data are currently recorded on a cash basis. Expenditure data by economic type are compiled by central government and the provinces. Data on bank and nonbank financing of the budget, including treasury bill operations, need to be made consistent with the monetary accounts. The recently introduced social security fund and off-budget activities are not included in fiscal data. Annual budget and outturn data are not disseminated according to an international standard, which complicates fiscal analysis. As last year, in April 2003, the authorities published in the *Official Gazette* the 2002/03 budget data by central government ministry and province and the 2001/02 outturn, which allows the identification of key spending categories.

Budget planning, execution, reporting, and cash management require significant upgrading, as noted by the October 2002 FAD mission on public expenditure management. Moreover, 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 various items to the central budget, such as timber related royalty payments.

While the budget data are published in the *Official Gazette*, no government finance data are presented in *IFS* country page or the *Government Finance Statistics Yearbook*. Fund technical assistance on the GFS framework would be valuable.

Central government debt data are compiled by two departments of the MOF; external debt by the External Financial Relations Department and domestic debt by the Budget Department. Debt data are comprehensive and are available by type of debt holder and instrument. Efforts are being made to further improve coverage, particularly relating to SOE debt.

Monetary accounts

The BOL regularly reports its balance sheet (with a 2-week lag) and commercial bank balance sheet (with a 4-week lag) to APD for program monitoring purposes, and to STA for publication in *IFS* with a lag of between one to two months. Although the authorities have made several improvements in compiling monetary statistics in recent years, the reporting by some banks, especially new branches of foreign banks, continues to be weak. A new chart of accounts for the BOL and commercial banks was introduced in October 1998. Most of the major recommendations made by the 1999 money and banking statistics mission have been implemented. The mission reviewed the new chart of accounts and found them sufficiently detailed to meet internationally accepted standards for the compilation of monetary statistics, but suggested some improvements in their presentation. The 2002 STA mission recommended further improvements in the chart of accounts, and also in the presentation and valuation of monetary data.

A follow-up mission is planned to take place towards the end of 2003. The mission will work to improve institutional coverage and classification of data from the new chart of accounts.

Balance of payments

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

Balance of payments statistics need significant improvements in the frequency and coverage in the following areas: (1) customs trade data, (2) the commodity composition of external trade, (3) services and income, (4) actual foreign direct investment flows, (5) separation of current and capital transfers as well as coverage of some type of grants, especially from international nongovernment organizations, (6) the reconciliation of fiscal and balance of payments data on external loans and grants, and (7) data quality and monitoring of external debt, especially of state owned enterprises. Since 2001, the MOF has adopted the Commonwealth Secretariat-Debt Recording and Management System (CS-DRMS) for processing and maintaining external debt data.

The introduction of new customs procedures, the Customs 2000 system and equipment, has been implemented (with FAD technical assistance) which started to produce more accurate trade data in October 2000. However, for a range of technical reasons, the customs department has not yet produced these data on a regular basis. The Fund missions have emphasized that this problem needs to be urgently addressed.

In order to produce accurate balance of payments updates on a regular basis, there is an acute need to improve the coordination between the agencies involved in BOP compilation, viz., the BOL, the NSC, the Customs and the External Financial Relations Departments of the MOF, the Department of International Cooperation (DIC) of the Committee of Planning and Cooperation (CPC), and the commercial banks.

Lao P.D.R.: Core Statistical Indicators
(As of August 20, 2003)

	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	08/20/03	08/03	06/03	06/03	06/03	07/03	07/03	Q1/03	Q1/03	06/03	2002	06/03
Date received	08/20/03	08/19/03	08/05/03	08/05/03	08/05/03	08/19/03	08/04/03	08/01/03	08/01/03	07/31/03	05/03	08/01/03
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/B
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 generally 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).

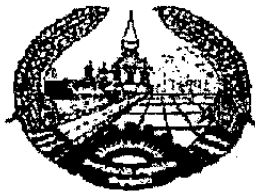
^{5/} All data are eventually published in periodic reports by the BOL and the National Statistical Center. No explicit embargoes apply. These data (except fiscal data) have also been published in *International Financial Statistics (IFS)* since the April 1996 issue (C - unrestricted use, O - other irregular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

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

	Latest single year			Same region/income group	
	1970-75	1980-85	1995-01	Fast Asia & Pacific	Low income
POPULATION					
Total population, mid-year (millions)	3.0	3.6	5.4	1,822.5	2,505.9
Growth rate (% annual average for period)	2.2	2.4	2.4	1.1	1.9
Urban population (% of population)	11.1	13.8	19.7	37.3	30.8
Total fertility rate (births per woman)	6.5	6.5	4.9	2.1	3.5
POVERTY					
<i>(% of population)</i>					
National headcount index	..	..	38.6 1/	..	..
Urban headcount index	..	..	26.9 1/	..	..
Rural headcount index	..	..	41.0 1/	..	..
INCOME					
GNI per capita (US\$)	..	..	300	900	430
Consumer price index (1995=100)	..	..	848	..	..
Food price index (1995=100)	..	..	..	..	..
INCOME/CONSUMPTION DISTRIBUTION					
Gini index	..	..	37.0	..	..
Lowest quintile (% of income or consumption)	..	..	7.6	..	..
Highest quintile (% of income or consumption)	..	..	45.0	..	..
SOCIAL INDICATORS					
Public expenditure					
Health (% of GDP)	..	..	1.3	1.8	1.1
Education (% of GDP)	..	0.4	2.3	2.3	2.8
Social security and welfare (% of GDP)	..	..	..	..	..
Net primary school enrollment rate					
<i>(% of age group)</i>					
Total	..	..	81	93	..
Male	..	..	85	92	..
Female	..	..	78	93	..
Access to an improved water source					
<i>(% of population)</i>					
Total	..	..	37	76	76
Urban	..	..	61	93	90
Rural	..	..	29	67	70
Immunization rate					
<i>(% under 12 months)</i>					
Measles	..	6	50	76	60
DPT	..	4	40	77	61
Child malnutrition (% under 5 years)	..	..	40	15	..
Life expectancy at birth					
<i>(years)</i>					
Total	42	47	54	69	59
Male	41	46	53	67	58
Female	44	49	55	71	60
Mortality					
Infant (per 1,000 live births)	140	128	87	34	80
Under 5 (per 1,000 live births)	209	182	100 1/	44	121
Adult (15-59)					
Male (per 1,000 population)	610	531	355	184	312
Female (per 1,000 population)	510	439	299	129	256
Maternal (per 100,000 live births)	..	..	650	..	..
Births attended by skilled health staff (%)	..	..	21 1/	80	..

Source: 2003 World Development Indicators CD-ROM, World Bank.

1/ Includes latest data in the range for 1995-2001.



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

Vientiane, August 28, 2003

Dear Mr. Köhler,

The attached Memorandum of Economic and Financial Policies (MEFP) sets out the objectives and policies of the Government of the Lao People's Democratic Republic (Lao P.D.R.) to be implemented through March 2004. This latest MEFP continues to build on the policy discussions since the Executive Board of the International Monetary Fund (IMF) approved a three-year arrangement for the Lao P.D.R. under the Poverty Reduction and Growth Facility (PRGF) on April 25, 2001. All performance criteria for September 2002 were met, except the one on contracting or guaranteeing of nonconcessional public sector external debt with a maturity of more than one year, and a waiver is being requested on the basis of the new concessional loan terms. On this basis and the generally satisfactory performance under the PRGF-supported program in 2002-03, we request the completion of the third review and the fourth disbursement under the arrangement.

