



The World Bank

31277

# **Lao PDR**

# **Economic Monitor**



The World Bank Vientiane Office

**OCTOBER 2003**

## BACKGROUND

With an estimated per capita income of US\$310 in 2002 (see Table 1), the Lao People's Democratic Republic (Lao PDR) is one of the poorest countries in the world. It is classified by the UN as a Least Developed Country (LDC). Nearly 77 percent of its population live on less than US\$2 a day and 39 percent (in 1997/98) below the national poverty line of \$1.5 a day; its social indicators are among the worst in this region, and close to the average for Sub-Saharan Africa.

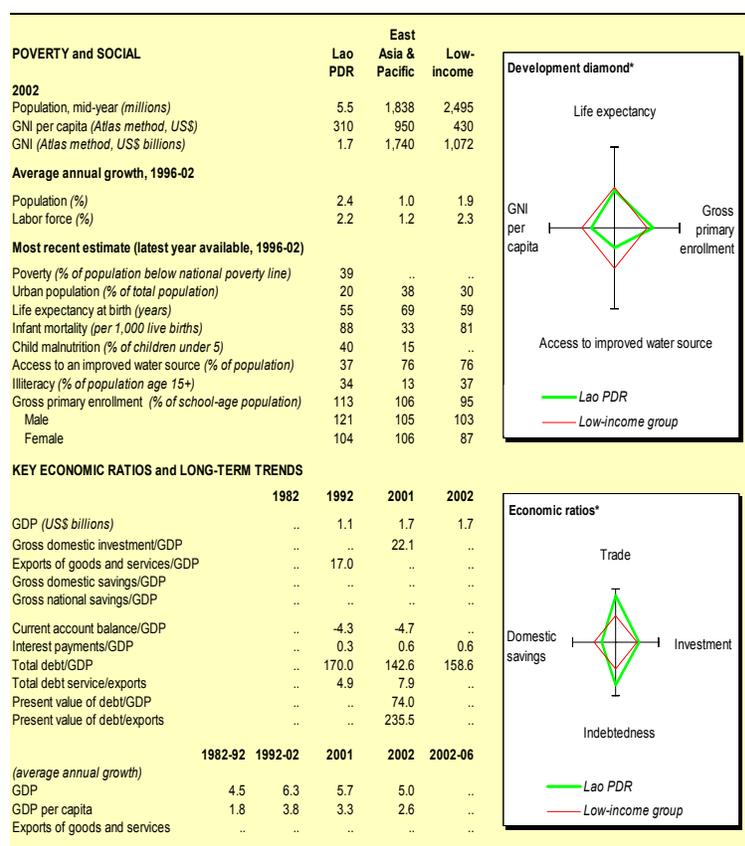
Lao PDR has a population of around 5.5 million and a land area of 236,800 square kilometers. It has significant natural resources like forestry, minerals and hydro-electric power. Agriculture remains the major sector of the economy, contributing around 51 percent of GDP and employing over 80 percent of the labour force; the industrial and service sectors account for the rest (23% of GDP for industry and 26% for services). Though landlocked, Lao PDR is in the center of the Mekong region, bordered by Thailand, Vietnam, Southern China, Cambodia and Myanmar.

In the 1990s, Lao PDR has grown rapidly and reduced poverty significantly. Real GDP grew by 7 percent during 1992-97 period and by 5.8 percent a year during 1999-2003 period, with the intervening years adversely affected by the East Asian crisis. Exports also grew at a rapid rate over this period. Nevertheless, the country is still heavily reliant on external support; in 2002/03, donor funded programs accounted for 7 percent of GDP, 39 percent of total public expenditure, and 61 percent of the capital budget.

**Transition.** The Government, introduced the "New Economic Mechanism" (NEM) in 1986, to begin the transition from a centrally planned to a market-oriented economy. Gradually, price controls were removed, farmers were allowed to work on their plots, the exchange rate system was unified, government's monopoly on trade removed, the number of state-enterprises reduced and private firms, allowed to be formed. Reforms stalled during the regional crisis, as Lao struggled with serious macroeconomic problems. With successful stabilization beginning in 2000, structural reforms picked up momentum in 2001.

**Fighting poverty.** In April, 2002, the Government of the Lao PDR finalized an Interim-Poverty Reduction Strategy Paper (I- PRSP). Using this and the five-year National Socio-economic Development Plan, the Government followed a consultative process to prepare the National Poverty Eradication Program (NPEP). In September 2003, this was presented to the donors' Roundtable Meeting and was much appreciated by the donors. It articulates Lao's development framework for poverty reduction, specifies the targets and goals that the country values and indicates the policies and public expenditure programs that will be needed to achieve those goals.

**Table 1. Lao PDR, EAP and Low-income World: Comparing Development Indicators**



Source: World Bank, Economic Indicators of Development, 2003

**ECONOMIC MONITOR – OCTOBER 2003** – covering 2003. The Lao PDR Economic Monitor (the Monitor) is issued in Lao and in English, twice a year (Spring and Autumn) by the World Bank in Lao PDR. It reports on recent economic performance (Chapter I) and progress on the Government's reform agenda (Chapter II). The Monitor is prepared by Somneuk Davading and Alessandro Magnoli, under the overall supervision of Kazi M. Matin. For inputs and comments, we would like to thank Michael Markels, Renuka Vongviriyatham, Amanda Carlier, and Sethaput Suthiwart-Narueput as well as Mr. Eric Sidgwick (IMF). We are also grateful to Dr. Khamlien Pholsena (CPC), Mr. Sirisamphanh Vorachit (MOC) as well as other Lao officials for sharing their time and their views with the team. Our thanks also go to the staff in Bank's resident mission who provided support to the Monitor.

The World Bank team will appreciate feedback on the structure and content of the Monitor.

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## ACRONYMS AND ABBREVIATIONS

ADB	Asian Development Bank	MOIC	Ministry of Information and Culture
AFTA	ASEAN Free Trade Area	MOFA	Ministry of Foreign Affairs
ASEAN	Association of Southeast Asian Nations	MOJ	Ministry of Justice
APB	Agriculture Promotion Bank	MOH	Ministry of Health
BCEL	Banque Pour Le Commerce Extérieur Lao	MOUR	Memoranda of Understanding
BOL	Bank of Lao PDR	NA	National Assembly
BOP	Balance of Payment	NPL	Non-Performing Loan
BPKP	Bolisat Phattana Khet Phoudoi	NPV	Prime Minister
BPO	Business Promotion Office	PM	Net Present Value
CEFT	Common Effective Preferential Tariff	NSC	National Statistical Center
CIC	Committee for Investment and Cooperation	PEM	Public Expenditure Management
COCI	Committee of Culture and Information	PER	Public Expenditure Review
CPC	Committee for Planning and Cooperation	PIP	Public Investment Plans
DDFI	Department of Domestic and Foreign	PMO	Prime Minister's Office
DOL	Investment Management	PPIAF	Public Private Infrastructure Advisory Facility
DONLUPAD	Department of Land Use Planning and Administration	PRF	Poverty Reduction Fund
CPI	Consumer Price Index	PRGF	Poverty Reduction and Growth Facility
EAP	East Asia & Pacific	RMFC	Rural Micro Finance Committee
ECC	External NPL Collection Committee	SAMD	State Assets Management Department
EDL	Electricité du Lao	SCB	State-owned Commercial Bank
EU	European Union	SIDA	Swedish International Development Association
FDI	Foreign Direct Investment	SOE	State-Owned Enterprise
FINNIDA	Finland International Development Association	STEA	Science, Technology and Environment Agency
FMAC	Financial Management Adjustment Credit	TOR	Terms of Reference
FMCB	Financial Management Capacity Building Credit	UNDP	United Nations Development Programme
FRP	Financial Recovery Plan	WASA	Water and Sanitation Authority
FY	Fiscal Year	WB	World Bank
GDP	Gross Domestic Product	WTO	World Trade Organization
GOL	The Government of Lao PDR		
GTZ	German Agency for Technical Cooperation		
HIPC	Highly Indebted Poor Country		
IMF	International Monetary Fund		
JICA	Japan International Cooperation Agency		
LDB	Lao Development Bank		
LMB	Lao Mai Bank		
LNCCI	Lao National Chamber of Commerce and Industry		
LTA	Lao Tourism Authority		
LTC	Lao Telecom Company		
LXB	Lane Xang Bank		
MAF	Ministry of Agriculture and Forestry		
MCTPC	Ministry of Communication, Transport, Post and Construction		
MDG	Millennium Development Goals		
MIH	Ministry of Industry and Handicraft		
MOAF	Ministry of Agriculture and Forestry		
MOC	Ministry of Commerce		
MOE	Ministry of Education		
MOF	Ministry of Finance		

## INTRODUCTION

In 2002/03 macroeconomic performance has been mixed. Real GDP grew somewhat less rapidly than last year, and is estimated to reach a rate of 5.5 percent. Inflation, after peaking in May 2003, has slowly begun to decline; tighter fiscal control has put inflation on a downward path. The exchange rate has been flexible but relatively stable. Exports are performing robustly and the external current account deficit remains at around 6 percent of GDP.

The government has also been continuing its reform efforts. The National Poverty Eradication Program (NPEP), articulating a medium term program of reforms and public spending program, has been discussed at the National Assembly. Various actions have been taken during 2003 in respect public expenditure management, state-enterprises, banking, natural resource management, trade, and private sector development even if they were taken more gradually than was originally expected.

