Lao People's Democratic Republic

Macroeconomic Strategy

Discussion Paper

for

Government/Donors

Round Table Meeting

June, 2000

Lao People's Democratic Republic
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Executive Summary

The launching of reforms under the New Economic Mechanism (NEM) in 1986 marked the beginning of a major effort to overcome historical obstacles to Lao development. Coupled with prudent macroeconomic management, these reforms have produced substantial socio-economic dividends. Our real economic growth rate averaged almost 7 percent from 1990 to 1997. This has contributed to all groups in Lao society, but most importantly the poor. From 1992/93 to 1997/98 the incidence of poverty fell from 45 to 39 percent.

Less than two weeks after we presented our macroeconomic plans at the Sixth RTM, Thailand was forced to float the baht. This is widely regarded as the trigger of the Asian financial crisis.

Macroeconomic Overview

Like all other countries in the region, the Lao economy suffered negative effects from the crisis. However, in the absence of well-developed capital markets, and thus of significant short term capital inflows, Lao PDR was spared the financial contagion that spread through most of the neighboring countries. Nevertheless, our economic growth rate slipped substantially, and we were unable to achieve our pre-crisis socio-economic development targets.

The agricultural sector provided some resilience, especially in the early stages of the crisis when world prices of rice and a number of other major crops remained high. Later during the crisis, agriculture benefited from a fall in the real exchange rate of the kip.

In the relatively early stages of the crisis the government responded with some large off-budget expenditure increases on rural infrastructure.

These additional expenditures, together with some major public sector revenue shortfalls, had serious and unintended monetary and inflationary consequences. Financing the fiscal deficit through borrowing from the central bank led to rapid money supply growth – at an annual rate of 115 to 135 percent between June 1998 and March 1999, and reaching over 200 percent in June and July of 1999. In September 1999 a sharp monetary contraction brought the money supply back under control.

Inflation began to accelerate in early 1998, and reached a peak of 167 percent in March 1999. Month-to-month inflation remained high until August 1999. Since then, it has been extremely low, and sometimes negative. This is reflected in declining annual inflation rates in recent months.

The monetary-induced inflation led to a massive fall in the nominal value of the kip and a much smaller but significant decline in its real value. In July 1999 the kip reached its lowest point of only 14.8 percent of its pre-crisis value relative to the baht. Over the period October 1998 to August 1999 the *real* value of the kip remained 20 percent below its pre-crisis level.

Strong fiscal and monetary measures initiated in the final months of 1999 have laid the foundations for renewed macroeconomic stability. The inflation rate has fallen sharply. The kip appreciated, in nominal and real terms and has remained stable (relative to the baht) since September 1999. The real value of the kip has now returned to its January 1997 level.

The principal policy measures responsible for these changes are cessation of money-financed expenditure increases, sharply reduced current and capital expenditures, and the use of treasury bill sales to absorb much of the excess liquidity in the money market.

Real growth has been maintained at reasonable levels, aided in large part by agriculture. A combination of strong international markets in the early phases of the crisis, a depressed real exchange rate, and, to a lesser extent, public infrastructure investments in the rural sector, provided a substantial boost to agriculture during this difficult period. At the same time, these factors helped to draw many more farmers into the market economy.

Risks

The principal challenge now will be to maintain this hard-won macroeconomic stability and to improve our economic performance in the post-crisis environment. In light of a number of major risks, this will not be an easy task.

- A higher real exchange rate and weaker international markets pose a new threat to agriculture.
- The higher real exchange rate will place additional burdens on the development of a more diversified and competitive economy.
- Large recent investments in rural infrastructure will impose further fiscal burdens for operating and maintenance needs at a time when the current side of the budget is already suffering from unavoidable spending squeezes in recent years.
- Additional budgetary demands are looming as a result of problems in the banking and SOE sectors.
- Weaknesses in revenue-raising capabilities need to be addressed.
- In the midst of this challenging fiscal environment, it will be necessary to make concerted efforts to resume our process of administrative and regulatory reform to promote the development of the private sector under the NEM.

Strategic Issues

The overriding goal of our macroeconomic strategy is to achieve sustainable growth with equity and poverty reduction. Our experience since the beginning of our economic reform program demonstrates the power of economic growth in helping the poor.

In light of current economic circumstances, our macroeconomic strategy will be aimed at three key issues.

- *Dealing with the unintended economic consequences of and optimally managing the large foreign exchange inflows from ODA, natural resources and FDI.*

  Substantial foreign exchange inflows, especially from ODA, create correspondingly large current and trade account deficits. They also put considerable upward pressure on our real exchange rate, to the detriment of agriculture and of a diversified outward oriented economy. This requires that we accelerate the economic reform process to reduce regulatory-induced high costs in our economy. We must also create an environment in which ODA, FDI and resource rents are used most effectively to meet our socio-economic development objectives.

- *Accelerating employment and income growth through a continuation of agricultural development and at the same time laying the groundwork for further economic diversification.*

  Our recent development efforts have focussed primarily on the agricultural and rural sectors. However, our population and labor force are growing rapidly. In addition, rising education levels and increasing exposure to our immediate neighbors and the broader global community are changing expectations and capabilities of our youth. It is now necessary, therefore, to shift our attention towards more diversified development. Our close links with the dynamic regional economy present us with many natural opportunities. The challenges will be to continue with the rapid reform of the legal and regulatory system to support the NEM, and equally importantly, to improve the mechanisms and institutions for implementing these reforms. This will require progress on a wide range of issues including financial sector reform and development, SOE reform, improvement of licensing and investment approval procedures, and trade policy reform.

  The new strategy is not a change of direction. It certainly would not involve any form of discrimination against agriculture and rural areas. It is simply a broadening of the focus of the market-oriented policy development already being implemented in agriculture, and further development and implementation of the NEM.

- *Improving the mechanisms and practice of fiscal and monetary management.*

  While the inflationary monetization of increased public investments may have been a necessary response to a potential economic emergency, we must now re-establish fiscal and monetary discipline. We need to develop an interbank market for foreign exchange and reduce our reliance on direct controls to deal with foreign exchange shortages. We must improve revenue-raising capabilities. We must redress the balance of public expenditures in favor of current as opposed to investment expenditures, and also towards social expenditures as opposed to "hard" infrastructure. Meeting these goals will be a very delicate balancing act, especially in the face of other fiscal dangers arising from rising debt levels and problems in the banking and SOE sectors.

Action Plan

Our report provides details on the tasks necessary to deal with these key strategic issues. Among the areas requiring attention are the following.

- Improving the competitiveness of traditional non traditional sectors through reinvigorating the NEM and human capital investment.

- Increasing the effectiveness of ODA through better coordination, improved project assessment capabilities, and ensuring the complementing of our reform efforts.

- Deregulating and improving the investment environment to attract more and better foreign and private domestic investment.

- Ensuring that natural resource rents are put to the best possible use in meeting our socio-economic goals.

- Renewed attention to financial sector and SOE reform.

- Enacting further reforms to increase the transparency and stability of the regulatory environment for the private sector

- Reducing and simplifying import regulations and the structure of import tariffs.

- Pursuing moderate monetary growth and price stability and refraining from cash rationing as an instrument of liquidity control.

- Developing a fully integrated interbank market for foreign exchange and letting market forces be the primary determinant of the exchange rate of the kip; restoring foreign reserve holdings to more appropriate levels.

- Maintaining spending discipline, while at the same time making necessary provisions for restoring and improving government salaries, and meeting necessary operating and maintenance expenditures; moving the balance of public expenditures more in favor of social expenditures on health and education.

- Improving public sector resource mobilization through a continuation of reforms in customs and income tax administration, a reexamination of pricing and royalties on resource products, and consideration of replacing our turnover tax with a full value added tax.

- Improving our systems of fiscal decentralization through better coordination of expenditure and revenue raising responsibilities, and measures to improve fiscal equity, both vertically, between levels of government, and horizontally, across different provincial governments.

Lao People's Democratic Republic
Macroeconomic Strategy

1. Introduction

The basic facts of the Lao economy are well known to our development partners. Lao PDR is small (in terms of population and market size), is well endowed with a number of natural resources, and is situated in the midst of one of the most dynamic regions of the developing world. This presents us with enormous development opportunities.

Ours is also still a very poor country. But we have made enormous progress in recent years. The launching of economic reforms under the umbrella of the New Economic Mechanism (NEM) in 1986 marked the beginning of a major effort to overcome historical obstacles to Lao development. Coupled with prudent macroeconomic management, these reforms have already produced substantial socio-economic dividends. From 1990 to 1997 our average annual real economic growth rate exceeded 6.5 percent, and from 1992 to 1997 it averaged 7 percent. This impressive record of economic growth has contributed to all groups in our society, but most importantly the poor. From 1992/93 to 1997/98 the incidence of poverty fell from 45 to 39 percent.

At the Sixth Roundtable Meeting in Geneva in June 1997 we presented plans for a continuation and deepening of the macroeconomic framework strategies that had been so successful over the first part of the decade. According to our Report to that Roundtable Meeting,

> "Further strengthening of our macroeconomic management is needed to attract more foreign investment, but also to reinforce the conditions for sustainable and equitable growth. The targets set in this regard include:
>
> - improvement of the performance of the banking sector by full interest rate liberalization, the introduction of new monetary instruments for the appropriate management of financial markets, the stabilization of the exchange rates and inflation, the enhancement of credit and savings mechanisms, and by the reinforcement of the Bank of Lao PDR's supervisory capacity;
> - reinforcement of fiscal discipline by improving revenue collection and expenditure rationalization through the development of a multi-year integrated macroeconomic framework (covering budget deficits, balance of payments constraints, etc.);
> - continuation of the modernization of the legal and regulatory framework enhancing private sector development and completing the transition to a fully functioning market economy, while advancing the necessary reforms critical to ensure social equity and the modernization of the State's functioning;
> - strengthening the organizational structures of the government, in ensuring in particular that the legislative, executive, judiciary and local administration organs operate according to their roles and tasks as defined in the Constitution, and in improving effective coordination at every level of government;

- reinforcement of the institutional development at the provincial and district levels, by pursuing decentralization, in particular with a view to provide sufficient services for the agricultural-forestry activities as well as the rural development priorities at the district level and in cooperation with the concerned socio-economic groups;

- establishment of planning and evaluation departments in a number of major ministries;

- upgrading of expertise and knowledge at every level of administration in order to improve competence and management capacities throughout the country to provide good services to its citizens;

- acceleration of the Lao PDR's preparation for the joining of ASEAN and AFTA by the structural and legal adjustment of the general economic environment and the progressive introduction of modern instruments of management (computers, facsimile machines, Internet information systems) and the enhancement of our human resources (negotiation skills, fluency in English, etc.)." (Lao PDR 1997 p.20)

These plans were ambitious but, in our view, necessary to achieve our equally ambitious development targets.

Less than two weeks after we presented these plans, the Government of Thailand was forced to float the baht. This is now widely regarded as the trigger of the Asian financial crisis. The crisis had a major impact on the economies of the region, and the ensuing shock waves were felt across the globe.

While our economy was hit less seriously than many others in the region, a variety of factors related to and stemming from the crisis have slowed down our growth relative to the targets set in the pre-crisis environment. Our experience has been similar in a number of ways to that of Vietnam. We recognize that a prolonged economic growth slowdown, without corresponding policy adjustments, will jeopardize the achievement of our ambitious development targets.

Since the regional crisis and our related policy responses have been the dominant feature of the recent macroeconomic environment, this will be the focus of the first part of this report.

However, the region has now entered the post-crisis recovery period, and it is this post-crisis environment that will be central to the government's medium term strategy. Therefore, a major part of this report will deal with the policy challenges we will face in the emerging recovery period.

In line with our long-standing policy goals, the overall focus of the country's development strategy will be growth with equity and poverty reduction. It is encouraging to note that our development partners, most notably the ADB, IMF and World Bank, are now placing much greater emphasis on poverty reduction in their lending and assistance strategies. We welcome this new emphasis on what we regard as a principal reason for the pursuit of sustainable economic development.

Sustainable economic growth is a necessary condition for poverty reduction in Lao PDR. Without economic growth, our country will fall further behind our neighbors and the world. More importantly, without economic growth, our poor will continue to struggle to meet their basic needs. They will lack the opportunities for personal development and the ability to contribute to our country's socio-economic development that should be their basic rights.

We do not consider growth and economic development to be the enemy of the poor. On the contrary, our own experience since the beginning of our economic reform program demonstrates the power of economic growth in helping the poor. Economic growth stemming from our reforms in the 1990s has already had a substantial effect on poverty reduction. This is consistent with a wide body of international evidence that sustainable growth is good for the poor (Dollar and Kraay 2000).

We consider poverty reduction as a highly appropriate and useful lens for focusing attention on the current challenges facing Lao PDR. Our goal is to build on our country's internal strengths, and especially those of its people, for the long term benefit of current and future generations. Through this approach, the government will assist in expanding opportunities and human development possibilities for the people of Laos.

2. The Crisis and Policy Responses: Overview

The Sixth Roundtable Meeting was held in Geneva on June 19-20 1997, less than two weeks prior to the floating of the Thai baht – an event that is often referred to as the trigger of the Asian financial crisis. The crisis had enormous short term social and economic impacts, and changed many basic assumptions about economic growth and financial stability in the region.

We divide our discussion of the implications of the crisis for Lao PDR into two parts. The first reviews the broad macroeconomic impacts and our domestic policy responses. The second provides a discussion of some of the more important socio-economic impacts on our population.

2.1 Overview of Growth, Inflation and Money

Like all other countries in the region, our economy suffered negative effects from the regional crisis. However, this was primarily a financial crisis arising from massive reversals of short term capital flows, with consequent effects on asset markets, financial systems and ultimately the real economies of the affected countries. In the absence of well-developed capital markets, and thus of significant short term capital inflows, Lao PDR was spared from the financial contagion that spread through most of the neighboring countries.

Our agricultural sector was also a source of strength and resiliency, especially in the early stages of the crisis when world prices of rice and a number of our other major crops remained high. Also unlike our regional neighbors, we responded in the relatively early stages of the crisis with some strong fiscal and monetary stimulus measures, aimed not only at stimulating aggregate demand, but also at meeting long term development needs of the agriculture and rural areas through provision of badly needed infrastructure.

This fiscal stimulus and capacity building program was described by the Honorable Bounnyang Vorachit, our Minister of Finance, at the World Bank/IMF Annual Boards of Governors Meetings in Washington DC last September:

> "The growth of the economy could have dropped to an even lower level if it had not been for the government's effort to concentrate public investment in the agricultural sector, the core of the Lao economy."