The Government believes that the policies and measures set forth in the attached MEFP are adequate to achieve the objectives of the reform program supported by the PRGF arrangement, but will take further measures that may be appropriate for this purpose. During the remaining period of the arrangement, the Government of the Lao P.D.R. will continue to consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultation. The Government will continue to provide the Fund 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.

As with previous PRGF reviews, the Government agrees to make these PRGF-related understandings public and authorizes the Fund to publish this letter and the attached memorandum, including through the Fund's external website.

In view of the delay related to the third review, the Government of the Lao P.D.R. hereby requests a one-year extension of the PRGF arrangement through April 24, 2005. The Government also requests that the fourth and fifth reviews be conducted by end-January, 2004 and end-July, 2004, respectively.

Finally, we would wish to assure you that the Government of the Lao P.D.R. is determined to fully implement the PRGF-supported program, and we hope we can count on the continued support of the Fund in our endeavors.

Chansy Phosikham
Minister of Finance
Ministry of Finance

Sincerely yours,

Phoumy Thipphavone
Governor
Bank of the Lao P.D.R.

**Memorandum of Economic and Financial Policies
of the Government of the Lao People's Democratic Republic
August 28, 2003**

I. INTRODUCTION

1. The reform program of the Government of the Lao People's Democratic Republic aims at raising economic growth, promoting broad-based development, and reducing poverty. Our efforts are being supported by an arrangement under the Poverty Reduction and Growth Facility (PRGF), in coordination with complementary programs supported by the World Bank and Asian Development Bank (AsDB). This memorandum reviews the implementation of the PRGF-supported program to June 2003 and lays out the economic and financial policies for the third annual program through March 2004.

II. PERFORMANCE UNDER THE PROGRAM

2. Economic performance in 2002/03 is expected to be mixed. Real GDP growth is estimated by the Government to remain at 5.9 percent. It is noted that the IMF staff estimate that growth is likely to decline to 5.3 percent due to the weaker external environment, the slowdown in tourism, reduced credit growth, and lower investment. Inflation, which was 7 percent (year-on-year) in early 2002, rose rapidly to 17 percent in June 2003, reflecting the effects of the depreciation of the nominal exchange rate (14 percent between May and September 2002) and higher oil prices in early 2003. The unfunded budget expenditures in 2001/02 that contributed to the kip depreciation in mid 2002 have been corrected. In particular, since October 2002 firmer financial policies from expenditure and bank credit controls and increases in interest rates have stabilized the exchange rate. Gross international reserves grew to \$207 million, 3.7 months of imports, by June 2003.

3. All but one of the end-September 2002 quantitative performance criteria were observed. The performance criterion for contracting and guaranteeing nonconcessional external public debt was exceeded because of a \$50 million loan for the Nam Mang 3 hydroelectric project, but in November 2002 the loan was made concessional. Two performance criteria set for end-March 2003, net domestic assets of the BOL and net credit to the government, were breached by modest margins as budget revenue during the first half of 2002/03 remained weak. In response, the Government enacted a fiscal package at end May to bring the fiscal program back on track. For June 2003 all benchmarks were met, except for the ceiling on net bank credit to government (which was exceeded by a small amount) and the contracting of nonconcessional external public debt, the latter on account of the lease by Lao Airlines.

4. In structural areas, the reform of state commercial banks (SCBs) has started. Bank restructuring has begun as evidenced by, among other developments, recent loan recoveries. In November 2002, the AsDB approved the Banking Sector Reform Program Loan (BSRPL) and all four international advisors have begun their assignments and recent loan recoveries indicate significant change in lending behavior. On state-owned enterprise (SOE) reform, the

Government has begun technical work on the restructuring strategies and programs for five large SOEs, including Electricité du Laos (EDL), the Phoudoi conglomerate, Pharmaceutical Factory No. 3, and Lao Airlines.

III. MACROECONOMIC FRAMEWORK AND POLICIES

5. In line with the Socio-Economic Development Plan for 2002/03 and the plan for 2003/04, we will continue to strengthen macroeconomic stability, reduce inflation to single digits, and maintain relatively stable exchange rates. These policies are aimed at accelerating development, especially rural areas, to promote poverty reduction. Thus, we expect real GDP growth to increase to about 6.2 percent (IMF staff estimate 5.8 percent growth) and inflation (12-month basis) to fall to about 10 percent by September 2003 and to 8 percent by September 2004.

Fiscal policies for 2002/03-2003/04

6. Despite the weakness in revenue, the Government will continue to implement the 2002/03 budget in a way that supports macro stability. Budget revenue for 2002/03 is expected to be about 95 percent of the budget (IMF basis) in nominal terms, but equivalent to 11 ½ percent of GDP, compared to 13 percent of GDP in 2001/02. In response to the emerging shortfall, the Government introduced a package of revenue and expenditure measures at end-May 2003. This comprised mainly reapplying the tax rates on petroleum as specified in the Tax Law, notably the re-imposition of the 5 percent turnover tax and the excise on petroleum (equivalent to a total of 17 percent ad valorem increase, effectively doubling the tax rate). The overall revenue yield from the package is expected to be KN 81 billion (0.4 percent of GDP) for the remainder of 2002/03; equivalent to KN 226 billion on an annual basis (1.1 percent of GDP). The fiscal measures also include the reduction and postponement of the wage increase (KN 30 billion), and reduced allocations for domestically-financed capital expenditure (at least KN 30 billion). With these measures (and program loans of \$17 million), bank financing is expected to be 0.2 percent of GDP.

7. The Government is in the process of clearing domestic arrears of KN 600 billion (3 percent of GDP) that have eroded the health of the banking system. Of the old arrears to contractors that have borrowed from the banks, totaling KN 360 billion, one third is to be paid off by September 2003 through the issuance of government bonds. Budget arrears from enterprise accounts at Treasury, which rose to KN 240 billion by September 2002, are also being cleared, of which KN 130 billion were cleared by end July 2003 through a combination of securities issues and the netting with tax liabilities. Strict expenditure controls have limited new arrears.

8. Looking ahead, the fiscal stance in 2003/04 will reverse the sharp slide in the revenue to GDP ratio while also continuing to limit bank financing. The Government will propose a 2003/04 budget that includes revenue at KN 2,900 billion (12.2 percent of GDP), excluding capital return. This will be achieved by first, maintaining the statutory duty, excise, and turnover tax rates on petroleum as well as the mobile phone excise tax which would increase

revenue by 0.6 percent of GDP. The increase in excise on luxury goods, including alcohol and tobacco, is projected to yield 0.1-0.2 percent of GDP. Second, we will issue, in consultation with Fund staff, implementing regulations for Presidential Decree 01 on tax incentives to ensure that budget revenue is safeguarded (a structural benchmark). While we believe that the appropriate regulations can be formulated for this purpose, we would be prepared to revise the decree, if necessary, to safeguard budget revenue. Third, we will not grant tax incentives under Decree 01 or under any other legislation that may come into effect after August 27, 2003 until the fourth PRGF review (a continuous structural performance criterion). Finally, we are introducing a national structure for the treasury and customs departments with field staff in all provinces paid by, and under the control of, the central Ministry of Finance (a structural benchmark), and transferring 20 of the largest enterprises in the provinces to the central large tax payer unit (a structural benchmark). At the same time, we will continue to review the impact of turnover tax reductions on revenue (estimated at 0.2 percent of GDP), investment, and economic activity.