## PART I – RECENT ECONOMIC DEVELOPMENTS

### The Macroeconomic Situation

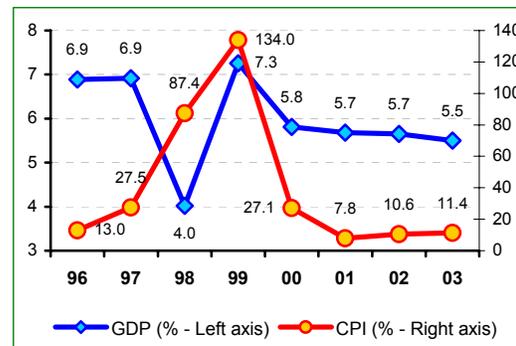
#### BACKGROUND

In the 1990s, Lao PDR grew at an annual average rate of more than 6 percent, and the incidence of poverty fell from 45 percent to 39 percent of the population. The regional crisis years of 1998 and 1999 saw inflation climb to an annual average of 110 percent and growth fall to 4 percent.

The economic situation for Lao PDR has been improving. The adoption of a stabilization program since 2000 and the implementation of a phased program of reforms since 2001 – in public expenditure management, banking, state-enterprises, forestry, trade has contributed to this improvement. During the 2000-02 period, inflation has averaged 15 percent and GDP growth averaged around 5.7 percent annually.

**Growth.** In 2003, real GDP growth slowed moderately. On the one hand, growth has been supported by relatively strong increases in industrial production and agriculture (despite floods) and; on the other, growth was dampened by lower private investment from reduced credit growth and, weakness in tourism (due to the SARS outbreak and regional tensions). In 2004, real GDP is expected to grow more rapidly, because of higher private investment, a modest recovery in tourism and higher exports. Projected stronger growth in Vietnam, Thailand, and the EU - which together account for the majority of Lao exports - would play an important role.

Figure 1. GDP Growth (%) and CPI (%)



Source: Lao authorities and WB staff estimates.

**Agriculture.** In 2003, the agricultural sector is expected to grow at around the same rate as last year. The outlook for the dry season rice crop looks promising, but coffee producers have been hit by bad weather. Exports of agricultural and forest products to neighbours have increased.

**Industry.** The industrial sector will grow fast this year and faster in subsequent years. Commercial interest in gold mining in Lao PDR has surged following the success of the Sepon mine, an Australian-backed project. Energy co-operation with Vietnam has been stepped up with a proposed hydroelectric power station. The future of the Nam Theun II hydroelectric project is clearer with the return of

Electricité de France (EdF), a key developer and sponsor of the project. In 2003, Lao and Thai officials met to settle business disputes involving state and private firms from both countries.

**Services.** The downturn in the tourism industry in the region and the country due to SARS early this year, has lowered growth in the service sector in 2003. It is recovering and is expected to grow faster next year. The Government is hosting the ASEAN Tourism Conference in Vientiane in early 2004 to promote tourism in the country and the region. In addition, the telecom services will continue to grow as telephone penetration rates rise.

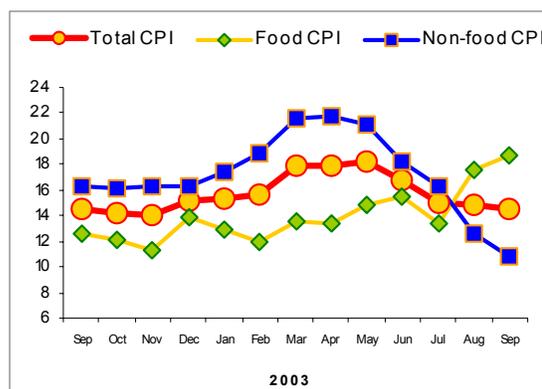
**Inflation.** Average inflation for 2003 is estimated to be around 11 percent, slightly higher than last year. In May 2003, year-on-year inflation had risen to 18 percent, due in part to increased government borrowing to finance a widening budget deficit. In addition, the large nominal exchange rate depreciation (14 percent between May and September 2002) pushed up prices of imported goods. Floods and higher oil prices in early 2003 also raised food prices. While the yearly average inflation in 2002 was 10.6 percent, the average of the first three quarters of 2003 was 16.2 percent.

The decline in inflation since May was driven by falling non-food prices. The CPI component for transport and telecommunications – after peaking at 18 percent in March-May due to higher oil prices – decreased in August to 13 percent. The price of housing also decreased during the rainy season, as did prices of household goods<sup>1</sup>.

**Fiscal Policy.** The widening fiscal deficit -- due to excessive capital spending in later part of 2001/02, and due to declining revenue in the early part of 2002/03-- was mainly responsible for the inflationary pressures in the system. The decline in revenue was due mainly to falling timber royalties by as much as 1 percent of GDP from its peak in 2001/02, as result of stricter enforcement of the log export ban. The halving of the turnover tax rate on domestic products also depressed revenues. The new Presidential Decree on Tax Incentives, intended for promoting private sector, could be costly in terms of lost revenue next year, though the Government plans to prepare implementing regulations in a way that would minimize the revenue loss from this new decree.

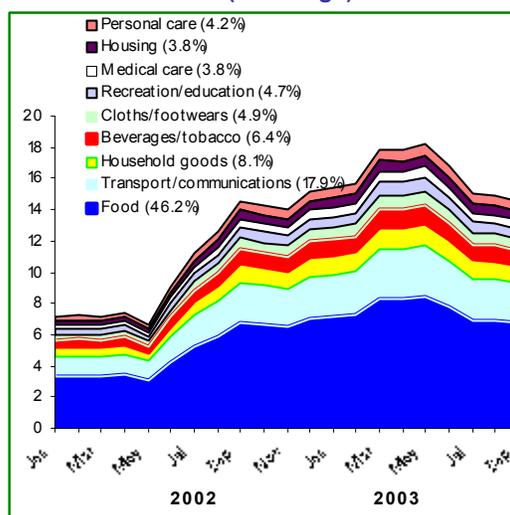
To address the revenue shortfall this year, the authorities decided in May 2003 to double the petroleum tax rate, which is expected to bring in additional revenue of 0.6 percent of GDP annually. This, coupled with stricter expenditure controls, has helped to contain the fiscal deficit.

Figure 2. Food and Non-food CPI (%)



Source: Lao authorities and WB staff estimates.

Figure 3. Decomposition of Non-Food CPI (% change)



Source: Lao authorities and WB staff estimates.

<sup>1</sup> The CPI is composed by the following nine consumer product groups: food (which constitutes the 46.2 percent of CPI); transport and telecommunications (17.9); household goods (8.1); beverages and tobacco (6.4); cloths and footwear (4.9); recreation and education (4.7); medical care (3.8); housing (3.8); and personal care (4.2). Figure 3. Decomposition of Non-Food CPI(% change) Source: Lao authorities and WB staff estimates.

However, significant arrears were accumulated, on top of the stock of arrears that existed before. About two-thirds of these arrears is planned to be cleared by the end of 2003/04, mainly by the issuance of debt clearance bonds. This will also settle Government's obligations to the contractors who in turn had overdue obligations to the SCBs, thereby supporting bank restructuring.

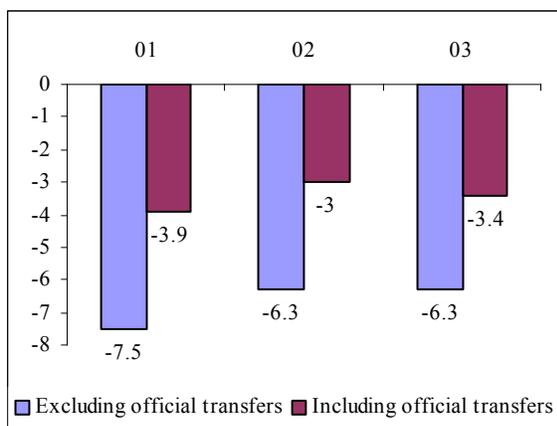
The Government also intends to improve the transfer and accounting of revenues, especially those of the central government, by developing customs and treasury departments into national operations. Also the tax department is expected to be strengthened, and the large taxpayer unit expanded. But, no specific measures have yet been taken towards that end.

Credit policy has been generally restrained for most of the current period, though this follows rapid credit expansion up to the middle of 2002. This has been due largely to cautious bank lending practices that were put into place by BOL in an effort to stem increases in non-performing loans (NPLs). Large credit repayments that were being made by distressed companies also contributed to the low credit growth during 2003. Until the new credit appraisal and risk management processes are established in the state-owned commercial banks (SCBs) credit flows are unlikely to be relaxed. The SCBs also raised short-term kip interest rates by 3 percentage points in November 2002.

### External Sector

The external sector is performing well. Export earnings growth in 2003 is much stronger than last year with exports to ASEAN countries are growing more rapidly. While tourism receipts remain depressed, the services sector continues to be robust. Imports have been growing faster than last year, but at a lower rate than export earnings. Thus the trade and current account deficits are expected to be similar to last year.

Figure 4. Current account balance (% of GDP)



Source: IMF. Estimate for 2002 and projection for 2003.

**External Debt.** Total debt service will rise by more than a fifth in 2003 relative to last year, and is estimated to be around 18 percent of exports of goods and services. It is expected to remain at around that level in the next year or two.

Recently Lao PDR and Russia made significant progress in resolving their outstanding debt issue. Consistent with the terms of the Paris Club, Russia has agreed to a 70 percent upfront discount resulting in a face value of debt of \$387 million. A specific agreement on the terms of repayment, including interest, grace period and payment modalities is expected by the end of this year.

<sup>3</sup> A careful phasing is needed to ensure that lower levels of government have the appropriate implementation capacity.

<sup>4</sup> Data for 2000/01-2001/02 fiscal years were published in April 2002.