For a number of reasons, therefore, our real GDP growth did not suffer nearly as much as many other countries (Table 1). The principal effects of the crisis in Laos arose from real impacts of changes in trade, investment and labor flows, and from the government's own policy responses. Because of the absence of serious financial contagion effects, the aggregate impact of the crisis on Lao PDR was much less than in most other regional economies. Nevertheless, the effects were significant, with real GDP growth in 1998 falling to 4 percent, in contrast to rates of almost 7 percent in the previous two years.

As can be seen in Table 2, while its role continues to diminish, agriculture (including fishery and forestry) remains the major contributor to our economy's total output. Its share of total output in 1998 was still more than 50 percent.

The sectoral growth data in Table 3 demonstrate that it was agriculture as well that made the largest contribution to growth in the early stages of the crisis. While services and industrial production both decelerated in 1997, agricultural growth increased significantly, from 2.2 percent in 1996 to 7.5 percent in 1997. This was due almost entirely to the crop production subsector, whose growth increased from 0.9 percent in 1996 (and –2.5 percent in 1995) to 16.2 percent in 1997. The real value of crop production continued to grow by 6.4 percent in 1998.

In volume terms, paddy production increased by 18 percent between 1996 and 1998, with most of the increase in 1997. A doubling of dry season paddy production in 1998 as a result of increased irrigation was offset by weather-induced decreases in wet season production. Wet season crops still dominate overall rice production. Over the same period (1997 and 1998), production of other crops including corn, sweet potatoes, cassava and coffee increased by 31 percent. Most of these increases occurred in 1998.

Table 1
Comparative Real GDP Growth Rates
(percent per year)

	1996	**1997**	**1998**	**1999**	**2000**
Lao PDR	6.8	6.5	4.0	5.2	na
Indonesia	8.0	4.5	-13.7	0.5	3.0
Korea	6.8	5.0	-5.8	10.2	6.0
Malaysia	8.6	7.5	-7.5	4.9	4.8
Philippines	5.8	5.2	-0.4	2.9	3.5
Thailand	5.5	-1.3	-10.0	4.0	7.0
China	9.6	8.8	7.8	7.1	7.0
Vietnam	9.3	8.2	5.8	4.7	4.6

Note: 1999 = estimates; 2000 = forecasts
Sources: Lao PDR: IMF 2000; other countries: World Bank 2000

Table 2
Sectoral Composition of GDP
(percentage shares)

	1994	**1995**	**1996**	**1997**	**1998**
Agriculture	57.6	55.7	53.3	53.3	52.6
Industry	18.1	19.2	21.1	21.2	22.0
Services	24.3	25.1	25.5	25.5	25.4
Total	100.0	100.0	100.0	100.0	100.0

Source: Calculated from IMF 2000, Table 3

Table 3
Sectoral Growth Rates
(percent per year)

	1994	1995	1996	1997	1998
Agriculture	8.3	3.1	2.2	7.5	3.7
Industry	10.7	13.1	17.3	8.1	8.5
Services	5.5	10.2	8.7	7.3	4.8
Total	8.0	7.0	6.8	7.0	4.0

Source: Calculated from IMF 2000, Table 3

Due to public sector revenue shortfalls arising from the crisis, our expanded investment program in irrigation and other infrastructure support for agriculture also had serious and largely unintended monetary and inflationary consequences.

These were also described by our Minister of Finance at last September's World Bank/IMF Meetings:

> "Public investments are largely dependent on domestic loans in the form of advances from the central bank, as a result of the shortfall of government revenue collection due to slow growth of production in the economy. As a consequence, Broad Money (M2) increased by 113 percent by the end of 1998 compared to 65 percent at the end of 1997. This has resulted in increasing pressure on foreign exchange demand to finance imports which, in turn, caused the Kip to depreciate even further resulting in CPI increase to a three digit level that continues to persist through the present days."

Figure 1 shows the path of inflation over the past three years. Prior to the crisis, in the first half of 1997, the annual inflation rate measured by the CPI stayed between 11.4 and 15.9 percent, fairly reasonable levels relative to our historical experience. Over the remainder of 1997, following the floating of the baht and the gradual depreciation of our own currency in line with the baht, inflation crept up to 25 to 28 percent. In January 1998, the inflation rate began to accelerate, a process that continued until it reached a peak of 167 percent in March of 1999. Month-to-month inflation rates remained high until August 1999 (Figure 2). Since September 1999 month-to month inflation has been extremely low, and sometimes negative. This is reflected in declining annual inflation rates in recent months.

Figure 1
Annual Rate of Change in CPI
(percent)

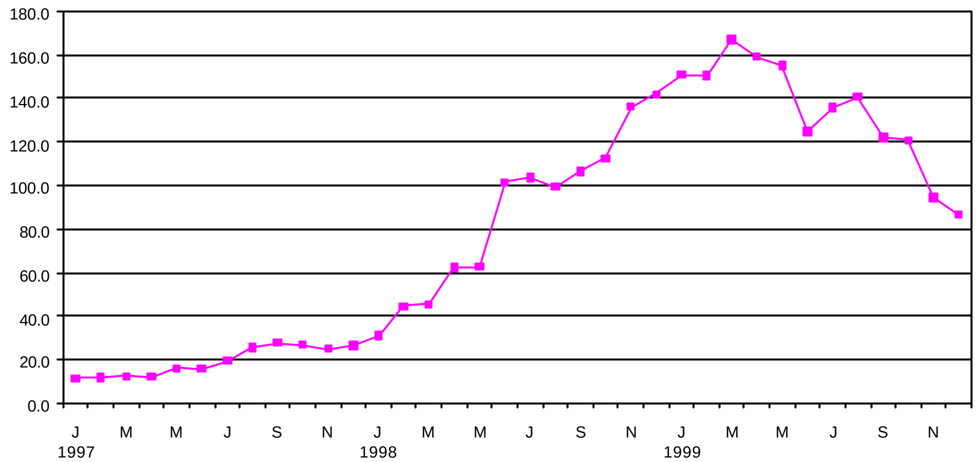
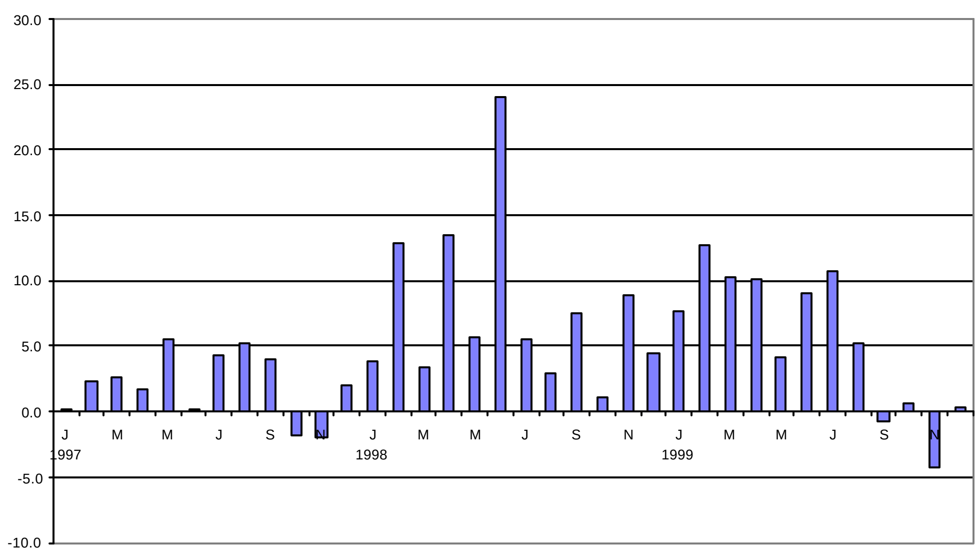


Figure 2
Monthly Change in CPI
(percent)



Figures 3 and 4 show the patterns of money supply growth that led to the inflationary spiral during the crisis. After following a pattern of steady and stable growth during 1996 and the first half of 1997, the money supply gradually began to accelerate in the second half of 1997 and first half of 1998. Its growth "stabilized" at the high annual rate of 115 to 135 percent between June 1998 and March 1999, after which it accelerated once more, reaching an annual growth rate of over 200 percent in June and July of 1999. Monthly money supply growth peaked at 14 to 20 percent in March to June of 1998 (Figure 4). In September 1999 a sharp monetary contraction (minus 37.2 percent growth of reserve money on a month-to-month basis) brought the annual rate of money growth to less than 100 percent for the first time since April 1998.

Figure 3
Annual Growth in Money Supply
(percent per year)

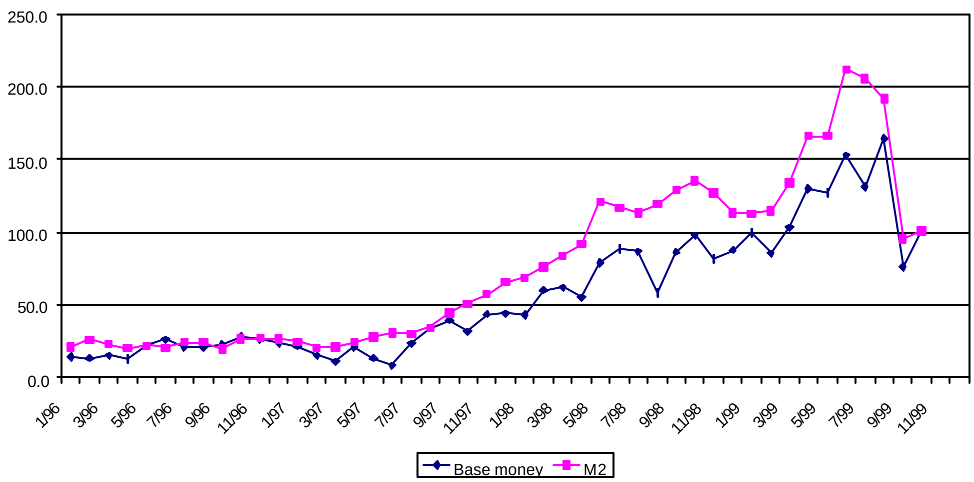
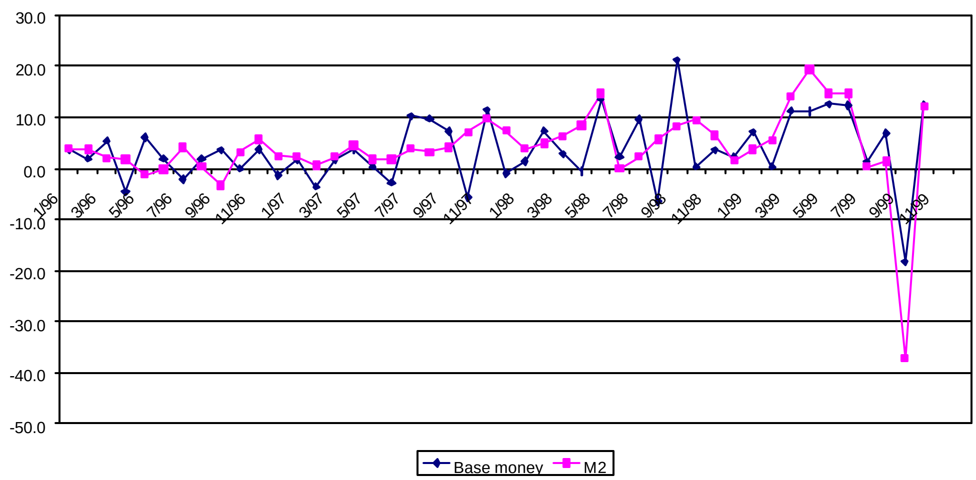


Figure 4
Month-to-Month Growth in Money Supply
(percent per month)

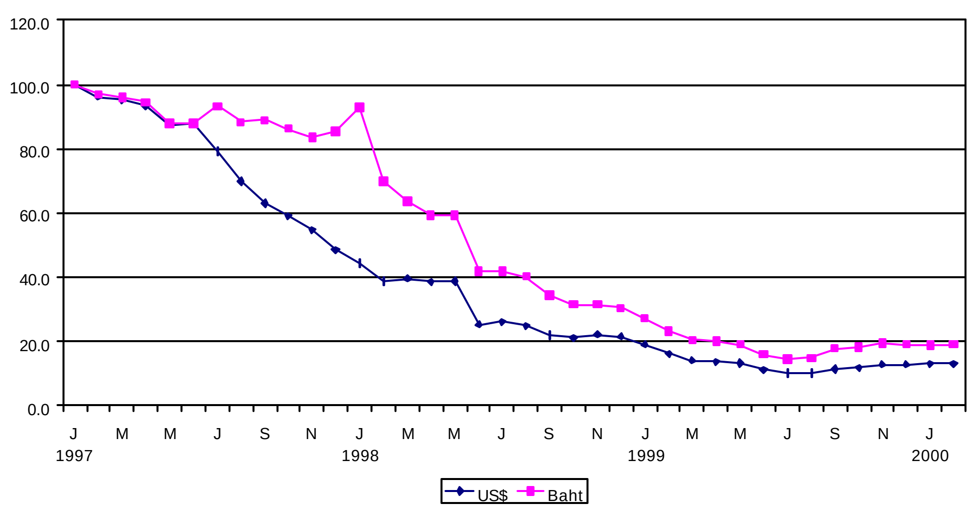


2.2 The Exchange Rate

Because of Lao PDR's small size and its strong trade and investment links with Thailand, our exchange rate is closely tied to the Thai baht. As is seen in Figure 5, the kip tracked the baht quite closely prior to and during the early parts of the crisis. Following the initial depreciation of the baht in July, the kip actually appreciated for a brief period relative to the baht. This was due to our attempt to reimpose the January 1997 nominal parity when the baht was floated. This was maintained for three months. In October we recognized the need for a correction and returned the exchange rate to the path we had been following earlier in the year.

Starting in early 1998, however, when the baht hit its lowest point relative to the dollar (January) and then began to appreciate, the kip diverged sharply from the baht (Figure 5). As a result of money-induced inflation that began in early 1998 (see Figure 2), the kip fell steeply and continuously until July 1999 when it reached only 14.8 percent of its pre-crisis value relative to the baht (or 10.3 percent of its pre-crisis US dollar value). (Note: by contrast, Thai inflation was very low, and often negative over the same period.) Since September 1999, when domestic inflation was once again brought under control, the kip has remained stable against the baht.