9. Current expenditure will rise by 0.9 percent of GDP. This is mainly due to the wage increase of 30 percent for civil servants at the beginning of the year to offset the significant increases in utility prices. Capital expenditure will be significantly reduced mainly due to the cuts in new domestically financed expenditure, including large projects in the pipeline, while externally financed capital expenditure are expected to remain steady. In addition, the budget will contain KN 194 billion in unallocated expenditures. Taken together with the projected increase in program loans, there will be no bank financing of the budget deficit.

10. To improve public expenditure management, we are implementing the reform plan described in Appendix I covering commitment controls, treasury operations, fiscal reporting, budget planning and execution, and auditing. In particular, we will continue to extend the new accounting system, enabling the introduction of the compilation of expenditure data by administrative unit at the central government level in the 2003/04 budget (structural benchmark). We will also complete a census of arrears as of end September 2003, by March 2004. We plan to seek additional technical assistance from donors to help implement some of these measures.

Monetary and exchange rate policy

11. The BOL will continue its firm monetary policy to reduce inflation. With the increase in foreign financing and the build-up of government deposits at the BOL in the year to March 2004, gross official international reserves will be at 3.7 months of imports. As a result, reserve money is expected to increase by 14 percent during the year through end-March 2004. Reflecting the limited availability of bankable projects, the kip component of reserve money is expected to remain high, but to decline later this year in line with a gradual pick-up in bank credit. While the SCBs will continue to restrain credit and improve credit quality, under the PRGF-supported program, SCB credit will be able to resume to a moderate growth rate of 9.5 percent through end-March 2004. However, actual credit growth will need to be based on a careful assessment of risk, especially for foreign exchange credits. With the

resultant inflow of deposits, broad money is expected to grow by about 18 percent in end-March 2004. We will also develop sales of transferable government securities.

12. We will continue to maintain a flexible exchange rate regime and limit the margin between the parallel and bank rates to under 2 percent. The Foreign Exchange Decree Law has been promulgated and implementing regulations are expected to be issued by June 2004.

IV. KEY STRUCTURAL REFORMS

13. In order to meet our poverty reduction objectives, we are committed to accelerate the implementation of the structural reform agenda with a view to achieving a higher sustainable growth rate and strengthening public resource management.

Banking sector reform

14. With the support of the AsDB, the World Bank, the European Union, and the IMF, the Government has begun to implement its banking sector reform program to secure operational improvements in the SCBs. These restructuring plans call for significant operational improvements over 3-4 years supported by international bank advisors and monitored in relation to performance targets, with the first test at end-September 2003. With the strengthening of the SCBs, we will aim to seek a strategic investor for one of the two SCBs by 2005.

15. Steady improvements in banking supervision will be made to complement bank restructuring. Given the capacity constraints, we will develop a targeted approach. On-site inspections will focus on the SCBs, especially examining asset quality, including verifying loan classification and adequacy of provisioning, adherence to BOL regulations on large borrower limits, foreign exchange exposure, and monitoring off-balance sheet operations. Completion of on-site inspections of the two SCBs as of September 2003 will be a structural performance criterion for end-November 2003. Off-site supervision is also being developed to help direct on-site inspectors to those areas in individual bank operations that need special attention. As part of strengthening the existing prudential regulations, we will require matured letters of credit to be recorded as credit and provisioned accordingly, and revise BOL Regulation 98 to clarify the terms for the reclassification of restructured loans and to improve reporting and monitoring of open foreign exchange positions.

16. To enhance competition in the banking system, we will equalize minimum capital requirements for banks with domestic and foreign shareholders, and allow foreign bank branches to operate on a nationwide basis. In that connection, the amendments to the Decree Law on Commercial Banks will be submitted to the Standing Committee of the National Assembly by January 2004.

SOE reform

17. Plans for the restructuring of the five large SOEs are under preparation. These plans will be reviewed by the Government and international experts, funded by the World Bank's

capacity building credit, will be assisting in the development and implementation of enterprise-specific restructuring plans. Sales of substantial non-core assets will be included in these plans to help resolve NPLs of SCBs. In addition, price adjustments of key utilities will continue with a view to reaching cost recovery levels within the time frames specified under the World Bank's Financial Adjustment Credit (FMAC). With regard to Lao Airlines, we expect that the company will cover the costs of its recent three-year lease of an Airbus, contracted without a government guarantee. The Government will not provide any financial support to the company, state bank lending, if any, will be on fully commercial terms, and we will ensure that the company's operations are consistent with the restructuring plan to be agreed under the FMAC.

External debt

18. We will refrain from contracting and guaranteeing nonconcessional public external debt. Overcoming past deficiencies, we have implemented the remedial measures to strengthen the monitoring and reporting of all public sector external debt, including (i) the revision of the Ministry of Finance Instruction 912 to include both external debt contracted by SOEs with government guarantee, and external debt without government guarantee; and (ii) the provision of a comprehensive report of all public sector external debt, including on all SOE external debt.

19. We have recently reached agreement in principle on our external debt to Russia. After rescheduling on the basis of a 70 percent upfront discount the resulting debt stock will be \$ 387 million, to be repaid over 33 years. Specific repayment terms will be agreed by the end of this year.

Other measures

20. The Government is continuing to develop its National Poverty Eradication Program (NPEP), which would serve as a basis for the Poverty Reduction Strategy Paper. The final document is now expected to be completed by October 2003, for presentation to the Boards of the Fund and the World Bank shortly thereafter.

21. We intend to participate in the IMF's General Data Dissemination System (GDDS). In preparation for this, we will soon nominate a GDDS coordinator, and are continuing to work on finalizing the metadata. The multisector statistics mission has prepared recommendations and an action plan to overcome weaknesses in macroeconomic statistics, and both are being reviewed and verified.

22. The BOL is implementing the recommendations of the safeguards assessment conducted by IMF staff. In particular, the audit of the BOL's 2001 accounts was completed at end-August on schedule with the assistance of an international audit firm, and the financial statements were reformulated to bring them closer to international accounting standards (IAS), and published. We have agreed to implement all the high priority recommendations of the on-site assessment. In that connection, the BOL has agreed to close and interactive cooperation with an international audit firm to assist the State Audit Authority (SAA)

conduct the audit of the BOL's 2002 accounts at international standards of auditing (ISA) and for the audit of the 2003 accounts to be conducted jointly with an international audit firm. As a start towards adopting IAS, we will adopt loan provisioning in the BOL's accounts consistent with BOL Regulation 98, to be phased in over four years starting with the 2003 accounts. Also the monetary data reported to the Fund have been reconciled to the accounting records.