## PART II – STRUCTURAL REFORMS

The Government of Lao PDR initiated a program of reforms in late 2001 to improve the management of public expenditures, state-enterprises (SOEs), state-owned banks (SCBs) and natural resources, in order to reduce waste and enhance efficiency, as well as increase the transparency and accountability of public resource use. If future increases in revenue from mining and hydro-power are to be used for improving social outcomes instead of financing losses of SCBs and SOEs, such improvements in use of public resources will be critical. In addition, the Government is also continuing its reforms in the areas of trade and in private sector development aimed at completing the transition to a market-economy, that Lao PDR initiated more than a decade ago. This section records the actions taken in these areas during 2003 (see the Boxes in the Annex for the actions that were taken in 2001 and 2002).

### Public Expenditure Policy and Management

Since 2001, the government of Lao PDR revived its public expenditure reform, in respect of both expenditure policies and allocations, as well as in respect of public expenditure management processes. With the share of revenues in GDP stagnating, and arrears accumulating, the spending choices are becoming more difficult and more critical, given the country's poverty reduction objectives are met. Phased payment of arrears is needed, as is a better balance between recurrent and capital expenditure. Social spending needs to be made more efficient and certainly protected. More effective public expenditure management processes will be useful to ensure that the decisions are taken through accountable and transparent processes, and the allocations reach their destinations.

**Public expenditure policy.** According to the recent Government's budget implementation report, capital expenditures - have increased, as share of the total spending in 2002/03. Correspondingly, current expenditures have decreased. This is planned to be reversed in the 2003/04 budget, which is a step in the right direction.

*Falling revenue is reducing current spending.* The share of revenue in GDP has fallen this year largely because of lower tax and non-tax revenue, the latter due to lower royalties from logging. Historically, the imbalance of recurrent spending relative to capital spending has led to irregular wage payments, especially in the provinces and general under-utilization of capacity. Also, restraint in domestically-financed capital spending is needed especially, if such increases in capacity cannot be supported with additional recurrent spending. Within recurrent spending, wages and salaries remain under pressure. Since a large share of the wage bill is accounted for by health and education workers, this also affects social sector service delivery. Thus more effective revenue mobilization measures will remain key in the medium-term, if the objectives of the National Poverty Eradication Program (NPEP) of Lao PDR are to be met.

**Table 2. Fiscal Operation (% of GDP)**

	2001/02	2002/03 est.
<b>Revenue &amp; Grants</b>	<b>14.5</b>	<b>13.5</b>
Revenue	13.1	11.5
Tax Revenue	10.6	9.6
Non-Tax Revenue	2.5	2
<b>Total Expenditures*</b>	<b>18.6</b>	<b>19.3</b>
Current Expenditures	7.8	7.4
O.W. Wages & Salaries	3.1	2.9
Capital Expenditures	10.8	11.9
O.W. Domestically-Financed	6.3	4.9
<b>Deficit (including grants)</b>	<b>5.4</b>	<b>4.2</b>

Source: IMF estimates

Note: \*Excluding SCB recapitalization costs

**Progress made by GOL.** For the second consecutive year – after a silence of more than five years – the Budget Department of the MOF prepared a breakout of spending by sector, economic and administrative classifications at both the central and provincial levels. Data are available for the 2001/02 outcome and the 2002/03 budget; a summary is presented in Table 3 below. These figures were published in the Official Gazette in April 2003.<sup>5</sup>

**Social spending.** The 2001/02 data in table 3 show a commendable increase in actual spending shares for health and education: indeed, health expenditure rose from 3.7 percent of total spending in 2000/01, to 5.0 in 2002/03; education went from 7.4 percent to 10.7 percent. About the 2002/03 plan, while the budget allocation for health has further increased to 5.9 percent, the education share weakens to 10.0 percent of total spending. The budget allocated for the Ministry of Communication, Transport, Post and Construction (MCTPC) has returned to about the 2000/02 level (21.1 percent in 2002/03) after it was cut to 16.0 percent in 2001/02. Allocations to agriculture continued to marginally decline from 16.6 in 2000/02 to 11.4 in 2001/02, down to the 2002/03 plan of 10.3 percent. As always, the challenge lays in ensuring that the budget targets are fulfilled, as actual spending and budget outcomes remain to be seen.

**Table 3. Lao PDR: National Budget Expenditure by Sector/Ministry**

(2001/02-2002/03)

Sectors/Ministries	2001/02 (actual)		2002/03 (est.)	
	(percent)	(% of GDP)	(percent)	(% of GDP)
Agriculture	11.4	2.2	10.3	2.5
Commerce	0.3	0.1	0.3	0.1
CPC	0.5	0.1	0.4	0.1
Defense	9.0	1.8	10.1	2.5
Education	10.7	2.1	10.0	2.4
Finance	19.5	3.8	16.6	4.0
Foreign Affairs	2.0	0.4	1.6	0.4
Health	5.0	1.0	5.9	1.4
Industry and Handicraft	1.9	0.4	2.1	0.5
Information and Culture	2.5	0.5	1.8	0.4
Interior	3.6	0.7	2.9	0.7
Justice	0.3	0.1	0.2	0.1
Labor and Social Welfare	3.3	0.7	3.8	0.9
MCTPC	16.0	3.1	21.1	5.2
PMO	2.9	0.6	2.5	0.6
Provincial Offices in Vientiane	5.5	1.1	4.2	1.0
Other	5.7	1.1	6.2	1.5
<b>Total Expenditure</b>	<b>100.0</b>	<b>19.7</b>	<b>100.0</b>	<b>24.4</b>

Source: Lao PDR Official Gazette April 2003 and research team's estimates  
Projected GDP growth for 2002/03 is 5.5 percent.

There has also been progress in completing a census of budget arrears as of the end of September 2003, identifying type, level of government, creditor and age of the arrear. A plan to avoid arrears and to most of the stock quickly is being developed; this will help to ease the squeeze on current spending as well.

### **Public Expenditure Management**

Reforms in public expenditure management processes were revived in 2001, but more several actions were taken for improving transparency, improving procurement and in working towards a better balance between recurrent and capital spending. The following actions were taken in 2003:

- Increases in transparency was maintained for the second year by the publication of the FY 2001/02 budget outturn and FY 2002/03 budget-plan in April 2003 in the Official Gazette, with classification by ministry, province, and sectors, a summary of which is provided in Table 3.
- The Procurement Monitoring Office (PrMO) was established within the Ministry of Finance, to oversee the implementation of better procurement processes and to assist in related capacity building activities. The office is operational in its new premises. In addition, the office is revising the implementing regulations, which is expected to be completed by the end of the year.
- A methodology for estimating the recurrent costs has been developed for core construction projects in the PIP and was applied to actual PIP projects in the training of staff from CPC and MOF around middle of 2003. Of the 149 new construction-related projects in excess of 1 billion kip, (90 percent of new projects are construction-related), recurrent costs were estimated for 96 of them.

For measures taken in previous years please refer to the Annex – Box 1.

<sup>5</sup> Data for 2000/01-2001/02 fiscal years were published in April 2002.

## Reform of State-Owned Enterprises

### BACKGROUND

**Recent Trends.** The objective of the government's SOE reforms is to enhance transparency, reduce waste and increase efficiency in order to promote their commercial viability. Reforms implemented in the early 1990s reduced the SOE sector by closing down, leasing, merging and selling a large number of SOEs. The number of SOEs today are fewer and they play a very small role in the economy in terms of its share in GDP and in total employment. Nevertheless, several large SOEs are generating a large share of the non-performing loans (NPLs) in the state-owned banking system which ultimately has to be funded by the taxpayers.

The Government's recent SOE reform program initiated in 2001 has three thrusts: (a) improving transparency and governance of state enterprises, (b) restructuring those enterprises which have caused losses to the state, and (c) rationalizing the regulatory and pricing environment for infrastructure SOEs, through tariff reform. Progress to-date has been relatively slow, but momentum has picked up in the last three months.

### **Actions Taken for SOE Reform in 2003**

**Monitoring performance of SOEs.** A system for collecting data and maintaining the data-base for annual monitoring of SOE performance is being established. A full list of 158 SOEs has been developed, but detailed information on them is still being collected for initial classification of SOEs on the basis of their performance. Detailed information has already been collected for the 50 central SOEs and they have been classified on the basis of their performance, using the selected classification criteria. The classification process is underway for the 22 Vientiane Municipality SOEs, having collected the data on them. However, information on the rest of the small provincial SOEs remains to be collected.

**Enterprise-Specific Restructuring.** The Business Promotion Office (BPO) in the Prime Minister's office is developing detailed time-bound restructuring plans for 4 large SOEs: Nam Papa Lao, BPKP, Pharmaceutical Factory No. 3, and Lao Airlines. They have contracted external consultants with the necessary expertise to help them with developing those multi-year plans, and the measures that they need to take to bring them to sustained commercial viability. Draft restructuring plans for all four SOEs have been completed and BPO is organizing workshop in early December 2003, of all stakeholders (BPO, MOF, management of SOEs, and relevant sector ministries responsible for the SOE-sectors) on these restructuring plans to discuss the proposed options for repaying their debts and bringing them to commercial viability. Once these multi-year plans are adopted formally by the Government, these enterprises will then be taking actions each year to repay and restructure debt, and move towards commercial viability and profitability, in line with the strategy proposed in NPEP on SOE reform.

Draft Memorandum of Understanding for Restructuring (MOUR) for Lao State Fuel Enterprise, Lao Export-Import Trading Company, Southern Bridge-Road Construction Company No. 13 and Agro-industrial Development Company are at advanced stages of preparation. But there has been very little progress in developing a MOU for restructuring DAFI, which is essential to ensure that it does not lose money and require tax payers to support it. Once these MOURs are completed, these enterprises will be developing detailed multi-year restructuring plans as well.