Figure 5
Foreign Exchange Value of Kip (1997 = 100)



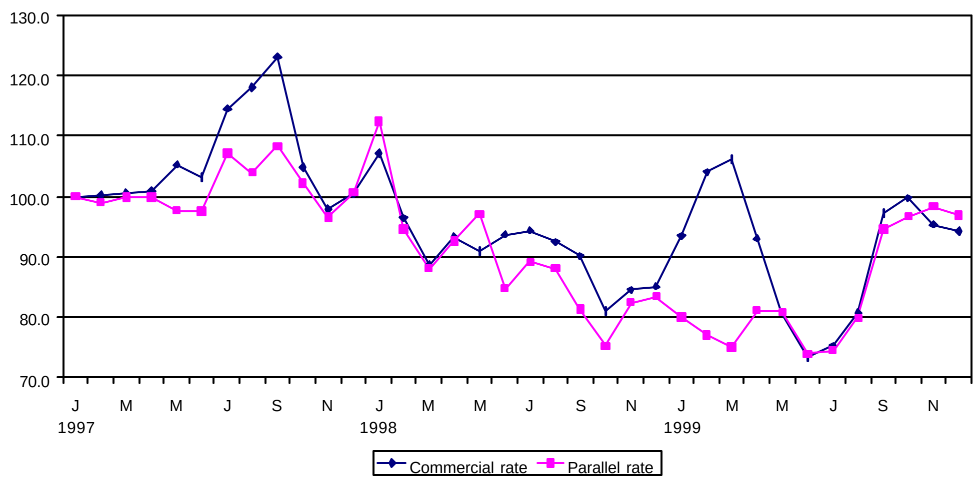
The value of the kip in terms of the baht depends in large part on relative rates of inflation between the two countries. The greater the rate of Lao inflation relative to Thailand's, the lower will be the value of the kip compared with the baht. If the kip is prevented from depreciating in response to a higher relative inflation rate, its real value will rise and it will become overvalued. If it depreciates more rapidly than required to compensate for differences in inflation rates, its real value will fall and it will become undervalued. In the absence of direct market interventions or of major shifts in capital inflows or other major determinants of the demand for and supply of foreign exchange, the exchange rate should adjust to differences in relative inflation rates to preserve its real value.

Figure 6 shows the evolution of the real exchange rate of the kip relative to the baht from 1997 to 1999. The calculations have been done for both the official and parallel exchange rates. It tracks the real value of the kip relative to where it was at the beginning of 1997.

The real exchange rate passed through three phases since January 1997.

During the first seven months of the crisis period (July 1997 to January 1998) the real value of the kip rose; i.e. the kip became overvalued relative to the baht. In fact, the overvaluation began prior to the floating of the baht as we tried to maintain a higher exchange rate than could be justified by our gradually increasing rate of inflation. The extent of overvaluation reached a peak in September, when we realized the need to abandon the (almost) fixed nominal parity with the baht.

Figure 6
Real Exchange Rate of Kip
(January 1997 = 100)

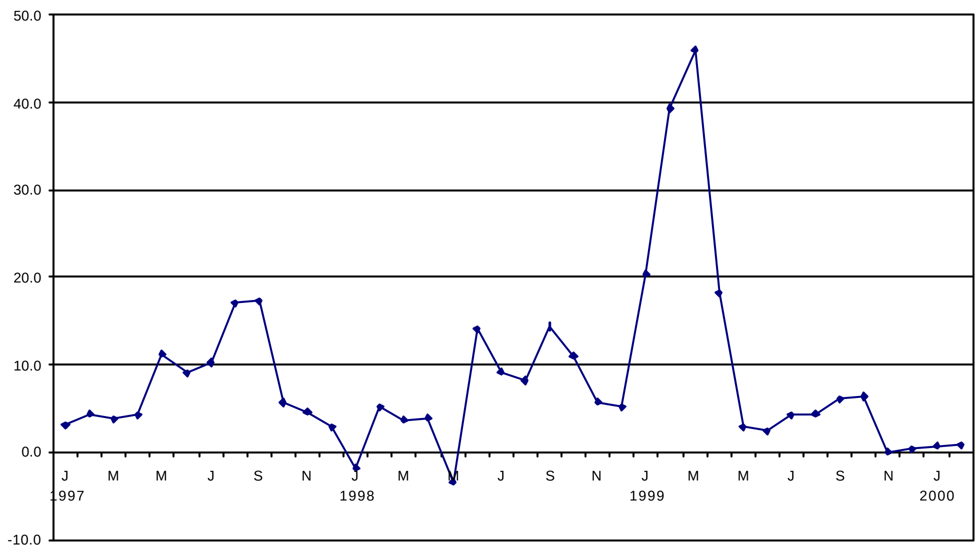


The second phase lasted from the beginning of 1998 until early in the second half of 1999, corresponding with our high and accelerating inflation rate. Over this period, the kip depreciated even more rapidly than would have been anticipated purely on grounds of relative inflation rates. As a result, the real value of the kip fell, and it became undervalued.

This under valuation continued until September 1999 when our changed monetary policies began to reign in inflation. This marked the beginning of the third phase, with the real value of the kip returning to its pre-crisis level.

Figure 6 shows as well that the official rate was almost always higher than the parallel rate and exceeded it by more than 5 percent for two periods – from May to October 1997 and from December 1998 to April 1999. A similarly large parallel market premium emerged during September and October 1999. The parallel market premium is shown explicitly in Figure 7.

Figure 7
Kip Parallel Market Premium
(percent)



The large parallel market premiums coincided with periods when we made extensive use of direct controls to protect what was either (in retrospect) an overvalued exchange rate or a rapidly declining rate. The temporary use of direct controls was a departure from steady progress in recent years towards unification of our exchange rate system and allowing foreign exchange to be allocated on a market-determined basis. This had been a key element of our market-based reform program.

It is unfortunate that it was necessary as part of the emergency situation created by the crisis to revert to older methods of control. As we knew from previous experience, such controls can be costly and difficult to enforce. They have the longer run effect of undermining the stability and confidence that we need to achieve in our monetary and financial institutions. The large parallel market premium that emerged in 1998 and 1999 is a reflection of the perceived market risks that arise from the use of direct controls. It certainly will be part of part of our post-crisis recovery program to return to strengthening the institutional foundations for market-based foreign exchange management.

The principal cause of the fall in the kip in 1998-99 was Lao inflation, which was in turn due primarily to domestic monetary expansion. Accelerating inflation increased market uncertainty, which caused a certain degree of market over-reaction. From time to time it was necessary to revert to direct controls on the parallel market. This increased perceived market risks and drove the parallel market even further from its equilibrium value. The financial instabilities and uncertainties created by the use of direct controls had a variety of unintended effects on the balance of payments that are discussed further below. In the end, it was our return to monetary stability that eliminated the underlying cause of inflation and permitted the exchange rate to stabilize.

2.3 Trade, ODA, Investment and the Balance of Payments

The real side of the balance of payments had a number direct impacts on our economy during the crisis. The crisis caused a sharp drop in incomes (or at least their growth rates) in most of Lao PDR's principal trading and investment partners. This had corresponding effects on the demand for Lao exports and much more so on the supply of foreign investment.

2.3.1 Foreign Investment

Following our initial economic reforms under the NEM in the late 1980s, and our gradual integration with the rapidly growing regional economy, foreign investment inflows grew steadily and rapidly through the first half of the 1990s. Disbursements reached US$176 million, or 9.5 percent of GDP, in 1996 (Figure 8).

Throughout the 1990s, foreign investment approvals have far outstripped actual disbursements. Approvals reached US$2.6 billion in 1994 and US$1.3 billion in 1996, both of which exceed the *cumulative* total of less than US$500 in foreign investment disbursements between 1994 and 1998 (Figure 8). From 1994 to1996, FDI approvals averaged an astonishing 91 percent of GDP, and reached almost 170 percent of GDP in 1994 (Figure 9).

Foreign investment approvals in the early 1990s were dominated by electricity projects. In 1994 and 1995, this sector accounted for over 80 percent of approved investments. In 1996, a reduction in approvals in this sector and increases in several others, especially hotels and tourism (US$211 million), other manufacturing (US$320 million), and "other" (US$504 million) began to redress the balance.

Since the beginning of the crisis in 1997, foreign investment approvals and disbursements have fallen off, with the sharpest declines occurring in approvals. The fall in approvals has been felt in all sectors except agriculture, which experienced some growth in 1999. Approvals amounted to US$123 million in 1998, and US$94 million in the first 10 months of 1999. While low in comparison with recent years, approvals were still almost 10 percent of GDP in 1998, a high number by international standards.

FDI disbursements declined from their peak of US$176 million in 1996 to US$56 million in 1998. At their peak in 1996, FDI disbursements amounted to 9.5 percent of GDP, which is much higher than almost any other country in the region. (By comparison, Vietnam, which had one of the highest rates of FDI inflow in the world in the mid 1990s, had an average rate of inflow of 9.1 percent between 1993 and 1997.) In 1998, with the lowest rate of FDI inflow since 1994, FDI still amounted to a quite respectable 4.4 percent of GDP.

Figure 8
Foreign Investment Inflows
(US$ millions)

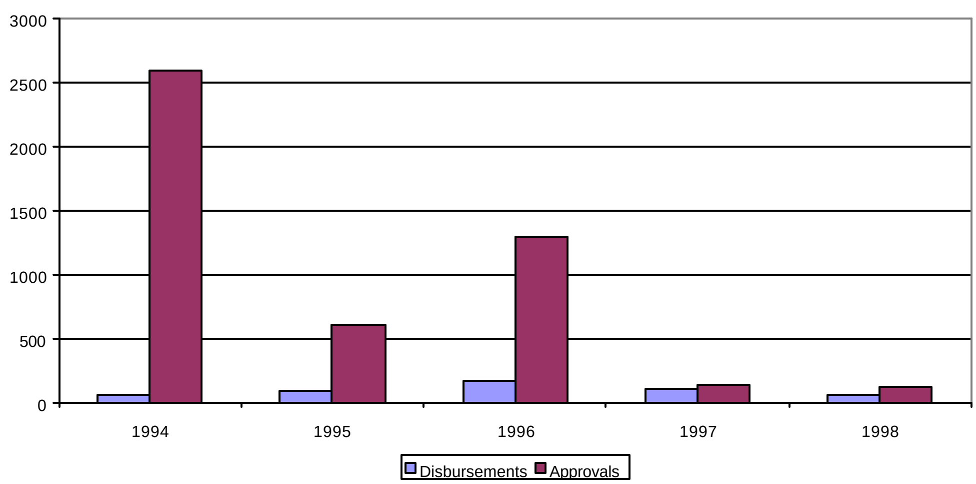


Figure 9
Foreign Investment Inflows
(percent of GDP)

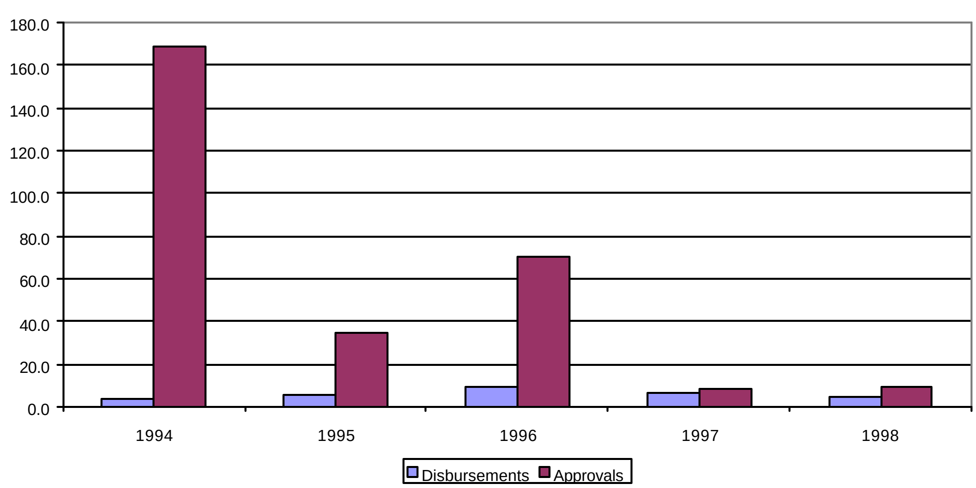
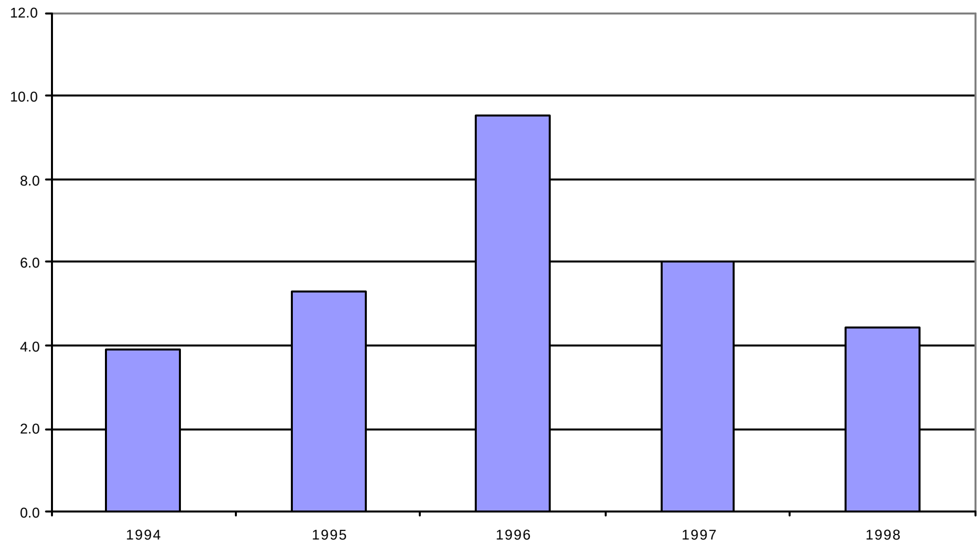


Figure 10
FDI Disbursements
(percent of GDP)



2.3.2 Other Non-Merchandise Sources and Uses of Foreign Exchange

In addition to FDI and merchandise trade (to be discussed below) Lao PDR has several other important sources of foreign exchange. By far the most important is Official Development Assistance (ODA), in the form of grants and long term loans. From 1994 until 1998 ODA flows have increased from 11.1 to 17.8 percent of GDP (Figure 11). Official loans have been the fastest growing component, rising from 4.9 percent of GDP in 1994 to 11.9 percent in 1998. While official transfers (grants) accounted for 63 percent of aid flows in 1994, they made up only 33 percent of the total in 1998. In US dollar terms, however, ODA inflows actually declined in 1998, by 16 percent in the case of loans and 24 percent for grants. Preliminary data for 1999, however, suggest that these inflows have risen considerably, in dollar terms and as a share of GDP.

The other two most important non-merchandise sources of foreign exchange in recent years have been net service exports and private remittances. Net service exports, which averaged only about 1.5 percent of GDP from 1995 to 1997, jumped to 5.6 percent of GDP in 1998, due in large part to liberalization and increased promotion of tourism, making a substantial contribution to foreign exchange earnings during the crisis (Figure 12). Overseas remittances (the principal component of private transfers in the balance of payments statistics) have also grown quite rapidly in recent years – from 0.6 percent of GDP in 1994 to 3.9 percent in 1998 (Figure 13).