V. PROGRAM MONITORING

23. Quantitative performance criteria for end-September 2003 and end-March 2004 on net domestic assets of the BOL and SCBs, net bank credit to government, net international reserves, public external debt, and external arrears (Table 1) will be included in the program. To supplement the quarterly monitoring of the financial program, indicative targets have been introduced complementing the ceiling on net domestic assets of the BOL, for kip-denominated reserve money, and for budget revenue (excluding grants). The structural policy undertakings for the fourth review, to be conducted by end-January 2004 and the fifth review by end-July 2004, are included in Table 2. The fourth review will focus on fiscal performance and the progress on the structural benchmark for the implementation regulations of Presidential Decree 01, as discussed in Para.8.

Attachments

- Table 1. Quantitative Performance Criteria and Benchmarks, 2002-March 2004
- Table 2. Key Structural Policy Actions Under the Third Annual PRGF-Supported Program
- Appendix I. Action Plan for Improving Public Expenditure Management
- Appendix II. Technical Memorandum on Program Monitoring

Table 1. Lao P.D.R.: Quantitative Performance Criteria and Benchmarks, 2002–March 2004

	2002		2003						2004	
	Sept. 1/		Mar.			June		Sept. 1/	Dec.	Mar. 1/
	Adj. Prog.	Est.	Prog.	Est.	Est. New Base	Prog.	Est.	Prog.	Prog.	Prog.
(In billions of kip)										
1. Net domestic assets of the Bank of the Lao P.D.R. (BOL) 2/ 3/	-437	-463	-532	-520	-638	-545	-613	-525	-624	-644
2. Net credit to the government from the banking system 3/	-361	-375	-359	-322	-378	-421	-415	-398	-398	-408
3. Net domestic assets of the state commercial banks (excluding net claims on government) 4/	1,537	1,453	1,610	1,404	1,571	1,740	1,563	1,780	1,732	1,763
4. Reserve money (in kip) 5/	...	261	...	342	342	293	423	320	393	445
5. Budget revenue (excluding grants) 5/ 6/	...	2,327	...	923	923	1,517	1,590	2,430	580	1,218
(In millions of U.S. dollars)										
6. Net official international reserves 3/ 7/	104	106	121	124	91	78	96	78	97	104
7. Publicly contracted or guaranteed nonconcessional external debt 8/ 9/										
- up to one-year maturity	0	0	0	0	0	0	0	0	0	0
- maturity of more than 1 year	0	50	0	0	0	0	0	0	0	0
of which: 1–5 years' maturity	0	0	0	0	0	0	0	0	0	0
8. External payments arrears 9/	0	0	0	0	0	0	0	0	0	0
Memorandum items:										
Nonproject budget support 6/	12.0	5.0	10.0	12.0	12.0	12.0	12.0	17.0	5.0	15.0
External debt service payments 6/ 10/	32.5	26.6	15.9	14.4	...	...	...	...	...	...
Program exchange rate (kip per dollar)	9,500	9,500	9,500	9,500	10,800	10,800	10,800	10,800	10,800	10,800
Foreign exchange component of required reserves / reserve money 11/	30	36	32	40	73	71	74	78	73	75

Sources: Data provided by the Lao P.D.R. authorities. The full definition of terms is contained in the Technical Memorandum on Program Monitoring (TMPM) (Appendix II).

1/ Performance criteria.

2/ 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.

3/ For purposes of verifying compliance with the program, the ceiling for net domestic assets of the BOL, and net bank credit to the government have been/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, until March 2003, any excess (shortfall) in debt service payments.

Net credit to the government will be adjusted upwards for the issue of debt clearance bonds.

4/ Comprising Banque du Commerce Extérieur Lao and Lao Development Bank. Net domestic assets of the SCBs 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. Net domestic assets of the SCBs will be adjusted downwards for the issue of debt clearance bonds.

5/ Indicative target.

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

7/ Net official reserves are calculated as net international reserves on a BOP basis less foreign currency component of required reserves. For the program until March 2004, we subtract the foreign currency component of reserve money.

8/ Ceiling applies to debts contracted or guaranteed by the government, public enterprises, or the BOL on nonconcessional terms. Ceilings are flows from March 2003 onwards. Excludes normal import-related credit and any borrowing associated with debt rescheduling. 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). Excludes the three-year lease contracted by Lao Airlines on May 27, 2003, with total monthly lease payments during the three-year period of \$3.42 million.

9/ Continuous performance criterion.

10/ Program adjuster until March 2003, excluding IMF.

11/ Foreign exchange component of reserve money for the revised program from March 2003 onwards.

Table 2. Lao P.D.R.: Key Structural Policy Actions Under the Third Annual PRGF-Supported Program

Policy Action	Conditionality	Status
A. Monetary policy, banking reform, and safeguards		
1. Complete the 2001 audit of the BOL by the National Audit Office, with the assistance of an international auditing firm, and in accordance with international auditing standards and prepare pro-forma 2001 financial statements in accordance with international accounting standards.	Structural benchmark, August 2002	Partially met. Although international standards of auditing not achieved, the accounts were recast to international accounting standards.
2. Implement two rounds of quarterly targeted inspections of the three SCBs including their 5 largest branches to verify asset quality, and implementation of instructions to limit the increase in lending and the issue of off-balance sheet commitments.	Structural performance criterion, November 2002	Met.
3. Maintain, in accordance with BOL 98, accurate loan classification on all loans, and full provisioning on all new and rescheduled loans from the start of 2000, and compliance with other key BOL bank supervision directives.	Subject of third review	Met.
4. Ensure that two international bank advisors have initiated their tasks in each of the two SCB groups.	Prior action, third review	Met.
5. Agree to undertake the audit of the BOL's 2002 accounts by the State Audit Authority with close assistance from an international audit firm, and to conduct a joint audit of the 2003 accounts.	Prior action, third review	Met.
6. Submit to the Standing Committee of the National Assembly amendments to the Decree Law on Commercial Banks that equalize the capital requirements for banks with domestic and foreign shareholders (with SCBs' capital requirements linked to their restructuring progress) and permit foreign bank branches to operate on a nationwide basis.	Structural benchmark, January 2004	
7. Complete on site inspections of the two SCBs to verify: asset quality, loan classification and provisioning, adherence to limits on lending, and implementation of key bank supervision directives, including loan classification and provisioning, foreign exchange exposure, and off-balance sheet operations as of September 2003.	Structural performance criterion, November 2003	
B. External public debt reporting		
1. Revise or supplement Ministry of Finance Instruction 912 to include external debt contracted by SOEs without a government guarantee, and provide comprehensive report of all public sector external debt, including all SOE external debt.	Prior action, third review	Draft revisions formulated and now in the Lao clearance process.