**Infrastructure Tariff Policies.** The absence of an explicit policy on the setting of tariffs and the principles guiding changes in those tariffs, has led to inappropriate pricing of water, electricity, telecommunications and aviation, and often to inadequate cost recovery for the SOEs supplying these services. This has led not only to a fiscal burden on the taxpayers but also a deterioration in those services for Lao people. The Government has been addressing this issue by revising tariffs upward, but plans to prepare and adopt explicit tariff policy that would guide these SOEs over the medium-term, in future setting and changing tariffs appropriately. Electricity tariffs have already been raised every month as a result of decision taken sometime ago. Water tariffs have been raised too, but not adequately, and only after a significant lag. The development of explicit tariff policy in each of these sectors is underway.

- *Water.* In March 2001, GOL approved the last increase in water tariffs, with an implementation timeframe spanning from November 2001 to June 2002. In June 2002, Nam Papa Na Khone Luang, the Lao Water Supply Company (LWSC) submitted a plan proposing new water tariffs for July-December 2002 but the plan was not approved by GOL. LWSC has prepared a new proposal for a water tariff reform up to 2005, which was submitted to GOL in early 2003, approved by the authority of Vientiane Municipality in the summer, and now is being reviewed by PMO for final approval. Therefore, water tariffs have not changed since July 2002.

**Table 4. Water tariff in Vientiane during 2001-03**

Water users	Vientiane capital city	
	(m <sup>3</sup> /mth)	(Kip/m <sup>3</sup> )
1. Households, government offices	1-5	219
	6-20	263
	21-50	329
	>50	383
2. Commercial (use for general purposes)	1-5	549
	6-20	602
	21-50	636
	>50	670
3. Industrial (use as raw materials)	5 - 50	855
	51-100	1,216
	>100	1,360
4. Embassies, foreign residential	1-10	6,184
	>10	7,668

Source: Lao authority (WASA, Nam Pa Pa Vientiane)

- A draft water tariff policy, indicating the mechanisms and principles for tariffs changes, has been prepared and the Minister MCTPC is reviewing the draft. Once the minister clears the draft, it will be sent to the cabinet for discussion and final approval of the Prime Minister.

- *Electricity.* Since May 2002, the GOL has been implementing a new policy on electricity tariffs. The policy aims at improving cost recovery of the service providers (EDL) and shall be completed by April 2005. At present, the electricity tariff is increasing by 2.3% per month for all categories of users except embassies and international organizations whose tariff is fixed in USD (see Table below).

**Table 5. Electricity tariff changes, 2002-03**

User categories	Minimum charge	Monthly increase	Electricity tariff (Kip per kwh)			
			May-02	Dec-02	May-03	Sep-03
	(Kip/month)		(actual)	(actual)	(actual)	(actual)
1. Residential	650					
1-50 kw/month	-	2.3%	64	75	84	92
51-150 kw/month	-	2.3%	150	176	197	216
>150 kw/month	-	2.3%	433	508	569	623
2. Embassies, intern. organizations	4,500	Fixed	9.9 cent	9.9 cent	9.9 cent	9.9 cent
3. Commercial and services	4,500	2.3%	468	549	615	673
4. Entertainment	4,500	2.3%	620	727	815	892
5. Government offices	4,500	2.3%	400	469	525	576
6. Irrigation	4,500	2.3%	167	196	219	240
7. Industrial, handicrafts, agriculture	4,500	2.3%	360	422	473	518

Source: Electricité du Lao (EDL)

- *Telecommunications.* Since April 1, 2002 the national telephone tariff has been increasing monthly by 5 Kips per minute for a year. The tariff for local calls has doubled while long distance has risen by 30 percent. Still, the ongoing tariff rate is below the cost recovery level. Telephone service providers (LTC, ETL) have submitted to the government a new joint proposal for tariff change, but there has been no change since April 2003.

**Table 6. Telephone tariff changes, 2002-03**

No.	Type of calls	Tariff increases (by 5 Kip per minute)							
		Apr-02	Jun-02	Aug-02	Oct-02	Dec-02	Jan-03	Feb-03	Mar-03
I.	<b>From fixed phone to fixed phone &amp; mobile</b>	( Kip per minute )							
	Local calls		60	70	80	90	95	100	105
	Long-distance calls								
	From fixed phone to fixed phone								
	<i>Between neighbour provinces</i>	205	215	225	235	245	250	255	260
	<i>Between non-neighbour provinces</i>	255	265	275	285	295	300	305	310
	From fixed phone to mobile phone								
	<i>Between neighbour provinces</i>	305	315	325	335	345	350	355	360
	<i>Between non-neighbour provinces</i>	355	365	375	385	395	400	405	410
II.	<b>From mobile to mobile &amp; fixed Phone</b>								
	Local call	155	165	175	185	195	200	205	210
	Between neighbour provinces	255	265	275	285	295	300	305	310
	Between non-neighbour provinces	355	365	375	385	395	400	405	410

Source: Lao Telecom Company (LTC) and MCTPC

- The Government has recently approved tariff revisions to take effect from November 1, 2003. These double tariffs for local calls, reduces charges for international calls by 30 percent and increases monthly line rental for households and firms by 50 percent, and equalizes the rental for Government, households and private firms. This is a very timely measure to bring tariffs more in line with costs.
- A draft tariff policy for telecommunication, providing the principles and mechanisms to be used for setting and adjusting telecom tariffs, is still under preparation. External consultants have been contracted to help with analysing the existing tariffs and the extent of implicit subsidy they imply, and developing the principles and mechanisms to be used for setting and adjusting telecom tariffs and working out the tariff rates resulting from those principles.
- *Aviation.* With regard to airfare, since 2002 Lao Airlines has been adjusting its air tariffs on a quarterly basis to cope with seasonal patterns of the tourist markets in the country and in the region. Air fares were raised first in June 2002, and then by more than 50% in September 2002. The tariffs for most routes remained unchanged in 2003, due to a sharp decline in overall sales (given the large shift from air travel to road transport services, which became significantly cheaper). The air tariff for international flights has not changed recently because it is fixed in USD and it is seen to be already high. However, more recently, partly due to the impact of SARS, the company has reduced air tariffs within the country, on average by 20 percent, since May 15, 2003. A draft tariff policy is being prepared as part of the restructuring plan that is being prepared for Lao Airlines.

For background on measures taken in previous years please refer to the Annex – Box 5.

## Financial Sector Reform

### BACKGROUND

The Lao banking system is small in absolute terms, with total system assets of approximately US\$400 million. It is also small in relative terms with total banking system assets less than 25% of Gross Domestic Product (GDP). In the first phase of reforms in the late 1990s, Lao moved away from a mono-bank system, separating central banking from commercial banking and permitting joint-venture and foreign banks into the country. In the mid-1990s, state-owned commercial banks (SCBs) had to be restructured and rehabilitated

However, the SCBs accumulated significant non-performing loans again. Thus restructuring those banks, improving regulation and supervision, and opening up the banking system were made key pieces of the current round of banking reforms initiated in 2001. The challenge is to get SCBs to run on more commercial principles, improving its lending decisions and its risk management. Two SCBs were merged into a new one, called Lao Development Bank (LDB) and various changes in regulations were issued in 2001 and 2002 (see Box in the Annex). Today, the banking system comprises of three state-owned banks. Including the Agriculture Promotion Bank (APB), three joint-venture banks, six branches of foreign banks, and one

representative office.

Beyond the priorities of stopping loss making activity, resolving NPLs and restructuring the operations of the SCBs, key next steps include setting a medium term strategy for the financial sector as a whole, including the role of the private sector. Strengthening the legal framework and judicial capacity to enforce contracts on a fair and timely basis through a specialized commercial court is being discussed as are improved accounting standards and practices

### **Actions taken for Financial Sector Reform in 2003.**

The Government of Lao PDR has taken the following actions in various related areas of recently:

#### **SCB Restructuring & Improvement.**

--The Bank of the Lao PDR (BOL) hired four international bank advisors (two each for BCEL and LDB) to assist with the development and implementation of better credit policies/procedures, new organizational and committee structures and operating guidelines. While interim credit policies are in place, both BCEL and LDB, with flow (post 2000) NPLs above 15%, have to operate under a restricted banking regime. This restriction doesn't permit an increase in their credit outstanding but SCBs can extend new credits to the extent that they collect on existing loans. The restricted regime will be lifted once permanent credit policies and procedures have been enacted and implemented by the banks, which is anticipated early next year.

-SCBs will be monitored and benchmarked against performance indicators. GOL will recapitalize SCBs which meet the performance indicators.

-An international audit firm was contracted to audit the 2001 and 2002 accounts of SCBs, based on international accounting standards. The audit includes diagnostic reviews of SCBs' statutory compliance, risk management, and internal control. These audits will serve as a reference for the ongoing reform program, going forward.

**Supervisory Capacity.** The Financial and Banking Supervision Department (BFSD) has improved its capacity to enforce proper loan classification and accounting of the off-balance sheet items by SCBs.

--BFSD issued a series of instructions to limit the net new lending by both BCEL and LDB, given that their flow NPLs have been greater than 15%, and this has actually happened. BOL has taken steps to strengthen its on-site supervision, and recently issued two new regulations on loan classification requirements and foreign currency exposure. These new regulations are to be effective next year.

--The BOL is also strengthening its supervisory capacity by training staff, though given the existing limitations, this will obviously be a gradual process.

**NPL resolution.** BCEL and LDB have identified the NPL resolution strategy (stock and flow) as well as action plans to address their largest flow NPL-accounts, which if successfully resolved, will reduce their NPLs substantially and signal the importance of debtors repaying their loans or undertaking the restructuring that is necessary for them to reschedule debt and repay loans. The twenty largest NPL accounts comprise about 90% of BCEL's flow NPLs and the top thirty seven NPL accounts comprise a significant portion of LDB's flow NPLs.