Figure 11
ODA Inflows
(percent of GDP)

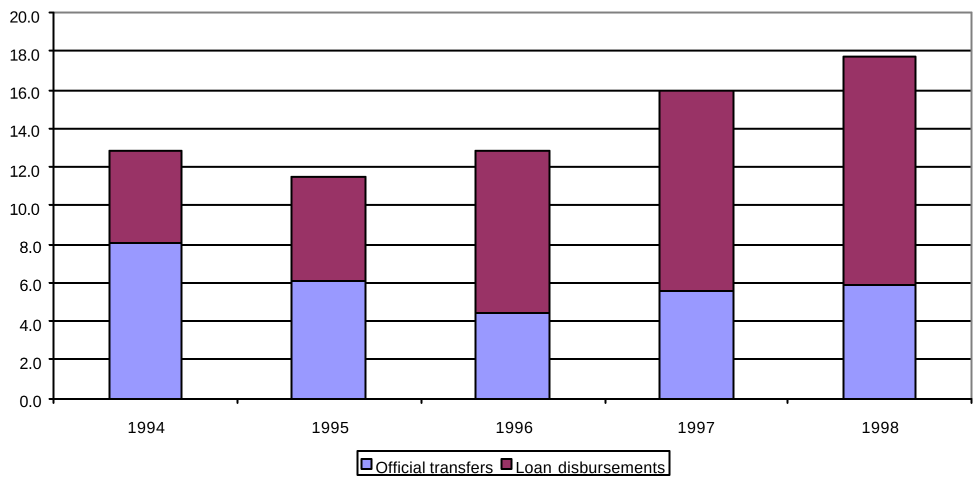


Figure 12
Net Service Exports
(percent of GDP)

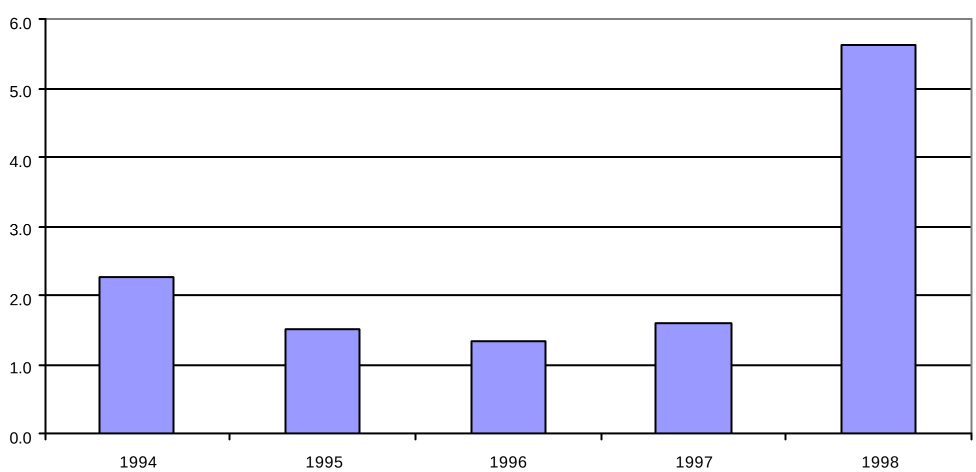
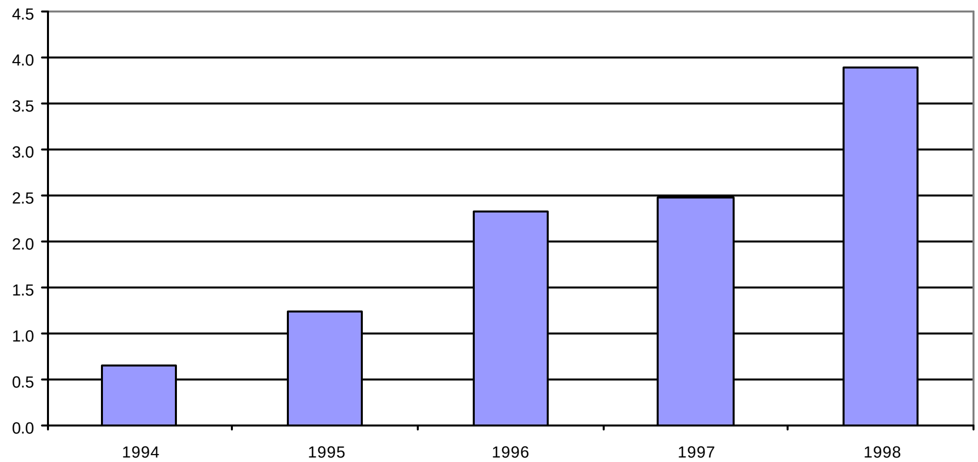


Figure 13
Net Private Transfer Inflow
(percent of GDP)



2.3.3 Exports, Imports and the Current and Merchandise Balances

Lao PDR has a relatively large merchandise trade deficit. However, it has fallen from US$369 million to US$216 million, or from 20.0 to 15.4 percent of GDP, between 1996 and 1998 (Figure 14). A similar pattern can be seen in our current account balance (Figure 15). Because of the net surplus on other (non-merchandise) current account items, the current account deficit has been smaller than the merchandise trade deficit, even after netting out official transfers. But whichever indicator is used, the pattern has been one of a declining trade or current account balance since 1996.

It is the large inflows of foreign exchange on other balance of payments lines that has allowed us to sustain relatively large trade and current account deficits. As a result, imports have exceeded merchandise exports by 115 percent (1996) to 64 percent (1998). The falling levels of our measured trade and current account deficits since 1996 are simply a reflection of declining inflows on the capital account.

We will return to this issue shortly.

Lao export growth had already slowed down substantially and thus was lower than in other regional economies prior to the crisis. As in the other regional economies, our export growth slowed down in 1996 and became negative in 1997. However, our export growth slowdown was less severe than in most of our neighbors (Figure 16). In 1998 and 1999 our export growth picked up substantially, with performance in each of these years exceeding that in the years immediately preceding the crisis.

Imports bore most of the adjustment to reduced foreign exchange inflows during the crisis. After growing by more than 17 percent in 1996, imports fell by 6.1 percent in

1997 and by another 14.7 percent in 1998. Preliminary estimates indicate a modest recovery of imports in 1999, with positive growth at a rate of 3.6 percent.

Figure 14
Merchandise Trade Balance
(percent of GDP)

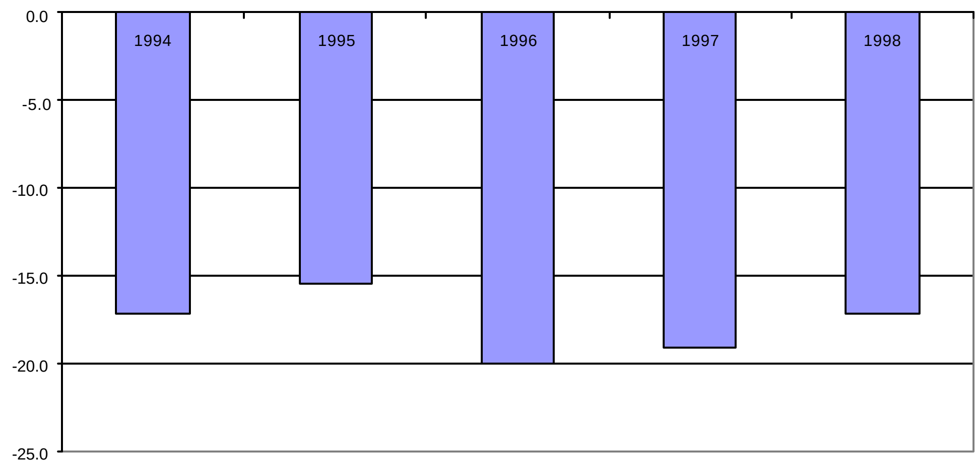


Figure 15
Current Account Balance
(percent of GDP)

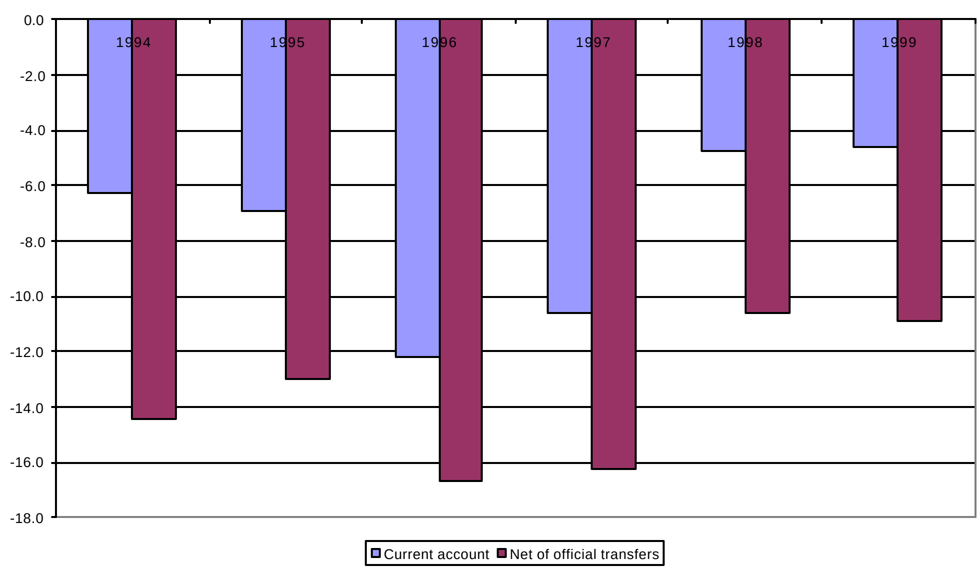
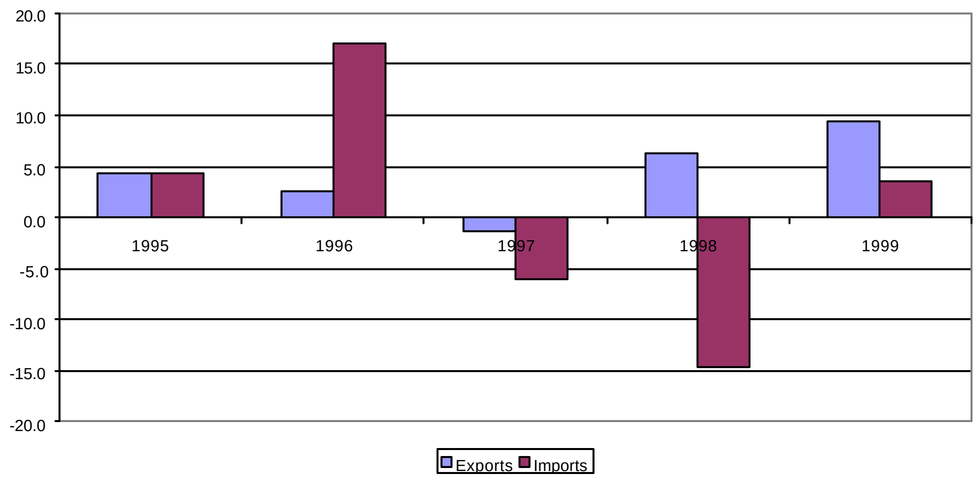


Figure 16
Export and Import Growth
(percentage growth in US$ values)



2.3.4 The Capital Account and Unresolved Data Issues

As can be seen in Figure 17, our recorded capital account surplus fell from 16.0 percent to 3.3 percent of GDP between 1996 and 1998. Unfortunately, this measure is subject to a very wide margin of error. The three main components of the capital account are FDI inflows, long term ODA loans, and "errors and omissions". Over the period from 1996 to 1998 FDI inflows declined from 9.5 to 4.4 percent of GDP and ODA loans rose from 8.4 to 11.9 percent of GDP. The net effect of these two components, therefore was a small decline in capital inflows from 17.9 to 16.3 percent of GDP – a fall of only 1.6 percent of GDP. The bulk of the decline in our capital account surplus over this period, therefore, is due to a sharp rise in the "errors and omissions" deficit – from 0.7 to 10.0 percent of GDP (Figure 18).

What this means, unfortunately, is that there was a very large increase (9.3 percent of GDP) in unrecorded net foreign exchange outflows from 1996 to 1998. We cannot know whether this was short term capital flight, large increases in unofficial imports, decreases in unrecorded exports, or changes in some other balance of payments transactions.

In light of our increased use of direct foreign exchange controls for balance of payments purposes, and of expectations and even rumors of much stronger measures, a certain amount of capital flight almost certainly occurred. For the same reason, use of direct and indirect import controls at the height of the crisis might also have caused some increase in unrecorded imports. Unfortunately, we cannot determine with any more certainty what is behind the large recent increases in errors and omissions. Improved data collection and compilation, together with less need to revert to undesirable direct controls, should reduce such problems in the future.

It is quite possible that the current account balances reported earlier could understate our deficit by as much as 9 or 10 percent of GDP. That is, our 1998 current account deficit could actually be three times larger than shown in Figure 15. This makes it very difficult to provide a complete macroeconomic analysis of our economy over the crisis period, and it raises difficulties in making projections upon which to base macroeconomic policies for the post-crisis recovery period.