Table 2. Lao P.D.R.: Key Structural Policy Actions Under the Third Annual PRGF-Supported Program (concluded)

Policy Actions	Conditionality	Status
<i>C. Fiscal policies and reforms</i>		
1. Strengthen central tax and customs departments, organize them on a functional basis, and transfer an additional large provincial customs point to the national customs service.	Structural benchmark, November 2002	Met. Completed integration of some customs divisions and established new audit and training division in tax department. Initial steps taken for more comprehensive strengthening of these departments in late 2003.
2. Agree on a medium-term plan for expenditure management, including controls on commitments, management of bank accounts, expanding budget nomenclature and improving the quality of fiscal data, and implement a system to identify expenditure by type of administrative unit for the education and health sectors for an important proportion of these sectors in the 2002/03 budget.	Structural benchmark, November 2002	Met. Plan agreed, and data on education implemented, but health data from expenditure tracking under FMAC delayed.
3. Continue improvements in revenue administration, including the national coordination of collections, and the preparation of the VAT.	Subject of third review	Improvements in tax administration lagging.
4. Implement a package of revenue and expenditure measures to close the fiscal gap in 2002/03, and also including the provision of debt clearance bonds, and an initial installment for clearing budget arrears.	Prior action, third review	Met. Debt clearance bonds are being issued.
5. Finalize the report of the survey/census of budget arrears as at end September 2002, identifying type, level of government, creditor, age of arrear and the methodology used. Develop a plan to avoid new arrears and clear at least KN 100 billion of the stock.	Prior action, third review	Components discussed with staff, awaiting written report.
6. Utilize the classification of expenditure by type of administrative unit at the central government level in the 2003/04 budget.	Structural benchmark, October 2003	
7. Extend the central large tax payer unit of the tax department by transferring 20 largest enterprises from provinces to the center, with further progress in monthly reporting and filing compliance, updating of taxpayer identification numbers, increasing quick audits, and collecting identified arrears.	Structural benchmark, November 2003	
8. Issue the instructions to centralize the national customs service and the national treasury, with field offices and their staff under the central government's direct control and on its payroll.	Structural benchmark, December 2003	
9. No tax incentives will be granted under Presidential Decree 01 or under any other legislation that may come into effect after August 27, 2003.	Continuous structural performance criterion	
10. Issue, in consultation with Fund staff, implementing regulations for Presidential Decree 01 on tax incentives to ensure that budget revenue is safeguarded.	Structural benchmark, end-November 2003	

Action Plan for Improving Public Expenditure Management

ACTION	TIMING
<p>I. TREASURY DEPARTMENT</p> <p><i>Enhance the role of the National Treasury to more effectively record revenues, expenditures, and bank and non-bank financing of the budget.</i></p>	
<p>A. Regulations and Procedures</p>	
<p>1. Decide/clarify on key strategic issues in the design of the Treasury system and the role of commitment controls.</p>	<p>October 2003</p>
<p>2. Complete draft of Treasury Regulations and manual of procedures, consistent with the agreed detailed approach to treasury reform. (Peripatetic technical assistance may be required.)</p>	<p>December 2003</p>
<p>3. Integrate the Treasury and Accounting Regulations in a single set of regulations, while resolving any inconsistencies with the various accounting regulations, based on the broad guidelines and subsequent experience. (Technical assistance may be required.)</p>	<p>December 2004</p>
<p>4. Integrate Treasury staff engaged within the Ministry of Finance, to be accountable to the head of the central Treasury, especially regarding central government bank accounts. As appropriate, have the central Treasury provide management services for treasury operations in provinces and districts.</p>	<p>Starting 2003/04</p>
<p>B. Fiscal Reporting</p>	
<p>1. Every district to transmit data on revenue, expenditure and treasury balances to provinces within 10 days after month-end (with a longer time frame, such as 15 days, for specified remote districts), to enable provinces to produce consolidated monthly reports and transmit them to the central treasury within 15-20 days after month-end, to allow the production of a preliminary consolidated fiscal report, fully reconciled with banking data, within 25-30 days after the end of each month.</p>	<p>Starting October 2003 Ministerial order issued, and compliance by most provincial governments. (Training of district staff needed)</p>
<p>2. Close monthly accounts at end-month uniformly for all levels of government, instead of closing them in some districts on the 20th of the month. (Substantial training required.)</p>	<p>Starting October 2004</p>

Action Plan for Improving Public Expenditure Management

ACTION	TIMING
<p style="text-align: center;">B. Fiscal Reporting (cont.)</p> <p>3. Identify all extrabudgetary funds and require financial reporting and accounting similar to that required for the budget (e.g. for the Road Fund, the Environmental Fund, the Unexploded Ordinance Fund, and the Poverty Fund).</p> <p>4. Publish the budgets of all extrabudgetary funds at the same time as the annual budget plan. Progressively integrate into the budget framework all retained revenues and their corresponding expenditures.</p>	<p>Starting 2003/04</p> <p>Starting 2004/05</p>
<p style="text-align: center;">C. Government Banking</p> <p>1. Introduce a register of all government accounts operated with the authority of the Ministry of Finance. Update the register of government bank accounts as new accounts are opened and old accounts are closed.</p> <p>2. Continue process of closing bank accounts established without treasury authorization.</p> <p>3. Minimize the delays in provincial transfers of central government revenues by establishing central government bank accounts at commercial banks located in large revenue centers without BOL branches, and promptly sweep those balances into BOL accounts.</p> <p>4. Establish a system of daily consolidation of data on key treasury bank balances.</p> <p>5. Consolidate government bank accounts for each level of government.</p> <p>6. Link all treasury accounts (with adequate communications links) into a single network of treasury accounts. (Technical assistance may be required.)</p>	<p>Register completed in March 2003</p> <p>Bank accounts closed by September 2003</p> <p>Starting 2003/04</p> <p>2003/04</p> <p>2003/04</p> <p>2004/05</p>

Action Plan for Improving Public Expenditure Management

ACTION	TIMING
D. Arrears	
<p>1. Complete a census/survey conducted jointly by Treasury Department and Budget Department of expenditure arrears as at September 30, 2002 covering all types of expenditures nationwide, including all enterprises' balances with the treasury.</p>	<p>March 2003, survey completed and reports being reviewed and followed-up</p>
<p>2. Formulate a time bound action plan of measures to: (1) clear arrears accumulated up until September 30, 2002 (including revenue sources); and (2) ensure that no new arrears are accumulated.</p>	<p>Completed in June 2003</p>
<p>3. Monitor accounts payable, enterprises' balances at the treasury, and other arrears on a monthly basis.</p>	<p>Starting December 2003</p>
<p>4. Gradually eliminate the stock of arrears revealed in survey. This could be partly achieved through issuance of treasury paper.</p>	<p>Starting March 2003; ending September 2005</p>
<p>5. Complete a census of expenditure arrears as of September 2003, including any new arrears accumulated during 2002/03.</p>	<p>March 2004</p>
II. ACCOUNTING DEPARTMENT	
<p><i>Continue improvements in the accounting system by extending the nomenclature system and applying these systems as computerization continues.</i></p>	
A. Budget classification	
<p>1. Revise the budget classification for expenditures to: (1) simplify the present classification by type of expenditure; (2) identify administrative units within ministries; and (3) introduce a level of government classification (central, provincial, and district).</p>	<p>To be introduced in 2003/04 budget</p>
<p>2. Harmonize the accounting codes with the proposed revised budget nomenclature.</p>	<p>September 2004</p>