--BCEL took the positive step of requesting that the Mekong Project Development Facility (MPDF), a multi-donor facility that deals with small enterprises, to assist firms referred by the SCBs, with the restructuring of their operations and of their debts.

--The Ministry of Finance (MOF) is also trying to reduce Government's arrears to local contractors for Government projects, which in turn were unable to repay loans to SCBs, resulting in NPLs. In 2003, the MOF issued two lots of Government bonds of 120 billion kip each directly to SCBs to clear these domestic arrears. The first lot of 120 billion kip was issued in July 2003 with one-year tenure and 11% semi-annual coupon. The second lot of 120 billion kip was issued in September 2003 with two-year term and 11% semi-annual coupon. The third lot is expected to be issued by the end of 2003 with 3 year term but coupon. The government has committed to issuing an additional 120 kip in bonds to SCBs which reach their performance milestones.

-- Law on Commercial Banks. The draft amendment of the Decree Law on Commercial Banks is being prepared for submission to NA by January 2004. The proposed amendment aims at: (1)

providing equal treatment of all banks under the law (all banks can be distinguished as “domestic” or “foreign” only, and face a similar legal regime and capital requirements), (2) improving corporate governance for both state and private banks by strengthening internal and external audits and administrative boards, (3) incorporating good banking decisions (to test and enhance decision making capability of owners and managers and strengthen on and off site supervision), (4) confirming GOL commitments with regard to SCB autonomy in decision making, interest rate setting and lending based on commercial principles.

**Rural and Micro-finance.** The final version of the policy statement and action plan on rural and micro finance was endorsed by the Governor of BOL after a long process of consultation in the provinces, including a major workshop of the provincial Deputy Governors. This policy statement and action plan was submitted to the Prime Minister’s Office (PMO) in July and the PMO has circulated the policy document to each Cabinet member for comments. Some of the comments have been provided and final approval of the Prime Minister is anticipated by the end of November. In the meantime, the Rural and Micro Finance Committee (RMFC) has formulated a strategy and detailed plans to implement the strategy to promote and support the development of micro-finance. Regulations on the micro-finance industry are also being drafted, and consultations are underway with various stakeholders.

For background on measures taken in previous years please refer to the Annex – Box 6.

## Natural Resources Management

### BACKGROUND

Lao PDR is endowed with valuable, productive and ecologically unique forests, which cover nearly half the country’s area. These play a central role in supporting both rural livelihoods and the national economy. Rural people, who comprise 85 percent of the population of Laos, are highly dependent on forests, especially as sources of food, raw materials, revenue and traditional medicines. Villagers may obtain half of their income and also half of their dietary protein from forest products and it is often the poorest that depend most heavily on forest resources in times of scarcity. Forests also contribute some 7-10 percent of Lao GDP and 15-20 percent of non-agricultural GDP. They supply around one fourth of total export earnings and although current royalty collection rates are low, forest royalties in the mid-nineties made up nearly 20 percent of GOL revenues.

**Rising issues.** Of a total land area of almost 23 million hectares, potentially productive forests now cover some 10 million hectares, or slightly more than 40 percent of the national area. This represents an alarming decline from an estimated 70 percent in 1940, to 64 percent in the mid-sixties and 47 percent in 1989. The trend runs contrary to the Government’s target of achieving 70 percent forest cover by 2020. Along with falling forest cover, Lao PDR is also confronted by forest degradation and the adverse social, economic, and environmental impacts with which it is associated. The effects are especially severe for the poorest segments of the Lao population, particularly women and ethnic groups, whose livelihoods are often closely tied to the health of surrounding forests. Forest degradation, which encompasses decreases in stocking densities, changes in species composition and size structure, and reductions in wildlife and plant populations, is in many areas as important as actual deforestation.

**Recent Steps and Achievements** Following the ‘Principles for Village Participation and Other Key Principles in Sustainable Participatory Management of Production Forests’ and PM Decree 59 on Sustainable Management of Production Forest (on May 22, 2002), the Government is now preparing ministerial implementing regulations for this Decree.

For background on measures taken in previous years please refer to the Annex – Box 2.

## Trade Reform

### BACKGROUND

**Trade policy** Lao PDR has been integrating gradually into the world economy since 1989. The reform processes accelerated after Lao PDR accession to the ASEAN and the joining of AFTA in July 1997. The highest current import tariff rate is 40 percent (compared to about 150 percent in 1995) and for most product groups is below 20 percent. The current tariff schedule has six tariff-rates: 5, 10, 15, 20, 30 and 40 percent, with un-weighted average tariff of 10 percent. Quantitative import restrictions remain. The country started to implement the AFTA Common Effective Preferential Tariff (CEPT) scheme in January 1998 and will complete the liberalization schedule by 2008: reducing its tariff on imports from ASEAN countries to 0-20 percent by 2005 and 0-5 percent by 2008. The Government has recently introduced one-stop services at customs border check-points to reduce bureaucratic procedures and provide better export and import services. Lao PDR has recently applied for the WTO accession and been working on the preparatory stage.

The Government of Lao PDR has continued its gradual process of integrating with the world economy and the region. It has also been taking actions to familiarize Lao citizens and business community with the reality of such integration. During 2003, a number of trade fairs were organised in the country by the Government aimed at promoting local products with participation from neighbouring countries, such as China, Malaysia, Thailand and Vietnam. At least a dozen seminars on ASEAN and AFTA were organised with two of them in Vientiane and Savanaket targeting local business communities on implementation of the CEPT scheme in 2005 and in 2008.

Recent actions relating to liberalization of import trade and to encourage both exports and imports have been taken as follows:

### GOL actions towards trade promotion, 2003

- Coverage of import and export restrictions are significant<sup>6</sup>, but registered importers interviewed say that they are able to import as much as they want. Only in the case of cement and steel rods for construction, import controls appear to be binding. Notice 204 specifies that a license from the Minister of Commerce/provincial offices of MOC is needed to import the following: Petrol and gas; Cars and parts for assembling vehicles of any type other than tractors; Cement; Steel; Jewellery; any of 17 foodstuffs that include all meats, eggs and poultry, animal feeds, sugar, canned foods, food colouring or seasoning, soft and alcoholic drinks (including beer) and animal medicines; seeds; Videos, movies, gambling machines, satellite TV receivers and telecommunications equipment; Sporting guns.
- Of the 1291 items on Lao's Temporary Exclusion List (TEL) under AFTA, 436 items were transferred to IL in January 2003, thereby putting 71 percent of all items and 45 percent of all dutiable imports by value in the IL<sup>8</sup>.
- On September 18, 2003 the Lao and US governments signed the first US-Lao Bilateral Trade Agreement (BTA) in Vientiane, which will go into effect after the US Congress enacts legislation authorising normal trade relations (NTR) between the two countries.
- PM Decision No.14/PM of February 28, 2003 allows the establishment of duty-free warehouses in Vientiane (near the friendship bridge) and Savannakhet (at Seno special economic zone) to facilitate the import processes.

<sup>6</sup> Each year through Notices to implement the general Decree No.205 of the Prime Minister issued on 11 October 2001 on this issue. Notice 203 of February 2003 defines the lists of prohibited imports and exports and these appear to be relatively uncontroversial bans related to public safety and morals plus those related to logging & raw timber exports.

<sup>7</sup> Licensing of vehicles is now used only mainly as a registration device as importers can import as many as they want

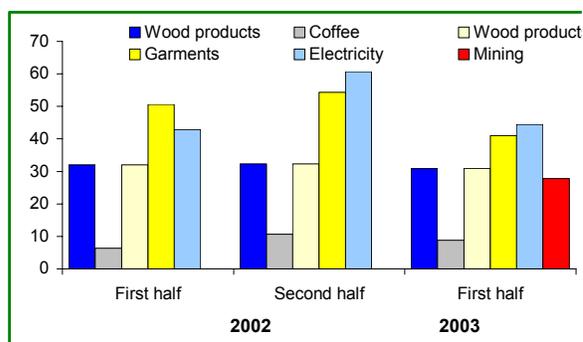
<sup>8</sup> Under AFTA, Lao PDR is committed to move all the items from its Temporary Exclusion List (TEL) to the Inclusion list (IL) by the beginning of 2005 and to reduce the CEPT rates on all IL items to between zero and 5 percent by the beginning of 2008.

- Supplementary Guiding Order No.530 of May 10, 2003, on business registration, has established sunset provision of *two days* for registration of local businesses in *trade* sector at one of the following three levels: central (MOC), provincial and district. However, the application must include: (1) an application form, (2) personal biography, (3) a statement of criminal records No.3, a copy of ID card and three pieces of 3x4 photo, (4) financial statement, (5) charter-by-law approved by trade agency (for entity as company only). Thus the application requirements remain quite time-consuming in terms of other formalities.
- Annex to the Supplementary Guiding Order No.530 (May 10, 2003) on business registration No. 538/MOC dated May 13, 2003 provides a division of business registration approval between different levels of government agencies: (1) MOC registers foreign companies (with registered capital from and over 200 thousands US\$), enterprises dealing with imports of vehicles and fuel and exports of wood and wood products, state enterprises and joint ventures established at central level; (2) provincial trade authorities provide registration to foreign investors (with registered capital below 200 thousands US\$), enterprises in agricultural, industrial and services sectors, trading firms, state enterprises and joint ventures established by local governments; (3) district offices can register and manage retail stores, shops, small super markets and other small services.
- Decree No. 125/PM of July 24, 2003 on organisation and operations of Lao National Chamber of Commerce and Industry (LNCCI) (replacing the decree No.175/PM of 20 August 1998 on areas of responsibilities of LNCCI) redefines the role, functional responsibilities, organisational structure and financial matters of LNCCI. LNCCI is an independent organisation that represents the business communities and acts as a bridge linking between the public and private sectors and brings together continuing dialogues between the government agencies and business communities. On behalf of its members, LNCCI negotiates with GOL and foreign partners on trade, industrial and services issues and establishes its representative offices abroad. It issues the certificate of origin to exporters and approves the establishment of business groups in the country. Being financially independent, LNCCI gets supports from its members (member fees), its own services (issuance of certificate, training and advisory services, trade exhibitions, etc.), the government as well as from individuals and local and international organisations.