Figure 17
Capital Account Balance
(percent of GDP)

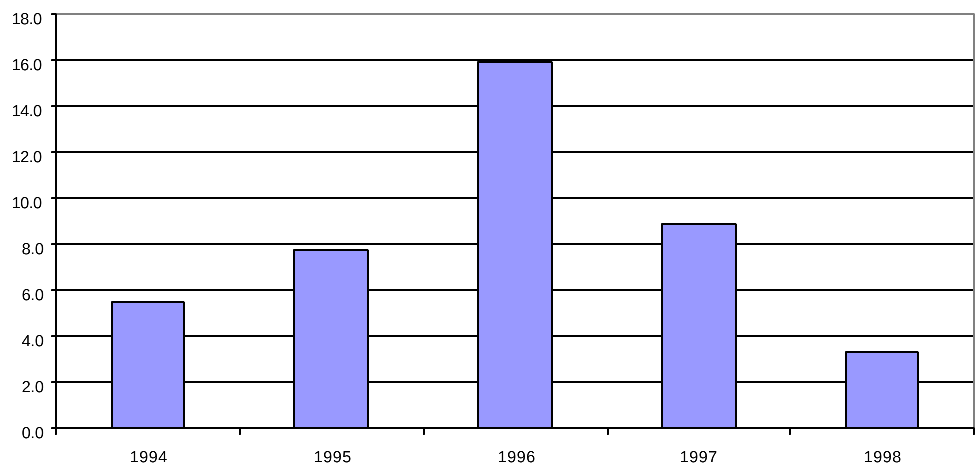
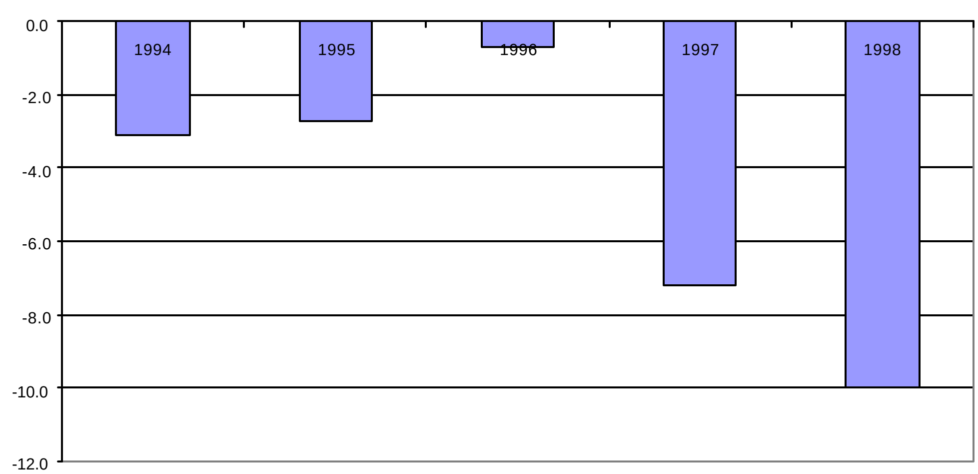


Figure 18
Errors and Omissions
(percent of GDP)



2.3.5 External Debt

Lao PDR's external debt is still dominated by nonconvertible Russian debt that, at an official exchange rate of SUR 0.6 per dollar, amounts to US$1,361 million. However, as a result of increasing utilization of facilities available from bilateral and especially multilateral creditors, our convertible currency debt has been growing rapidly. Between 1994 and 1998 convertible currency debt almost doubled, from US$579 million to US$1,100 million. The growth of the two main components of our external debt is shown in Figure 19.

The depreciation of the kip since the beginning of the Asian crisis has increased the real burden of our external debt by far more than is indicated by the increase in its dollar value. Between 1994 and 1996 our rapid economic growth had actually led to a fall in the ratio of external debt to GDP, despite considerable new borrowing over the period. However, the crisis has reversed this trend dramatically, with the debt to GDP ratio rising from 118 to 195 percent between 1996 and 1998 (Figure 20).

The same trends are shown in the debt service ratio – debt service payments as a percent of gross export revenues. Our debt service ratio has tripled, from 3.3 to 9.9 percent, between 1994 and 1998 (Figure 21).

Figure 19
External Debt
(millions of US dollars)

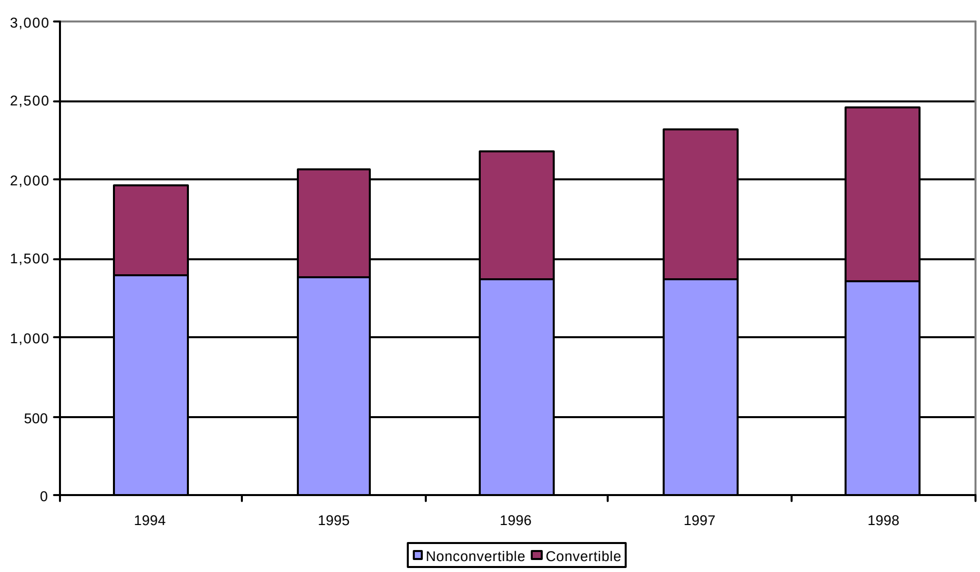


Figure 20
Ratio of External Debt to GDP
(percent)

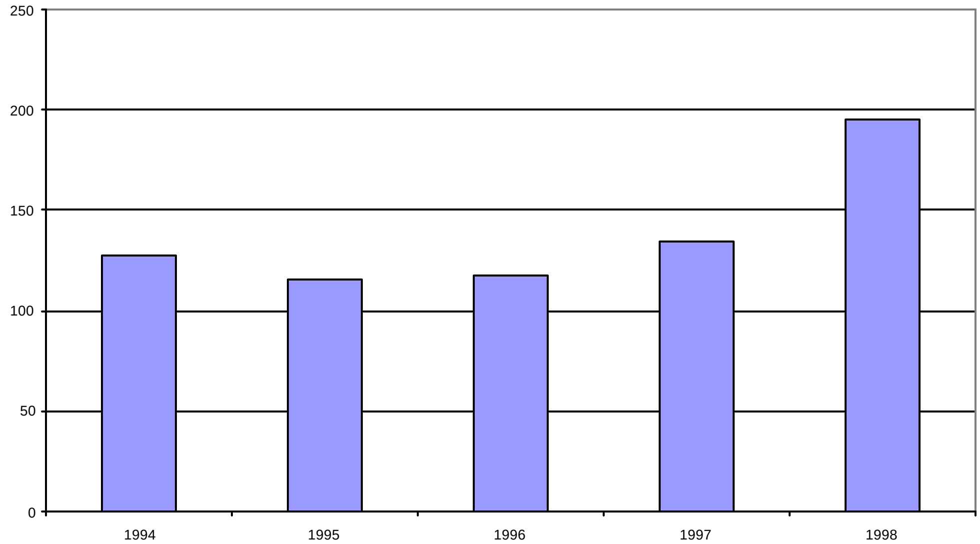
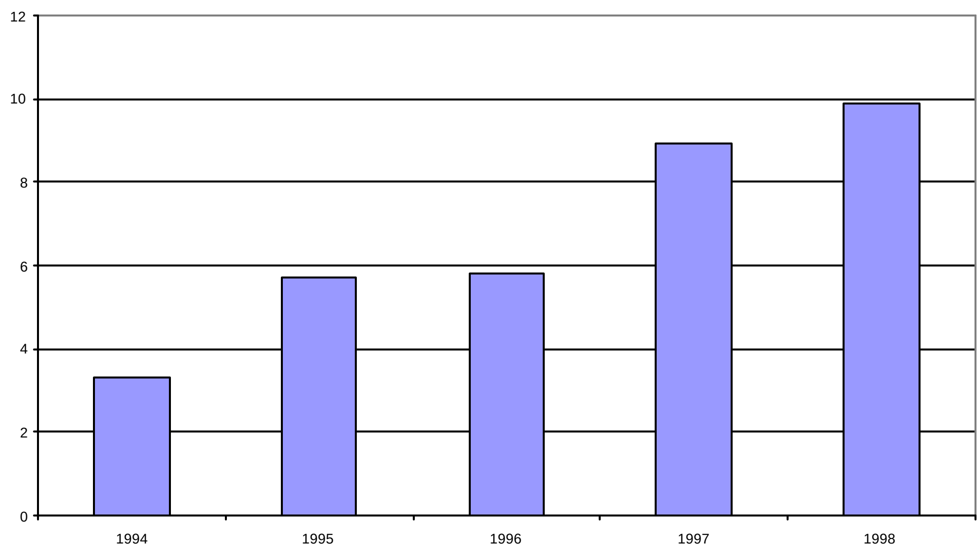


Figure 21
Debt Service Ratio
(percent of exports)



2.4 Fiscal Effects

As mentioned earlier, the crisis had some serious effects on our overall fiscal system – on both the revenue and expenditure sides. Figure 22 shows both the rising expenditures in 1997/98 that resulted from our aggressive fiscal stimulus and agricultural development expenditures that year, and declining revenues arising from the effects of the crisis. In 1998/99 expenditures were brought closer into line with pre-crisis patterns, at levels that are lower (in terms of their percentage of GDP) than we have attained for quite a number of years. Meanwhile, revenues remained at their lower levels.

2.4.1 Government Revenues

Tax collections account for over 80 percent of our own source fiscal revenues. Relative to GDP, tax revenues fell by 18.3 percent between 1995/96 and 1998/99, from 10.8 percent of GDP to 8.8 percent (Figure 23). Based on pre-crisis figures from 1995/96, our five most important tax revenue sources are import duties (23.1 percent of tax revenues), timber royalties (19.4 percent), turnover tax (19.4 percent), profits taxes (12.0 percent), and excise tax (9.3 percent). Of these five main revenue sources only one, excise tax collections, did not decline as measured by its share of GDP. Import duties and timber royalties fell by 52 percent and 49 percent respectively according to this measure. Profits taxes and turnover taxes fell by 24 percent and 9 percent respectively.

Figure 22
Government Revenue and Expenditure
(percent of GDP)

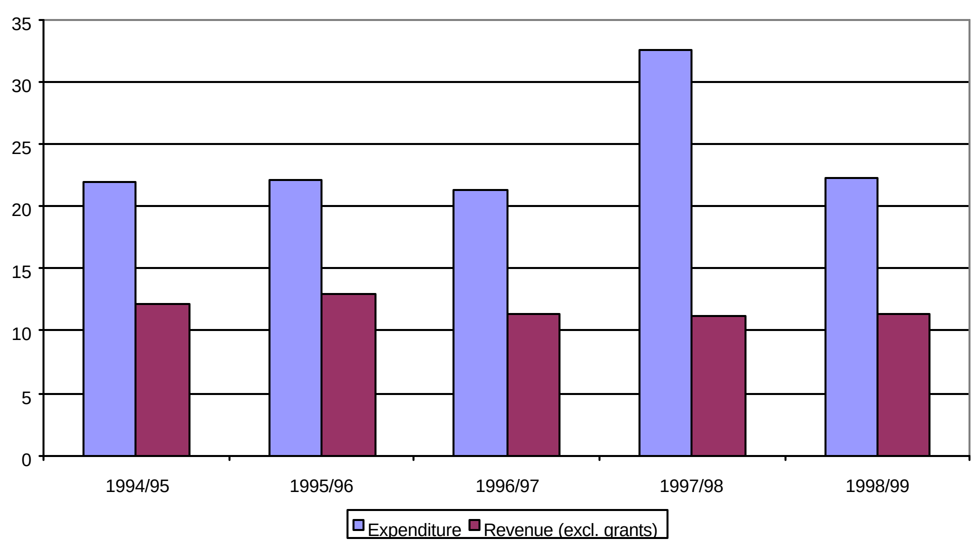
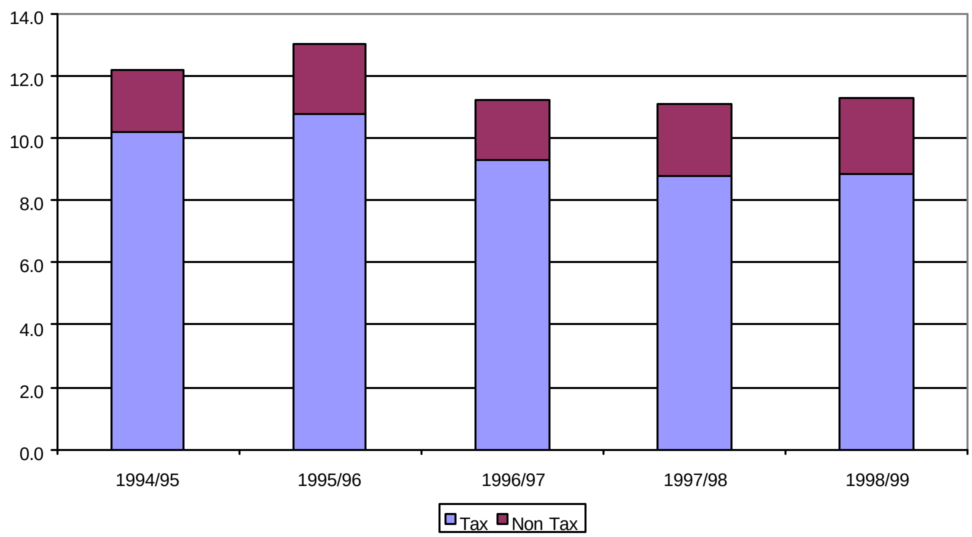


Figure 23
Tax and Non Tax Revenue
(percent of GDP)



It is because of these revenue shortfalls that we needed to revert to inflationary borrowing from the central bank during the crisis.

The fall in import duty collections arose in part from declining imports due to the crisis and in part from disruptions in Customs valuation systems arising from domestic inflation and exchange rate instability. The most basic problem was long delays in adjusting the exchange rate used for converting foreign currency import values into kip. Using an exchange rate of 4,000 kip per dollar when the market exchange rate is 8,000 kip is equivalent to a 50 percent across the board reduction in import duty rates. While this could be thought of as a major trade liberalization measure, this was not our intention, and it resulted in serious revenue losses. We increased the rate for all imports except a range of fuel products from 4,000 to 7,000 kip per dollar late last year, and did the same thing for all fuel products except diesel fuel and kerosene recently.

As another measure to improve customs administration and revenue collection, we have recently entered a contract with a French surveying company, Bureau Veritas, to assist in a new system of pre-shipment import inspection and import valuation. As part of their contract, this company will also assist with training of our own customs officials. The new system will begin operating in June 2000.

Timber royalties have been another major source of weakness in revenue collections. These royalties have fallen from $37 million in 1994 and 1995 to only $8 million in 1998. Part of this decline is due to diminishing rates of recorded log production since 1996. However, royalty collections per cubic meter have fallen from $74 in 1994 to only $16 in 1998, indicating that there must be additional reasons for declining royalty revenues. This is a major fiscal and resource management challenge, and is discussed further below.

2.4.2 Government Expenditures

As government revenues fell during the crisis, expenditures rose, especially in 1997/98 (Figure 22). Total government expenditures rose from the 1994/95 to 1996/97 levels of 21 to 22 percent of GDP to 32.5 percent in 1997/98. All of this increase was in respect of capital expenditures, which more than doubled from 11.8 to 24.4 percent of GDP in 1997/98 as we engaged in a massive campaign of rural infrastructure and irrigation investments (Figure 24). Because of the combined fiscal pressures of the revenue shortfalls described above and this capital expenditure campaign, it was necessary to find savings in other areas. As a consequence, current budgetary expenditures fell from 9.5 to 6.4 percent of GDP between 1996/97 and 1998/99 – a decrease of 33 percent. Government wage and salary expenditures have fallen by 51 percent over the same period, from 4.5 to 2.2 percent of GDP.