Action Plan for Improving Public Expenditure Management

ACTION	TIMING
A. Budget classification (cont.)	
<p>3. Adopt a multi-module budget and accounting classification system in line with the computerization of all central ministries' and provinces' budgets, and budget execution systems. In particular, introduce the functional classification of expenditure (as defined in the IMF's GFS Manual) and "cost centers".</p>	<p>Starting 2004/05</p>
<p>4. Introduce a single system of coding for budgeting and accounting to be used in the computerized system being developed.</p>	<p>Starting 2005/06</p>
<p>III. BUDGET DEPARTMENT</p> <p><i>Budget preparation procedures should be revised to bring forward the budget preparation cycle to provide a more specific expenditure framework early in the fiscal year. In addition, commitment controls should be reviewed for effectiveness and efficiency.</i></p>	
<p>1. Clarify the various regulations and instructions on expenditure control, especially the implementation of pre-disbursement controls (including on commitment) and its degree of centralization in conjunction with line ministries and provinces.</p>	<p>By end 2003</p>
<p>2. Experiment with streamlining expenditure controls by the Budget and the External Financial Relations Departments for selected line ministries and provinces, while preserving overall fiscal management.</p>	<p>During 2003/04</p>
IV. AUDIT AND CONTROL	
<p>1. Transmit to the State Audit Authority (SAA) the budget outcome for 2002/03.</p>	<p>May 2004</p>
<p>2. The SAA to report to the National Assembly on the consolidated fiscal accounts for 2002/03.</p>	<p>August 2004</p>
<p>3. Review the roles and responsibilities of the various internal control and audit agencies in the MOF, the Prime Minister's Office, and in spending ministries.</p>	<p>March 2004</p>
<p>4. Rationalize the various inspection and internal audit agencies.</p>	<p>Starting 2004/05</p>

GOVERNMENT OF THE LAO PEOPLE'S DEMOCRATIC REPUBLIC

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, and indicative targets, specified in the **Memorandum of Economic and Financial Policies (MEFP)** of the Government of the Lao People's Democratic Republic (Lao P.D.R.), dated August 28, 2003, 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 the Lao P.D.R. (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. The yen proceeds from the Japanese commodity grants are excluded from gross foreign assets of the BOL and included in other items (net). GOFLBOL comprise foreign liabilities of the BOL with original maturity up to, and including, one year, and the use of Fund resources.

¹ For items 1 to 8 in Table 1.

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

Item 2: Net credit to the 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) and the Lao Development Bank (LDB).³ 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: Reserve money (in kip)

5. Reserve money (in kip) is defined as total reserve money (paragraph 2) minus all non-government foreign currency deposits held at the BOL.

Item 5: Budget revenue (excluding grants)

6. Budget revenue (excluding grants) is defined as total tax and nontax revenues received by the government within the framework of the state budget, excluding capital return.

Item 6: Net official international reserves (NIRBOL)

7. NIRBOL is defined as “freely available” GFABOL minus GOFLBOL minus the foreign currency component of banks’ required reserves, clearing deposits, and other foreign currency deposits 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). The yen proceeds from the disbursements of the Japanese commodity grants are not included in NIRBOL.

³ Following the merger of the Lane Xang and Lao May banks into LDB all references in Appendix II to Lane Xang Bank and Lao May Bank now apply to LDB.

Item 7: Publicly contracted or guaranteed nonconcessional external debt

8. Ceilings on external debt are calculated as commitments from end-March 2003 onwards, and will be monitored on a continuous basis for the length of the PRGF arrangement. They exclude concessional credits, use of Fund resources, normal trade-related credits, and any borrowing associated with debt rescheduling. For the length of the PRGF arrangement, neither the government, the BOL, nor any other agency acting on behalf of the government will contract or guarantee short-term external loans.

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

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

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

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

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

- **Short-term external debt** includes all short-term external debt obligations having an original maturity of up to one year, but excludes short-term trade credits.
- **The public sector** is defined to include the Government of the Lao P.D.R., the Bank of the Lao P.D.R., state-owned enterprises, or any other agency acting on behalf of the government.
- **Nonconcessional external debt** is defined as debt having a grant element of less than 35 percent. **The grant element** of a debt is determined by comparing the net present value (NPV) of the financing costs and principal repayments with the nominal value of the debt. The NPV of financing costs and principal repayments will be calculated with a discount rate based on the OECD CIRRs (6-month average as of February 15, 2003) 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.
- Excluded from this performance criterion is the three-year lease of an Airbus by Lao Airlines, as specified in the contract signed on May 27, 2003, with total monthly lease payments during the three-year period of \$3.42 million.

Item 8: External payments arrears

9. Defined as the stock of external arrears on debt contracted or guaranteed by the government or the BOL, except on debt subject to rescheduled 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. For the length of the PRGF arrangement, 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 end-June 2003, there were no external payments arrears.

B. Test Dates

10. Quarterly quantitative targets have been established for items 1 to 6. The quantitative target on item 7 and 8 will be applicable on a continuous basis.

11. Quantitative targets (items 1, 2, 3, 6, 7, and 8) for the test dates of end-September 2003 and end-March 2004 are performance criteria, and the disbursement associated with observance of end-September 2003 performance criteria will also be contingent on the completion of the fourth review. Items 4 and 5 are indicative targets.

C. Program Monitoring Exchange Rates

12. 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 2002 balance sheets of the BOL and commercial banks would be subject to valuation adjustments.

13. 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 10,800 = US\$1. SDR assets and liabilities will be valued at a fixed midpoint program exchange rate of SDR1 = US\$1.40086. 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

14. **The program ceilings for NCG (and NDASCB)** will be adjusted upwards (downwards) by the amount of the issue of debt clearance bonds to settle the stock of outstanding budget arrears prior to 2001/02.

II. STRUCTURAL PERFORMANCE CRITERIA AND BENCHMARKS

15. The on-site inspections and the reports to the BOL Governor are to follow the formats recommended by the IMF banking supervision advisor. The reports, which will be provided to the IMF (excluding customer specific information) would also detail progress made in developing the on-site examination system and the steps being taken to address identified areas of weaknesses.

III. PROGRAM MONITORING AND REPORTING REQUIREMENTS

16. 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, LDB; total government deposits at the BOL; 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 as compiled by the Economic Research Department and as compiled by the Accounting Department.	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.	Monthly within four weeks of the end of each month.
The monetary survey, the consolidated balance sheet of the commercial banks, and the individual balance sheets of the two SCBs. Each of the two 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.	Monthly within four weeks of the end of each month.
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.



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International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Third Review of Lao P.D.R.'s PRGF-Supported Program and Approves US\$6 Million Credit

The Executive Board of the International Monetary Fund (IMF) on September 12, 2003, completed the third review of the performance of the Lao People's Democratic Republic under a three-year Poverty Reduction and Growth Facility (PRGF—see [Press Release No. 01/18](#)) arrangement. The Board also approved a waiver for the performance criterion on external debt, and an extension of the PRGF arrangement for one year, through April 24, 2005.

In reviewing the country's Poverty Reduction Strategy Paper (PRSP) Preparation Status Report, the Board also determined that progress on the development of the full PRSP is satisfactory and provides a sound basis for continued access to the Fund's concessional financial assistance.

The completion of this review will enable Lao P.D.R. to draw an amount equivalent to SDR 4.53 million (about US\$6 million) from the IMF, which would bring total disbursements under the arrangement to SDR 18.12 million (about US\$25 million).