## Developments in respect of trade

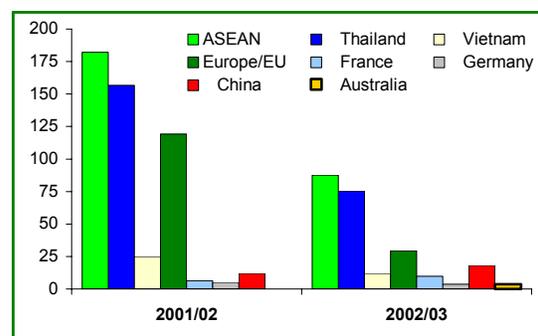
**Composition of exports.** Lao exports are highly concentrated in few product categories. In 2002, garments were 33.6 percent of the total, electricity 33.3 percent, wood and wood products 20.6 percent, and coffee 5.5 percent. These product groups accounted for more than 90 percent of total exports. However, from 2003 onwards mining products (gold and copper) will become one of the key exports and will drive future export growth. In the first half of 2003, as compared with the same period of 2002, Lao exports of coffee increased by 37.5 percent, forestry products by 51 percent, and electricity by 3.5 percent. Conversely, garments dropped by 19 percent and wood products by 3.4 percent. Exports of gold for the first half of 2003 were about US\$28m (see figure 5).

Figure 5. Exports of Major Commodities (US\$ m)



Source: The Lao authorities and WB staff estimates

Figure 6. Exports according to Country/Region of destination (US\$ m, FY)



Source: The Lao authorities and WB staff estimates

## Box 1: Discrepancies in Export Data

There are large discrepancies among the estimates of exports provided by different agencies in Lao PDR. These discrepancies were documented and analysed by Brenning et al. (2002). The new data obtained from the MOC around early 2003, show even greater discrepancies; according to this new data, exports *grew* at 6.8 percent per year between 1996 and 2000, whereas, according to BOL data reported by Brenning et al, exports *fell* over this period at an annual rate of 5.6 percent. Since the period 1996–2000 covers the Asian crisis, the BOL estimates seem more plausible than the new MOC estimates, but even if attention is restricted to the estimates taken from Brenning, the range of estimated export growth rates for the period 1996–2000 is over 7 percentage points: from –5.6 percent per year (Bank of Lao) to 1.5 percent per year from an international source (i.e. UNCOMTRADE) using data reported by Lao’s partner countries.

These discrepancies are the result of differences in coverage and of errors in measurement. Possible sources of measurement error include the failure of customs officials at border check points to record trade flows correctly, the failure of MOC officials to record licensing data correctly, the non-use of import licenses and computational errors in processing raw data. Brenning (pp.2–5) summarizes the differences in coverage, which include differences in treatment of re-exports, transit trade, informal border trade (estimates of smuggling) and exports of electricity, which are excluded from the UNCOMTRADE data. The UNCOMTRADE data on Lao exports is the sum of imports from Lao PDR reported by all partner countries (with one important exception for Lao i.e. Vietnam) and is available with a two-year lag i.e. data is available for 2001. But UNCOMTRADE data comprise of c.i.f. value of imports from Lao whereas domestic Lao sources report exports on f.o.b. basis. Within Lao, the Customs Department value trade at administratively set check-prices, whereas MOC and BOL value trade at transaction prices; MOC data is based on license applications but the Customs data is derived from the customs declarations. The most recent year for which the IMF’s International Financial Statistics (IFS) provides data on exports of goods is 1999, as does the World Bank’s World Tables.

To obtain the most updated export statistics on Lao PDR, it is therefore necessary to go to different government agencies and request officials to download their series, the exact definitions and coverage used in each case being generally uncertain, which is clearly a less than satisfactory state of affairs. It would be more useful if each agency issued publicly available data on a quarterly basis in a format (coverage and measurement methods) that normally remained unchanged from quarter to quarter, and certainly across several years. If a new method of measurement or changes in coverage was implemented, methods for comparing one with the other would be provided. The exact definitions of the variables released by each agency each quarter could then be clarified and discrepancies between the estimates of each agency could be understood and analyzed in a more systematic way than is currently possible.

The annual estimates of exports that were used to obtain growth rates in Table 7, were obtained by combining World Bank World Tables data for years up to and including 1998, with data from the Lao monetary authorities for years after that, and we hope that they are probably at least as good as any of the other data that exists. It has the advantage of covering the whole period after the introduction of the ‘New Economic Mechanism’ in 1986 and right up to 2002.<sup>10</sup> According to these estimates, exports grew at 9 percent per year in the first four years of the reform period, 1986–90, and then at an amazingly rapid rate of 28 percent per year in the next 5 years. This latter estimate is roughly consistent with that of the UNCOMTRADE data, according to which exports grew in this period, 1990–95, at 26 percent per year. Export growth clearly slowed to 2 percent per year in the second half of the 1990s, which is plausible given the Asian crisis. Recent Lao data suggest that it grew also at only 2 percent per year in the most recent period 2000–2002. In 2003, export growth appears to have picked up, and the Lao authorities are projecting export growth of 9 percent in 2003.

**TABLE 7: EXPORT GROWTH**

Growth (% p.a.)	
1986-1990	9.0
1990-1995	27.5
1995-2000	2.1
2000-2003	2.1

Source: World Bank World Tables (1990-98); Lao authorities (1999 and after).

<sup>9</sup> This statement refers to *balance of payments* exports data (IFS line 78aad). More recent IFS data on a *customs basis* (IFS line 70 .d) are available, but are not consistent with the other elements of the balance of payments.

<sup>10</sup> The data from the World Bank World Tables (WBWT) are identical to those in the IMF IFS CD ROM for the years for which both give data, but the data in the latest IFS CD-ROM only go back to the March quarter of 1994, whereas those in the WBWT go back to 1984. For 1999, which is the last year given by the WBWT and IFS-CD ROM, both report exports of goods of \$338.2 million. According to the latest estimates of the Lao monetary authorities, which are used in Table 3 and 3, exports of goods in 1999 were \$342.1 million. Since this discrepancy is only 1 percent, it is trivially small compared to the other discrepancies in measuring export performance.

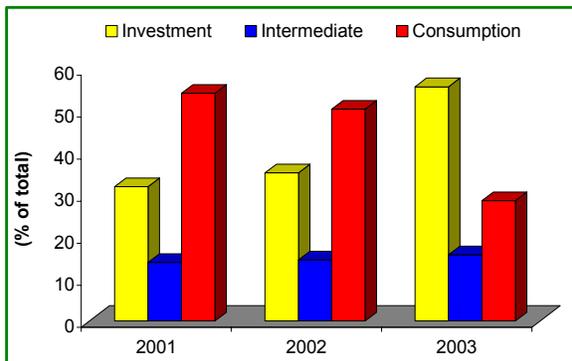
**Destination of exports.** Current exports markets are mostly limited to a few countries/regions: ASEAN (Thailand, Vietnam) and the EU (France, Germany, Italy, Belgium, etc.) and there is little market diversification beyond these two. China is becoming a potential export market: in the last few years exports to this country have increased significantly, especially for wood, forestry and agricultural products (by about 50 percent for the first half of 2003 compared to the same period of previous year – from US\$12m in 2002 to US\$18m in 2003). Lao exports to Australia are expected to grow rapidly in the near future, especially for products of mining sector.

**Composition of Lao imports.** Imports can be classified into three main product categories: investment, intermediate, and consumption goods. In 2001-2002, consumption imports (mainly fuel, food, cloths, and vehicles) represented the 52 percent of total imports, a high proportion if compared to the 32-35 percent of investment imports (mainly fuel, machinery and equipment) and to the 14 percent of intermediate imports (raw materials for garments and other industries). However, this composition has been gradually changing: consumption products decreased from 54 percent in 2001 to 50 percent in 2002; investment imports increased from 32 to 35 percent – ultimately contributing to the growth of Lao economy as whole, and intermediate goods, especially raw materials for industry also slightly increased, to accommodate the growth in investment imports by manufacturing industries.

**Quarterly patterns.** In the first quarter of the year, investment imports are usually higher (54 percent in 2002 and 58 percent in 2003) and consumption goods are low (24 and 30 percent, respectively). A reverse trend is seen in the other three quarters, when the share of investment imports is low and the percentage of consumption goods is high.

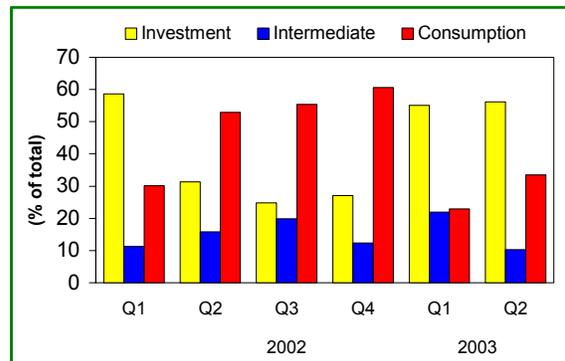
**Provenance of imports.** The imports origin mainly in the following countries: ASEAN (mainly Thailand, Vietnam and Singapore), China, Japan, ANIEs (Korea), EU and other countries.