The emergency spending measures undertaken in response to the crisis diverted us from some of the priorities set out at the previous RTM and in our corresponding SEDP and PIP. In particular:

- instead of redressing previous imbalances between capital and current expenditures, the balance was temporarily pushed even further towards investment spending, and

- we were unable to switch spending priorities, as planned, towards greater emphasis on social and human development targets, especially in health and education.

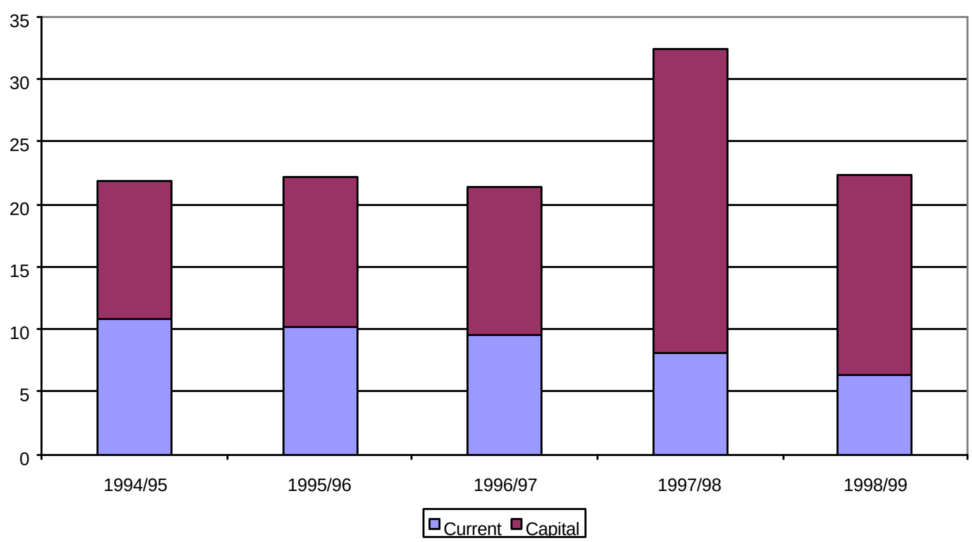
An improved balance of public expenditures in favor of current expenditures is essential to achieving the levels of growth necessary to meet our development priorities. Investments that are not properly maintained, managed or utilized will have low economic and social returns. Schools need teachers and books. Health clinics and hospitals need doctors, nurses, vaccines and medicines. Irrigation pumps need petrol. Road surfaces need to be maintained or else they will be washed away by rains and floods.

All new public investments bring with them a future stream of associated operating and maintenance (O&M) expenditures necessary for them to achieve their planned objectives and potential socio-economic returns. If the pre-crisis balance of capital versus current expenditures – 45 to 50 percent current – was precarious, the present balance –25 to 30 percent current – is much more dangerous. The O&M requirements of the huge investments in recent years, together with O&M deficits arising from earlier investments, and the tighter fiscal constraints due to reduced growth, present us with a major challenge for public expenditure planning for the next few years.

Greater emphasis on social and human development expenditures, especially in health and education, will be of even greater importance in the post-crisis recovery period than it was previously. This will be central to achieving our long term socio-economic goals, including poverty reduction and laying the foundations for economic diversification. The fiscal pressures alluded to above will present a major challenge to us in meeting these needs.

We face some serious fiscal planning challenges in the post-crisis recovery period with respect to spending priorities.

Figure 24
Capital and Current Expenditures
(percent of GDP)



2.5 Other Legal, Regulatory and Administrative Responses

Central to our economic success in the 1990s has been the reform of regulatory, legal and administrative structures to support the development of an outward oriented market system. This is essential to creating an environment in which the private sector can be a major contributor to our socio-economic development. At the RTM Launching Meeting in January this year, we listed seven major laws that had been promulgated since the Sixth RTM. Since then we have passed several additional laws.

These are steps of major importance. However, a great deal remains to be done, in the form of additional laws, and even more importantly implementing regulations and development of smooth and transparent administrative practices.

In the midst of the crisis a number of provinces and districts passed regulations restricting imports and exports of various basic goods. Restrictions on imports were designed to promote local production and conserve foreign exchange. Such measures had the side effect of raising local prices and hence hurting buyers of these goods. They are likely to have unintended implications for other policy goals such as tourism promotion. Restrictions on exports were designed for the opposite reason, to keep local prices low, thus subsidizing consumers and implicitly taxing farmers. These kinds of measures will have to be carefully examined in the context both of fiscal and administrative decentralization and of our commitment to freer trade in the framework of AFTA, the WTO and our own longer term trade and industrial development goals. The same is true of recent investments aimed at increasing self-sufficiency in basic industrial goods such as cement and fertilizer.

3. Socio-Economic Impacts

The crisis affected Lao growth far less than that of many of our neighboring countries. However, while the aggregate real effects of the crisis have been relatively small, the large changes in price levels and the exchange rate had significant differential effects across socio-economic groups.

Workers relying on inflexible nominal wages, most notably those on government salaries, suffered from incomplete adjustment of their incomes to rising consumer prices. Private sector wages have tended to be more flexible than in the public sector. Companies in successful tradable goods activities have generally managed to maintain higher real wages than in other firms.

Urban residents are much more dependent, in general, on wage income than are those in rural areas. As a result, the burden of adjustment to lower real wages fell disproportionately on urban areas.

In addition, urban dwellers have much less opportunity for subsistence food production. Their resulting greater dependence on markets rather then own production for food made them more vulnerable to inflation over the crisis period.

In more general terms, net producers and sellers of tradable goods were able to benefit most from the real exchange rate depreciation over the crisis period. This was especially true of those operating in markets that were not restricted by artificial constraints on trading possibilities.

In particular, the real depreciation of the kip, together with increased output of a number of agricultural products and increases in many international agricultural product prices in the early stages of the crisis, presented opportunities for Lao farmers with market connections to border areas. This was especially true where access to markets was relatively unrestricted. Many responded to these market incentives and benefited from rising real incomes as a result.

On the other hand, producers and sellers of non-tradables and net consumers of tradables were most vulnerable to the rapid inflation and real exchange rate depreciation.

It is becoming increasingly apparent that the hardest cores of poverty in our country are in the areas that have the weakest links to the market economy. Our dual rural economy was highlighted recently in our strategic vision for the agricultural sector.

> "These areas have followed divergent paths of development in recent years. The lowlands are entering a period of agricultural transformation where market forces are starting to deliver agricultural inputs through commercial channels and farm households are consuming part of their farm production and marketing the remaining part.
>
> "The uplands present a different picture. Here, agriculture is basically subsistence and farm households are locked in an acute poverty trap, created in part by lack of regional market access, absence of productivity increasing technology flows and lack of capital needed to fuel the transformation process." (p. vii).

There is limited evidence on what has happened to upland areas during the crisis. The real depreciation of the kip, together with improved transport and communications links apparently helped to bring previously remote upland farmers into the net of the market economy, with subsequent increases in their real incomes. As for the others, since a principal reason for their poverty is their isolation from markets, it is most likely that they have been little affected by the crisis.

While increased agricultural infrastructure investments are having their expected effects in improving agricultural productivity, their financing was the source of the inflationary spiral whose effects have been referred to already. Fiscal pressures also required unfortunate reductions in planned current expenditures on social and human resource development. Combined with increases in the prices of many basic educational and health-related inputs, these budget cuts had a significant impact on certain vulnerable groups. Redressing these expenditure and budgetary imbalances will be a major focus of our post-crisis macroeconomic policy strategy.

Private remittances from abroad, whose net inflow increased during the crisis, provided an important form of social safety net. However, the change in net remittances arose for several reasons, the most important of which might have been changes in temporary migration patterns between Lao PDR and neighboring countries. On the one hand, the depreciation of the kip decreased the attractiveness of our country to temporary workers from China and Vietnam. On the other hand, declining job opportunities and pressures in neighboring countries for temporary workers to return to their homes resulted in significant amounts of return migration to Lao PDR.

Urban dwellers, on average, depend more than those in rural areas on overseas remittance income. The depreciation of the kip would have produced a significant windfall for recipients of remittances whose foreign currency values remained unchanged. Of course, the return of many Lao workers from abroad reduced an important source of remittance income.

The return of Lao workers not only reduced remittances, but also put considerable pressure on labor markets and social support mechanisms. The departure of many Chinese and Vietnamese workers, however, created new demands for Lao workers, who showed their adaptability by moving into what have tended to be non-traditional occupations such as construction and roadwork.

4. The Current Macroeconomic Situation

Our economy is less well developed than most of our regional neighbors. This gives rise to many structural differences and has ensured that the economic crisis affected us differently than our neighbors. Each country has designed its policy responses according to its own particular circumstances and priorities. Many countries have been criticized for erring on the side of fiscal and monetary stringency, and the IMF itself has acknowledged being too slow in recommending a relaxation of the tight fiscal stances in a number of the crisis countries (Lane *et al* 1999). We did not make this mistake. If our own strategy erred, it was on the side of *excessive* monetary and fiscal stimulus as a means of dampening the social impacts of the crisis on our people.

Major emergencies require drastic and speedy counter-measures. Nevertheless, we recognize that the emergency and the associated policy responses have underscored and in some instances aggravated underlying structural problems. These now need to be dealt with. High and unpredictable inflation causes instabilities and real burdens that are unacceptable as a part of the long term macroeconomic environment. Now that the regional recovery is under way, a return to our long run macroeconomic strategies is required. Resumption of monetary stability and fiscal prudence are now necessary.

Strong and decisive fiscal and monetary measures initiated in the final months of 1999 have laid the foundations for renewed macroeconomic stability. The inflation rate has fallen sharply, as seen in the month to month changes in the CPI (Figure 2). The kip has appreciated, in nominal and real terms.

The principal policy measures responsible for these changes are cessation of money-financed expenditure increases and the use of treasury bill sales to mop up of the stock of excess liquidity in the money market.

Real growth has been maintained at reasonable levels, aided in large part by continued agricultural strength. A combination of strong international markets in the early phases of the crisis, supportive public infrastructure investments in the rural sector, and a depressed real exchange rate provided a substantial boost to agriculture during this difficult period. At the same time, these factors helped to draw many more farmers into the market economy.

Our principal challenge now will be to maintain this hard-won macroeconomic stability. In light of a number of major risks, this will not be an easy task.

- A higher real exchange rate and weaker international markets will pose new difficulties for our agricultural sector.

- The higher real exchange rate will place additional burdens on the development of a more diversified and competitive economy.

- Large recent investments in rural infrastructure will impose further fiscal burdens for operating and maintenance needs at a time when the current side of the budget is already suffering from unavoidable spending squeezes in recent years.

- Additional budgetary demands are looming as a result of problems in the banking and SOE sectors.

- Weaknesses in revenue-raising capabilities that appeared in recent years need to be addressed.

- In the midst of this challenging fiscal environment, it will be necessary to marshal the policy-making and administrative resources to resume and make major progress in the design and implementation of the NEM.

These are difficult, but not insurmountable challenges. In the remainder of this report we outline in more detail the key strategic issues facing us the post-crisis macroeconomic environment, and the main elements of our strategy for dealing with them.

5. Macroeconomic Strategy: Key Issues

Based on our assessment of recent experience, and our review of some of the important lessons from the crisis, we see three key sets of closely related strategic issues.

- The hidden effects, and especially the upward pressure on the real exchange rate, of large foreign exchange inflows from ODA, resource rents and FDI.

- The need to increase economic diversification and employment growth.

- The need to improve fiscal and monetary management.

These strategic issues are discussed in turn in the remainder of this section.

5.1 Influences on and Key Role of the Exchange Rate

Relative to GDP, Lao PDR has very large inflows of foreign exchange from a number of sources – ODA, FDI, logs, hydro electricity exports, remittances, etc. While such inflows are a source of wealth and could be used to make significant contributions to Lao development, they also have some less understood consequences. In particular, they raise the real exchange rate. This in turn reduces the international competitiveness of our agricultural sector and the development prospects for a diversified, labor intensive non-agricultural manufacturing sector.

The fall in the real exchange rate that resulted from our massive fiscal and monetary stimulus in 1998/99 demonstrated how a more benign exchange rate environment can be of benefit to the agricultural sector. The more favorable exchange rate over the crisis period helped not only farmers in the immediate border areas of Thailand, but also those in more remote regions in the north of the country.

In general, a higher value of the real exchange rate hurts farmers and is detrimental to the competitiveness of outward oriented manufacturing industries. Our large capital inflows present a number of macroeconomic policy challenges.

5.1.1 Competitiveness

We have sizeable deficits on the trade and current accounts because of correspondingly large inflows of foreign exchange from other sources. The effect of foreign exchange inflows on the real exchange rate is the principal mechanism for decreasing the competitiveness of potential new export industries and hence maintaining the trade and current account deficits.

While ODA, FDI, timber and hydro electricity exports provide considerable income to Lao PDR, they create very few jobs. Our population and labor force continue to grow rapidly. Neither agriculture nor the public sector can be expected to provide the jobs necessary to absorb these increases.

Through irrigation, opening of markets, and other means of productivity improvement, we will continue to support the vital role of agriculture in the economy. However, as Thailand's experience in the 1980s so clearly demonstrates, excessive reliance on extensive agricultural growth through land clearance and deforestation can have devastating social and environmental impacts.

The public service has been absorbing a disproportionately large share of new labor force entrants in recent years. It is certainly necessary and important to have a strong and well trained public service. However, even at current staffing levels, it will take some time for us to restore real salaries to pre-crisis levels. The public service should not and cannot be used as a principal source of employment for our growing labor force.

As a means of achieving our long term growth targets, and more importantly of creating jobs for our young and growing labor force, it is critically important to overcome as much as possible the anti-competitive effects of our high real exchange rate on labor intensive tradable goods industries. This will be central to our macroeconomic strategy in the coming years. The two most important elements in this regard will be

- reinvigoration of the reforms launched under the NEM, and
- recommitment to human resource development.

5.1.2 Effectiveness of ODA

By its sheer magnitude alone – 17.8 percent of GDP in 1998 – official development assistance has a profound impact on our economy. While flows of this size can be used to great benefit in promoting our long term development, they are not costless.

- As already indicated, these inflows have a significant effect on our real exchange rate, with consequent implications for competitiveness of the tradable goods sectors of our economy.
- Coordination of ODA inflows imposes enormous demands on public sector management capabilities. Large amounts of our country's scarce management skills are occupied by the "business" of aid coordination.
- ODA inflows create inevitable incentives for the diversion of managerial and entrepreneurial energies into various kids of rent-seeking activities.
- Public sector expenditure priorities are heavily influenced by donor priorities. Donors are heavily biased towards capital expenditures; they currently finance about 80 percent of our public investment budget. It is difficult to ignore the resulting influence on our own expenditure decisions.