The PRGF is the IMF's concessional facility for low-income countries. PRGF-supported programs are 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. 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.

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

“Under their PRGF-supported program, the Lao authorities have continued to make progress at strengthening macroeconomic performance and implementing structural reforms in key areas. Economic growth remains relatively robust and inflationary pressures have eased.

“The tax measures recently adopted by the authorities are important initial steps to strengthen the fiscal position, but further efforts are needed to generate additional resources for poverty reduction. In this connection, it will be essential to implement fully the planned institutional reforms in the tax, customs, and treasury areas. However, care will need to be exercised in

designing the implementing regulations for new tax incentives in order to avoid undermining revenue raising efforts. On the expenditure side, the priorities include strengthening management and efficiency by tightening the procedures for monitoring and ensuring accountability. These actions will help to better assess and formulate cost-effective poverty programs. Continued strengthening of the fiscal position will also require closer monitoring of the external debt, especially debt contracted by the state-owned enterprises.

“The central bank has continued to pursue appropriate monetary and exchange rate policies, which have contributed to an easing of inflationary pressures. It will be important that state commercial banks remain prudent in granting new credits so as to strengthen their loan portfolios.

“Regarding structural reforms, the authorities have made a start on state bank restructuring, including improved credit appraisals and the stricter enforcement of loan repayments. Greater competition in this sector, and enhanced banking supervision, will provide further impetus to these reforms. To address the vulnerabilities identified in the safeguard assessment report, it will be important that the central bank continue to improve its accounting system, and conduct an audit of its accounts for 2003 in line with international standards. In the state-owned enterprise sector, there is a pressing need to speed up the pace of reform, including by establishing hard budget constraints, divestiture, and a strengthening of management—including through partnerships with the private sector.

“The authorities are moving toward a full Poverty Reduction Strategy Paper (PRSP), and the PRSP preparation status report provides a basis for continued concessional assistance to the Lao P.D.R. by the international community. The Fund looks forward to the final PRSP, expected by late 2003,” Mr. Carstens said.

**Statement by Sri Mulyani Indrawati, Executive Director for
Lao People's Democratic Republic
September 12, 2003**

I. Introduction

1. The Government of the Lao People's Democratic Republic (Lao PDR) continues to implement the reform program, aiming at raising economic growth, promoting broad-based development, and reducing poverty. The reform efforts have been supported by the International Monetary Fund's (IMF) Poverty Reduction and Growth Facility (PRGF) and similar arrangements of the World Bank and the Asian Development Bank (AsDB). Performance under the PRGF-supported program in 2002/03 is generally satisfactory, and the government is ready to move ahead with the implementation of the economic and financial policies set forth under the third annual program through March 2004.

II. Recent Developments and Performance under the Program

2. Real GDP growth in 2002/03, like the previous year, has been quite robust, and is estimated to remain at 5.9 percent, attributed mainly to industrial production and agriculture. The IMF staff estimate is somewhat lower, 5.3 percent, to take into consideration the weaker external environment, the slowdown in tourism, lower investment and reduced credit growth.

3. Inflation rose rapidly from 7 percent (year-on-year) in early 2002, to 18 percent in May 2003, due to the lagged effect of the nominal exchange rate depreciation between May and September 2002. As the effect of the depreciation has run its course and a tight fiscal stance has been maintained since October 2002, inflation began to fall to 17 percent in June 2003, and continued to decline to less than 15 percent during July and August 2003.

4. The exchange rate has remained stable for about a year and the spread between the bank and parallel market rates has been kept below 2 percent due mainly to a tight fiscal policy on expenditures, firmer financial policy on bank credit controls and an increase in interest rates. In addition, an improved balance of payment position, evidenced by growth in gross international reserves to \$207 million, or 3.7 months of imports by June 2003 helped stabilize the kip.

5. On the structural front, the reform of state commercial banks (SCBs) has begun. Since the AsDB's approval of the Banking Sector Reform Program Loan (BSRPL) in November 2002, four international banking advisors have been appointed and have commenced their assignment. As a consequence, significant change has been made in the lending behavior of SCBs as reflected by the improvement in loan recoveries and the reduction in credit growth in recent months. As for state-owned enterprise (SOE) reform, technical work on the restructuring strategies and programs has started for five large SOEs, including Electricité du Laos (EDL), the Phoudoi conglomerate, Pharmaceutical Factory No. 3, and Lao Airlines.

6. With regard to Performance under the Program, all but one of the end-September 2002 quantitative performance criteria was observed. The performance criterion for contracting and guaranteeing nonconcessional external public debt was exceeded because of \$50 million loan for Nam Mang 3 hydropower project, which was made concessional in November 2002. Two end-March 2003 performance criteria, net domestic assets of the Bank of Lao PDR (BOL) and net credit to the government were not met by modest margins as budget revenue during the first half of 2002/03 remained weak. In response, a fiscal package was enacted at end-May 2003 to bring the fiscal program back on track. For June 2003 all benchmarks were met, with the exception of the ceiling on net bank credit to government, which was exceeded by a small amount, but is expected to be taken care of by the corrective fiscal measures implemented at end-May 2003.

III. Program for 2003/04

Fiscal policies 2002/03¹:

7. On the fiscal front, the package of revenue and expenditure measures introduced at end May 2003 will continue to be implemented and maintained, to attain the expected 95 percent of the budget in nominal terms, equivalent to 11 ½ percent of GDP. The revenue measures include mainly reapplying the tax rates on petroleum and the excise on petroleum as specified in the Tax Law. The expenditure control measures include the reduction and postponement of the wage increase (KN 30 billion) and reduced allocations for domestically financed capital expenditure by about KN 30 billion.

8. In addition, the problems of overhanging domestic arrears of KN 600 billion, which have weakened the banking system have been addressed. To date, one third of the KN 360 billion old arrears to contractors that have borrowed from the banks has been paid off through the issuance of government bonds. Furthermore, budget arrears from enterprise accounts at Treasury amounting to KN 130 billion have been cleared, through a combination of securities issues and the netting with tax liabilities. New arrears have also been limited through strict expenditure control.

Fiscal policies 2003/04:

9. As regards the fiscal stance in 2003/04, efforts will be made to reverse the sharp slide in the revenue to GDP ratio and to limit bank financing. The 2003/04 budget to be proposed at the end of September includes revenue at KN 2,900 billion (12.2 percent of GDP) excluding capital return. In view of attaining the set revenue target, a range of measures will be implemented. These include maintaining the statutory duty, excise and turnover tax rates on petroleum and the mobile phone excise tax; increasing the excise on luxury goods including alcohol and tobacco; and ensuring that the implementation regulations for Presidential Decree 01 on tax incentives to be issued will adequately safeguard budget revenue.

¹ The fiscal year runs from October through September

10. Capital expenditure will be significantly reduced mainly due to the cuts in new domestically financed expenditure to offset the rise in both domestic and foreign debt service resulting from debt clearance bonds and Russian debt. However, current expenditure will increase by 0.9 percent of GDP, due mainly to the wage increase of 30 percent for civil servants to offset the significant increases in utility prices, tariffs and recent petroleum tax increases, in order to restore the real wage level to that of the mid-1990s. This policy is purely motivated by increasing living costs and will be a one-off adjustment. My authorities do not intend to repeat this policy as they are mindful of the fiscal implications and as it could cause inflationary pressures.