Figure 7. Imports of major commodities, 2001-03



Source: The Lao authorities. 2003 is the first half only.

Figure 8. Quarterly imports of MC, 2002-03



Source: The Lao authorities

**Future prospects.** To foster export growth, GOL needs to take measures to better exploit the Lao export potential. For instance, its needs to provide incentives for: a) export diversification – moving from hydropower and mining to live animals, livestock-based products, and labour intensive manufacturing (such as secondary wood processing products, knitted and garments, handicrafts, footwear, etc.); and b) export expansion to potential niche markets in the region (AFTA, China, Japan, and ANIES) and other parts of the world (EU, Australia, Canada, and USA). The opportunities are there: for example, Laos could take advantage of the duty-free regime granted to its exports by China (duty-free for more than 200 items), Australia and Canada (and – perhaps – in the near future, the US). To be successful in these new markets Lao exporters need to carry out marketing research (market requirements, demand, and competition), studies on licensing procedures, and regulatory frameworks.

## Private Sector Development

### BACKGROUND

The Constitution of 1991 protects state, collective and private forms of ownership. During the 1990s an active program of legislation began to lay the foundation for the development of market based rules and institutions to support private sector development. The foreign investment legislation was passed in 1988 and a legal basis for land for use and transfer began to be established in 1992-93. Today all agricultural production and most of manufacturing production is in private hands; the industrial sector accounts for 5 percent of employment and state-enterprises cover only around one percent.

Nearly 97 percent of manufacturing units are small (less than 10 employees). Of the medium and large units, 35 per cent were privately owned by Lao citizens and 55 per cent were joint ventures with foreigners; the rest were owned by government (including provincial governments).

Foreign investments have been flowing into garments, wood processing, tourism, hydropower generation and more recently, mining. Between FY 2000/01 to FY 2001/02, foreign investment volume increased and approvals of investment increased tenfold (from US\$42m to US\$492m for the same period), largely due to mining and hydropower. The main foreign investors are from Thailand, Malaysia, Vietnam (ASEAN), China, Australia, South Korea, Taiwan, France, the Netherlands and United States. In 1997, a new law replaced a number of previous land laws, to set out key institutional responsibilities for land management and administration. At the moment, though ten ministries (such as MOAF, MIH, MCTPC, LTA, MOIC, STEA and others) are responsible for land management, MOF takes charge of centralized coordination through land registration, land titling and land leasing. The Department of Lands (MOF) is the core national agency responsible for the design and implementation of land administration programs, and Department of National Land Planning and Development (PMO) ensures the coordination and implementation of national policies, legislation and regulation of land administration and management.

**Insecurity of tenure.** The majority of property holders lacks official recognition and legal long-term rights. In both urban and rural areas, most property holders do not have the ability to make legally binding transactions and to use their land as a collateral for loans. The demand for titles is extremely high in all areas with high population density and growth.

**Lack of resolution in policy and regulatory decisions.** Many important policy decisions on land registration and management have been delayed for years. The GOL inability to enact policies based on research and consultation, to create consensus among agencies involved, and to effectively implement them is admittedly holding back the resolution of a number of problems. In addition, a number of issues in implementing the Land Law have emerged since its passage; the main issues has been a lack of explicit instructions for procedural handling of the law's provisions during the first registration. A lack of legal and procedural clarity applies also to the following cases: land under foreign ownership, land in excess of size limits prescribed by the Land Law, parcels covering planned roads, land under corporate ownership, and the land of Lao who fled the county.

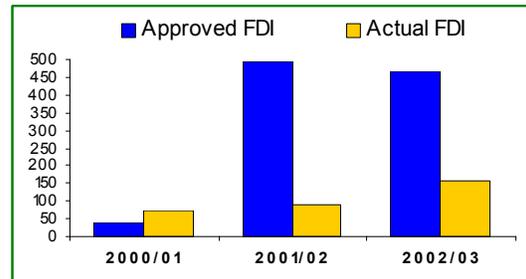
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<sup>11</sup> Under AFTA, Lao PDR is committed to move all the items from its Temporary Exclusion List (TEL) to the Inclusion list (IL) by the beginning of 2005 and to reduce the CEPT rates on all IL items to between zero and 5 percent by the beginning of 2008.

## Foreign Direct Investment (FDI)

In FY 2002/03 the actual FDI inflow increased by 67 percent, from US\$93m in 2001/02 to US\$155m in 2002/03 (see Figure 9), with a big jump in mining investments. Approvals of foreign investment decreased slightly from a relatively high level of 2002/02. Overall, the rise in FDI has gone hand in hand with improvements in the approval process for foreign investment in manufacturing; the process for approving FDI in natural resources remains more discretionary.

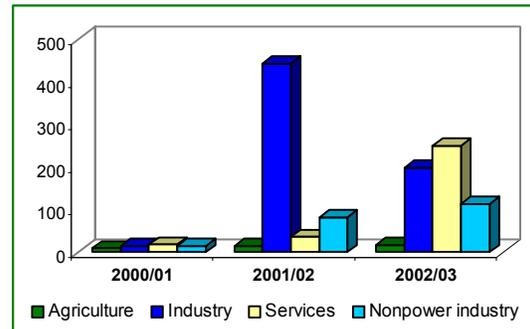
Figure 9. FDI in Lao PDR (US\$m)



Source: Lao authorities (DDFI)

**FDI by Sector.** At the moment of publication, data on sectoral distribution of actual FDI inflow was not available, but that for approvals is shown in the figure 10. Industry (including mining and hydro) and services (mainly tourism) received the largest shares of FDI in both the current year and the previous year.

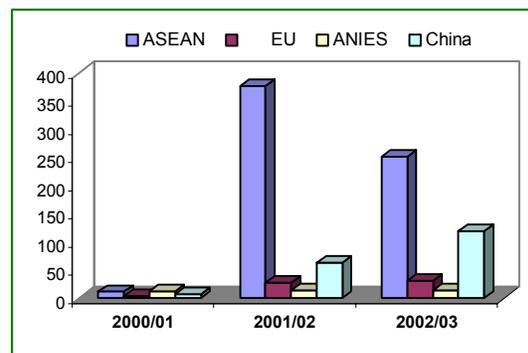
Figure 10. Approved FDI by sector (US\$m)



Source: Lao authorities (DDFI)

**FDI by Country.** In recent years, the key countries/investors in the approvals have been ASEAN (mainly Thailand, Malaysia, Vietnam), China, Australia, EU (mainly Belgium and France) and ANIES (S. Korea and Taiwan). In 2002/03 as compared to the previous year, approved investment from China nearly doubled, whereas from EU, ANIES remained at around the same level (see figure 11).

Figure 11. Approved FDI by country (US\$m)



Source: Lao authorities (DDFI)

**Reforms in Climate for Private Investment.** Further actions to improve the climate for private investment, including foreign investment, is needed. Most of the private firms are very small, with very few medium-sized firms. Business licensing and registration is still very cumbersome and investments in natural resources remain highly discretionary. Improved and more transparent rules are needed in respect of land, approvals of investment, tax policy and contract enforcement; in addition improvements in infrastructure and in human resources will remain key to investments. Efforts should be made to enhance the efficiency of transport, logistics and customs for garment manufacturers if

garment exports is not to fall sharply following the expiry of the multifibre agreement (MFA). The Government of Lao has taken the following recent actions to improve the investment process:

- PM Decree dated 23 April 2003, on roles and responsibilities of CIC at central and local levels. The decree provides local governments with new autonomy over investment and defines organisational structure, roles and responsibilities of CIC and other relevant line-ministries and agencies at central and local levels. It serves as a strategic guidance for CIC at all levels for decision-making process including approvals, promotion, management and monitoring of domestic and foreign investment. The effective implementation of the decree would contribute to the improvement of the investment environment in the country.
- Amendment of Lao constitution, especially with regard to chapter 2 on Social and Economic System. The new text states that GOL promotes every economic sector, including domestic and foreign investment, a modern industry, enterprises and services in order to accelerate economic growth of the country. The constitution further confirms the Government intention to guarantee interest in property and lawful capital of all investors. This change should help in increasing the investors' confidence.
- Publication of Quarterly Newsletter by DDFI. The government issued in July 2003 the first Quarterly Newsletter, to disseminate FDI information to investors and to promote foreign investment. The Newsletter provides recent updates on investment regulations (mainly on decentralized management and approval process at the central and provincial levels), tips for applications, investment incentives for various priority sectors and investment zones, and data on the cost of doing business in the country (business costs – land, office space, factory building, warehouse; and production costs – labor, utilities, i.e. electricity, water, fuel/gas, and telephone). More information is available on the website: [www.invest.laopdr.org](http://www.invest.laopdr.org)

For background on measures taken in previous years please refer to the Annex – Box 3.

## **Land Reform**

### ***Recent development of the land reform program***

According to a preliminary estimate made by the GOL, there are about 1.6 million land parcels in Lao PDR. During the last few years of the land reform program more than 100,000 land titles were granted to local people, in both urban and rural areas<sup>12</sup>. In the next five years, the government plans to grant the land titles to about 400,000 families in urban, peri-urban, and lowland agricultural areas.

The second phase has started shortly after. The overall objective of reform is to foster the development of efficient land markets and facilitate domestic resource mobilization, in order to strengthen the basis for long-term sustainable economic and social development in the country. Private investment will be encouraged once these land –rights are well documented and can be used as collateral if needed.