These are some of the constraints and influences imposed by ODA in the Lao context. Given the large role of ODA in our economy, improvements in aid management and coordination are of very high priority.

With donor assistance, we have begun to re-examine processes and procedures for aid coordination. In this regard, we are undertaking reforms in project cycle management, we are preparing a decree on Government Roles and Responsibilities in the Planning and Management of ODA, and we have begun to systematize processes for the recruitment and administration of international personnel working on development cooperation. We are also engaged in a project to improve aid project databases.

At the macroeconomic level, the aid coordination issue is much larger than this. As indicated earlier, the only way to counteract the anti-competitive exchange rate effects of aid inflows is through doubly effective economic reform measures and complementary human development initiatives.

ODA can be used to help achieve these goals. A growing body of international evidence that is of direct relevance to Lao PDR suggests that market oriented economic reforms and ODA can be highly complementary in promoting socio-economic development. A recent review of international experience concludes that the effectiveness of aid programs does not necessarily depend on the magnitude of their financial contributions (World Bank 1998, and Burnside and Dollar 1997). The principal determinant of the success of ODA was found to be the domestic policy environment in the recipient country. Aid is successful in promoting long term development in countries where governments pursue strong, market-oriented economic reform programs, and where policy-makers are able to make and implement sound economic decisions. Aid that supports poor economic policy regimes, on the other hand, was found to be ineffective in promoting socio-economic development. These are strong, even if not very surprising, conclusions.

International experience seems to indicate that the determinants of good economic policies, and their relationship, if any, to ODA are complex. Unlike foreign investors, whose decisions must be appraised against their profitability, donors are driven by diverse motives, and are hampered by the absence of simple success indicators. Thus, on the supply side ODA suffers from the absence of the market-based self-correcting mechanisms that operate with FDI. Similarly, without transparency and accountability in domestic policy determination, aid can be used in recipient countries to sustain unproductive rent-seeking, political and other activities, to the detriment of socio-economic development. International experience shows that aid can be used to support governments in deferring hard policy choices and thus sustain bad development policies.

The challenge for Lao PDR, in concert with our international development partners, is to maximize the effectiveness of ODA in achieving our socio-economic development goals. We need to ensure that aid resources are directed, as efficiently as possible, to our most important development and social needs. To do this, we need to improve our own policy and expenditure assessment capabilities. We return to this theme further below. And we certainly need to proceed as speedily as possible, within the bounds of our own domestic constraints and capabilities, with our outward oriented, market-based economic reform program.

5.1.3 Maximizing Benefits from FDI

Following the implementation of the NEM and associated economic reforms we have benefited from substantial inflows of foreign investment, complementing the growth of private investment arising for the same reasons. However, in recent years, rates of private investment, both foreign and domestic, have fallen off considerably. Foreign investment fell from 9.5 percent of GDP in 1996 to only 4.4 percent in 1998. Our gross domestic investment rate fell from 29 percent in 1996 to an estimated 23.5 percent in 1999 (ADB 1999, Appendix 1). A large portion of the vast amount of FDI approved over 1994 to 1996 has never yet been realized. While this is due in large part to crisis-related postponements of several major hydro electricity projects, it also reflects some fundamental difficulties in attracting new investments. A recent survey indicated as well that a significant proportion of approved and realized foreign investments have subsequently ceased operation in Lao PDR (IMF 1999).

Macroeconomic instability due to high and variable inflation, rapidly changing exchange rates, and uncertainties about the availability and price of foreign exchange contributed to our difficulties in attracting investment most recently. Now that macroeconomic stability has been restored, we can return to some of the fundamental issues involved in reforming our investment climate.

A large part of our foreign investment has been of a very capital intensive nature, and has been aimed at capitalizing on our abundant natural resources, especially the potential for hydro electricity developments and the exploitation of our forests. The next largest target of foreign investments has been in local service industries, most importantly transportation, telecommunications and tourism. Lagging furthest behind have been investments in manufacturing, especially in outward oriented activities aimed at export markets and efficient import substitution. This is unfortunate since it is in exactly these labor intensive areas where there is the greatest potential for new kinds of job creation and skill enhancement. This appears to reflect a general bias in our foreign investment approval and promotion system in favor of large, capital intensive projects. The attractiveness of service industries and the lack of attractiveness of outward oriented manufactures also reflect the exchange rate biases discussed earlier.

A principal goal of our economic reform program is to create a secure legal environment in which investors' decisions are based only on market opportunities and relevant market risks. At the same time, transparent and non-distorting tax and regulatory systems will ensure that decisions based on private returns generate high and sustainable long term growth in line with our socio-economic development needs.

To this end, we passed a Foreign Investment Law in 1994. In terms of almost all of its features – breadth of sectors open to foreigners, profit and income tax rates, import privileges on materials and equipment, profit repatriation and protection of basic property rights – this law is one of the region's most liberal and investor friendly. Despite this, a number of problems remain. Most of these problems arise from two sources – the lack of sufficient implementing regulations, and conflicts with other government laws and regulations. Among the other laws and regulations that sometimes conflict with the intent of the Foreign Investment Law are the Mining and Electricity Laws, the Domestic Investment Law, and foreign exchange regulations and controls. In addition a wide range of licensing, approval and permit systems under a number of agencies and at different levels of government and administration create confusion and raise the costs of investors.

In order to resolve such issues, we have continued to scrutinize and improve investment procedures. Among the most important has been the establishment of the Foreign Investment Management Committee (FIMC) in the Prime Minister's Office as a "one-stop-shop" for foreign investors. But it will be necessary for us to continue to review other laws and regulations for mutual consistency, and to complete and update relevant implementing regulations.

In designing our FDI policies, we must bear in mind that more is not always better, and that the benefits we get from FDI depend very much on the policy environment we create for it. We do not wish to offer excessive fiscal or other incentives to attract foreign investment. We certainly do not wish to create artificial monopolies or other such regulatory incentives for this purpose. We want to ensure that foreign and domestic investors are treated in a similar manner. Our general objective is to continue with our economic reform measures in order to improve the private sector investment environment. This is a key part of our strategy for achieving our long term socio-economic development goals.

5.1.4 Natural Resource Rents

Timber and hydro electricity exports generate rents (revenues in excess of all costs of production) and significant export revenues. Relative to the amounts of revenues and capital investment involved, these activities are not significant direct employment creators. Furthermore, the indirect negative effects of the associated foreign exchange inflows on the competitiveness of more labor intensive outward oriented industries could be significant.

The socio-economic impacts of timber production and hydro electricity development, therefore, depend primarily on the rents that are created and how they are utilized.

As indicated earlier, royalty collections on logs have fallen off quite dramatically in recent years. The data are summarized in Table 4. Despite the fact that log production was the same in 1998 as in 1994, total royalty collections have fallen from $37.1 million to $8.2 million over that period. On a unit basis, royalty collections have fallen from $74 per cubic meter in 1994 to only $16 in 1998.

This enormous decrease is due only in small part to declining world log prices. While the economic rents in logs have certainly declined in response to the crisis, the share collected in the form of royalties has fallen by a much greater amount. Since there have been no major changes in our royalty rates in recent years, the opposite should have been the case – i.e. the public share should have risen. We do not yet have a complete understanding of what has happened. However, one factor is almost certainly the fact that royalties are applied only to *exports* of logs. The fact that royalties are not based on production of logs leaves many opportunities for avoidance, including illegal log exports.

Table 4
Timber Royalties

	Log Production (cum. thousands)	Royalties (billions of kip)	Royalties (millions of US$)	Royalties (US$ per cum.)
1994	500	26.7	37.1	74
1995	819	34.6	37.4	46
1996	659	31.7	33.2	50
1997	560	36.9	17.3	31
1998	500	35.0	8.2	16

The recent experience with log royalties raises some important issues with respect to our macroeconomic strategy.

- What can be done to improve enforcement of royalty collections? These royalties are based on one of our most precious natural resources, and could make a major contribution to our socio-economic goals of growth with equity and poverty reduction. However, to realize this potential, the rents must be realized in the government budget or be utilized in some other development-enhancing manner.

- What is the socio-economic rationale for exempting domestically used logs from royalty collections? The underlying justification for such a policy must be in terms of the distribution of the benefits of cheap logs among the domestic population. There are two possible threads to a justification along such lines. The first is in terms of the implicit (and very large) subsidies this gives to downstream export processing industries. The second is in terms of the direct benefits to poor Lao citizens arising from access to substantially under priced logs. Any benefits along either of these lines must be justified as well in light of the large opportunity costs of forgoing the export or standing value of a very valuable resource. These issues need to be investigated on the basis of international experience and investigation of domestic data on log production and use in Lao PDR.

- What is the appropriate domestic response to fluctuations in world log prices? Recorded harvests have declined somewhat over the crisis period. However, there are some indications that unrecorded production has declined by less, and might even have increased. And as already indicated, public sector royalty collections have fallen precipitously. In these circumstances, and in light of our socio-economic goals, the best investment of our timber resources during periods of low prices might be to leave them standing in the forest until the market recovers.

The regional crisis has had a large impact on our plans for and revenue expectations from the hydro electric sector. At a minimum, it will result in substantial delays in several major projects, as well as reduced revenue flows due to lower prices. This will substantially reduce the rents available from this source. These unexpected developments should give us cause to reflect on the most optimal way to make use of rents that are available. One of our traditional channels for distributing these rents has been through relatively low electricity prices for domestic users. Subsidized prices are of obvious assistance to the users of electricity. At the same time, as with any price subsidy, they will tend to encourage its wasteful use. These effects must be weighed against each other in terms of their impact on our principal socio-economic goals of growth with equity and poverty reduction. A principal factor in this regard is the extent to which the implicit subsidy generates employment and/or provides benefits to our lower income citizens.

5.2 Diversification and Employment Growth

In light of the overwhelming importance of agriculture and the rural population in our country, recent development efforts have focussed primarily on these sectors. We also recognize, however, that few countries in the world have developed solely on the basis of agriculture and rural development. Our population and labor force are growing rapidly. This makes sole dependence on agriculture and the rural sector unsustainable and possibly environmentally dangerous as well. In addition, rising education levels and increasing exposure to our immediate neighbors and the broader global community are changing expectations and capabilities of our youth.

For these reasons, it is necessary now to begin to shift our attention towards more diversified development. Our close links with the dynamic regional economy present us with many natural opportunities in this regard. The challenges will be to continue with the rapid reform of the legal and regulatory system to support the NEM, and equally importantly, to improve the mechanisms and institutions for implementing these reforms.

The new strategy is not a change of direction. It certainly would not involve any form of discrimination against agriculture and rural areas. It is simply a broadening of the focus of the market-oriented policy development already being implemented in agriculture and further development and implementation of the NEM. (For a review of this strategy as it pertains to agriculture, see Lao PDR 1999.)

The key to the success of this approach will be the effectiveness with which we are able to improve the fiscal, legal, administrative and regulatory environment for the private sector. This will require progress on a range of issues from financial sector reform and development to improvement of licensing and investment approval procedures. A number of these issues also have important implications for the government budget, which is discussed in a later section as well.

5.2.1 Financial Sector Reform

The financial sector is very important for private sector development. It is important for mobilizing national savings. It is a principal means for processing and utilizing relevant investment information, and for channeling savings into the most productive investment sectors. It is a key instrument for facilitating the financial transactions that correspond to domestic and international trade, and for providing working capital that is essential for the smooth functioning of enterprises.

The Lao financial sector is still very weak and underdeveloped, and hence is unable to provide an adequate level of service to our emerging private sector. Despite some major reforms in recent years, and recapitalization of the state-owned commercial banks (SOCBs) in 1994, our banking system suffers from high levels of non-performing loans, and very weak lending and supervisory practices. Poor implementation of laws and regulations, official pressures for directed lending towards preferred firms and sectors, and weak skill levels have all contributed to these difficulties.

It is necessary to restore the financial soundness of the banking system, and to improve banking and supervisory practices in order that this key sector can contribute to the goal of diversification and growth of the private sector and contribute to meeting our socio-economic development goals.

5.2.2 SOE Reform

Among the early successes of our economic reform program was the SOE sector. In many respects, we can be proud to think of ourselves as international leaders in this regard. In the early years of the reforms we were very successful at tightening financial controls, improving management practices, privatizing SOEs, and exposing them to the forces of market competition. By the end of 1997, there remained only 56 centrally managed SOEs, of which 24 we consider to be of a strategic nature and hence needing to remain in the state sector. In addition, there remains a large number of small scale SOEs at both the central and provincial levels.

Unfortunately, the disruptions of the economic crisis delayed the SOE reform process, as it was very difficult to force further adjustments in the midst of a harsh macroeconomic climate. This has had some serious consequences that will now have to be dealt with. A combination of weak management practices, market difficulties arising from the crisis, and pricing constraints imposed in order to achieve social objectives during the crisis have made many of the remaining SOEs extremely weak. They are a source of many of the banking sector's non-performing loans, and pose a serious threat to the government budget. Furthermore, a number of special privileges granted to SOEs, together with special price controls on many of the goods they produce constitute a serious barrier to efficient resource allocation and to private sector development.

For all of these reasons, we now have to rededicate ourselves to the completion of our SOE reform program. This will include a reconsideration of the socio-economic development purposes served by special pricing rules applied to key SOEs, including EDL, Nam Pa Pa Lao, Lao Aviation and the Lao State Fuel Company. In addition, we will need to find ways to increase market competition and ensure that the SOE sector does not serve as a barrier to private sector development.

5.2.3 Business Licensing and Regulation

We have alluded earlier to the problems in the regulatory environment for foreign and domestic investors. If we wish to achieve our goals of economic diversification and employment, the private sector will have to be the primary vehicle. For this to be the case, the regulatory environment must be as simple, stable and transparent as possible. The state must focus on the areas in which it is best able to contribute. This includes the establishment and supervision of laws governing contracts and financial transactions. We certainly will need to play a role in designing and enforcing necessary environmental regulations. We might need to implement a competition law. Of equal, if not greater importance to business and investment laws themselves is their implementation. This requires complete and clear implementing regulations, and institutions and individuals that can be counted on to apply them fairly and efficiently.

Other than this, we must aim to be as non-intrusive as possible. As mentioned in the previous section, we must ensure that SOEs do not get preferential financial or regulatory treatment. We must remove unnecessary government-imposed barriers to entry, especially in the form of restrictive licensing and investment approval regulations. This is especially important in the trading sector, an issue to which we return below.