11. My authorities are aware of the staff's concerns on the decree on tax incentives for investment and the revenue losses this could incur, however, they are undertaking these measures to emphasize and promote the private sector. Whilst my authorities realize the need to protect the tax base, they also realize the need to develop the private sector for the long-term growth of the economy, as well as to reduce poverty; incentives are a necessary enticement for private sector development. As highlighted in the staff paper, "the PRSP-based process of the NPEP is building a consensus that, while many obstacles remain, poverty reduction can only be achieved through market-based growth from the private sector". The authorities are fully aware of, and will not allow this new initiative to undermine, the fiscal position, and are willing to work with staff to formulate implementing regulations to safeguard budget revenues, which they are confident can be done together with the Decree, and are even willing to revise the Decree if deemed necessary.

12. With regard to reversal of the turnover tax reduction enacted in 2002/03, as proposed by staff, my authorities are of the view that it would be inappropriate to include such a measure in this budget, as such a quick about-turn, so soon after its implementation, would damage their credibility and only involves a modest direct revenue loss. However my authorities have agreed to review this in the next budget. Also, the introduction of the VAT has been put back to 2006, in order to have sufficient time to be adequately prepared for such a venture.

13. In view of addressing the deficiencies in public expenditure management, the government is implementing the reform plan which focuses on commitment controls, treasury operations, fiscal reporting, budget planning and execution and auditing. The reforms undertaken will both tighten expenditure controls and improve information systems through the development of a national treasury, the rationalization of government bank accounts, and the introduction of a classification of expenditure by administrative unit at the central government level. Efforts will also be intensified to clear budget arrears identified in the recent survey of arrears and the bank restructuring process, through issuing of debt clearance bonds to settle budget obligation to contractors for capital projects with NPLs at the SCBs mainly incurred before 2001.

Monetary and exchange rate policies:

14. In order to reduce inflation, the monetary stance of the BOL will continue to remain firm. With an expected increase in foreign financing, net credit to the government by the BOL is expected to decline slightly. This will allow gross international reserves to further

increase to \$228 million (3.8 months of imports) by September 2004. As a result, the growth in reserve money is expected to be limited to 15 percent in 2003/04.

15. The SCBs credit will continue to be restrained and limited to 16 percent in the year to September 2004, compared with 18 percent growth for total commercial bank credit. The SCBs credit extension will be based on a careful risk assessment under new appraisal procedures, especially for foreign exchange credits. Under this cautious stance, broad money is expected to grow by 19 percent in the year September 2004.

16. To avoid pressure on the exchange rate, BOL will phase the redemption of securities or issue new securities to reduce excess liquidity as warranted. In this connection, the government will continue to maintain a flexible exchange rate regime and keep the spread between the bank and parallel market rates under 2 percent. The implementation regulations for the Foreign Exchange Decree Law are in the drafting process, and are expected to be issued by June 2004.

IV. Key Structural Reforms

Banking sector reform:

17. The government will continue to implement the banking sector reform program supported by the AsDB, the World Bank, the European Union and the IMF. With the four international bank advisors in the field, operational improvements in the SCBs are expected to be realized over the 3-4 year period through monitoring performance targets. As the SCBs strengthen under the reform process, the government will seek a strategic investor for one of the two reformed SCBs by 2005.

18. At the same time, The BOLs supervisory and regulatory role over the banking and financial institutions will be upgraded through the development of on-site inspections and off-site supervision. Existing prudential regulations of BOL need to be strengthened and revised, in particular Regulation 98 pertaining to the reporting and monitoring of open foreign exchange positions of banks. In this connection, the requirement will be made for matured letters of credit to be recorded as credit and provisioned accordingly. In addition, the BOL undertakes to submit the amendments to the Decree Law on Commercial Banks to the Standing Committee of the National Assembly by January 2004. The said amendments will provide for enhanced competition in the banking system by equalizing minimum capital requirements for banks with domestic and foreign shareholders, and allowing foreign bank branches to operate on a nationwide basis.

SOE reform:

19. The process of restructuring the five large SOEs is at the stage of preparing restructuring plans. The government, in collaboration with international experts working under the World Bank's Capacity Building Credit, will review the plans and assist in the development and implementation of enterprise-specific restructuring plans. Furthermore, in view of reaching cost recovery levels set within the time frames under the World Bank's Financial

Management Adjustment Credit (FMAC), the price of key utilities will continue to be adjusted. This includes Lao Airlines, which is expected to be able to cover the costs of its recent three-year lease of an Airbus.

External Debt:

20. The government has recently reached agreement in principle on the external debt to Russia. As a result of rescheduling on the basis of a 70 percent upfront discount, the resulting stock of debt of \$387 million will be paid over 33 years. Specific repayment terms are expected to be agreed upon by the end of this year.

21. The government will refrain from contracting and guaranteeing noncessional public external debt. To avoid future deficiencies, remedial measures have been implemented to strengthen the monitoring and reporting of all public sector external debt. This includes (i) the revision of the Ministry of Finance Instruction 912 to include both external debt contracted by SOEs with government guarantee and external debt without government guarantee; and (ii) the provision of a comprehensive report of all public sector external debt, including on all SOEs external debt.

Other measures:

22. The Round Table Meeting (RTM) on the National Poverty Eradication Program (NPEP) has recently been held in Vientiane. The final NPEP document, which will incorporate comments made during the RTM, is expected to be completed by October 2003, for submission to the Boards of the IMF and the World Bank for consideration and acceptance of NPEP to serve as a basis for the Poverty Reduction Strategy Paper.

23. The Government intends to take part in the IMF's General Data Dissemination System (GDDS). To this end, a GDDS coordinator will soon be nominated and the process of finalizing the metadata will be pursued. In the meantime, the recommendations and action plan prepared by the multi-sector statistics mission are being reviewed and verified.

24. The audit of BOLs 2001 accounts was completed at end-August, on schedule, with the assistance of an international audit firm, and the financial statements were reformulated to be more aligned with international accounting standards and published. The BOL has also agreed to implement all the high priority recommendations of the on-site assessment, particularly to maintain close and interactive cooperation with an international audit firm to help the State Audit Authority (SAA) conduct the audit of the BOLs 2002 accounts at international standard of auditing (ISA). Furthermore, BOL has also agreed that the audit of the 2003 accounts be conducted jointly with an international audit company.

25. The government intends to authorize publication of the Staff Report, EBS/03/127; Progress Report on the NPEP; and the Joint-Staff Assessment of the progress report on the NPEP.

26. As stated in the letter of intent, the government of the LAO PDR believes that policies and measures set forth in the attached Memorandum of Economic and Financial Policies (MEFP) are adequate to achieve the objectives of the reform program supported by the PRGF arrangement, and therefore remains committed to implementing them in order to achieve the set objectives thereof. In conclusion, my authorities reiterate their profound gratitude and appreciation to the Board, Management and staff of the IMF for the continued support granted to the Lao PDR in relation to the country's poverty reduction and growth process.