### ***Measures taken in 2003***

- Establishment of National Land Policy Committee (NLPC) by PM on March 25, 2003, which represents a number of line ministries/agencies involved in land administration and management and is in charge of providing an effective oversight mechanism to resolve policy issues as they

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<sup>12</sup> With the financial and technical support of the World Bank and AusAID, the Lao government has been implementing the Land Titling Project (LTP) as the core land reform program of the past few years. The first phase (phase I) of the project started in 1997 and ended in September 30, 2003. Other donors, such as the EU and SIDA (land use planning and land allocation program in rural and forest areas), GTZ (land management and land use planning), FINNIDA and JICA (urban mapping and geographic information system) are also involved.

arise and to facilitate the development of a comprehensive land policy framework. DONLUPAD is assigned as the secretariat of NLPC.

For background on measures taken in previous years please refer to the Annex – Box 4.

## ANNEX BOXES ON ACTIONS TAKEN IN PREVIOUS YEARS

### Box 1. GOL actions on Public Expenditure Management

#### **Measures taken in 2002**

- Decree No. 57/PM on the Management of Public Investment, issued on May 22, 2002. The decree requires that PIP submissions for new public projects in excess of 1 billion kip in the FY02/03 budget include estimates of associated recurrent costs during the operating period. The rationale is that it will help Lao PDR correct the imbalance between investment and recurrent expenditures in the budget, which at present is heavily skewed towards the former, by clearly identifying recurrent cost requirements.
- FY 2000/01 outcome and FY 2001/02 budget published in April 2002 with classification by ministry, province, and services. The publication of the budget in the Official Gazette enhances budget transparency. However, the budget classification remains incomplete. The current budget nomenclature allows an economic classification and some functional accounts on an ad-hoc basis. The budget classification system needs to be revised to allow for the identification of administrative units and level of government (central, provincial, district) classification, and to be harmonized with the accounting nomenclature.
- The Government adopting the Accounting Regulations in July 2002 to implement Decree 20/PM on General Regulation of Public Accounting, to enhance financial accountability and transparency as well as internal financial control over revenues and expenditures. The regulations cover basic features of internal control that must be established and maintained in each ministry, province, district and agency, and also provide financial statements of the Government which are to be submitted to the National Assembly at the end of each FY.

### Box 2. GOL Decrees on National Resource Management

#### **Measures taken in 2002**

- Management of Production Forest” (Minutes of meeting review of draft Decree on the Management of Production Forest No. 0351/AF.02) and Decree No. 59/PM on the Sustainable Forest Management of Production Forestry, issued on May 22, 2002. These principles and legislation provide a sound basis for establishment and management of production forest with participation of local people in all aspects including zoning, planning, logging, log sales and benefit sharing according to agreements between local authorities and villages.

### Box 3. GOL actions to improve Private Investment Climate

#### **Measures taken in 2001**

- GOL has taken steps towards improving transparency and simplifying investment registration processes. A number of websites (inter alia: [www.invest.laopdr.org](http://www.invest.laopdr.org), [www.moc.gov.la](http://www.moc.gov.la)) have been set up to provide basic information about the country's legal frameworks, business and investment related laws, sector and industry information and other services.
- Decree No.46/PM March, 2001 on the Implementation of the Law on the Promotion and Management of Foreign Investment provides basic guidelines for improving registration and speeding up approval processes for foreign investment. Based on this decree, total approval time for different types of projects has been reduced from 90-180 days to 45-60 days over the last year. However, this process needs to be shortened further in order to catch up with neighbour countries (eg., in Vietnam only 15 days).

#### **Measures taken in 2002**

- Further to Decree No.46/PM, Decision of the Chairman of CIC, dated 27 February 2002, has decentralized approval of foreign investment projects, extension of foreign activities and establishment of branches of foreign companies in Lao PDR. It defines four size-classes of foreign investment based on value: (1) equal or less than US\$1m, (2) from above US\$1m to US\$5m, (3) from above US\$5m to US\$10m, (4) Above US\$10m. Approval of FDI equal or less than US\$1m can be done at the provincial level by all provinces. However, in large provinces, such as Vientiane Municipality, Savannakhet, Champasack and Luangprabang, the ceiling for provincial approval is US\$2m and less).

#### **Box 4. GOL decree on land reform**

##### ***Measures taken in 2001***

On land, PM Decree 237/PM 2001 provides more clarity in the institutional setup and main functions and activities of the Department of National Land Use Planning and Development (DONLUPAD), which is responsible for the coordination of land-related policy<sup>13</sup> and inter-agency consultations on appropriate institutional arrangements.

#### **Box 5. GOL actions on SOE reform**

##### ***Measures taken in 2001***

- A unit - the Business Promotion Office (BPO) - was established in Office of Prime Minister to centralize and manage SOE reforms, and a Minister was named to head the office;
- Governance of the largest loss-making state-owned enterprise, Bolisat Phatthana Khet Phoudoi (BPKP) was transferred from the Ministry of Defense to the Ministry of Finance, with BPO charged with the restructuring of BPKP;
- Management audits were undertaken in Lao Aviation and Phoudoi, leading to change in top management of Lao Aviation;
- Financial Recovery Plan (FRP) for EdL agreed with donors and its implementation initiated;
- A new telecommunication law, passed in April 2001, lays the framework for telecom regulations, opening the sector to private participation beginning of November 2001.

##### ***Measures taken in 2002 and first half of 2003***

- Decree No. 54/PM, May 2002, on Management of State-Invested Enterprises, and its Implementing regulations, Dec 2002, clarified the role and responsibilities of the Directors and managers of SOEs and their financial reporting requirements and provided guidance on capital investment in SOEs, procurement/transfer/replacement of assets, and the treatment of dividends, and; outlined sanctions for SOEs violating the regulations.
- Memoranda of Understanding (MOU) dated May 15, 2002 on restructuring BPKP, Lao Aviation, Nam Papa Lao, and Pharmaceutical Factory No. 3, setting out the broad parameters of the proposed restructuring, to be used as the basis for preparing detailed multi-year restructuring plans.
- Top management of BKPK and Pharmaceutical Factory No. 3 changed to facilitate SOE restructuring.
- Letter of the Minister of Finance No. 618/MOF dated April 10, 2002 on new electricity tariff policy;
- White paper on water tariff policy; a draft 'Water Supply Authority (WASA) Charter' on Regulation of Water Supply Operations" is also under review. This is expected to give WASA the authority to function as the water supply sector regulator.
- PPIAF supported consultants working on water and telecommunication tariff policy.
- Gradual increases in tariffs for aviation, electricity, water and telephone.

<sup>13</sup> The Land Law 01/97/NA (April 12, 1997) repeals a number of previous laws (1979, 1989, 1992) and serves as the new basis for land administration and management in Lao PDR, defining institutional responsibilities for land administration and registration (especially for eight categories of land in Lao PDR: agricultural, forest, construction, industrial, communication, cultural, water-area land and land for national defence and peace-keeping), and (2) sets out the basic rights and obligations of the land user.

PM Decree 22/PM of 1999 is on implementation of the 1997 Land Law.

Presidential Decree on Land Tax (03/PDR of August 12, 2000) provides new guidelines for land tax collection and management, with detailed tax rates for each type of land and its location.

<sup>14</sup> The Land Law 01/97/NA (April 12, 1997) repeals a number of previous laws (1979, 1989, 1992) and serves as the new basis for land administration and management in Lao PDR, defining institutional responsibilities for land administration and registration (especially for eight categories of land in Lao PDR: agricultural, forest, construction, industrial, communication, cultural, water-area land and land for national defence and peace-keeping), and (2) sets out the basic rights and obligations of the land user.

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## Box 6. GOL actions in the Banking Sector

### **Measures taken in 2001**

- 0.5% to 1% of performing loans; Notice No. 209/BFSD dated June 15, 2001, reiterating that a commercial bank shall comply with Regulation No. 03/BOL, which set ceiling for lending at 60% of collateral value and for lending to a single borrower at 10% of the bank's capital, and a commercial bank shall comply with Regulation No. 98/BOL on loan classification, suspension of accrued interest income on a loan which becomes overdue for longer than 90 days, and restriction on new lending to a defaulted borrower;
- Regulation No. 98/BOL on loan classification;
- project, promotion of export and import substitute, and rice plantation) and focus on loan recovery;
- 2001, which distinguish required provision on stock (subject to regulatory forbearance) and flow (in accordance with Regulation No. 98/BOL)<sup>9</sup>, reiterate SCBs to stop accruing interest income on NPLs, require SCBs to submit to BFSD a report on directed lending.

### **Measures taken in 2002**

- Instruction 01/BOL dated Jan. 10, 2002 on notional capital, credit to large customers, and level of NPLs;
  - Instruction No. 03/BOL dated March 14, 2002, which restricts SCBs to grow their risk portfolio if flow NPL ratio exceeds 15% and reduce the branch approval limits. This regulation is aimed to stop further deterioration of SCBs' assets;
  - Notice No. 15/CIMD dated April 24, 2002, which gives clarification of Instruction No. 03/BOL;
  - Notice No. 566/MOF dated March 31, 2002 on autonomy of SCBs. The objective of this notice is to ensure that SCBs have full autonomy in operating their banks on a commercial basis;
  - The Rural and Micro Finance Committee (RMFC) was established on Feb.15, 2002 under Bank of Lao PDR (BOL) to make assessment of the rural and micro-finance industry, formulate a policy statement, and develop an action plan for the implementation of a rural and micro-finance reform program;
  - The External NPL Collection Committee (ECC) was established under BOL with the mandate to support debt restructuring on a voluntary basis by SCBs and debtors;
- Signed Memoranda of Understanding for Restructuring (MOUR) for each SCB dated March 31, 2002, stating the basic principles under which the restructuring will be conducted;
- Two SCBs, Lao Mai Bank and Lane Xang Bank, were merged into the "Lao Development Bank" (LDB) and has been operating as such since the end of 2002.



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