An additional complication in the deregulation of the business environment in Lao PDR is the considerable autonomy of provincial governments in making business and investment regulations. Despite efforts to consolidate all foreign investment procedures in a "one stop shop" in the FIMC, for instance, investors still face many requirements at the provincial and even district levels, some of which might even contradict those at the central level. This problem is not peculiar to Lao PDR; but the degree of autonomy of provincial governments in our country is much greater than in many other countries.

The resulting wide variety of business laws and regulations imposes additional coordination and information costs on investors, and thus increasing uncertainty and adding to their costs of doing business in Lao PDR. This is an additional difficulty we must face in reforming and improving the business and investment environment in our country.

5.2.4 Trade Policies

A key element in the promotion of diversification and employment growth, especially in a small country like ours, is an open and transparent trade policy regime. Whether measured by population or income, our national market is far too small to contemplate self-sufficiency as a viable industrial strategy. Furthermore, our location at the center of one of the most dynamic regions of the world economy makes regional and international integration not only almost unavoidable, but also an obvious advantage in designing our socio-economic development strategy.

Our import tariff regime comprises only six rate categories, ranging from 5 to 40 percent, with an average rate of about 20 percent. This leaves some room for improvement, especially by compressing the range through lowering the top rates. This will increase the neutrality of the regime and will also reduce political pressures for special exemptions and diminish incentives to smuggle. It should be noted, however, that significant amounts of our imports are in the form of raw materials and intermediate inputs used for export production (e.g. garments). This is a necessary and unavoidable form of exemption that is required to maintain the competitiveness of our export industries. Such exemptions, of course, are subject to some potential abuse, and we must guard against that.

The more serious difficulties with our import and export regimes in recent years have been with quantitative restrictions on a variety of imported products, and licensing requirements imposed on both importers and exporters.

Quantitative restrictions have been imposed for a variety of reasons, most of which have stemmed from our desire to conserve foreign exchange and reduce pressures on the exchange rate during the period of the crisis. In the post crisis period, as we move towards a more market oriented exchange rate management mechanism (see below), most such controls will become redundant. We then will be able to liberalize import and export licensing requirements, and allow most import and export activities to be undertaken on a competitive basis, subject only to basic registration and applicable taxes and duties.

As indicated at the beginning of this discussion, the use of import taxes or regulatory controls for the sole purpose of achieving self-sufficiency *per se* is inappropriate and would be very costly for a small country like ours.

Commitments we have undertaken as part of our membership in AFTA will impose time requirements on the implementation of many of the policy changes suggested here. However, we recognize that it is in our own self interest to engage in these reforms and would hope as much as possible to apply all changes in tariffs and import and export licensing requirements on trade with all international trading partners. Negotiation of agreements for WTO accession would be conducted in the same spirit.

5.3 Fiscal and Monetary Management

A number of key monetary and fiscal management issues have arisen and/or become more apparent as a result of our efforts to deal with the economic crisis.

5.3.1 Monetizing of Public Expenditures

Excessive monetizing of public expenditures through borrowing from the central bank is highly destabilizing, and should only be conducted in the most serious of emergencies, such as those we faced during the recent crisis. Excessive monetary growth is inflationary and has undesirable macroeconomic and socio-economic side effects.

In future, monetary policies should be directed primarily at stabilizing domestic price levels and to increasing confidence in the stability of the macroeconomy.

5.3.2 Instruments of Monetary Policy

In order to achieve our monetary goals, we must aim at stable and non-excessive monetary growth. We need to be able to refrain from cash rationing as an instrument of liquidity control. Cash rationing raises costs of economic activities and diminishes confidence in the banking system.

5.3.3 Exchange Rate Management

Although the parallel market premium has virtually disappeared since we restored macroeconomic stability, we need to fully integrate the official and "underground" markets. We need to eliminate any future need for foreign exchange rationing in the form of either direct market controls or indirect limits on demand thorough regulation and control of imports. This will require a unified market, with an active and open interbank market for foreign exchange. To meet unanticipated emergencies, we will need to restore foreign exchange reserves to more appropriate levels.

5.3.4 Public Expenditure Levels and Priorities

Our fiscal experience since the previous RTM has been turbulent. Expenditure levels grew far more than originally planned as a result of our spending measures to cushion the impacts of the crisis and to improve rural and agricultural infrastructure.

Unfortunately, the balances between capital and current expenditures and between social and other types of developmental expenditures have diverged from what we had planned prior to the crisis. At this time, we need not only to restore the balances but also to deal with some of the unintended consequences of the spending patterns of recent years. The fiscal burdens of recent expenditures will make restoration of some of these balances even more difficult than before. Spending on government salaries, and on operations and maintenance have been squeezed to perilously low levels. At the same time, the need to restore fiscal stability will make it very difficult to meet current needs, let alone make up some of the critical deficits that have emerged.

In addition, hidden deficits that have developed as a result of weaknesses in the SOE and banking sectors will add further fiscal burdens in the near future.

There is a clear need for us to be able systematize the planning and implementation of public sector expenditures. High on the list of priorities are improvements in our own capabilities for evaluating spending alternatives and for accurately assessing future expenditure implications of current expenditure plans. This must include closer and more effective coordination of public expenditure plans with our donors, who are a major source of the funding of many of these expenditures.

The challenges we will face with respect to both the level and composition of public expenditures in the immediate future are daunting. Since a very large portion of spending, especially on public investment, is financed with donor funds, we are hopeful that our development partners will be able to assist us in resolving some of these expenditure issues.

5.3.5 Public Sector Resource Mobilization

At the same time as our expenditure needs grew during the crisis, revenue collections diminished. As a result, it has been necessary for us in the very short run to restore fiscal stability through drastic expenditure reductions. Some of the consequences have been described above. This is clearly not a viable long term solution. A more viable longer term strategy must include measures to restore public sector resource mobilization capabilities.

We have already alluded to some of the issues related to the restoration of customs and forest royalty collections. In addition, we need to renew efforts at improving income tax collections, especially from the largest tax-paying units. We also need to explore other possibilities, including replacing the current turnover tax with a value added tax, and imposing excise taxes on luxury goods as an alternative to the current systems of import restrictions.

In addition to issues of tax design and tax administration, it is imperative that we ensure continued rapid economic growth to provide a buoyant base for public sector revenue collections to meet our socio-economic development needs.

5.3.6 Fiscal Decentralization

Although ours is a small country, we are also relatively sparsely populated and our population is widely dispersed. For these and other historical reasons our government administration is, in many respects, highly decentralized. Approximately 80 percent of government employees are at the provincial and local levels. A large proportion of tax collections is administered at the provincial level. Provincial governments have very wide regulatory powers, including the authority to control imports and exports. On the expenditure side, however, the central government retains relatively highly centralized control.

This system gives rise to a number of important regulatory and inter-agency coordination issues, some of which have been alluded to earlier. In addition, it raises serious fiscal issues related to revenue-raising and expenditure responsibilities. Our systems of fiscal decentralization are still very much in flux, and will continue to change as economic development and the opening of our market economy transform many of the basic parameters of our regional economic structures.

In the process, we will wish to bear in mind a few underlying principles that will be central to the achievement of our socio-economic goals.

- Provincial and local regulations cannot be permitted to distort and interfere with the efficient operation of national markets and with our integration into the regional and global economies.

- Assignments of expenditure responsibilities across levels of government must take account of the efficiency with which they can be carried out at different levels. The same must be true of revenue responsibilities.

- There must be rough correspondence between expenditure allocations and revenue responsibilities at each level of government, as a means of ensuring accountability. That is, there must be vertical balance in expenditures and revenues across levels of government, and there must be adequate incentives for fiscal effort by provincial governments.

- We must ensure that the residents of poorer provinces and districts do not suffer unduly as a result of fiscal decentralization. This will require measures for at least partial compensation for differences in fiscal capacities across provinces.

6. Macroeconomic Strategy: Plans and Future Directions

We face many important and difficult challenges in designing a macroeconomic framework for the post-crisis Lao economy. Our overall economic performance during the crisis was quite successful, especially as it affected the rural poor. Our growth rates over this period outperformed most of our neighbors. Nevertheless, some legacies of the crisis will continue to impose costs into the future. Furthermore, the crisis also caused us to slow down and in some cases even temporarily reverse plans for macroeconomic reform that we presented at the previous RTM. It is against this background that we must plan our post-crisis strategy.

6.1 Basic Themes

Our overriding goal is to achieve sustainable growth with equity and poverty reduction. The key to our strategy remains the further development of an open market economy, which we still consider to be the best way to serve the needs and aspirations of our people. This requires not only the development of a strong private sector, but also the improvement of laws, regulations and capabilities of the government in providing a supportive institutional framework, necessary physical infrastructure, and the essential tools for the human development of our people.

Two cross-cutting themes underlie all the elements of our macroeconomic strategy:

- greater transparency and improved information flows, and
- appropriate timing and sequencing of reforms.

6.1.1 Transparency and Information Flows

Sound macroeconomic policies must be based on accurate and timely information. Their successful implementation requires that all economic actors have access to the most up to date information about economic trends and about government policies. The policies themselves have to be as simple and transparent as possible.

The IMF has provided us with some very helpful guidelines for reporting of basic macroeconomic data for the monetary, fiscal, external, real and state enterprise sectors. While these guidelines are framed in the context of meeting the monitoring needs of the IMF, we recognize the equal if not greater importance of these data for our own use in policy formulation and evaluation. In addition, general dissemination of such data, on a timely basis, to firms, investors, traders and consumers will assist them in making more informed private decisions and thus greater contributions to our socio-economic development.

For our economic reform program to be effective, it is also important that information about laws and regulations be widely disseminated and that they be clearly understood and fairly and predictably implemented. On our part, this requires much greater attention to the timely formulation of implementing guidelines and regulations. As indicated earlier, we have passed many important new economic laws in recent years, and it important that we ensure their proper implementation.

6.1.2 Capacity for Change, and the Timing and Sequencing of Reforms

Our reform agenda is very ambitious. Many changes are necessary, on the part of the government and the people. We cannot afford to delay any longer than necessary. Nevertheless, ours is a small and still relatively underdeveloped country. As a consequence, our capacities are limited. We must be aware and work within the bounds of our own capacities for change. This will require difficult decisions about where to concentrate our energies and resources.

Since we cannot do everything at once, we will need to develop a strategy for the sequencing of reforms. We will also need the assistance of our international development partners in increasing our capacities for change. Such help would include a broad range of technical assistance to government departments and agencies, as well as the development of human capacities in all sectors of society.

6.2 Main Elements of Macroeconomic Strategy

We conclude here by providing a brief summary of the highlights of our macroeconomic strategy. More complete explanations of the rationale for these elements of the strategy have been provided earlier.

Improving competitiveness through the NEM and human capital investment

- In order to improve the competitiveness of traditional and non-traditional sectors of the Lao economy, especially in light of the real exchange rate effects of large foreign exchange inflows, we intend to reinvigorate the NEM through market-based economic reforms, and through greater and more effective investments in human capital.

Increasing the effectiveness of ODA

- In order to maximize the effectiveness of ODA, we intend to work to improve GOL/donor coordination of ODA flows. This will ensure greater consistency with our socio-economic development goals and with domestic capabilities to meet subsequent operating and maintenance requirements. With donor assistance, we hope to significantly increase our capacity to evaluate the socio-economic impacts of proposed ODA activities. Above all, we wish to ensure that ODA complements as well as possible our reform efforts.

Getting the most out of FDI

- We need to attract more and better foreign (and domestic) investment. The most important step in this regard will be to continue with the deregulation of the business and investment environment. We will improve the implementing regulations of our

Foreign Investment Law, and continue to search for and resolve inconsistencies with other laws and regulations, at all levels of government. The speed with which we can proceed with our whole administrative and economic reform program will have a direct bearing on the benefits we are able to obtain from foreign investment.

Natural resource rents

- We intend to undertake a thorough review of the collection and uses made of rents from our natural resources, especially those arising from hydroelectricity and timber production. We wish to ensure that these rents are being put to the best possible use in meeting our socio-economic goals.

Financial sector reform

- We plan to continue our program of financial sector reform and development. The continuing financial difficulties of the SOCBs need to be resolved once again. At the same time, reforms in their business practices and in the regulatory environment will be implemented in order to ensure that these problems do not arise again and that the banking sector is able to play a productive role in private sector development.

SOE reform

- Following the disruptions occasioned by the economic crisis, we plan to resume and complete our program of SOE reform. This will include further privatization, increased accountability and improved management practices of remaining SOEs, increased competition in relevant markets, and reconsideration of special pricing policies imposed on products of key SOEs.

Business licensing and regulation

- We intend to enact further reforms to increase the transparency and stability of the regulatory environment for the private sector. This will include improvements in the regulations and practices for implementing existing laws, and examination of the possibility of a new business law that would simplify, clarify and supercede previous business licensing laws and regulations.

International trade policies

- Our overriding trade policy goal is to reduce and simplify the current system of import protection. We intend to eliminate all licensing and quantitative restrictions on imports and exports that are not necessary for public health, safety, or national security reasons. We will replace existing restrictions on imports of luxury goods with excise taxes. We will narrow the range of import tariff rates and substantially reduce the use of special-purpose duty exemptions. We will move as rapidly as possible to honor our AFTA commitments, and to pursue entry into the WTO, for the simple reason that free and open trade is the best possible policy for a small country like ours.

Monetary policies

- We will not engage in excessive monetization of government expenditures through borrowing from the central bank. We will pursue moderate monetary growth to ensure stability of prices and improve confidence in the macroeconomy. We will refrain from cash rationing as an instrument of liquidity control.

Exchange rate management

- We will continue with plans to develop a fully integrated interbank market for foreign exchange and let market forces be the primary determinant of the exchange rate of the kip. We will resist pressures to engage in direct or indirect foreign exchange rationing as a means of dealing with apparent temporary shortages. We will restore foreign reserve holdings to more appropriate levels.

Public expenditure priorities

- Following the major increase in capital expenditures during the crisis, we are in the process of restoring spending discipline, while at the same time making necessary provisions for restoring and improving government salaries, and meeting necessary operating and maintenance expenditures. We are also determining how to move the balance of public expenditures more in favor of social expenditures on health and education. In order to make public expenditures more effective, we will continue to increase our capabilities for socio-economic assessment of public sector investment alternatives.

Public sector resource mobilization

- In order that the burden of fiscal adjustment not fall unduly on expenditures and thus put many of our socio-economic development plans in jeopardy, we are making major efforts to improve public sector resource mobilization. This will include a continuation of improvements in customs and income tax administration, a reexamination of pricing and royalties on resource products, and consideration of replacing our turnover tax with a full value added tax.

Fiscal decentralization

- Based on law number 192 on the roles of the central and provincial governments, which was passed in November 1999, we will continue to improve our systems of fiscal decentralization. This will include coordination of expenditure and revenue raising responsibilities and ensuring necessary fiscal equity, both vertically, between levels of government, and horizontally, across different provincial governments.

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